



Dipartimento di Economia e Finanza

# THE DRIVING FORCE OF CAPITALISM ACCORDING TO SCHUMPETER

RELATORE

Prof. Luca Fiorito

GRETA MICONI

Matricola 181591

## **Table of Contents**

<b>1.0 INTRODUCTION</b>	<b>3</b>
<b>1.1 Schumpeter's Biography</b>	<b>4</b>
<b>2.0 SCHUMPETER'S CAREER TAKEOFF</b>	<b>6</b>
<b>2.1 Growth Theory According to Schumpeter</b>	<b>6</b>
<b>2.2 'THE THEORY OF ECONOMIC DEVELOPMENT'</b>	<b>7</b>
<b>3.0 WAR AND POLITICS</b>	<b>11</b>
<b>3.1 Pre-Capitalist Period</b>	<b>11</b>
<b>3.2 Austria</b>	<b>12</b>
<b>3.3 The Gran Rifiuto</b>	<b>13</b>
<b>4.0 CAPITALISM</b>	<b>14</b>
<b>4.1 Prologue: What He Had Learned</b>	<b>14</b>
<b>4.2 New Intellectual Directions</b>	<b>15</b>
<b>5.0 COMPARISON OF DIFFERENT TYPES OF ANALYSES</b>	<b>19</b>
<b>5.1 Comparison With Marx</b>	<b>19</b>
<b>5.2 Marx and Schumpeter on Creative Destruction</b>	<b>20</b>
<b>5.3 Obsolescence of the Entrepreneurial Function</b>	<b>22</b>
<b>5.4 Capitalists Transformation and Socialization</b>	<b>22</b>
<b>5.5 Schumpeter and Wells</b>	<b>22</b>
<b>5.6 Schumpeter and Wells on Monopolistic Competition</b>	<b>23</b>
<b>5.7 Balancing destruction and Faith in Markets</b>	<b>24</b>
<b>6.0 POLICY AND ENTREPRENEURSHIP</b>	<b>25</b>
<b>6.1 The 'Schumpeterian' Program</b>	<b>25</b>
<b>7.0 THE PROCESS OF CREATIVE DESTRUCTION</b>	<b>27</b>
<b>7.1 Creative Destruction and Obsolescence</b>	<b>27</b>
<b>7.2 Business Cycles, Business History</b>	<b>28</b>
<b>8.0 CONCLUSION</b>	<b>32</b>
<b>BIBLIOGRAPHY</b>	<b>34</b>

## 1.0 INTRODUCTION

Joseph Alois Schumpeter is considered to be one of the greatest economists and ‘political thinkers’ of the twentieth century. His theories regarding innovations and entrepreneurs are likely to be his most excellent contributions to the economic world. He said “carrying our innovation is the only function which is fundamental in history”, he also stressed that it is entrepreneurship that “replaces today’s Pareto optimum with tomorrow’s different new thing”. Schumpeter was born in Czechoslovakia, spent his childhood in Vienna and always in Vienna he took his law degree. He died in his sleep in 1950.

After his death his name was relatively forgotten. In this regard is emblematic to mention a nice anecdote to observe how he was undervalued during his era. This anecdote happened in 1939 during a seminar in Harvard organized to debate Schumpeter’s work on *Business Cycles*. During the seminar it was evident that nobody had viewed his work. One of the participants of the seminar referred that ‘*in the discussion everyone talked about Keynes whose General Theory had recently appeared, and not about Schumpeter’s work*’. Many students later said that Schumpeter was fuming and he had never been as angry as during that seminar.

He had to wait about thirty years in order to come back again into the scene. In 1983 *Forbes*, a leading magazine in business and financial news, published an article about him saying that “his work is more relevant today”; in 1986 J. K. Galbraith, an American economist and public intellectual, drew him as “the most sophisticated conservative of this century”. In 2000 *Business Week* titled an article about him “America’s hottest economist died fifty years ago”. One of the most significant biographies on Schumpeter was written by Thomas McCraw (2007), which describes “*Schumpeter would reinvent himself over the years, thinking not of the past but how he might move forward*”.

In 2007 the economist Richard Swedbeg (from Cornell University) in his ‘Rebuilding Schumpeter’s Theory of Entrepreneurship’ (2007) says that “*of all theories of entrepreneurship that exist, his theory is still, to my mind, the most fascinating as well as the most promising theory of entrepreneurship that we have*”.

He was a thinker, a scholar, a political scientist, a man of wide intellectual horizon, uncommon critical acumen and with huge knowledge, always ready to assist and help his students to whom he devoted most of his time. He could speak and write both German and English. He published a huge numbers of articles, essays, books, booklets and reviews even though our knowledge on his theory of entrepreneurship is still partially restricted because several Schumpeter’s work is still accessible only in German. Today his work and theories are very important and precious, applied in our economy and suit the current era where innovation has been

raised and profits are always more important than ever, where markets are characterized by big tensions of international competitions and companies must now count on more complex structures of advanced technologies. (Prencipe, 2016)

In this paper I analyzed his works and theories starting from the very beginning of his works to then concluding the paper with how innovation is seen as today and how his theories are still used to this day. I start by examining when his career first took off. Opening with how he views economic growth, the factors that influence growth and most importantly how he connects economic growth to entrepreneurs themselves. Then I start approaching his greatest works and theories, setting off with his famous book ‘ *Theory of economic development*’ in which he evaluates capitalism and innovation combined. Here I explain how he connects entrepreneurship and entrepreneurs to capitalism.

In the third chapter I begin with evaluating why his theories were not successful during the World War, since people did not even have enough money for shelter or food, of course no one was concerned or paying attention to Schumpeter’s thoughts and theories about innovation and being an entrepreneur during that time. But this did not demoralize Schumpeter; instead he kept working on his ideas and patiently waiting for his success. While in chapter four I go more in depth with Schumpeter’s thought about innovation and how innovation according to Schumpeter was an essential part of a country’s growth. I later analyze and compare Schumpeter’s views with other great economists. From the comparisons we can notice an abundant amount of differences but at the same time many similarities.

I finally examine his thoughts on viewing innovation as being a process of creative destruction, and I end with another one of his great books called ‘*Business Cycles*’.

## **1.1 Schumpeter’s Biography**

Schumpeter was raised in a traditional, upper-class family and that contributed to enriching his personal experience. He studied in Vienna, spent a brief period visiting England, practicing law in Egypt, a short period in Japan, was a professor at the University of Bonn, and then his final move was to the United States. During his studies he disagreed with his professor Boehm’s assumption on how a certain amount of labor and land and given technology, without any innovation, and capital would have a positive marginal productivity. Prof Joseph Schumpeter was one of the most important economists of his era and one of the great professors of the University of Harvard.

His famous book “The theory of Economic Development” was published in 1912, when he was twenty-nine. This book represents an elaboration and development of ideas that he had until then; all his ideas were developed in his early work. He had also a quick incursion into the political life as Minister of Finance in Austria’s first Republican government, an experience that must have only reinforced his conviction that science and politics are incompatible. (Haberler, 1951)

What made his position outstanding was the fact that he had specific concern with science, and with the process of knowledge itself. The adventure and the experience itself meant more to him than the ending discovery. His intuition was that all fruits are destructible and only as good as the ‘new seed’ it embodied. He was concerned with the future of the economic and social science, while others were worried about future of the economic system and society. (Leontief, 1950)

## 2.0 SCHUMPETER'S CAREER TAKEOFF

### 2.1 Growth Theory According to Schumpeter

Schumpeter discusses about growth in his book on the history of economic thought, analyzing two different types of economists. The way he differentiates the two types is by examining the variety of ways in which people think about growth. He distinguishes two types of groups; the pessimists, and the optimists. Schumpeter argues that most of economists fall within the pessimists group, such as Thomas Malthus, David Ricardo, and James Mill. These economists according to Schumpeter were pessimists because they strongly accentuated decreasing return, increasing rent, and the stationary state. They kept affirming this fact even though the economy that surrounded them was growing at a rate that excelled past years. Schumpeter commented on their thoughts saying that 'they were convinced that technological improvement and increases in capital would in the end fail to counteract the fateful law of decreasing returns.'

For Schumpeter the causes of economic growth were purely noneconomic. For him the institutional environment that inspires entrepreneur activities, early capitalism, and laissez-faire government encourages economic growth. Although he analyzed economic factors, he continued to pursue his idea that the main elements of the growth of the system, and elements that will reduce growth are strictly noneconomic factors. Schumpeter called the growth that was taking place in the now industrialized world as 'entrepreneurs'. He thought of entrepreneurs as people who were not just considered a businessman or a manager, but an unordinary individual who has an inborn talent of taking risks, and the ability to introduce innovative products and technology into society. Clearly stating the differences between an innovation and an invention. Only a few people are able to see beyond a simple idea, viewing an idea as an opportunity of a potentially creating a new invention from which you will exploit personal gain. The personal gain that an entrepreneur receives is actually the economies gain. Preceding the introduction of a successful innovation, other people will follow the new innovation that has just been put into the market, and this new product or technology will eventually spread throughout the economy. From this you can detect that the essential sources of economic growth are found in the activities that entrepreneurs undertake, not in the activities that are undertaken by the follower. Since the follower in contrast with the entrepreneurs are seen as risk-adverse. An entrepreneur that has success will promote the growth of large firms, eliminating the risk-adverse firms, which are known as the less efficient firms. The elimination of the smaller firms also meant that a large part of capitalism would have been removed. But what will end up happening is that the larger firms will become risk-adverse as time goes by, they will end up making and taking decisions with more caution. The committee will

become bureaucratic; managers will incline in undertaking activities more carefully and prudently. What Schumpeter feared the most was how the ending of a laissez-faire government meant that the government would have started to intervene more in the market. (Landreth,2002)

## 2.2 'THE THEORY OF ECONOMIC DEVELOPMENT'

His famous book "*Theory of Economic Development*" was published while he was a professor in Czernowitz. This book is an original elaboration and development of his own analysis of capitalism and represents an extensive source of study for other scientists. The idea of a group of despicable capitalists in Schumpeter's eyes is seen as a group of generous entrepreneurs. In this book Schumpeter analyzes the traditional economic concept: the theory of the circular flow of production and consumption. This theory, first grown in the eighteenth century, illustrates the way and how an economy works. Entrepreneurs carry out goods and services and their employees are paid. On the other hand employees, as purchasers, buy these goods and services. Next, entrepreneurs use the money earned from the sale of goods and services in different types of ways, for; investment, manufacturing, monetary compensation, payment to the workers, and after that the cycles starts again. The circular flows are comparable to a river that continually runs and that can go upwards or drops down. But the effective inundation or desiccation doesn't show up, and the river can never leave its course. This constant-state economy, which Schumpeter had represented in his first book, shows up again in *The theory of economic development* at the outset for his authentic significance: endless economic innovation under capitalism. While his idea in the first book was to appease fighting economic schools, here he started to destroy completely 'fresh ground.' In his new idea, the circular flows become greatly uneven.

Inundation and desiccation become customary, and entrepreneurial experiences regularly chop new channels into economic scenery. Academic economists, even though it meets a positive response with almost all businesspeople, have rarely accepted this key intuition. Entrepreneurship is nearly unthinkable to "model" through the usage of equations that yield mathematical proofs (In *The theory of Economic Development* develops the central aspect that entrepreneurs have in the real sphere of capitalism. He realizes that an entrepreneur is not a common business executive, or even the proprietor or chief executive of a prosperous company.

Schumpeter defines entrepreneurs as '*individuals who exploit market opportunity through technical and/or organizational innovation*'.

He says that entrepreneurs are seen as "the modern type of captain of industries". Schumpeter analyzes not only the economic part of entrepreneurship but the sociology part as well. He

comments with saying ‘ We can assume that every healthy man can sing if he will. Perhaps half the individuals in an ethnically homogenous group have the capacity for it to an average degree, a quarter in progressively diminishing measure, and, let us say, a quarter in a measure above the average; and within this quarter, through a series of continually increasing singing ability and continually diminishing number of people who possess it, we come finally to the Carusos.’

Next Schumpeter defines the motivation of entrepreneurs; ‘The typical entrepreneur is more self-centered than other types, because he relies less than they do on tradition and connection and because his characteristic task--- theoretically as well as historically consists precisely in breaking up old, and creating new, tradition.’ He describes the behavioral features of the entrepreneur as a category. He realizes that the entrepreneur, on the contrary with the traditional manufacturer or vendor, is not only supervising constantly the production and consumption but is really forging the future. Schumpeter realizes that the entrepreneur’s target is not only to become rich or satisfy other hedonist wishes. Rather he or she feels ‘the dream and the will to found a private kingdom’ – usually a family business empire. ‘Then there is the will to conquer: the impulse to fight, to prove on-self superior to others, to succeed for the sake, not of the fruits of success, but of success itself... Finally, there is the joy of creating, of getting things done, or simply of exercising one’s energy and ingenuity...’

He then discusses what society looks like from the outside by saying; ‘The upper strata of society are like hotel which are indeed always full of people, but people who are forever changing.’ Businesses grow or fall, in the same way as entrepreneurs and their families. ‘This represents the most important factor of rise in the social old businesses and hence the existences dependent upon them, there always corresponds to it a process of decline, of loss of caste, of elimination.’ Schumpeter awards huge attention to families – both for the entrepreneurs who establish new firms and for the progressive waste of business energy that usually followed by proceeding generations remains the same.

In *The theory of economic development*, Schumpeter realizes that the deeply rooted ways of thinking can’t easily be dethroned, and then he describes a parallel between this obstacle and similar blocks in business. ‘... We find it exceedingly difficult to adopt a new scientific point of view/method... So it is also in the economic world’. The impediments in business are social and economic, and those who believe their interest jeopardized will fight eagerly against innovation. ‘The resistance manifest itself first of all in the groups threatened by the innovation, then in the difficulty in finding the necessary cooperation, finally in the difficult in winning over consumers.’

The establishment of new market is fundamental. Schumpeter recommends that companies often must promote and aim at increasing demand of their goods. ‘The spontaneity of wants is

small'. Thus, it is 'the producers who as a rule initiates economic change, and consumers are educated by him if necessary; they are, as it were, taught to want new things, or things which differ in some respect or other from those which they have been in the habit of using. Therefore, while it is permissible and even necessary to consider consumers' wants as an independent and indeed the fundamental force in a theory of the circular flow, we must take a different attitude as we analyze change.' Which was a powerful point of view to make in 1911. He declares that the list of the individuals' wishes is not by nature large but, if accurately stressed, can become voracious. Schumpeter introduces the idea of "the entrepreneur" who cut the routines of old methods and forms of production with profound innovations indicating five distinctive categories of innovation that represent the entrepreneurial activity:

1. *New products* – by introducing new goods or new quality of good which consumers don't yet know and that can more satisfy their needs.
2. *New method of production* – for which there is not experience
3. *New source of supply of raw materials*
4. *The opening of new market* – a market where the firms have never tried to enter before
5. *New ways to organize industries* – (ex: the creation of becoming a monopolistic firm in a market)

In *The theory of economic development*, Schumpeter accentuates the function of new firms in creating innovations that arrest the circular flow. New companies 'do not arise out of the old ones but start producing beside them.' Schumpeter realizes that 'it is not the owner of stage-coaches who builds railways.' Schumpeter also says that 'the entrepreneur is never the risk bearer. The one who gives credit comes to grief if the undertaking fails.. Even though he may risk his reputation, the direct economic responsibility of failure never falls on him.'

Schumpeter's view of one of the critical factors to the success of innovations is the financial part that comes with an innovation. Funds are themselves the consequences of fruitful innovation and in which next we shall observe entrepreneurial earnings. 'That is to say, the financial ground of development derives not from *penny-pinching* but rather from new sources of funds, that means also money developed by banks investments.' In this system entrepreneurs and investment bankers conduct an important role. Investment bankers are seen as the 'producers' of money.

*The Theory of Economic Development* is an excellent, but the period when it was published was not favorable. This is due to many different reasons. During that time the First World War completely changed the attention of people, they starting to become more concern with peace than with the economic development of the country. And the fact that Germany lost the war

didn't help to give to the book the resonance that it deserved. The English version did not come out until 1934, and during that time Schumpeter's prominence on entrepreneurship was again not important at that time, due to contemporary problems occurring. With the worldwide 'Great Depression' resources were scarce to feed people, let alone establishing new businesses and innovations. (McCraw, 2009)

## 3.0 WAR AND POLITICS

### 3.1 Pre-Capitalist Period

During the first World War and the second World War Schumpeter did not take active part in politics, most of his life was wholly devoted to teaching and studying. He briefly served as a consultant to the Socialization Commission in Berlin and then as the Minister of Finance in Austria's first Republican government. One has the impression that he liked neither political life nor his political colleagues. Schumpeter was full of energy; vitality was part of him and the lavish expenditure of it his characteristic way of life. He was always available to his students and devoted to them a great amount of his time. He was a man of wide intellectual horizon, uncommon critical acumen, his knowledge ranged from Greek philosophy, English parliamentary history, Italian literature and French Romanesque architecture. He was a man of great and exceptional talent, he was a great writer and speaker in both German and English. (Leontief, 1950)

In 1918 he gave a lecture in Vienna, which later on became an article about Austria's expectations during and after the war. The article was called 'The Crisis of the Tax State,' it analyzes the relation between taxation, war and capitalism (by the word tax state, Schumpeter intends the government of a capitalist State)- Schumpeter starts with the pre-capitalist period. He declares that someone who studies the fiscal history of a country – that is how it wants to use its funds – 'discerns the thunder of world history more clearly than anywhere else'. He says that all efforts were crucial in the growth of either a nation or a state. A Nation can survive from a war only if it has a modern tax system to bear military expenses.

During that period for the country-builders, it had demonstrated unexpectedly their military experiences concurred with the development of the entrepreneurial capitalism. Nations could be able to collect sufficient money for military expenditures because for such dynamic economic system, avoiding at the same time the destruction of individuals' motivations to work. If taxes ever grew high enough to put at risk those motivations, then entrepreneurship itself would vacillate and the tax state might failure. Under prudent management, the country could even lower tax rates in such a way that tax incomes grew higher – entrepreneurial earning being 'the premium which capitalism attaches to innovation.' Schumpeter proceeded to say that enormous request for social services in any nation could arrest the flow of 'golden eggs' by eliminating the 'capitalist goose.' Schumpeter then declared that his own Country could survive after 1918 even though it had troubles. The proper remedy would be easy: first a "capital levy" to manage inflation; next a strategy for progressive clearance of the war debt; then proper actions to captivate foreign

investments, and above all the support toward local entrepreneur to invest at home. Entrepreneurship, credit and innovation must be reinforced with any available instrument.

In 1919 he became minister of finance in the government of the new Austrian Republic. He can't be considered a successful Finance Minister but not for his unquestioned ability but for all those factors which characterized that chaotic period and made Schumpeter's task very difficult. From one side he had to face starving population, low food rations, supply of raw materials, food and fuel were interrupted, the war were lost, new frontiers, enormous war debt and inflation. The political situation was also very unstable as well. From another side he had against the conservatives and the socialist: the first because suspected him of being a socialist, the second because his view and financial policies were essentially conservative. In 1921 he assumed directorship of the Biedermann Bank in Vienna. The bank did not long survive the crisis and went bankrupt in 1924. This failure was only one of the first in the series of Austrian bank failures. (McCraw, 2009)

## 3.2 Austria

In 1922, three years after he finished being Finance Minister, Austria was in a profound economic crisis. When the circumstances appeared to be better, it then suddenly dropped again. Shumpeter describes the scene as; 'Austria is like a patient who has had practically all his organs injured by an explosive catastrophe. Such a patient cannot simply come to the physician and ask for a pill to make him well; rather, it is necessary to cure each organ though special methods.. That would indeed be a work of years, but it comes down to the psychological effect (on the entrepreneur) that would ensure if this work were begun in earnest' (McCraw, 2009)

In 1925 he returned back to academic life where he was appointed as Professor of Economics at Bonn on the Rhine. While in Bonn he wrote a significant numbers of very important articles on current economic questions, he found time for many book reviews, he wrote also an essays on the theory of social class. He went to Harvard as visiting Professor in 1927 and 1931. In 1932 he became a permanent professor at Harvard where he spent eighteen years. The Harvard's years were impressive for his scholarly achievements. While in Harvard he married a descendant of an old New England family, an economist in her own right who often was his counsellor in all practical matters. The time from his professorship at Bonn until his death was his second period of incredible productivity. These were the years of his books "*Business Cycles*" and "*Capitalism, Socialism and Democracy*". (Heilbroner, 1993)

### 3.3 The Gran Rifiuto

At the end of the war, banks fell deep into difficulties, like almost all banks in the Nation on the failing side. The nation still had power but was deprived of funds. In 1921 Schumpeter declared with enthusiasm that ‘The level of business is growing after all, and the financial and commercial infrastructure is till largely intact’. Schumpeter now had a chance to place the theories he had accentuated in his academic works: the relevance of entrepreneurship for economic expansion and the crucial part of banks in building credit for funding new investments. The period was really tough for entrepreneurs of which Schumpeter was so affectionate to. As he said in 1921, the soul of the economy didn’t place in paper securities or even in production tools ‘but in the psychological relations between people and in the mental state of the individual.’ The essential seemed dreary, people didn’t want to assume risks: the community is extremely complicated and emotional entity, and ‘each individual industrialist or merchant who sets afloat his own little boat.’ He proceeded to point out still again the important role of credit. Austria had to update its business structure, for ‘we are now standing before the most significant case of credit need in capitalistic society—the one case in which credit is indispensable.’ Austria ‘begs for foreign capital,’ Schumpeter said, ‘and then when it comes screams about being overwhelmed by foreigners.’ The Nation was acting ‘like some town dealing with tourism: they can’t live without tourism, but when tourists arrive, they insult or hassle them, or try to exploit them in a petty-minded manner.’ Definitively Austria’s industries hadn’t sufficient credit and modern technology. (McCraw, 2009)

## 4.0 CAPITALISM

### 4.1 Prologue: What He Had Learned

The years after the deaths of Johanna his mother and Annie his second wife, Schumpeter turned aside from economic theory and concentrated his attention toward the study of cultural and social events. He already learned, or was soon to determine, that the models of pre-capitalist community revealed some very inveterate human values and traditions.

Capitalism is so new that it is forever progressing into a ‘gray legal area’, and business rumors – principally in finance – have been so recurrent that they may be considered as ingrained to the system. As a result, capitalism needs frequent modifications of the law, valid implementation procedures, and regular surveillance. Public law through complex legal structure – regulations of contracts, competition, partnerships, corporations, and so on – is very important. By 1925 Schumpeter knew very well almost all of these procedures. He understood that capitalism could have various structures in different nations and that it brought profound but not inevitably definitive political consequences. He realized that capitalism developed democratic and representative government but had no need for them.

In 1911 Schumpeter had categorically declared in *The theory of Economic Development* that in any nation individual entrepreneurs are the key for the economic development. He considered that if the system grew freer - the more rights made certain by the government – then more opportunities for unconstrained entrepreneurs and consequently the greater the possibilities for economic development. He anticipated the connection between capitalism and personal freedom. Then in 1919 he released an article where he wrote that in the nineteenth-century America, differently from other nations, the best brains had bunched up together to do business. By having the people with the best brains working together is what made the United States become so powerful. The United States of America reached its role as the world’s dominant economy because since the beginning of time, America, had big entrepreneurial enthusiasm. Schumpeter said that once a country achieves a fully developed capitalism method, it doesn’t only create a better better living for the upper class people, but also the lives of common individuals. He and some other economists who arrived to this conclusion in the end were absolutely right. For Schumpeter entrepreneurs are the agents of innovation. Entrepreneurs are possessed by “the dream and the will to found a private kingdom”. Innovation is hard to realize and afford “all successful businessmen stand on ground that is crumbling beneath their feet”.

## 4.2 New Intellectual Directions

After the death of Annie he began to revise *The Theory of Economic Development*, and started to work on another manuscript which he named his 'money book'. Money is one of the hardest themes to illustrate and comprehend. In 1917 Schumpeter published a great article on money where he highlighted the role of it and credit in the economic development, strengthening what he had said in *The Theory of Economic Development*. He ended up not publishing this article, he judged the effort that he put into his article as being of 'bad performance'.

Schumpeter realized that in order to study accurately money or any other economic argument, one must take in consideration history, sociology and other fields. Without proper observation in these subjects, one could never comprehend the institutions that influence the economic development, such as capital markets, the legal system, and political bodies, that are linked to the money argument.

In the first article "*The Tendencies of Our Social Structure*" (1928), he analyzes the connections of social, political and economic methods that regulate a country. He says that in modern Germany, many problems come from divergence between the nation's economic system and its social scheme. He writes that Germany is now wholly capitalist in its economic structure but that it had arrived too rapidly and that the social structure remained anchored in rural and archaic mindset. As early as 1871, he specifies that almost two thirds of Germany's population lived on farms or in towns. While less than 5% lived in cities. But by 1925, the proportion of the population increased by five times the number, while the percentage of people living in farm areas decreased by half. Big jump in rural yields had generated this change. Only 4% of Germany's farms used machinery in 1882, over 66% did by 1925. Many farms did not develop in volume during this time, but industrialization permitted their proprietors to increase the production with fewer employed. Schumpeter wrote in an article during that time saying; 'As much as agrarian reformers still agitate,' Schumpeter said, 'within the rural sphere the farmer has got what he wanted.' For factory workers, the social system grew totally in a different way. Classic artisan, who considered their business as own dominion, hated the new factory-based capitalist system.

Capitalism concerned not only the mechanization of production but also meant a large flow from the rural area into the cities of a big numbers of farm workers to work with the new instruments. At the same time a big number of businesses had come up. Schumpeter foresees that the tendency toward bigger firms will persist. But in any modern economy, the class scheme can't be defined between labor and capital; it 'is not even close to being as simple as Marxist theory'.

Schumpeter says that the true division exists within the new industrial structure. In the new economy, business families grow and drop very fast that it is very difficult to define them as social classes. Schumpeter says that 'the fast change in the position of families in the upper classes, there is clearly taking place a very democratic and effective selection of brains.' The economy had introduced the world of meritocracy, which is innately antagonistic to the hereditary class.

Entrepreneurship is a function, not to name a class. Schumpeter declares that we should always remember that 'entrepreneurs very often are themselves former workers and sons of workers' Experienced and inexperienced workers act in diverse manners, especially experienced workers. They have an authentic interest in the new economic and social structure.

Schumpeter then describes the 'class phenomenon' by stating that members of the same class behave differently with one another than when they are interacting with member of other classes. This is all there is to it: 'They are in closer association with one another; they understand each other better; they work more readily in concert; they close ranks and erect barriers against the outside; they look out into the same segment of the world, with the same eyes, from the same viewpoint, in the same direction.'

A correct conclusion is situated in the constant activity and competitive innovations that arise with capitalist business. Marx himself talked about this activity. No firms, Schumpeter answered, can ever hold a leading place of its industry without doing a lot of this - — 'without blazing new trails, without being devoted, heart and soul, to the business alone.' One might say that would be sufficiently a good custom of saving, living prudently to keep a firm on a solid base. Schumpeter says that any firm embracing these routines – anyhow they look excellent at first sight – will soon be beaten by combative, courage, competitive entrepreneurs. 'The introduction of new production methods the opening up of new markets—indeed, the successful carrying through of new business combinations in general—all these imply risk, trial and errors, the overcoming of resistance, factors lacking in the treadmill of routine.' 'As to the question why this is so, it is answered by the theory of entrepreneurial profit.' New entries in the industry will provide original concepts, make more earnings, and remove incumbents from business – just making their objective economic growth does this.

Successful people, once they have become wealthy, they end up not searching and they stop searching for economic growth. They turn into despising the demands of continuous innovation. They desire to live an enjoyable and better life. That's because great enterprises generally outgrow the abilities of founding families to sustain a position at the top of their industries. Under actual form of capitalism, the aim to keep a top position is very hard to

sustain. 'Industrial leaders must shoulder an often unreasonable burden of current work, which takes up the greater part of each day.' Entrepreneurs require 'extraordinary physical and nervous energy.' The most excellent of entrepreneurs can support their achievement on a great position only if they have 'that special kind of vision.. concentration on business to the exclusion of other interest, cool and hard-headed shrewdness—traits by no means irreconcilable with passion.' Entrepreneurs running in very big companies must have even more capacity. Entrepreneurs must understand how to 'woo support' among their co-workers, 'handle men with consummate skill'. The manner to comprehend general economic development, is by looking closely to specific industries and breaking them down piece by piece. The beginnings of large development always arrive from innovations in particular production, which then diversify into other sectors of economy – the suppliers of these firms, the distributors, and finally the consumers. In general, industry-specific innovation 'does not follow, but creates expansion.' Schumpeter says that none of this can be argued in the typical economists' language of equilibrium. Rather, innovation needs constant disequilibrium – bring by entrepreneurs overly preoccupied with what they are carrying out. Innovation is mainly 'a feat not of intellect, but of will... a special case of the social phenomenon of leadership.' The obstacles to innovation are 'the resistances and uncertainties incident to doing what has not been done before.'

'Innovation, being discontinuous and involving considerable change and being...typically embodied in new firms, requires large expenditure previous to the emergence of any revenue...' 'Credit-creation' therefore, becomes an essential part both of the mechanism of the process and of the theory explaining it.' Here Schumpeter comments and emphasizes again how much credit is essential for entrepreneurs. All these aspects, Schumpeter says, are deep-rooted in the capitalist routine. Other factors – wars, earthquakes, new technologies and inventions – are not the origin of the continuous modifications that mark capitalism. Instead, modification is an essential element of capitalism itself, and it arrives from entrepreneurial attitude within the structure. This 'one element in the capitalist process, embodied in the type and function of the entrepreneur,' will kill any equilibrium.

In 1928 Schumpeter says that innovation usually took advantage from the development of big business, because big companies could sustain the risk of new method. He brings the example of the United States of America. In the beginning of the 20<sup>th</sup> Century, big companies like American Telephone and Telegraph, Eastman Kodak, DuPont and General Electric created new department with the only purpose to develop new goods and method of production. The innovation entered as part of their business routine, and this

represented a deep revolution. Meanwhile, as Schumpeter had predicted, new firms continued to arise and work beside the big companies, in opposition to the belief of many other economists. (McCraw, 2009)

## 5.0 COMPARISON OF DIFFERENT TYPES OF ANALYSES

### 5.1 Comparison With Marx

Joseph Schumpeter stated depressions were 'self-correcting'; saw them as a benefit to the society as a whole. Stating also that there could be no type of equilibrium at less than full employment. Growth was connected to most affluent stage of the process cycle of the economy, since this phase was the phase that represented the new products and technologies that were introduced to the economy. But having too much of a development ended up over extending businesses. So why is depression beneficial according to Schumpeter? Well because it modifies the economy, by removing firms that are less efficient than others, which prepares the economy to grow in a healthy, and well-mannered way with only efficient firms. On the other hand, Marx viewed depression as a type of phenomenon that lead to the final collapse of an economic system. Marx also viewed the downfall of capitalism as inevitable because it had within itself the contradictions that would destroy it. While Schumpeter on the contrary, viewed the ending of capitalism as the success factor for the economy as a whole.

According to John E. Elliott the Marxian model of stationary equilibrium, does not take into account the capital-labor division that contradicts Marx's model of steady-state economy. Marx's model of stationary equilibrium is created presuming<sup>2</sup> accumulation, while Schumpeter's model transcends mainly from the entrepreneur himself. Both theories pin point the nature of capitalism to discontinue in the future, but Schumpeter's thoughts on economic development and technical change are what he views as being an initiative of the entrepreneur. While Marx's view is that the structure of accumulation is a form of capitalists development. The main difference is that Marx visualizes the ability of success and survival for an individual to depend on the ability to accumulate large amounts of capital. At the same time Schumpeter's paradox states that capitalism is being destroyed not by its failure but by its successes. How Schumpeter always claims that it is 'creatively destructive'. Two main pillars sustain Schumpeter's analysis: The first pillar is how Schumpeter views the entrepreneur as being the major function that drives capitalism. The second pillar is the understanding of rationalization as a result of capitalism. Schumpeter declares that an individual entrepreneur is responsible for the development of capitalism. He viewed entrepreneurs as the 'chief tragedy of modern society'. The main idea of capitalism for Schumpeter is founded in the discontinuity of its development with the fact that capitalism lies under the influence of the entrepreneur. Schumpeter regards this process of rationalization noticing that capitalism diminishes the need for a leader to smooth the economic development, therefore decreasing the period of time that comes between other less innovative firms that are entering the new market. As the system

fades away, so does the role of the entrepreneur. With the declining of the entrepreneur, the capitalist class will tend to fade away, and the class itself is with no doubt ruined.

Marx's theory of the downfall of capitalism is a complete other story. Marx notices that capitalism involves the progression of rationalization and socialization together. He does not mention any importance of how a leadership could cause the downfall of capitalism. What was a huge threat in Marx's mind was how capital tend to create carriers with its own expansion. (Foster, 1983)

## **5.2 Marx and Schumpeter on Creative Destruction**

Visions of the future of capitalism from both Marx and Schumpeter are impressively similar to one another. This similarity is represented from their extreme focus on the progress of capitalism and also on creative properties; secondly, by how they examine the variety of dysfunctions that capitalism has; and last but not least their analyses on how creatively destructible institutions are and how capitalism changes attitudinally.

Schumpeter questioned; 'can capitalism survive?' He replied to this question on his own, stating how the expected collapse of capitalism is not recognized to emerge from the breaking point of the state in which the economy fails. But rather its very success threatens social institutions that protect it, and with no doubt create conditions that point directly to socialism. What is its end result? Well that capitalism is being killed by its own achievements. How does Marx contradict what Schumpeter is saying? The Marxian contradiction is that capitalism cannot possibly survive due to economic failure. While on the other hand you have Schumpeter declaring that the destruction of capitalism is what indeed creates success in an economy.

Schumpeter and Marx emphasized that capitalism was an evolutionary process. Their prospective of seeing capitalism as an evolutionary process was due to the fact that they viewed the main dynamics of capitalism development to be evolutionary. Stating that the process comes from within the economic system, hardly by outside sources. Occurring with discontinuity rather than smoothly and continuously. Bringing 'qualitative changes' or innovation seen as revolutions, which further displace the equilibrium state of the economy, since it creates new radical conditions. Which brings us to the discussion of the innovational process. The innovation process perpetually transforms the economic structure from within, instantly destroying the old structure.

Marx expressed his view on creative destruction;

“It cannot exist without constantly revolutionizing the instrument of production, and thereby the relations of production, and with them the whole relations of society. The need of a constantly expanding market for its product chases the bourgeoisie over the whole surface of the globe. The bourgeoisie, by the rapid improvement of all instruments of production, by the immensely facilitated means of communication, draws all nations, even the most barbarian, into civilization. The bourgeoisie, during its rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding generations together.”

Schumpeter's observation con what Marx had to say was the following:

“Constant revolutionizing of production, creating that spells the obsolescence and consequent destruction of any industrial structure of production that exists at any moment: capitalism is a process, stationary capitalism would be a *contractio in ad jecto*. But this process does not simply consist in increase of capital by saving, as the classics had it. It does not consist in adding mail-coaches to the existing stock of mail coaches, but in their elimination by railroads. Increase of physical capital is an incident in this process, but it is not its propeller.”

Regarding Marx's opinion on capitalism, for him capitalism destroys the old capitalist economy, and regularly revolutionizes it. During the revolution process it breaks all sort of barriers that fringe the development of production, needs, and the utilization of natural forces. Marx similarly as Schumpeter viewed the accumulation of capital as a process that occurs with no regularity, and with consequences that would happen in cycles.

Schumpeter speaks about entrepreneurs while Marx writes about capitalists. Schumpeter makes it extremely clear that for him capitalists are individual that are successful entrepreneurs, if you are not successful you never become a capitalist. The ones that are unsuccessful for Schumpeter become managers. An entrepreneur according to Schumpeter is an individual that manifests the ambition for an increase in profits and power, which contradicts what Marx's idea of a capitalist.

Schumpeter's idea of production is that it's made of the technology that is needed for the production and of the prices, this is what makes a market ready for the new adaption for consumer's new demand for new services and products. In his analysis, he states how for him periodic fluctuations are not a barrier for the growth of the economy. As a matter of fact, growth is actually a result of the periodic fluctuations, of the ups and downs that an economy goes through. Depressions are considered normal and healthy in an economy. Why? Well this stage of the economy often occurs at the time at which new innovations are put into the market. The stage of depression is the stage that comes before the stage of prosperity of an economy. This part of the process is key for the elimination of inefficient businesses, which are the businesses that no longer innovate. As new

products and new services replace the older ones, making them obsolete, this is key for the growth of the entire economy. At the time of the entering of new innovation in the market, it is normal to have a surplus. This is because there are many uncertainties with new innovation, one of which could be the failure and the probability of competition might stand in the way of that new innovation when it is successful. The rare occasion of having high profits is what society pays for the contributions of the economies entrepreneurial leaders. In the case of monopoly, innovation creates a monopolistic position for that firm that is currently innovating. But there is a tendency for innovations to spread among other firms, there's the problem of imitation as well, so the monopolistic position might just be a temporary state of the innovating firm. Both Schumpeter and Marx associate capitalism to creation and success. Capitalisms defective weaknesses are actually a need in order to create a development process of an economy. (Elliott, 1980)

### **5.3 Obsolescence of the Entrepreneurial Function**

Considering an entrepreneurial capitalism, innovations are incorporated into firms. The economy is competitive and it is divided by the growth derived from new innovations, and the actual process of carrying out the new innovations, which ends up becoming the main measure of the economic body itself. The large innovating firms, maximizes economic progress by having research department and by making the firm exercise entrepreneurial activity. Schumpeter's point is that entrepreneurship doesn't become obsolete, but he points out that as the process of innovation becomes increasingly maximized, the entry of new products and services become increasingly more difficult as time goes on. (Elliott, 1980)

### **5.4 Capitalists Transformation and Socialization**

Schumpeter proclaims that the tendency in the economy for slow progression is due to the incorporation of both the process of transformation and socialization. According to Schumpeter transformation is another word for destruction. In an 1928 article, Schumpeter states that the process of transformation is one of the key elements of capitalism. (Elliott, 1980)

### **5. 5 Schumpeter and Wells**

Schumpeter is considered to be one of the greatest economist of the 20th century. Modern economists remember him for his work *Capitalism, Socialism and Democracy* where he refused the vision of perfect competition in favor of a world characterized by creative destruction in which competition between giant oligopolies pushed the world toward even greater technological mastery.

Another economist, before Schumpeter, treated the same argument in 1889: his name was David Wells. Wells was the most important economist within the US government. Wells became as a protectionist, but then he thought that manufacturing in the United States was so powerful that there was no reason to have fear of international competition. He believed that a combination of violent competition and rapid technological advances would push the economy into chaos. Wells realized that competitive forces would not allow producers to recover their investments in fixed capital. As a result the market would self-destruct.

For David Wells, anticipating Joseph Schumpeter's widely acclaimed idea of creative destruction. The measure of the technical success of any invention was the extent to which it could destroy capital values. He offered the example of "the notable destruction or great impairment in the value of ships consequent upon the opening of the [Suez] Canal". He concluded, "nothing marks more clearly the rate of material progress than the rapidity with which that which is old and has been considered wealth is destroyed by the results of new inventions and discoveries". Wells's analysis influenced a generation of economists. (Perelman, 1995)

## **5. 6 Schumpeter and Wells on Monopolistic Competition**

Schumpeter's theory of creative destruction can be fairly interpreted as an introduction to his defense of monopolistic practices.

He realizes that monopolistic practices provide "greater expansion of total output than could be secured by an entirely uncontrolled onward rush that cannot fail to be studded with catastrophes". The parallels with Wells are striking. Both realized that seemingly uncompetitive arrangements were necessary to promote the rapid adoption of new technologies. Schumpeter seemed to imply that the combined force of the entrepreneur (or the large corporation) together with the advantages of modern technology would naturally drive the economy forward. But he also asserted that the large corporation is an ineffective vehicle for progress.

Wells was more specific in discussing the problem of monopolistic practices. He argued, "the great producers should come to some understanding among themselves as to the prices they will ask; which in turn naturally implies agreements as to the extent to which they will produce". He also added that falling prices will create a dangerous level of real debt. (Perelman, 1995)

## 5.7 Balancing destruction and Faith in Markets

The major point of divergence between Schumpeter and Wells was that Schumpeter had more faith in markets; Wells said that the market forces, left to them, would tend to create overcapacity. Wells realized that monopoly power would not just be used to introduce additional technology, but to eliminate existing capacity. Otherwise, the economy would be plagued by overproduction, leading to a perpetual recession or even depression. For Wells, industrial rationalization through monopolies, cartel and trusts was the only route open to foster new investments.

Schumpeter assumed that these new industries create additional sources of demand, which can absorb the energies released by declining industries. For example, railroads replaced canals, and trucks eliminated much of the demand for railroads.

In taking this position, Schumpeter's theory of the business cycle was essential. He realized that the business cycle as the product of natural rhythms, although he proposed two conflicting explanations of these rhythms. He explained that booms occur because major innovations and the wave of innovations will continue until the economy is reconfigured to the new technology. Recessions then follow while innovations subside. In either case Schumpeter explained that cycles are not "like tonsils, separable things that might be treated by themselves, but are the beat of the heart, of the essence of the organism that displays them".

Schumpeter held that business cycles are not usually traumatic. He contended, "the physical volume of total transactions typically falls only insignificantly" during a recession. He even predicted that research would prove how "exaggerated the popular conceptions of the ravages of depression, are." For Schumpeter, these relatively painless downturns can easily wipe out excess capacity, freeing up the economy for a renewed bout of growth.

However, Schumpeter was ready to concede that a "depression, unlike recession, is a pathological process to which no organic functions can be attributed." The line between a gentle recession and destructive depression wasn't always easy to see. In 1934, Schumpeter confidently proclaimed:

[Depressions] are but temporary. They are the means to reconstruct each time the economic system on a more efficient plan. But they inflict economic losses while they last, drive firms into the bankruptcy court, throw people out of employment, before ground is clear and the way is paved for new achievement of the kind which has created modern civilization and made the greatness of this country.

A few years later, however, Schumpeter would refer to the Great Depression as "catastrophic," because it disrupted the organization of the economy. (Perelman, 1995)

## 6.0 POLICY AND ENTREPRENEURSHIP

### 6.1 The 'Schumpeterian' Program

It is quite easy to recognize a 'Schumpeterian' program - For any grade of study one is going to start: the individual entrepreneur, the business company, the industry or even the country. At all stages, Schumpeter's decisively indicative test is whether the participants are seeking innovation and carry about creative destruction. (McCraw, 2009)

Schumpeter writes "in every scientific venture the thing that comes first is Vision. That is to say, before embarking upon analytic work of any kind we must first single out the set of phenomena we wish to investigate and acquire intuitively a preliminary notion of how they hang together or, in other words, of what appear from our standpoint to be their fundamental properties". Schumpeter admits that ideology has a huge power. He writes, "...analytic work begins with material provided by our vision of things and this vision is ideological almost by definition...the way in which we see things can hardly be distinguished from the way in which we wish to see them." He suggests using methodological procedures to limit ideological interference. (Heilbroner, 1993)

Now going back to what was happening during those times. Well the German economy was having problems, the economy started to precipitate into in depth depression. Unemployment reached 10% in 1929, 25% in 1931, and a colossal 33% during the winter of 1932-1933. These apocalyptic episodes, and a lot of Schumpeter's essays on public policy sent them straightly. When Germany progressively fell into an economic crisis, Schumpeter moved toward the study and suggestions that he showed in more approachable style than his classic academic scripts. Between 1925 and 1932 he published a wide series of essays about the German economy and on the economic strategy of the government. He focused on 4 subjects: tax level and public budgets regarding the reparations; salary and unemployment; business growth and bankruptcy; and the hidden nature of capitalist society. On his first article he criticized the industrial policy to rescue old firm or firms with lower productivity growth. Schumpeter says that Germany could restore economic success by selecting lending companies in industries with high growth potential. 'The strong ones, or those that can become strong, are to be strengthened, but the weak ones are not to be nursed.' Firms must be driven to embrace innovative processes. It is hard to implement these sort of practices for companies but he pushes for progress, stable outlook, keeping away from any quick economic fix. Which according to Schumpeter would make things worse off in the long run.

Schumpeter says that innovation does not have boundaries and thus none to having economic progress under capitalism. In 1930 he published "Change in the World Economy" where

he viciously criticize the concept that there were no limits to the technological development and thus to economic progress. Many new occasions, and new innovations will connect with old ones to develop even more rapid growth. Schumpeter also queries another common contention: that the impact of the Great War on Americans gave them economic advantages over Europe, and from this Europe could never have possibly made a come-back. He specifies that the cause of the American strong prosperity was its raw material richness. He added that the correct use of these raw materials has brought the United States on the top, and Europe behind.

In 1927 he wrote “The function of entrepreneurs and the interest of the worker” where he indicates how entrepreneurs and workers are quite equal, and this equality between the two is everlasting. Schumpeter’s key point is that the voracious hunting of prosperity, and the prize that it implies, is what brings entrepreneurs and their financiers to employ much of their work, time, ability, commitment, attention and money into new business whose future is totally risky. High entrepreneurial benefits are important not only for the company but for the entire community since entrepreneurship, and the starting of new companies increase jobs. Schumpeter says that the history of entrepreneurship illustrates an important trend affecting families that constantly reach and then arrive at the peak position and then lost it, in an eternal up and down. In an article Schumpeter says that the entrepreneurial capacity modifies when firms grow too big for a singular person to guide. In huge companies, the business has thus modified from an individual who conceive new solutions to someone who also approves or refuses new ideas coming from experts inside the company. For giant company, the entrepreneur must have technical expertise; in addition, the capacity to consider the goods of the company in its entirety. Therefore, the appearance of “trust” has modified the list of abilities that entrepreneurs must have but is created a consequence caused by the removal of family members in favor of true experts.

Schumpeter was not opposed to economic intervention but he argued that when a state does intervene, it has to remember that without any entrepreneurship, growth will not occur. Schumpeter says that all strong companies have been entrepreneurial at some moment in time, however a certain firm can be more entrepreneurial in one moment and less in another. A company starts to die when its innovation decrease. (McCraw, 2009)

## 7.0 THE PROCESS OF CREATIVE DESTRUCTION

### 7.1 Creative Destruction and Obsolescence

Creative destruction is seen as the cycles of death and birth of nature. It was seen as a process of obsolescence. In the sense that a business, a product, or a technology is creatively destroyed because some other innovation is used which eliminates the previous. Therefore making the previous product, technology, and business obsolete. Even businessmen can be creatively destroyed by other businessmen that possess greater innovations. According to Joseph Schumpeter, creative destruction is when capitalism reaches its 'purest' form. In the United States of America this happened from about 1850 to 1914. During this period a man was said to be an innovator if he practiced a 'novel method of production.' Schumpeter thought of innovations as new and less costly methods to produce older goods. (Strassmann, 1959) He said that creation began with destruction, that it was the core of economic development. (Prencipe, 2016) The first impact is destruction. Why? Well the first stage that the economy goes through is composed of three effects: losses, disturbances and unemployment. During the nineteenth century, entrepreneurs invested knowing that changes could happen at any moment in time, with the impact of new goods and technologies. During this period, losses caused by unforeseen obsolescence barely arose, but when they did arise it usually involved specialized devices. The general process of innovation led to losses between firms that were devoted to older products or methods.

The process of innovation may be qualitative meaning that the product or service could be replaced. Do innovations that consist in creative destruction only involve qualitative differences? Well an innovation that has the capability to cause a product or service to become obsolete cannot be the same as the product that is becoming obsolete. The rate of growth usually decreases quickly for new products compared to older ones. This is due to the fact that they are new, innovations start with a rate of expansion so high, that they cannot be maintained. Furthermore, innovations in methods of production always involve qualitative change, which occasionally means that the destruction is not just a partial destruction of an older industry or sector. What often happens is that innovations end up reducing the rate of growth in sectors that are said to be obsolete. Indeed, qualitative differences were the key to surpassing competitive similarities. (Strassman, 1959)

## 7.2 Business Cycles, Business History

Schumpeter was undoubtedly the leading economic theoretician to work on business cycles. His two-volume book *Business Cycles* is his least successful monumental work. Yet this first attempt of trying to understand how and if business cycles have a pattern is what changed the way he initially thought about capitalism. *Business cycles* predicted the arrival of new, meticulous business history. Today, research that is spent of understanding business cycle is done with a team of about half a dozen staticians, economists, and scientists. This kind of organization during 1920's and 1930's was just beginning and Schumpeter commenced the job utterly on his own. Schumpeter picked the title *Business Cycles* not only because the subject was said to be trendy at the time (at the time business cycles was the subject to which everyone was puzzled about, even before the Great Depression people could not stop commenting on this phenomenon), but also because his intention was to accentuate the economic regression and increase capitalism. 'Cycles are not, like tonsils, separable things that might be treated by themselves, but are, lie the beat of the heart, of the essence of the organism that displays them.' He tries to fit business growth and collapse into foreseeable wave periods of regular duration. He says that it 'is indeed difficult to see' why these phenomenon of growth and collapse might happen at certain gaps.

The essence of *Business Cycles* is its abundant information about the blooming of business structure in Britain, Germany and mostly in the United States. He points out firms that work in five fields that are at the top of development: cotton textiles, railroads, steel, automobiles, and electric power. He also underlines three governmental innovations decisive to the growth of capitalism: the factory, the corporation, and the financial structure. He begins by first fixing a general theory of the evolution of capitalists. In this model, the words 'new men', 'entrepreneurs' and 'new firms' are recurring throughout the theory, describing them as the key drivers of innovation. All firms react adjusting themselves to the different situations, but original feedback arrives only from entrepreneurs with innovative ability. Their innovations comes under different schemes: for example, 'the case of a new commodity,' 'a new form of organization such as a merger', and 'the opening up of new markets.' Innovating companies do not develop equally throughout the economy. The rising firms are those firms that build up a new organizational or technological structure in a particular industry – either in that same business or in others associated to it. At the same time, there is a powerful element that societies have that indeed resists desirable innovations, because they tend to take vengeance on arrangements that already exists. As a result, 'the history of capitalism is studded with violent bursts and catastrophes.' The adaptation is not a smooth process but something 'more like a series of explosions.' The building of a railroad where none had stayed, for example, 'upsets

all conditions of location, all cost calculations, all production functions within its radius of influence.’ Innovation is seen as a ‘double-bladed sword,’ since you have both costs and benefits.

Next Schumpeter directs his glance to the central figure of the structure, the entrepreneur or has he writes the ‘new man’ and to the entrepreneur’s ally, the ‘profit’. He admits that in certain circumstances it is difficult to recognize the entrepreneur. In the true world of business, ‘nobody ever is an entrepreneur all the time, and nobody can ever be only an entrepreneur.’ Especially in big companies, the entrepreneur usually not only brings in new ideas but also realizes daily management. For any sort of type of innovation the entrepreneur ‘may, but need not, be the person who furnishes the capital.’ Of all economic system, capitalism makes possible individuals to turn into entrepreneurs before they have enough resources to locale a company. At the end, ‘it is leadership rather than ownership that matters.’ The flop of both the classical economists and Karl Marx was that they didn’t seem to understand in distinct to Schumpeter, the crucial flaw in the analysis of capitalism. Individuals who own money have less difficulties to become entrepreneurs. Schumpeter also comments on how entrepreneurs are not the risk barriers; ‘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 to which he invested.’ Schumpeter says the most important incentive for entrepreneurs is the profit — ‘the premium put upon successful innovation.’ When other individuals in the same business notice the high level of profit, they immediately try to emulate the innovation. Entrepreneurs do their best to maintain their high profit for as long as possible, even if patents, and future innovation, secret processes, and advertising – each operates an action of ‘aggression directed against actual and would-be competitors.’ The high profit lasts only a short period of time because other individuals try to reproduce exactly the same innovation, which ends up causing the fall of the market prices.

The main topic of *Business Cycles* is the enormous difficulty to apply different procedures of production. Schumpeter points out that the ‘destructive part of creative destruction has always been quite real.’ In addition to the innovation in production, entrepreneurs had to modify consummation tendency. Entrepreneurs had to persuade hesitant customers the necessity to buy new goods. Here Schumpeter points out the important role played by the marketing section of a company are what create mass consumption and economic growth. From the investors and producers’ point of view, it did not matter if new wants did not match real needs. He says; ‘Needs, whatever they may be, are never more than conditioning factors, and in many cases mere products of entrepreneurial action.’

While analyzing the industrial revolution – and discerning the essence of change which if the core of his theory – Schumpeter makes a clear division between inventors and entrepreneurs,

and between inventions and innovations: ‘The making of the invention and the carrying out of the corresponding innovation are, economically and sociologically, two entirely different things.’ Sometimes the two relate, but they are never equal, and innovations are often more significant than inventions. Schumpeter writes ‘the actual setting up of new production functions—is a distinct phenomenon.’ There is a sort of domino effect that happens with innovations, in which new innovations destroys the old innovations, and this continues endlessly. Needs may be considered as the mother of inventions, but it does not mean that they inevitably create innovations.

Schumpeter likes to bring as an example of ‘new men’ and ‘new firms’ referring to the American railroad industry. In the 1830’s entrepreneurs began the new rail line to transport raw materials from inlands to seaports. When the steam engines were improved and became more powerful, and when the coal mines started to become better developed, railroad replaced almost every canal and highway. In 1840’s the ‘railroadization’ of the United States started. By the 1890’s an efficient and large railroad system connected all the territories of the United States. It had low-prices and was very rapid. Everyone, like manufacturers, wholesalers, and retailers could send or receive goods very quickly. ‘Everything else turned on the roads and was either created or conditioned by them.’ Railroads incremented the use of coal, iron, steel and petroleum all around the United States. Schumpeter says that railroads were a part of the general business of the ‘organism’. This was an emblematic of capital evolution. ‘The more an innovation becomes established, the more it loses the character of an innovation and the more it begins to follow impulses, instead of giving them.’ By 1873, which is when the worldwide depression started, there were many ups and downs of railroading. The process of ‘liquidation, absorption, adaptation’ which are said to be the frequent companions of innovation—was ‘an unusually long and painful affair.’

Schumpeter saw the development of big businesses, along with the fusion activity, as a having a large innovation in finance and management – realized by ‘new men’ and ‘new firms.’ He thought they produced big benefits: ‘new units of control, new principles of management, new possibilities of industrial research, and at least eventually new types of plant and equipment.’ They helped the ‘absolute optimum’ method to sell new and emerging technologies. While recognizing some that there were destructive abuse with big businesses, Schumpeter writes in *Business Cycles* that the pattern of the movement was a key and logical phase for the consequent growth of industrial economies. But what he saw was that start-ups always arose and grew uninterruptedly side by side with big businesses.

Beside the railroad example another example of the capitalist development that Schumpeter was fond of was the automobile industry. Car production incorporates many innovations, such as: interchangeable parts, modern machine tools, internal combustion engine, and new methods to

produce steel. In the creation of new financial system, Schumpeter says that the automobile business was 'almost in a class by itself.' He highlights that the major development for both industries (car and steel) was their sharply declining prices.

'Capitalist evolution spells disturbance, capitalism is essentially a process of economic change.' If the change does not occur, 'capitalist society cannot exist'. If the capitalist motor stops, the economic system will sink. The innovation plays an essential role in launching the engine and maintaining it working. Capitalism can endure only if there is industrial progress. (McCraw, 2009)

## 8.0 CONCLUSION

Today there's an ample amount of evidence supporting Schumpeter's opinion on the phenomenon process of creative destruction. Mostly how this phenomenon nowadays is considered to be the core of the factors that influence economic growth. Innovation is the winds of economic development as Schumpeter would say, and it is regarded as the engine of growth.

The definition of entrepreneurship according to Schumpeter is that when someone defines oneself to being an entrepreneur, it is when there are new combinations of factors in a product, service, distribution, credit and other parts of economic activity. I can add for example a new machine, or I can combine differently every part of the production process, and they are all considered to be innovations. Innovation is not necessarily considered to just be a technological innovation but it could also be an organization innovation or even a commercial innovation. We have four types of innovations that are studied today; the first is product innovation, which is when there is a change in what an organization offers to the market, then we have position innovation where you take an existing product and you bring that product or service to another market. Next we have process innovation, that is the change by which we bring a product or service to a market, and finally we have business model innovation, which is the way by which companies approach to extract value.

Schumpeter comes from a period of time that was known to being the period of 'big empires', a period of big fortunes, meaning a huge amount of profits. All these profits were coming from new industries or new types of methods. But those big profits are made only if you are the first one to come to the market. There are known as monopoly gains. Nowadays we know that monopoly gains only last for a specific amount of time. Why do monopoly gains last only for a short period of time? Well, the reason is that there are firms that are going to come into the market and they will start to imitate your production or service, and this takes away a firm's monopoly gain.

Schumpeter was one of the most influential economists of the 20<sup>th</sup> century, and still today all of his assumptions regarding being an entrepreneur and innovations hold. He describes the process of new innovations as 'creative destruction', and this is because the process eliminates the old innovations and replaces them with new ones. What is the process driven by? As I stated above, the copying of the new innovations drives the process, which consequently causes the profits of the firm to decrease, which then creates incentives for other firms to search for new innovations. This is essentially what Schumpeter's describes capitalism to be.

One of the most significant statements said by Schumpeter is that agents are rational, only when facing problems that are known, so they consequently act in a certain way when problems are known. But when we look and examine entrepreneurs, their response is not a rational action, the

entrepreneur has no way of knowing all the effects of an innovation, an entrepreneur cannot anticipate all the consequences of his or her choice. What basically happens is that the entrepreneur chooses new frameworks from start to finish but this framework only exists in his mind. To innovate is not difficult, what is tremendously difficult is to be able to innovate successfully. This is why an entrepreneur is considered to be a risk taker, but this was not always true for Schumpeter. The one who risks according to Schumpeter is not necessarily the entrepreneur but the banks, the creditors, the investors, the shareholders. Since what they are doing is investing and paying for a product or service to which they do not have the certainty that it will become successful.

Innovation is known as the process of discovering a creating. We live in a world of technology now a days, everything that surrounds us is slowly all turning to technology. Everything is being destroyed but at the same time created. It is absurd to think that even Schumpeter's thoughts and ideas on innovation and creative destruction are still studied today, and how his theories hold and are in use even to this day.

## BIBLIOGRAPHY

- Landreth, Harry, and David C. Colander. *History of Economic Thought*. 4th ed. Boston: Houghton Mifflin, 2002. Print.
- Foster, John Bellamy. "Theories of Capitalist Transformation: Critical Notes on the Comparison of Marx and Schumpeter." *The Quarterly Journal of Economics* 98.2 (1983): 327-31. JSTOR. Web.
- Strassmann, W. Paul. "Creative Destruction and Partial Obsolescence in American Economic Development." *The Journal of Economic History* 19.3 (1959): 335-49. JSTOR. Web.
- Perelman, Michael. "Retrospectives: Schumpeter, David Wells, and Creative Destruction." *The Journal of Economic Perspectives* 9.3 (1995): 189-97. JSTOR. Web.
- Leontief, Wassily. 'Econometrica.' *The Journal of Economic Society* 18 (1950): 103-110. JSTOR. Web.
- Elliott, John E. "Marx and Schumpeter on Capitalism's Creative Destruction: A Comparative Restatement." *The Quarterly Journal of Economics* 95.1 (1980): 45-68.
- Prencipe, Andrea, and Vangelis Souitaris. "Entrepreneurship, Innovation, and Technology." *Luiss*. N.p., n.d. Web.
- Haberler, G. "Professor Joseph A. Schumpeter." *The Review of Economics and Statistics* 33.2 (1951): 89-90. JSTOR. Web. 11 June 2016.
- McCraw, Thomas K. *Prophet of Innovation: Joseph Schumpeter and Creative Destruction*. Cambridge, MA: Belknap, 2009. Print.
- Heilbroner, Robert. "Was Schumpeter Right After All?" *The Journal of Economic Perspectives* 7.3 (1993): 87-96. JSTOR. Web.