Spring 2001

Schumpeterian Dynamics

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Appendix E - UNIVERSITY HONORS PROGRAM
SENIOR PROJECT - APPROVAL

Name: Jonathan McKernan

College: Arts + Sciences Department: Economics

Faculty Mentor: Dr. Matt Murray

PROJECT TITLE: SCHUMPETIAN DYNAMICS: A THEORY OF THE DYNAMIC FUNCTIONING AND DEVELOPMENT OF CAPITALISM

I have reviewed this completed senior honors thesis with this student and certify that it is a project commensurate with honors level undergraduate research in this field.

Signed: ___________________________ Faculty Mentor

Date: 5-9-01

General Assessment - please provide a short paragraph that highlights the most significant features of the project.

Comments (Optional):

<See attached>
MEMORANDUM

TO: University Honors Program  
FROM: Matt Murray, Head  
DATE: 10-May-01  
SUBJECT: Honors Thesis-Jonathan McKernan

Jonathan McKernan has recently completed his honors thesis under my supervision. He has been a pleasure—and challenge—to work with on this project! Jonathan struggled a bit to find a specific topic, a reflection of his desire to sink his teeth into something that he could truly have an impact on. He chose a daunting subject, a review of two books by one of the great economists of all time, Joseph Schumpeter. The purpose of the review was to learn about dynamic models of capitalism and determine whether they represent a viable alternative to the static models utilized by contemporary neoclassical economists. His conclusion is that dynamic models are essential to capturing the forces of capitalism that are constantly in flux across time and space.

Jonathan clearly worked hard in understanding two terribly difficult and dense texts. And he went well beyond the traditional review by comparing the methods espoused in these books to the mainstream methods of today. He required little guidance and feedback once he had chosen his topic. His final written product is exceptional in all dimensions. It is well written, creative, and thoughtful. Of course, I disagree with some of his interpretations and conclusions! That's fine. It is rare that a student seeks to both learn and teach in the research they undertake.
SCHUMPETERIAN DYNAMICS
Jonathan McKernan
May 2, 2001

INTRODUCTION

Below is a survey of Schumpeter’s work. Part One is a summary of *The Theory of Economic Development* (TED) and *Capitalism, Socialism and Democracy* (CSD). Part Two is a review of the Schumpeter’s concept of “dynamics” in these two works. Part Three is a conclusion advocating additional use of the dynamic analysis, especially for certain aspects of economic theory, like the business cycle. In the end, Schumpeter seems to increase our awareness that capitalism is by nature functions and develops dynamically.

PART ONE: SUMMARY OF TEXTS

*The Theory of Economic Development*

*Chapter I: The Circular Flow of Economic Life as Conditioned by Given Circumstances*

For Schumpeter, choosing where to start must have been a taxing proposition. Although difficult to rigorously defend, I intuit that Schumpeter understood that the nature of the starting point, especially the unquestioned assumptions, would dominate the following analysis. From this perspective it is both unusual and understandable that Schumpeter would start with a detailed description of the “circular flow.” This discussion “shall provide ourselves with the necessary principles, and familiarize ourselves with certain conceptual devices, which we shall need...cogs to grip the wheels of received theory.”¹ By tailoring the “circular flow” to his unique taste, Schumpeter slants the argument to bias his own understanding of economic development.

¹ TED, 4.
A qualification should be introduced here. Schumpeter’s theory of economic development is not related directly to the problems of less-developed countries like the Third World. It is a theory of how development, more specifically innovation, originates and is financed in a capitalist economy. Thus Schumpeter’s *The Theory of Economic Development* is a crucial aspect of Schumpeter’s larger understanding of the dynamic development and functioning of the capitalist system. His *Capitalism, Socialism, and Democracy* to some extent depends on this work, especially the understanding of the entrepreneur, to aggregate to a theory detailing the inevitable transition of capitalism to socialism.

Schumpeter does not start directly with his theory of statics. Instead, Schumpeter first draws the boundaries of economic analysis. For him, “The social process is really one indivisible whole.” Any discussion of economics requires an abstraction of what makes a fact “economic.” For Schumpeter, economic facts relate directly to economic conduct, which is “conduction directed towards the acquisition of goods.” By defining a realm for economics, Schumpeter artificially narrows the “indivisible whole” to allow for theory. Economic theory must extend itself until it reaches a “non-economic bottom.” However, Schumpeter soon recognizes himself the problems with this distinction between “economic” and “non-economic” realms, and perhaps he fails to maintain this divide throughout the analysis. In part, this confusion may explain much of Schumpeter’s interest in the distinction between statics and dynamics.

The “circular flow” of *The Theory of Economic Development* is essentially the system of general equilibrium that Walras developed. Schumpeter was a keen student of Walras, and he possessed a keen faith in the theory, even in the face of insightful critiques of Keynes,

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2 TED, 3
3 “The designation of a fact as economic already involves an abstraction.... A fact is never exclusively or purely economic.” (3)
4 TED, 3.
5 TED, 5.
Schumpeter's contemporary. Schumpeter's circular flow is "of a commercially organized state, one in which private property, division of labor, and free competition prevail." Interestingly, Schumpeter reduces the agency of the actors in the circular flow by defining the circular flow largely in terms of the "force of custom." The production decisions of previous periods exercise almost complete control over the present and hold producers "in iron fetters" so that "all goods find a market." All this "Economic activity may have any motive, even a spiritual one, but its meaning is always the satisfaction of wants." In other words, production occurs only for consumption. Schumpeter's circular flow is heavily conditioned by production. He takes consumer wants as a given, an exogenous variable. For Schumpeter the process of production is characterized "by the concept of combinations of productive forces. The results of these combinations are the products." Schumpeter reduces the "productive forces" to two inputs: land and labor. Ultimately, all goods are produced by these two basic inputs. Interestingly, capital is absent from this list. Actually Schumpeter defines capital as a fund of purchasing power, not as means of production. "Capital" in the traditional Smithian sense, as an input into the production process, is for Schumpeter simply embodied land and labor, a good like any other.

Adopting Marshall's concept of marginal utility, Schumpeter concludes that the ultimate equilibrium of the circular flow is one where marginal cost equals marginal utility and profits

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7 TED, 5.
8 TED, 6.
9 TED, 8.
10 TED, 10.
11 In other words, in Schumpeter's model there is no production for the intrinsic value of the work. Schumpeter adopts Marshall's understanding of work as creating disutility. Ironic perhaps considering Schumpeter's interest in Marx.
12 TED, 15.
13 "We can resolve all goods into "labor and land" in the sense that we can conceive all goods as bundles of the services of labor and land" (17).
approach zero. The resulting production decisions soon crystallize into custom, allowing the circular flow to repeat itself indefinitely. Again, the “force of custom” is paramount: “This stability is indispensable for the economic conduct of individuals. In practice they could not, in by far the majority of the cases, do the mental labor necessary to create this experience anew.”

By rooting the circular flow in custom, Schumpeter is already biasing the argument in favor of his view of development. For Schumpeter, the primary agent of development is the entrepreneur who implements new combinations. In bringing innovation to fruition, Schumpeter believes that the entrepreneur breaks out of the “iron fetters” of custom, ending the statics of the circular flow.

Schumpeter also devotes considerable attention to the misconception that profits occur in the circular process. He acknowledges that a surplus over cost can occur for a time period following a spontaneous change in the data, for example a change in consumer wants. However, like Marshall he calls them “quasi-rents” and insists that they fade away with the functioning of the competitive process. Also there are returns to production that accommodate risk of failure in the enterprise. However, “The risk-premium is no source of gain for the producer” and should not count as a surplus over costs. In the end, “Labor and land share the whole national dividend, and there are just as many consumption goods on hand as are necessary to satisfy their effective demand and no more.”

Notice that there is no discussion of savings in the circular flow. Schumpeter’s circular flow originates with a stock of production goods. The depreciation of these goods is offset in the price of the associated consumption goods. “Under these conditions … there is no class whose

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14 “the last increment of every product will be produced without a gain in utility above costs.... But further, it follow that in production generally no surplus value above the value of producers' goods can be attained.” (29) i.e. MU=MC and “profit”=0.
15 TED, 29.
16 TED, 40.
17 TED, 34.
18 TED, 33.
19 TED, 44.
characteristic is that they possess produced means of production or consumption goods.\textsuperscript{20} Also in this circular flow, money has “no other role than that of facilitating the circulation of commodities.”\textsuperscript{21} By discussing describing savings as inessential to the nature of the circular flow, Schumpeter is biasing his argument toward his upcoming theories of credit and interest. Increasingly the repercussions of Schumpeter’s specific definition of the circular flow become more obvious.

Chapter II: The Fundamental Phenomenon of Economic Development

The circular flow was static and unchanging; real economic life undergoes changes.\textsuperscript{22} Yet, “They [the changes] cannot be understood by means of any analysis of the circular flow, although they are purely economic and although their explanation is obviously among the tasks of pure theory.”\textsuperscript{23} Schumpeter calls these changes that occur outside the circular flow “development”: “By ‘development,’ therefore we shall understand only such changes in economic life as are not forced upon it from without but arise by its own initiative, from within.”\textsuperscript{24} Development “is a distinct phenomenon, entirely foreign to what may be observed in the circular flow….”\textsuperscript{25} Building a theory of development is the thrust of the book. Whether or not Schumpeter actually endogenizes all the elements of development is subject to debate.

Schumpeter first adds greater clarity to the definition of development. Development occurs in “the sphere of the industrial and commercial life, not in the sphere of the wants of the consumers of final products.”\textsuperscript{26} This is because “the spontaneity of wants is in general small…. It is, however, the producer who as a rule initiates economic change, and consumers are educated by him if necessary…”\textsuperscript{27} In the circular flow, the consumer reigned supreme. In understanding

\textsuperscript{20} TED, 45.  
\textsuperscript{21} TED, 53.  
\textsuperscript{22} TED, 61.  
\textsuperscript{23} TED, 61.  
\textsuperscript{24} TED, 63.  
\textsuperscript{25} TED, 64.  
\textsuperscript{26} TED, 65.  
\textsuperscript{27} TED, 65.
change, it is the producer to which we must look. Thus, Schumpeter has hinted at his understanding of development: “Development in our sense is then defined by the carrying out of new combinations.”

There are five such new combinations: the introduction of a new good; the introduction of a new method of production; the creation of a new market; the conquest of a new source of supply; the reorganization of an industry.

However, development would seem impossible in the context of a circular flow. In the circular flow, all resources are in use. Thus, “new combinations must draw the necessary means of production from some old combinations.” Development would require an intrusion into the circular flow. This is the role of credit. By exercising command over the means of production, a central authority loans the necessary means to the developer. The provider of credit is the capitalist. The problem for development is “the problem of detaching productive means (already employed somewhere) from the circular flow and allotting them to new combinations. This is done by credit, by means of which one who wishes to carry out new combinations outbids the producers in the circular flow in the market for the required means of production.”

However, this credit does not originally come from previous savings. Recall that in the circular flow there is no saving as there is little incentive to save (retirement and rainy-day funds at the most). “The most important incentive, the chance of participating in the gains of development, would be absent [in the circular flow].” The first financings of development can only be accomplished by the outright creation of purchasing power, which is done by banks. “The banker, therefore, is not so much primarily a middleman in the commodity “purchasing power” as a producer of this commodity.” The banker makes development possible.

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28 TED, 66.
29 TED, 66.
30 TED, 68.
31 TED, 69.
32 TED, 71.
33 TED, 72.
34 TED, 73.
35 TED, 74.
The banker makes development possible, but it is the entrepreneur who is the real agent of development. "The carrying out of new combinations we call 'enterprise'; the individuals whose function it is to carry them out we call 'entrepreneurs.'" Entrepreneurial activity is exclusively tied to development. Thus, there is a difference between "capitalists" and "entrepreneurs." The capitalist puts forth the means of production necessary to introduce the new combinations. Thus, the entrepreneur bears none of the risk inherent to new combinations; risk falls on the capitalist. Of course, Schumpeter recognizes an individual can assume several economic functions. If an entrepreneur puts forth his own credit toward a new combination, the actor also assumes the function of a capitalist: "the entrepreneur's essential function must always appear mixed up with other kinds of activity." The entrepreneur is not present in the circular flow, where there is no effort toward new combinations. The entrepreneur can, and usually does, lose his identity after he establishes a new combination and "settles down to running it [the new combination] as other people run their business." Also, the entrepreneur is not a profession, and entrepreneurs do not form "a social class." An actor is only an entrepreneur when developing, which is usually a temporary undertaking.

So what kind of person can be an entrepreneur? In the circular flow, an individual can easily follow the routine of the "force of custom" in making his decisions. However, an entrepreneur in seeking to establish a new combination now finds an enemy in the "force of custom": "While he [the entrepreneur] swims with the stream in the circular flow which is familiar to him. He swims against the stream if he wishes to change its channel." Thus, the entrepreneur is a rare individual. In ordinary circular action, there is no need for leadership. But to develop the entrepreneur must deal successfully with the uncertain nature of original

36 TED, 74.  
37 TED, 75.  
38 TED, 77.  
39 TED, 76.  
40 TED, 78.
undertakings, the psychological reluctance to depart from routine, and even the adverse reaction of the “social environment against one who wishes to do something new.” The difficulty of leadership is not in finding new possibilities. These exist independently. Instead it is a question of “doing the thing” that is so difficult. “It is, therefore, more by will than by intellect that the leaders fulfill their function, more by ‘authority,’ ‘personal weight,’ and so forth than by original ideas.” One wonders how Schumpeter’s understanding of the entrepreneur would change if he did not believe so thoroughly in the “force of custom.”

Chapter III: Credit and Capital

The Nature and Function of Credit

The nature of Schumpeter’s circular flow requires a very specific conception of credit. Schumpeter’s theory of credit thus reflects the intricacies of his foundational assumptions: “The fundamental notion that the essence of economic development consists in a different employment of existing services of labor and land leads us to the statement that the carrying out of new combinations takes place through the withdrawal of services of land and labor from their previous employments.” In other words, for Schumpeter “in the circular flow there would be no idle stocks for the needs of the entrepreneur.” Credit, created by banks, gives the entrepreneur the purchasing power to command the means of production he requires for development, which is also the power to remove means of production from other uses.

The manner in which Schumpeter fashions his theory of credit restricts the essential importance of credit to the entrepreneur: “in principle no one other than the entrepreneur needs...
There are of course other forms of credit, for example “consumptive-productive credit” used by businesses and individuals. However, these aspects of borrowing can be ignored “without overlooking anything essential.” In fact, without development the ability to borrow for consumptive-productive purposes would not exist since the institutional framework would not exist. Again, “The essential function of credit in our sense consists in enabling the entrepreneur to withdraw the producers’ goods which he needs from their previous employment’s, by exercising a demand for them, and thereby to force the economic system into new channels.”

However, when banks create credit aggregate supply remains unchanged. “Yet ‘new demand’ [the entrepreneur’s demand for production goods] becomes possible in a very obvious sense. It causes a rise in the prices of productive services. From this ensues the ‘withdrawal of goods’ from their previous use...” In other words, the bank’s creation of credit, and its use by the entrepreneur, leads to a “credit inflation.” However, the credit inflation is only temporary. If the entrepreneur prosecutes the new combination successfully then the total value of his produce will exceed the total cost of the goods he “stole” from their previous use. The increase in aggregate supply leads to a price deflation greater than the inflation. It is not immediately clear why Schumpeter does not anticipate an increase in aggregate demand with the increasing aggregate supply that would cancel out the price deflation.

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49 TED, 102.
50 TED, 103.
51 TED, 104.
52 TED, 104.
53 TED, 106.
54 TED, 108.
55 TED, 108.
56 TED, 109.
57 TED, 110.
58 TED, 110.
Schumpeter’s circular flow foundation leads to a theory of credit that then dominates his understanding of capital. “Capital is nothing but the lever by which the entrepreneur subjects to his control the concrete goods which he needs, nothing but the means of diverting the factors of production to new uses, or of dictating a new direction to production.”59 In other words, capital is a means to obtain productive means. It is not a productive means itself as in the Marxist sense.60 “It is a fund of purchasing power.”61 “We shall define capital, then, as that sum of means of payment which is available at any moment for transference to entrepreneurs.”62

The Money Market

Like consumption and production goods, capital also must have a market. This market is what “the business man calls the money market.”63 In the money market, there are supply and demand aspects: “on the demand side appear entrepreneurs and on the supply side producers of and dealers in purchasing power, viz. bankers, both with their staffs of agents and middlemen. What takes place is simply the exchange of present against future purchasing power.”64 “The money market is always ... the headquarters of the capitalist system, from which orders go out to its individual divisions, and that which is debated and decided there is always in essence the settlement of plans for further development.”65 “Thus the main function of the money or capital market is trading in credit for the purpose of financing development. Development creates and nourishes this market.”66

Chapter IV: Entrepreneurial Profit

From Schumpeter’s understanding of development follows also his theory of entrepreneurial profit. Schumpeter uses a simple definition: “Entrepreneurial profit is surplus

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59 TED, 116.
60 TED, 118.
61 TED, 120.
62 TED, 122.
63 TED, 123.
64 TED, 125.
65 TED, 126.
66 TED, 127.
After attempting a proof that a surplus over production costs can exist, Schumpeter describes "the second act of the drama" where "new businesses are continually arising under the impulse of alluring profit." This process is similar to Adam Smith's understanding of the entry of imitating innovators who force the evaporation of the profit to the original innovation. Similarly, for Schumpeter, "the final result must be a new equilibrium position, in which, with new data, the law of costs again rules, so that now the prices of the products are again equal to the wages and rents of the services of labor and land...." In other words, "the surplus of the entrepreneur in question and of his immediate followers disappears."

The next question is how much profit the entrepreneur will obtain. The entrepreneur accomplishes a profit through leadership, and thus "To the leadership function is imputed the value of the new products minus the value which could be realizes without it." Schumpeter clarifies this vague statement by describing the temporary monopoly position of the entrepreneur: "Since the entrepreneur has no competitors when the new products first appear, the determination of their price proceeds wholly, or within certain limits, according to the principles of monopoly price. Thus there is a monopoly element in profit in a capitalist economy." Thus, there is no marginal-cost-marginal-benefit logic to profit in the conventional sense: "the problem of profit lies precisely in the fact that the laws of cost and of marginal productivity seem to exclude it." This conclusion is immensely important. Since the entrepreneur is by definition a rare individual and since the entrepreneur's reward bears no relation to work effort (except that work effort may establish a minimum acceptable profit), an "industrial manager who frequently plays the entrepreneurial role, can generally be adequately remunerated with much less than the full

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67 TED, 128.
68 TED, 129-130.
69 TED, 131.
70 TED, 131.
71 TED, 132.
72 TED, 143.
73 TED, 144.
74 TED, 152.
This thesis is paramount to Schumpeter’s *Capitalism, Socialism, and Democracy* and its socialization of innovation.

Schumpeter clearly defines the mechanism that determines the entrepreneur’s reward for leadership. He also defines what happens to this profit when manager-like entrepreneurs enter and compete away the entrepreneur’s monopoly power and thus his entrepreneurial profit. Since “the new process of production will be repeated” the particular means of production—land and labor—that the managers employ in the production of the new good will raise in price under the increased demand. In turn, “The value of the former services of labor and land will first increase and then will diffuse themselves over all others.” In the end, the profit will spread across the entire economy as marginal costs are equated and “Hence, the values of all services of labor and land will rise correspondingly.” Like Smith, Schumpeter recognizes that “new combinations” benefit all factors of production by increasing their incomes.

**Chapter V: Interest on Capital**

So far most of Schumpeter’s theory has been easy to accept. The circular flow was an abstraction. The concept of economic development seemed close to Adam Smith. The theory of credit, especially the paramount importance of bankers, might have been somewhat foreign to our understanding, but was easily dismissed as a minor detail. Any growing concerns evaporated with the theory of entrepreneurial profit, which was just an extension of the theory of development. However, Schumpeter’s theory of interest is radically unfamiliar to conventional understanding. By trying to understand the theory of interest, we then perceive just how far Schumpeter’s other theories departed from mainstream economics.

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75 TED, 153.
76 TED, 155.
77 TED, 148.
78 TED, 148.
79 TED, 148.
Schumpeter defines interest as “a premium on present over future purchasing power.”80 There are several causes of interest, for example the consumptive loan, and these can exist in the circular flow with no development. “But they do not constitute the great social phenomenon that needs explaining. This consists of interest on productive loans.”81 In Schumpeter’s theory of interest, the central thesis is that “productive interest has its source in [entrepreneurial] profits, that it is by nature an offshoot of the latter, and that it ... spreads from the profits incident to the successful carrying out of new combinations over the whole economic system....”82 This is also to say that ‘the “static” economy knows no productive interest.”83

To prove this thesis, Schumpeter must clarify the channels through which entrepreneurial profits flow to the receivers of interest. He opens with a discussion on interest on capital: “First there is the question of the source of this stream of goods: in order that it may flow, a value, out of which it may come, must first of all exist. Secondly there is the question of the reason why this value becomes the spoils of these particular individuals.”84 He reformulates the issue: “The existence of interest constitutes a problem because we know that in the circular flow the whole value product must be imputed to the original productive factors, that is to the services of land and labor.”85 There are three prior solutions to this problem: “as the spoliation of wage-earners a (the [Marxist] theory of exploitation), as the wages of the labor of capitalists (labor theory in the literal meaning), or as the wages of the labor embodied in the instruments of production and raw materials (...James Mill and McCulloh).”86 However, these all fail as explanations. More generally, interest is sometimes argued to exist as a reward for waiting. Schumpeter rejects this argument.87 In a circular flow with no interest or inflation, we could imagine an agent being

80 TED, 157.
81 TED, 157.
82 TED, 158.
83 TED, 158.
84 TED, 159.
85 TED, 160.
86 TED, 160.
87 TED, 170.
given a lump sum, who would then parcel the sum out rationally across the years he expects to live. In other words, there is nothing rational about delaying or accelerating gratification, except in exceptional cases like retirement or rainy day funds. In the end, none of these proposed explanations describe how a permanent surplus is created and then not distributed to the means of production. 88

Instead, “We turn to those surplus values which owe their existence to development, and which are much more interesting. . . . All streams of goods which flow to individuals under any other title than wages, rent, and monopoly revenue must directly or indirectly be due to them.” 89 From this follows the six postulates of Schumpeter’s theory of interest: first, “interest flows essentially from the surplus values just considered” 90; second, interest flows from entrepreneurial profit 91; third, “Since interest is permanent it cannot be understood simply as a surplus value from concrete goods” 92; fourth, “in a communist or non-exchange society in general there would be no interest as an independent value phenomenon” since “The agent for which interest is paid simply would not exist in a communist economy” 93; fifth, if entrepreneurs “were in a position to commandeer the producers’ goods they need” they would not have to pay interest, but because they “must call in the capitalist to help them” they must pay interest 94; sixth, interest is an element in the price of purchasing power regarded as a means of control over production goods.” 95

In other words, there was not (productive) interest in the circular flow. Development originates a new surplus over costs. Since the entrepreneur cannot independently access the necessary means of production, he allies with the banker. In return for credit, the entrepreneur pays interest to the banker. Unlike the other actors in the circular flow, the entrepreneur is

88 TED, 172.
89 TED, 172.
90 TED, 173.
91 TED, 174.
92 TED, 175.
93 TED, 176.
94 TED, 177.
95 TED, 184.
willing to place a premium on present over future because he anticipates a greater product from
the new combination.

However, this value premium characteristic of the entrepreneur has a wider than expected
effect, particularly in the money market. On the demand side, there is little change: entrepreneurs
still need credit to finance new combinations. However, the introduction of interest to the
economy drastically alters the supply side of the money market. Now other actors have an
incentive to forgo consumption and become capitalists in the Schumpeterian sense (providing
funds to the entrepreneur). In other words, development creates the phenomenon of savings.

Although some saving had occurred in the circular flow (for retirement or rainy days), now
savings takes on an entirely new meaning. Interest then comes to dominate any credit-related
transaction, even where interest was before unimportant (like land capitalization). “In this way
the interest phenomenon extends gradually over the whole economic system….” Schumpeter
ends by foreshadowing *Capitalism, Socialism, and Democracy*: “I wished to explain the interest
phenomenon but not to justify it. Interest is not, like profit for example, a direct fruit of
development in the sense of a prize for its achievements. It is on contrary rather a brake—in an
exchange economy a necessary brake—on development, a kind of ‘tax on entrepreneurial
profit…. Therefore it is important to state that interest is only the consequence of a special
method of carrying out new combinations, and that this method can be much more easily changed
than the other fundamental institutions of the competitive system.” As a side interest, this
comment to some degree resembles Keynes’s theory of interest. Although Keynes seems to
attribute interest to the scarcity of capital, Keynes resembles Schumpeter by emphasizing the
institutional context of interest as a phenomenon. For both, interest is not an inevitable fact of

96 TED, 195.
97 TED, 200.
98 TED, 202.
99 TED, 211.
economic life. Revision of the relevant social and economic institutions can even eliminate the presence of interest.

Chapter VI: The Business Cycle

Schumpeter closes The Theory of Economic Development with a summary of his theory of business cycles that would later be the centerpiece of his two-volume Business Cycles. The theory of development dovetails well with the "theory of crises" since the entrepreneur is the central agent to both theories. The thesis of Schumpeter's theory of the crises is that the booms and troughs of the business cycle represent alternating periods of "swarm-like" entrepreneurial activity followed by the recession-creating absorption of the new innovation into the economic system. Actually, Schumpeter qualifies this thesis himself by stating that there are depressions caused by non-economic occurrences, for example war. However at least one aspect of the business cycle can be attributed to the nature of entrepreneurial activity: "new combinations are not, as one would expect according to the general principles of probability, evenly distributed through time...but appear, if at all, discontinuously in groups or swarms."101

Therefore, Schumpeter's theory of crises requires that new enterprises do not occur independently of one another. Instead there is a swarm-like appearance of new enterprises that produces the boom of the business cycle. Entrepreneurs appear in clusters because "the appearance of one or a few entrepreneurs facilitates the appearance of others, and these the appearance of more, in ever-increasing numbers."104 This is because "the pioneers remove the obstacles for others not only in the branch of production in which they first appear, but, owing to the nature of these obstacles, ipso facto in other branches too."105

100 TED, 220.
101 TED, 223.
102 TED, 224.
103 TED, 225.
104 TED, 228.
105 TED, 229.
social or political in nature and thus their removal by one especially talented entrepreneur benefits others less qualified leaders.

However, the boom can by definition not proceed forever. For Schumpeter, the boom ends when the swarm-like cluster is interrupted and the economic system enters a periodic depression, which is the “economic system’s struggling to towards a new equilibrium position, its adaptation to the data as altered by the disturbance of the boom.” Three factors interrupt the boom. First, the wave of innovation drives up the prices of land and labor, gradually reducing the set of available new combinations that will be profitable. Second, the new combinations often compete with the products of older businesses, and these older firms are gradually driven out of the economy. In fact, it is the “average time which must elapse before the new products appear ... that fundamentally explains the length of the boom” creating sectional unemployment. And third, when entrepreneurs repay the loans they had used to finance the new combinations they create a credit deflation, which the banks react to by restricting credit. The recession is actually not entirely a “bad” even with the accompanying fall in employment. It is during the calm of the recession that the economy adjusts itself to the new combinations, gradually eliminating the entrepreneurial profits, redistributing them to the factors of production. “The economic nature of depression lies in the diffusion of the achievements of the boom over the whole economic system through the mechanism of the struggle for equilibrium.”

**Capitalism, Socialism, and Democracy**

Schumpeter’s *The Theory of Economic Development* relied on a distinction between statics and dynamics (see the three pronged distinction relating the entrepreneur and custom).

106 TED, 231.
107 TED, 232.
108 TED, 232.
109 TED, 233.
110 TED, 234.
However, the differences between the two are vague, perhaps even to Schumpeter himself. Schumpeter’s later *Capitalism, Socialism, and Democracy* offers some more thought on this distinction, although in the end more obscurity results than clarity. Below is a summary of part of *Capitalism, Socialism, and Democracy*, Schumpeter’s analysis of how and why capitalism must inevitably transform itself into socialism. It ignores Schumpeter’s commentary on Marx, his dissertation on the workability of socialism, and his analysis of the relationship between socialism and democracy. These relate only indirectly to the Schumpeterian Dynamics.

*Prologue*

Schumpeter begins his analysis with “Can capitalism survive? No. I do not think it can.” However, this statement is meaningless without a description of why the death of capitalism will occur. According to Schumpeter, “The thesis I shall endeavor to establish is that the actual and prospective performance of the capitalist system is such as to negative the idea of its breaking down under the weight of economic failure, but that its very success undermines the social institutions which protects it, and ‘inevitably’ creates conditions in which it will not be able to live and which strongly point to socialism as the heir apparent.” Marx believed capitalism’s failures would result in its destruction at the hands of the proletariat. Schumpeter tries to prove that capitalism’s successes would be the ironic cause of its death.

*Chapter V: The Rate of Increase of Total Output*

Schumpeter feels compelled to “prove” that there had been historically a dramatic increase in the standard of living and that that “progress” had been the result of capitalism as a mode of production. Although commonly accepted, especially currently, this founding thesis is essential to Schumpeter’s larger argument. There are several interesting aspects to this particular discussion. For example, Schumpeter believes capitalism had been especially beneficial for the

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111 TED, 245.
112 TED, 251.
113 CSD, 61.
poor: “Measured in real terms, relative shares have substantially changed in favor of the lower income groups. This follows from the fact that the capitalist engine is first and last an engine of mass production which unavoidably means also production for the masses.”

Schumpeter then attempts to integrate his theory of development from The Theory of Economic Development into his understanding of the growth in output, especially the theory of the business cycle.

*Chapter VI: Plausible Capitalism*

Schumpeter extends the argument of the previous chapter to prove “first, that there is an understandable relation between the capitalist order and the observed rate of increase in output; second, that, given such a relation, the rate of increase was actually due to it and not to particularly favorable conditions which had nothing to do with capitalism.... and [third] whether there is any reason why the capitalist engine should ... fail to go on working as it did in the past.” The first and second issues were more relevant during Schumpeter’s time. However, the third point, which revolves around supposed deficiencies in capitalism, especially the speculation about the growing influence of big business, are still relevant today.

Schumpeter deals with the first issue by detailing how the capitalist order has institutionalized economic growth. According to Schumpeter, “Bourgeois society has been cast in a purely economic mold: its foundation, beams, and beacons are made of economic material.” This economic mold is “strong enough to attract the large majority of supernormal brains and to identify success with business success.” Society is thus galvanized to produce, leading to a growing output.

Schumpeter deals with the second and third issues only indirectly with a strong critique of mainstream economics, especially its understanding of the merits of capitalism. While the
classical economists did a great service to society by proving that the profit motive did not necessarily run counter to the interests of society, they did not actually succeed in proving that the profit motive must necessarily maximize production. According to Schumpeter, "The principle [that the profit motive maximizes well being] ... applies to a state of static equilibrium. Capitalist reality is first and last a process of change. In appraising the performance of competitive enterprise, the question whether it would or would not tend to maximize production in a perfectly equilibrated stationary condition of the economic process is a hence almost, though not quite, irrelevant." In fact, contrary to the classical economics, perfect competition is not the rule, and actually monopolistic competition and oligopoly better characterize the economy. In actuality, "private enterprise is little more than a device to curtail production in order to extort profits which are then correctly described as tolls and ransoms."  

Chapter VII: The Process of Creative Destruction

Schumpeter concludes the previous chapter with a scathing critique of capitalism. This critique seems to contradict Schumpeter's earlier discussion of the virtues of capitalism and its expansion of output. However, the critique of the prior chapter originated from a statics perspective. Schumpeter agrees that "capitalist reality is unfavorable to maximum performance in production." However, Schumpeter also adopts a dynamic, more time-inclusive perspective of capitalism which actually proves that what other economists interpret as a fault in economic reality, the monopoly power that pervades throughout the economy, is actually capitalism's strength. In fact, "a shocking suspicion dawns upon us that big business may have had more to do with creating that standard of life than with keeping it down." Capitalism is "an evolutionary process" that "is by nature a form or method of economic change and not only never

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119 CSD, 73.  
120 CSD, 76.  
121 CSD, 77 i.  
122 CSD, 79.  
123 CSD, 80.
is but never can be stationary.”126 Capitalism is “a history of revolutions”: “This process of Creative Destruction is the essential fact about capitalism.”127 However, “the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.”128

Chapter VIII: Monopolistic Practices

Schumpeter trailed off the last chapter with a description of “creative destruction” that is the real source of capitalism’s vitality, as opposed to some imagined production maximization motivated by the pursuit of profit. This chapter illustrates how monopolistic-styled business actually drives “the process of creative destruction.” “We must now recognize the further fact that restrictive practices … acquire a new significance in the perennial gale of creative destruction, a significance which they would not have in a stationary state or in a state of slow and balanced growth.”129 It is through monopoly power that “it might prove to be the easiest and most effective way of collecting the means by which to finance additional investment. But in the process of creative destruction, restrictive practices may do much to steady the ship and alleviate temporary difficulties.”130 This advantage to internally financing investment (as opposed to for example a bank) is that “Long-range investing under rapidly changing conditions … is like shooting at a target that is not only indistinct but moving” and the business often has a more accurate idea of the future return of the investment than the bank can have.131 Monopolies “largely create what they exploit”132 and manage to hold onto their position only for a short time.133

124 CSD, 81.
125 CSD, 82.
126 CSD, 82.
127 CSD, 83.
128 CSD, 84.
129 CSD, 87.
130 CSD, 87.
131 CSD, 88.
132 CSD, 101.
133 CSD, 99.
To reinforce the essential nature of monopoly power in creative destruction, Schumpeter discusses what perfect competition would actually mean to innovation. "Perfect competition implies free entry into every industry.... But perfectly free entry into a new field may make it impossible to enter at all. The introduction of new methods of production and new commodities is hardly conceivable with perfect—and perfectly prompt—competition from the start. And this means that the bulk of what we call economic progress is incompatible with it."\textsuperscript{134} In fact, a perfectly competitive industry exhibits "waste" and inefficiencies not normally recognized. For example, the perfectly competitive industries are more likely to be routed by a recession since they are not able to build sufficient reserves. "In the last resort, American agriculture, English coal mining, the English textile industry are costing consumers much more and are affecting total output much more injuriously than they would if controlled, each of them by a dozen good brains."\textsuperscript{135} "Perfect competition is not only impossible but inferior, and has not title to being set up as a model of ideal efficiency."\textsuperscript{136}

\textit{Chapter IX: Closed Season}

Schumpeter ends his analysis of the vitality and virtue of capitalism by dismissing five potential "exceptional circumstances" to which some may attribute the historic growth in output besides the capitalist order. They are government action, gold, population growth, new land, and technology. Schumpeter easily dismisses each has irrelevant, insignificant, or as a product not cause of the growth.\textsuperscript{137}

\textit{Chapter X: The Vanishing of Investment Opportunity}

Schumpeter then must analyze the future potential of capitalism to continue to expand output. More specifically, he must refute the idea, popular during his time and growing out of Marx, that the opportunities to invest were decreasing. Although Schumpeter agrees (like

\textsuperscript{134} CSD, 105.
\textsuperscript{135} CSD, 106.
\textsuperscript{136} CSD, 106.
Keynes) that “it is one of the safest predictions that in the calculable future we shall live in an 
embarrass de richesse of both foodstuffs and raw materials, giving all the rein to expansion of 
total output that we shall know what to do with.”138 On the whole, concerns of vanishing 
investment are irrelevant to this analysis which is concerned with the next forty years.139

Chapter XI: The Civilization of Capitalism

Now, “Leaving the precincts of purely economic considerations, we now turn to the 
cultural complement of the capitalist economy—to its socio-psychological superstructure, if we 
wish to speak the Marxian language—and to the mentality that is characteristic of capitalist 
society and in particular of the bourgeois class.”140 Like Marx, Schumpeter seems driven to 
isolate some underlying force that drives the evolution of “the indivisible whole” of society. For 
Schumpeter, this primary force is reason. Schumpeter thus takes great care to document how 
reason originates in primitive man and then spreads to the rest of society.141 Again, like Marx, 
Schumpeter tends to think dialectically and believes that this primary force turns back upon what 
it had earlier created: “When the habit of rational analysis of, and rational behavior in, the daily 
tasks of life has gone far enough, it turns back upon the mass of collective ideas and criticizes and 
to some extent “rationalizes” them by way of such questions as why there should be kings and 
popes or subordination or tithes or property.”142 In a perhaps unconscious attempt to get back to 
Marx, Schumpeter writes that “All logic is derived from the pattern of the economic life... that the 
economic pattern is the matrix of logic.”143 In other words, “capitalism—and not merely 
economic activity in general—has after all been the propelling force of the rationalization of 
human behavior.”144 Although this nostalgia for Marx is touching, it seems Schumpeter has

137 CSD, 107-110.
138 CSD, 116.
139 CSD, 113.
140 CSD, 121.
141 CSD, 121-122.
142 CSD, 122.
143 CSD, 123.
144 CSD, 125.
fallen into a circular logic trap. Economics is for Schumpeter manifested reason, reason in praxis; reason drives economics, not the other way around. Everything in the "indivisible whole" of the social organism is thus related to the capitalist mode of production. There is a "capitalist art and the capitalist style of life." And in the spirit of a dialectical logic, there are even capitalist radicals who critique the system that is there own lifeblood.

Chapter XII: Crumbling Walls

These critical intellectuals are part of the force that will undermine capitalism, precipitating its transition to socialism. However, there is another dynamic that undermines the capitalist system that Schumpeter must discuss first: the "obsolescence of the entrepreneurial function." In the habit of The Theory of Economic Development, Schumpeter states "that the function of entrepreneurs is to reform or revolutionize the pattern of production by exploiting an invention." In the past, the introduction of a new combination was difficult in the face of the "force of custom." The entrepreneur had to be a remarkable personality. Schumpeter however believes that now the introduction of new enterprises is now being reduced to a routine:

"Technological progress is increasingly becoming the business of teams of trained specialists who turn out what is required and make it work in predictable ways." Thus, economic progress tends to become depersonalized and automatized. Bureau and committee work tends to replace the individual action." The resulting extinction of the entrepreneur transform the social fabric of the "indivisible whole." "Economically and sociologically, directly and indirectly, the bourgeois...depends on the entrepreneur" for income and new recruits. Thus if capitalist evolution ceases or is automated the industrial bourgeois will disappear.

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145 CSD, 126.
146 CSD, 132.
147 CSD, 132.
148 CSD, 133.
149 CSD, 134.
At the same time, the bourgeois by gaining ascendancy has sowed the seeds of its own destruction. Schumpeter writes “I have called the bourgeois rationalist and unheroic. He can only use rationalist and unheroic means to defend his position or to bend a nation to his will.”

In fact, “the bourgeois class is ill equipped to face the problems, both domestic and international, that have normally to be faced by a country of any importance. Without protection by some non-bourgeois group, the bourgeoisie is politically helpless and unable not only to lead its nation but even to take care of its particular class interest. Which amounts to saying that it needs a master.”

In the past, feudal lords had been the bourgeoisie’s protector and master. However, “In breaking down the pre-capitalist framework of society, capitalism thus broke not only barriers that impeded its progress but also flying buttresses that prevented its collapse.”

Paralleling the death of the entrepreneurial function and the bourgeoisie’s loss of a protecting master, “the capitalist process pushes into the background all those institutions, the institutions of property and free contracting in particular, that expressed the needs and ways of the truly ‘private’ economic activity.” Schumpeter is referring to the death of the small producer and trader that occurred at the hands of big business. By replacing storeowners with shareholders, capitalist evolution diluted the bourgeoisie’s interest in its property.

“Dematerialized, defunctionalized and absentee ownership does not impress and call forth moral allegiance as the vital form of property did. Eventually there will be nobody left who really cares to stand for it....”

Chapter XIII: Growing Hostility

To summarize the proceeding chapters: “The capitalist process ... eventually decreases the importance of the function by which the capitalist class lives [the entrepreneur]...also...tends

150 CSD, 137.
151 CSD, 138.
152 CSD, 139.
153 CSD, 141.
154 CSD, 142.
to wear away protective strata, to break down its own defenses, to disperse the garrisons of its
entrenchment. And...capitalism creates a critical frame of mind which, after having destroyed
the moral authority of so many other institutions, in the end turns against its own....”

The increasingly focused critical attitude toward capitalism might dismay the industrialist. Certainly
he can make a case for the system, but “any pro-capitalist argument must rest on long-run
considerations. In the short run, it is profits and inefficiencies that dominate the picture. In order
to accept his lot, the leveler or the chartist of old would have had to comfort himself with hopes
for his great-grandchildren” (a stab at Keynes?).

Still, despite their discontent, “the mass of people never develops definite opinions on its
own initiative. Still less is it able to articulate them and to turn them into consistent attitudes and
actions.” This is the role of the intellectual. Ironically, “unlike any other type of society,
capitalism inevitably and by virtue of the very logic of its civilization creates, educates, and
subsidizes a vested interest in social unrest.” Capitalism makes its own critic in the
intellectual. Schumpeter seems unfavorably disposed to the intellectual: “Intellectuals are in fact
people wield the power of the spoken and the written word, and one of the touches that
distinguish them from other people who do the same is the absence of direct responsibility for
practical affairs.” Capitalism originates the intellectual as a “by-product of the capitalist
engine” through its emphasis on freedom of press and speech and by subsidizing in exchange for
their support in garnering public opinion. Thus, “any attack on the intellectuals must run up
against the private fortresses of bourgeois business which, or some of which, shelter the

155 CSD, 143.
156 CSD, 145.
157 CSD, 145.
158 CSD, 146.
159 CSD, 147.
160 CSD, 149.
Hence, "the unwillingness and the inability of the capitalist order to control its intellectual sector effectively." \(^{162}\)

Even the capitalist order's approach to education undermines its foundations. For example, "higher education ... may create a particularly important case of sectional unemployment" by biasing against "white collar" work. \(^{163}\) Also, "it may create unemployability of a particularly disconcerting type. The man who has gone through a college or university easily becomes psychically unemployable in manual occupations without necessarily acquiring employability in, say, professional work." \(^{164}\) In the end, institutions of higher education "swell the host of intellectuals in the strict sense of the term whose numbers hence increase disproportionately. They enter it in a thoroughly discontented frame of mind. Discontent breeds resentment." \(^{165}\) Eventually, "the role of the intellectual group consists primarily in stimulating, energizing, verbalizing and organizing this material [the discontent with the capitalist order] and only secondarily in adding to it." \(^{166}\)

Chapter XIV: Decomposition

"Faced with the increasing hostility of the environment and by the legislative, administrative and judicial practice born of that hostility, entrepreneurs and capitalists—in fact the whole stratum that accepts the bourgeois scheme of life—will eventually cease to function." \(^{167}\) One way the capitalist order decays is through the "Evaporation of the Substance of Property." As already discussed, the stockholder loses interest in what he owns: "his will to fight and to hold on is not and cannot be what it was with the man who knew ownership and its responsibilities in the fullblooded sense of those words." \(^{168}\) Even more important is "the

\(^{161}\) CSD, 150.
\(^{162}\) CSD, 151.
\(^{163}\) CSD, 152.
\(^{164}\) CSD, 152.
\(^{165}\) CSD, 153.
\(^{166}\) CSD, 153.
\(^{167}\) CSD, 156.
\(^{168}\) CSD, 156.
disintegration of the bourgeois family.” Due to “the rationalization of everything in life” by the capitalist engine, men and women, under rational utilitarian logic decide to have fewer children. In other words, “the capitalist process, by virtue of the psychic attitudes it creates, progressively dims the values of family life.” This decay of the family then precipitates “the Evaporation of Consumers’ Property.” For example, apartments replace homes as generally “the desirability of incomes beyond a certain level is reduced.” On the whole, “the typical bourgeois is rapidly losing faith in its own creed.” Finally, there is a “nationalization of industry” ending the entrepreneur, the capitalist and the bourgeois style of life.

PART TWO: SCHUMPETER’S DYNAMICS

Schumpeter’s works often seem ambiguous and stimulate confusion. Much of the complexity of his writing seems to originate in Schumpeter’s approach to economic analysis. Schumpeter was an expert economic historian and also possessed an appreciation for social sciences other than economics. This multi-disciplinary interest was especially unique during his time when other economists thought “cross-fertilization might easily result in cross-sterilization.” Interestingly Schumpeter even strove toward an “economic sociology.” Perhaps this diversity of interests manifested itself in Schumpeter’s ambiguous complexity.

Thinking in terms of the inductive-deductive dichotomy is interesting here. Economics professes to be deductive in its analysis. It uses foundational assumptions together with logic to deduce conclusions. On the other side is the inductive approach. Sociology is usually described as an inductive social science: it surveys empirical data to generalize to conclusions. Schumpeter seems to try to appreciate the shortcomings in each method of analysis. His works, especially

169 CSD, 157.
170 CSD, 157.
171 CSD, 158.
172 CSD, 159.
173 CSD, 161.
Capitalism, Socialism and Democracy, do not usually exhibit a great concern for explicitly stating assumptions and instead use a narrative to “tell the story,” in this case the story of the death of capitalism. On the other hand, Schumpeter also does not build his argument through a heavy dependence on observation. There is something of a logical progression, especially in The Theory of Economic Development, which builds theories to describe the scientific object of inquiry.

Schumpeter therefore seems to avoid a strictly deductive or inductive approach, hence his economic sociology. Inductive observation and generalization can culture a set of foundational assumptions. Deductive logic could then extend analysis beyond “what meets the eye.” Such an analysis inherently tends toward a hermeneutic knowledge, a circular loop of understanding that avoids the pretense of final answers to big questions. Schumpeter’s approach is especially interesting giving his intellectual context. Early twentieth-century Vienna seemed to culture this approach: hence Freud and Wittgenstein. Whether this permanence of complexity is “good” (the postmodern intellectuals) or “bad” (the objectivists) is irrelevant here. What matters is the ambiguity that obtains. Dealing with such complexity must be done on its own terms, through a hermeneutic approach that avoids final clarity.

Schumpeter’s complexity leads to a variety of interesting questions, especially in regards to potential contradictions. From these questions, I have chosen an interest in a specific aspect of Schumpeter’s methodology: his understanding and use of the concept “dynamics.” I believe Capitalism, Socialism and Democracy and The Theory of Economic Development present insight into Schumpeter’s position on “dynamics.” To begin the analysis, I restate Schumpeter’s specific references to dynamics.

(1) Because of this fundamental dependence of the economic aspect of things on everything else, it is not possible to explain economic change by previous economic conditions alone. For the economic state of a people does not

\[174\] CSD, 162.
emerge simply from the preceding economic conditions, but only from the preceding total situation.\textsuperscript{175}

(2) Improvement, according to this traditional view [Smith, Mill], is something which just happens and the effects of which we have to investigate, while we have nothing to say about its occurrence \textit{per se}. What is thereby passed over is the subject matter of this book.\textemdash J. B. Clark (\textit{Essentials of Economic Theory}), whose merit is in having consciously separated "static" and "dynamics," saw in the dynamic elements a disturbance of the static equilibrium. This is likewise our view, and also from our standpoint an essential task is to investigate the effect of this disturbance and the new equilibrium which then emerges. But while he confines himself to this and just like Mill sees therein the meaning of dynamics, we shall first of all give \textbf{a theory of these causes} of disturbances in so far as they are more than mere disturbances for us and in so far as it seems to us that essential economic phenomena depend upon their appearance... [Clark looked at two causes of disturbance, population and increases in capital] But the other two (changes in technique and in productive organization) require special analysis and evoke something different again from disturbances in the theoretical sense. This non-recognition of this is the most important single reason for what appears unsatisfactory in economic theory. From this insignificant-looking source flow, as we shall see, a new conception of the economic process...\textsuperscript{176}

(3) But "static" analysis is not only unable to predict the consequences of discontinuous changes in the traditional way of doing things; \textbf{it can neither explain the occurrence of such productive revolutions nor the phenomenon which accompany them.} It can only investigate the new equilibrium position after the changes have occurred. It is just this occurrence of the "revolutionary" change that is our problem, the problem of economic development in a very narrow and formal sense. The reason we have so stated the problem and turn aside from traditional theory lies not so much in the fact that economic changes, especially, if not solely, in the capitalist epoch, have actually occurred thus and not by continuous adaptation, but more in their fruitlessness.\textsuperscript{177}

(4) The problems of capital, credit, entrepreneurial profit, interest on capital, and crises (or business cycles) are the ones in which this fruitlessness [referred to in (3) above] will be demonstrated here.\textsuperscript{178}

(5) In the first edition of this book, I called it ["a treatment of this phenomenon [development] and the process incident to it"] "dynamics." But it is preferable to avoid this expression here, since it leads us astray because of the associations which attach themselves to its various meanings. Better, then, to say simply what we mean: economic life changes; it changes partly because of changes in the data, to which it tends to adapt itself. \textbf{But this is not the only kind of economic change; there is another which is not accounted for by influence on the data from without, but which arises from within the system....} what we are about to consider is that kind of

\textsuperscript{175} TED, 58.
\textsuperscript{176} TED, 59 (i)
\textsuperscript{177} TED, 62.
\textsuperscript{178} TED, 63 (i).
change arising from within the system which so displaces its equilibrium point that the new one cannot be reached from the old one by infinitesimal steps.

(6) Hence, our position may be characterized by three corresponding pairs of opposites. First, by the opposition of two real processes: the circular flow or the tendency towards equilibrium on the one hand, a change in the channels of economic routine or a spontaneous change in the economic data arising from within the system on the other. Secondly, by the opposition of two theoretical apparatuses: statics and dynamics. Thirdly, by the opposition of two types of conduct, which, following reality, we can picture as two types of individuals: mere managers and entrepreneurs.179

(7) [a footnote to above statement] The words “statics” and “dynamics” the author would not now use in the meaning they carry above, where they are simply short expressions for “theory of the circular flow” and “theory of development.”180

(8) The principle [that competitive industry tends to maximize output], as far as it can be proved at all, applies to a state of static equilibrium. Capitalist reality is first and last a process of change. In appraising the performance of competitive enterprise, the question whether it would or would not tend to maximize production in a perfectly equilibrated stationary condition of the economic process is hence almost, though not quite, irrelevant.181

(9) Dynamic analysis is the analysis of sequences of time. In explaining why a certain economic quantity, for instance price, is what we find it to be at a given moment, it takes into consideration not only the state of other economic quantities at the same moment, as static theory does, but also their state at preceding points of time, and the expectations about their future values. Now the first thing we discover in working out the propositions that thus relate quantities belonging to different points of time is the fact that, once equilibrium has been destroyed by some disturbance, the process of establishing one is not so sure and prompt and economical as the old theory of perfect competition made it out to be and the possibility that the very struggle for adjustment might lead such a system farther away from instead of nearer to a new equilibrium. This will happen in most cases unless the disturbance is small. In many cases, lagged adjustment is sufficient to produce this result.182

(10) It should be noted that the defining feature of dynamic theory has nothing to do with the nature of the economic reality to which it is applied. It is a general method of analysis rather than a study of a particular process.... To judge the functioning of perfect competition from the standpoint of capitalist evolution is therefore not the same thing as judging it from the standpoint of dynamic theory.183

179 TED, 82.
180 TED, 82 (i).
181 CSD, 77.
182 CSD, 103.
183 CSD, 104 (xxiv).
Already the complexity of Schumpeter's views is obvious. Schumpeter himself seems unclear on the exact meaning of “dynamics” as seen in (7), or at the least, he has changed his views after the first addition of *The Theory of Economic Development*. I think that Schumpeter may have harbored at least two understandings, perhaps interrelated, of the concept “dynamics”: there is dynamic analysis and dynamic process. (10) supports this dichotomy. “[D]ynamic theory [dynamic analysis] has nothing to do with the nature of economic reality to which it is applied. It is a general method of analysis rather than a study of a particular process.” Hence, “the standpoint of capitalist evolution [dynamic process] is therefore not the same thing” as “the standpoint of dynamic theory.” (1) also supports the dichotomy. In (9) Schumpeter restricted dynamic analysis to “economic” variables in the fashion of *The Theory of Economic Development* (recall “economic facts” versus “a non-economic bottom”). However, (1) does not restrict trying to explain economic change to economic conditions. Whatever explanation yield by an inclusion of the non-economic conditions would not comply with Schumpeter’s understanding of economic theory. The analysis of dynamic process thus would not be in the strictest sense “economic” and thus must be distinct from dynamic analysis.

Schumpeter seems to define explicitly dynamic analysis in (9) as “the analysis of sequences of time.” However, there is less clarity on the nature of a dynamic process: what is the meaning of “dynamic process”; why did Schumpeter feel compelled to make a distinction; what is not a dynamic process. (1) yields significant insight. Schumpeter generally is interested in the long run. *The Theory of Economic Development* deals with economic growth, while *Capitalism, Socialism and Democracy* deals with the transition from capitalism to socialism. Both works, but especially *Capitalism, Socialism and Democracy* deal with long run concerns and also non-economic topics, for example the bourgeois family, the critical intellectual, and the unheroic, rationalistic bourgeois mentality. These non-economic topics are absolutely essential to Schumpeter’s understanding of long-run capitalist evolution. I believe that it is this evolution of
the capitalist society, of great interest to Schumpeter as a sociologist and a historian, that constitutes Schumpeter's understanding of dynamic process. There is therefore a "dynamic process as a perspective" for Schumpeter.

This understanding of dynamic process coincides well with (8) and (10). Schumpeter is heavily focused on capitalist evolution, which is necessarily not entirely economic in nature. However, focusing on capitalist evolution causes a revaluation of the traditional conclusions of mainstream economics on topics like welfare maximization. From the standpoint of an interest in dynamic process, "Capitalist reality [which is more than just an economic reality] is first and last a process of change." And from this standpoint traditional interest in equilibrating mechanisms and perfect competition become "almost, though not quite, irrelevant." In fact, from this point of view, even restrictive practices take on a new meaning. Instead of being a cause of inefficiency and thus a social burden, restrictive practice, when viewed from the perspective of dynamic process, become essential, even virtuous. To repeat however, these revaluations rest on a point a view not completely economic in nature. Like dynamic analysis, dynamic process as a perspective looks at future and past periods, but unlike dynamic analysis also to non-economic variables.

The "dynamic process as perspective" yielded a unique understanding that diverges from mainstream economics. This difference grows out of the failure to appreciate the capitalist order as unending change. Since dynamic analysis also deals with time, perhaps it also yields unique results. In fact, according to Schumpeter in (4) the "correct" theories of capital, credit, entrepreneurial profit, interest on capital, and crises only obtain through a dynamic analysis. Schumpeter clearly defines dynamic analysis in (9) as "the analysis of sequences of time." However, Schumpeter seems to confuse "dynamic process as a perspective" and dynamic analysis throughout the work. This confusion may be the reason he dropped the earlier use of "dynamics" to parallel "theory of development." Yet Schumpeter continues to herald the
superiority of “dynamics” (dynamic analysis) over “statics” (general equilibrium theory).

Dynamic analysis, according to (2), will present a “theory of these causes of disturbances [of equilibrium].” According to (3), statics is “not only unable to predict the consequences of discontinuous changes in the traditional way of doing things; it can neither explain the occurrence of such productive revolutions nor the phenomenon which accompany them.” According to (5), “there is another [kind of economic change besides those caused by changes in data like consumer wants] which is not accounted for by influence of the data from without, but arises from within the system....what we are about to consider is that kind of change arising from within the system....” To summarize, dynamic analysis is superior to statics\(^{184}\) because, by including time as a variable, dynamic analysis is able to include other relevant economic phenomenon, which are within the economic system, that will eventually and inevitably\(^{185}\) cause the equilibrium to be disrupted. Time is of the essence. In statics, time is not included. Since the variables that cause disturbances in an equilibrium manifest themselves only occasionally, which is to say in the presence of time, statics is unable to see the resulting change, which does still occur from within. Statics can therefore not present a “theory of the causes of disturbances” of the equilibrium.

Schumpeter’s theory of the business cycle is a good example of the superiority of dynamic analysis in understanding a specific phenomenon. For Schumpeter, business cycles occur because of the swarm-like rush of entrepreneurial activity. This swarm-like avalanche occurs only occasionally. This is not to say that it originates from outside the system. The swarm is a product of the economic system. An entrepreneur originates.\(^{186}\) He removes the barriers to other entrepreneurs. They enter the economy and introduce new enterprises. The new business

\(^{184}\) At least for some phenomenon.  
\(^{185}\) “Inevitably” because capitalism is change.  
\(^{186}\) Schumpeter is unclear on the cause of the origin of the original entrepreneur. I believe it is safe to preserve his emergence as an endogenous variable since it is likely a function of interest rates, etc.  

*Business Cycles* addresses this theory of crises more closely.
activity accelerates economic activity. However, now the means of production rise in price, while old business die out. A recession results, allowing the prices of land and labor to stabilize. Eventually a swarm of entrepreneurs again grows out of the again favorably climate. Here, in the theory of the business cycle, all variables are endogenous, within the system, yet there is no equilibrium. Change occurs from within and continually. Dynamic analysis allows this perpetual change to be included into theory by including time-sensitive variables. Schumpeter’s other theories rely on variables that are also time sensitive and thus dependent on dynamic analysis.

**PART THREE: CONCLUSIONS**

I believe it useful to divide Schumpeter’s understanding of the concept “dynamics” into two standpoints: the perspective of dynamic process and the approach of dynamic analysis. Both yield insights into the economic system and the “indivisible whole” of society that mainstream economics do not. As we saw, “the perspective of dynamic process” allowed us to see how various aspects of the capitalist system fit into the big picture of capitalist evolution, the major dynamic process. By stepping back, the perspective led to a revaluation of many conclusions of mainstream economics. Most interestingly, the dynamic process as perspective revolutionized our view of big business and its monopoly power: “perfect competition is not only impossible but inferior, and has no title to being set up as a model of ideal efficiency.”

Even more interesting was the accomplishments of Schumpeter’s dynamic analysis. By recognizing that time was important to some economic actors and agents—in other words, they must age like wine to be important—Schumpeter’s dynamic analysis revealed a “theory of the causes of disturbances” in the equilibrium. This new theory allowed us a greater understanding of the dynamic functioning of capitalism that culminated in a theory of business cycles radically divergent from mainstream economics.

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187 CSD, 106.
I think we might also look at Schumpeter's dynamic analysis to further "endogenize" the economic understanding. The relevance of time to each economic actor and process is complicated and the focus of Schumpeter’s _Business Cycles_. However, I believe we could imagine time, more accurately the periodic nature of the influence of time, as an expression of the interaction of other economic variables. This allows us to avoid randomness as the exogenous variable that can never be removed. In thinking of time this way, we can further approximate the dynamic functioning of the economy, which is best characterized as never-ending change, and thus advance the economics as a social science.\(^{188}\)

\(^{188}\) A particularly interesting thrust toward endogenization would be the dynamic analysis of changes in consumer wants. Schumpeter leaves these changes in data largely to the realm of the unimportant. However, changes on the demand side also occur completely within the system. Schumpeter himself writes that many changes in consumer wants occur through the influence of the entrepreneur who "educates" the consumer demands. Still, many changes in demand that seem random, for example the various consumer fetishes like the latest clothing fashions. I believe these also can be endogenized through dynamic analysis.