PART 3.4

Dynamics of Capitalism (II):

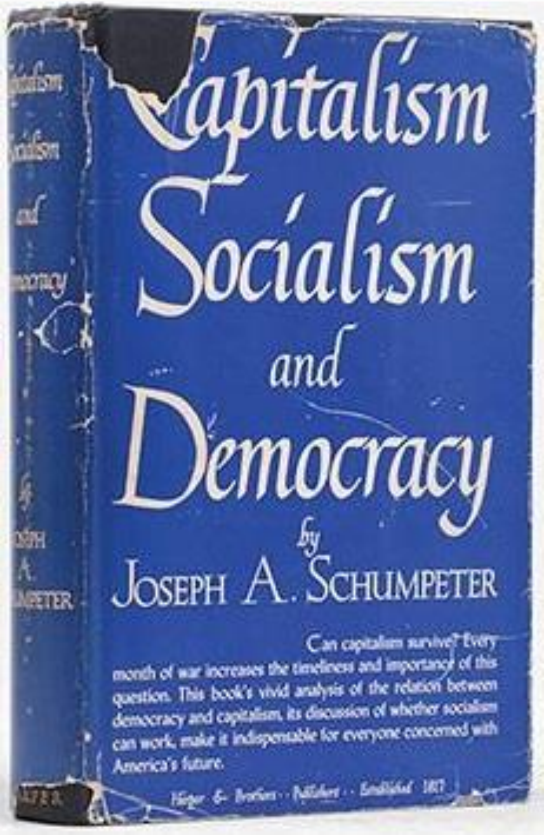
Schumpeter & Creative Destruction

JOSEPH A. SCHUMPETER

Joseph A. Schumpeter
(1883-1950)

- Born and educated in Austria.
- Schumpeter began his career studying law at the University of Vienna, taking his PhD in 1906.
- In 1909, after some study trips, he became a professor of economics and government at the University of Czernowitz. In 1911, he joined the University of Graz, where he remained until World War I
- In 1919, Schumpeter became Minister of Finance in Austria, presiding over the hyperinflation of the period, and was dismissed later that year.
- He returned in 1921 to the private sector and became the president of a small Viennese bank, which collapsed in 1924.

JOSEPH A. SCHUMPETER



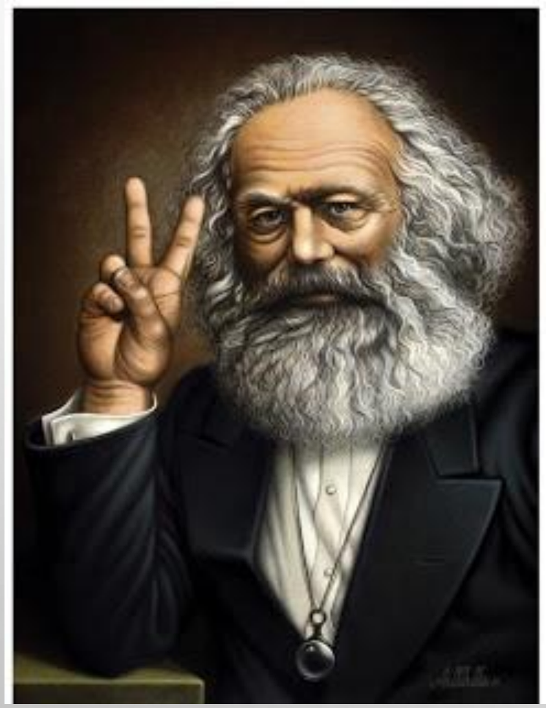
- He emigrated to the United States in 1932, and became professor at Harvard.
- Schumpeter also became known for his opposition to Marxism and socialism that he thought would lead to dictatorship
- His theory replaced Marx's view of greed-driven capitalism with dynamic, innovative entrepreneurship, clearly differentiating the capitalist from the entrepreneur.
- He published several books, but *Capitalism, Socialism, and Democracy* (1942) stands out.

MARX'S CREATIVE DESTRUCTION

Hudist god Shiva is simultaneously destroyer and creator

- When Schumpeter's visionary *Theory of Economic Development* (1912) was published, classical and neoclassical thought as well as Marx's *Das Kapital* had already been exposed to scholarly scrutiny by the learned community for some time.
- In Marxist economic theory the concept refers more broadly to the linked processes of the accumulation and annihilation of wealth under capitalism.
- In The Communist Manifesto of 1848, Karl Marx and Friedrich Engels described the crisis tendencies of capitalism in terms of "the enforced destruction of a mass of productive forces“
- Marx establishes a necessary link between the generative or creative forces of production in capitalism and the destruction of capital value as one of the key ways in which capitalism attempts to overcome its internal contradictions

MARX'S CREATIVE DESTRUCTION



- Modern bourgeois society, with its relations of production, of exchange and of property, a society that has conjured up such gigantic means of production and of exchange, is like the sorcerer who is no longer able to control the powers of the nether world whom he has called up by his spells.
- The epidemic of **over-production**: how does the bourgeoisie get over these crises?
- On the one hand by enforced destruction of a mass of productive forces; on the other, by the conquest of new markets, and by the more thorough exploitation of the old ones.
- That is to say, by paving the way for more extensive and more destructive crises, and by diminishing the means whereby crises are prevented.

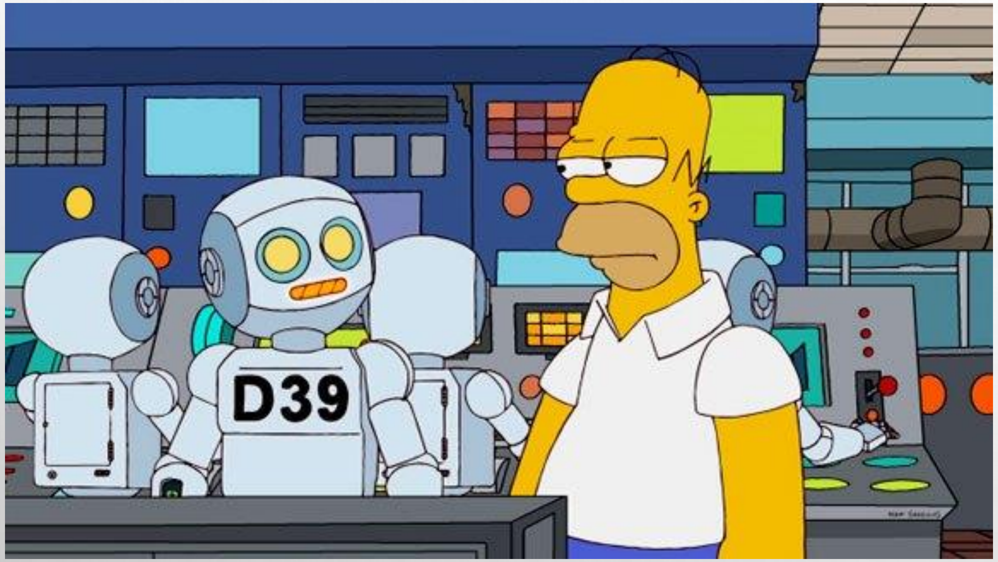
MARX'S CREATIVE DESTRUCTION

- The destruction of **exchange value** combined with the preservation of **use value** presents clear opportunities for new capital investment and hence for the repetition of the production-devaluation cycle.
- The destruction of capital through crises means the depreciation of values which prevents them from later renewing their reproduction process as capital on the same scale.
- This is the ruinous effect of the fall in the prices of commodities. It does not cause the destruction of any use-values. What one loses, the other gains.
- Society suddenly finds itself put back into a state of momentary barbarism; it appears as if a famine, a universal war of devastation, had cut off the supply of every means of subsistence; industry and commerce seem to be destroyed.

MARX'S CREATIVE DESTRUCTION

- Values used as capital are prevented from acting again as capital in the hands of the same person. The old capitalists go bankrupt. [...]
- A large part of the nominal capital of the society, i.e., of the exchange-value of the existing capital, is once for all destroyed, although this very destruction, since it does not affect the use-value, may very much expedite the new reproduction.
- This is also the period during which moneyed interest enriches itself at the cost of industrial interest.

SCHUMPETER'S CREATIVE DESTRUCTION



- Joseph Schumpeter developed the concept out of a careful reading of Marx's thought, arguing that the creative-destructive forces unleashed by capitalism would eventually lead to its demise as a system.
- According to Schumpeter, the "gale of creative destruction" describes the "process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one".
- The key to an analysis of capitalism, which Schumpeter understood as being inseparable from the existence of constant change, was to comprehend how it destroyed and, at the same time, recreated itself.

SCHUMPETER'S CREATIVE DESTRUCTION

- Capitalism [...] is by nature a form or method of economic change and not only never is but never can be stationary.
- [...] The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.
- The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one.
- This process of **Creative Destruction** is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in.

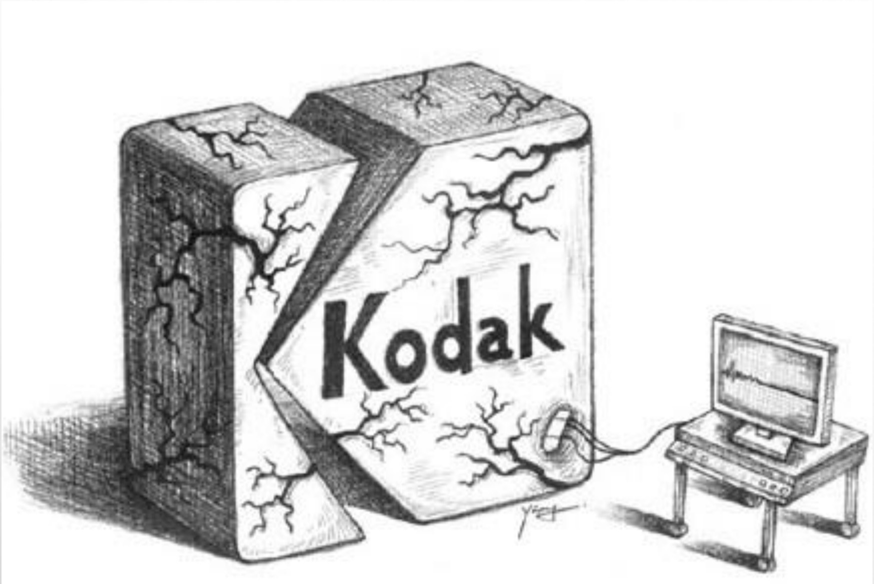
SCHUMPETER'S CREATIVE DESTRUCTION

- In Schumpeter's vision of capitalism, innovative entry by entrepreneurs was the disruptive force that sustained economic growth, even as it destroyed the value of established companies and laborers that enjoyed some degree of monopoly power derived from previous technological, organizational, regulatory, and economic paradigms
- However, Schumpeter was pessimistic about the sustainability of this process, seeing it as leading eventually to the undermining of capitalism's own institutional framework
- 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.
- That process, impressive in its relentless necessity, was not merely a matter of removing institutional deadwood, but of removing partners of the capitalist stratum, symbiosis with whom was an essential element of the capitalist schema.

SCHUMPETER'SCREATIVE DESTRUCTION

- "The railroadization of the Middle West as it was initiated by the Illinois Central."
- He wrote, "The Illinois Central not only meant very good business whilst it was built and whilst new cities were built around it and land was cultivated, but it spelled the death sentence for the [old] agriculture of the West.".

SCHUMPETER'SCREATIVE DESTRUCTION



- Companies that once revolutionized and dominated new industries – for example, Xerox in copiers or Polaroid in instant photography – have seen their profits fall and their dominance vanish as rivals launched improved designs or cut manufacturing costs. In technology, the cassette tape replaced the 8-track, only to be replaced in turn by the compact disc, which was undercut by downloads to MP3 players, which is now being usurped by web-based streaming services.
- Companies which made money out of technology which becomes obsolete do not necessarily adapt well to the business environment created by the new technologies.

SCHUMPETER'SCREATIVE DESTRUCTION

- Creative destruction is a powerful economic concept because it can explain many of the dynamics or kinetics of industrial change: the transition from a competitive to a monopolistic market, and back again.
- It has been the inspiration of endogenous growth theory and also of evolutionary economics.

SCHUMPETER'SCREATIVE DESTRUCTION

- Successful **innovation** is normally a source of temporary market power, eroding the profits and position of old firms, yet ultimately succumbing to the pressure of new inventions commercialized by competing entrants.
- Schumpeter identified innovation as the critical dimension of **economic change**.
- He argued that economic change revolves around **innovation, entrepreneurial activities, and market power**.
- He sought to prove that innovation-originated market power can provide better results than the invisible hand and price competition.
- He argues that technological innovation often creates temporary monopolies, allowing abnormal profits that would soon be competed away by rivals and imitators.
- These temporary monopolies were necessary to provide the incentive for firms to develop new products and processes.

SCHUMPETER'SCREATIVE DESTRUCTION

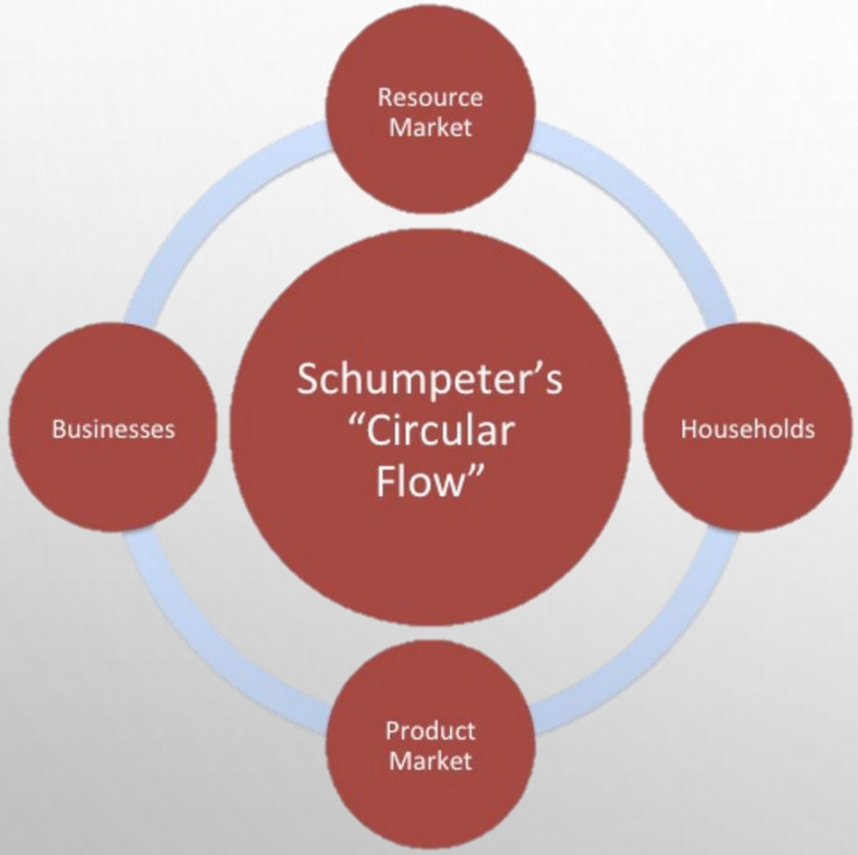
- While Marx clearly admired capitalism's creativity he [...] strongly emphasized its self-destructiveness.
- The Schumpeterians have all along gloried in capitalism's endless creativity while treating the destructiveness as mostly a matter of the normal costs of doing business".
- The creation of something new usually requires that something old be eliminated, for example, changes in the structure of demand or production result in structural unemployment.

https://www.youtube.com/watch?v=uosKhQGewoE

ECONOMIC DYNAMICS

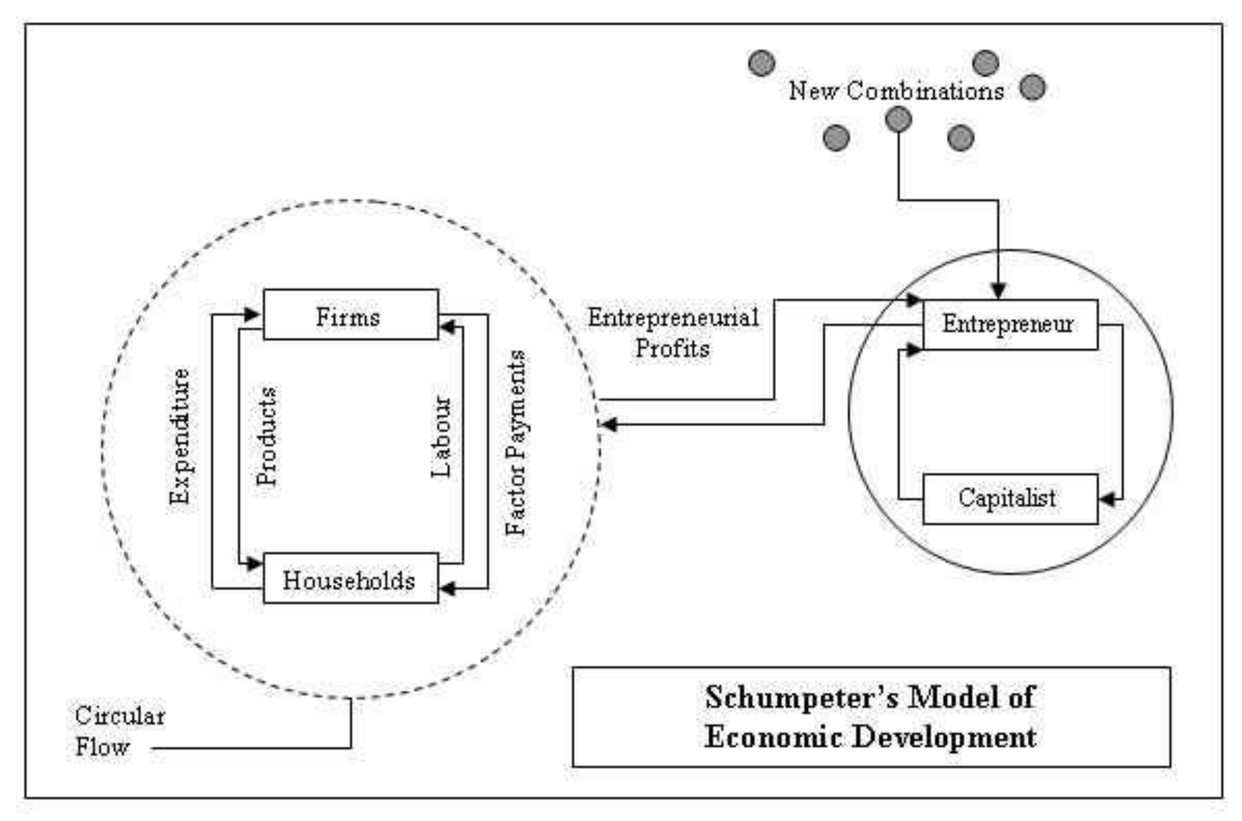
- "Economic life never is static; it lies in the very nature of development." The question thus arises: Who is "carrying out"?
- Schumpeter's straightforward answer to that is that the **entrepreneur**.
- The essence of capitalist dynamics, in Schumpeter's view, thus boils down to a continuous pursuit of carrying out new combinations as an **entrepreneurially driven process**

ECONOMIC DYNAMICS



- The circular flow of economic life is essentially a perfectly static model of the economic system, stripped of all its dynamic elements.
- While this does not preclude growth founded on population increases, changes in consumer tastes, etc. - or, in other words, all change that can be continuously absorbed - it does exclude all discontinuous development.
- All economic action in the circular flow is repetitive and based on prior experience.
- As in all theories of stationary equilibrium, the aggregate quantities of supply and demand, expenditures and receipts, tend toward equality

ECONOMIC DYNAMICS



- The circular flow was not intended in any way as an explanation of capitalist reality.
- It was rather an abstract construction utilized for the purpose of highlighting some very real aspects of the economic process.
- Schumpeter arrived at his model of the circular flow by elimination of the entrepreneur, the source of all development.

ECONOMIC DYNAMICS

- Entrepreneur who initiates the process of innovation is the central of the process of economic development.
- Entrepreneurs are neither capitalists nor inventors; they see the potential of inventions and assume risk in innovating.
- The basic driving force behind structural economic growth is the introduction of **new combinations** of materials and forces, not the creation of new possibilities.
- This concept covers the following five cases:

  (i) The introduction of a new good – that is one with which consumers are not yet familiar – or a new quality of a good.

  (ii) The introduction of a new method of production – that is one not yet tested.

  (iii) The opening of a new market – that is a market into which the country in question has not previously entered.

  (iv) The conquest of a new source of supply of raw materials or half-manufactured goods.

  (v) The carrying out of the new organization of any industry, like the breaking up of a monopoly position.

ECONOMIC DYNAMICS

- Economic evolution is based on cyclical disruptions and breaks of economic structures, an endogenous transformation that results from the ‘process of creative destruction’ as an essential feature of modern capitalism.
- This points at the internal logic of the cyclical restructuring of modern capitalism for evolutionary change.
- An evolutionary theory is:
- **Dynamic** — such that the dynamics of the processes, or some of their parts, can be represented;
- **Historical** — in that it deals with historical processes which are irrevocable and path-dependent;
- **Self-transformation** — in that it includes hypotheses relating to the source and driving force of the self-transformation of the system.

SOCIALISM

- Thus, the progressive development of rationalization, the levelling of social barriers, democratization, etc., all serve to reduce the importance of leadership in the economy.
- As the economic process is rationalized, however, innovation itself becomes liable to such rational calculation and it becomes increasingly difficult for the individual entrepreneur to stay ahead of the game.
- It becomes more and more difficult for the individual entrepreneur to find the investment channels in which "he" can receive an adequate return on "his" investment.

CAPITALSIM

- Can Capitalism Survive?

- Schumpeter answers "no" .

- But he says, “If a doctor predicts that his patient will die presently,” he wrote, “this does not mean that he desires it.”

- Schumpeter, as he himself stated, agreed with "the Marxian proposition that the economic process tends to socialize itself - and also the human soul

CAPITALISM

- Schumpeter agrees with Karl Marx that capitalism will collapse and be replaced by socialism. He predicts a different way this will come about.
- Marx predicted that capitalism would be overthrown by a violent proletarian revolution, which actually occurred in the least capitalist countries
- Schumpeter believed that capitalism would gradually weaken by itself and eventually collapse.
- The success of capitalism would lead to **corporatism** and to values hostile to capitalism, especially among **intellectuals**.
- Entrepreneurial capitalism evolves through its own logic into "fettered" capitalism, or in other words, capitalism as its manifests itself in the "trustified" stage in which big business dominates.

CAPITALISM

capitalist civilization is rationalist and "anti-heroic." The two go together of course. Success in industry and commerce requires a lot of stamina, yet industrial and commercial activity is essentially unheroic in the knight's sense — no flourishing of swords about it, not much physical prowess, no chance to gallop the armoured horse into the enemy, preferably a heretic or a heathen — and the ideology that glorifies the idea of fighting for fighting's sake and of victory for victory's sake understandably withers in the office among all the columns and figures.[33]

- Consequently, in line with the socialization process, entrepreneurial activity increasingly falls into the hands of big business and government. The entrepreneur is replaced by the bureaucratic manager.
- In his view, the ideology of accumulation for accumulation's sake is obviously less effective than the warrior ideology.

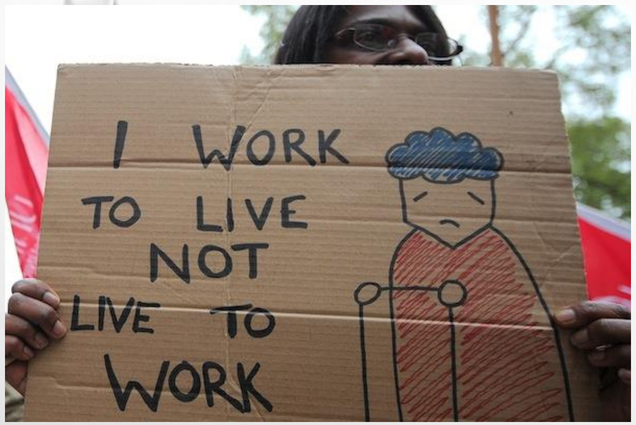
CAPITALISM

- The rationalization of everything in life also results in the breaking up of the family and of the home as an institution at the base of society.
- All of this gives the incentive not to procreate, and capitalist society also, Schumpeter points out, provides increasingly effective means of prevention

CAPITALISM

- Capitalism, by its very nature, creates a social group with a vested interest in social criticism (i.e., the intellectuals).
- **"Intellectuals"** are a social class in a position to critique societal matters for which they are not directly responsible and to stand up for the interests of other classes.
- Intellectuals tend to have a negative outlook of capitalism, even while relying on it for prestige, because their professions rely on antagonism toward it.
- The growing number of people with higher education is a great advantage of capitalism, according to Schumpeter.
- Yet, unemployment and a lack of fulfilling work will cause intellectual critique, discontent and protests.
- The intellectual will develop critical ideas against free markets and private property, even though these institutions are necessary for their existence.

CAPITALISM



- Parliaments will increasingly elect **social democratic parties**, and democratic majorities will vote for restrictions on entrepreneurship.
- Increasing workers' self-management, industrial democracy and regulatory institutions would evolve non-politically into **"liberal capitalism"**.
- Thus, the intellectual and social climate needed for thriving entrepreneurship will be replaced by some form of **"laborism"**.
- This will restrict "creative destruction" and so will burden and destroy the capitalist structure.
- Schumpeter noted that increases of taxes, public policies favoring labour organisations, price controls, and licensing requirements that increase the costs of doing business are the greatest impediments to entrepreneurship.
- Under oppressive conditions, for example, the former Soviet Union, China, and present day Islamic societies, very few people innovate.

SOCIALISM??

- There will not be a revolution, but merely a trend for social democratic parties to be elected to parliaments as part of the democratic process.
- He argued that capitalism's collapse from within will come about as majorities vote for the creation of a welfare state and place restrictions upon entrepreneurship that will burden and eventually destroy the capitalist structure.
- In Schumpeter's view, socialism will ensure that the production of goods and services is directed towards meeting the 'authentic needs' of the people
- It will overcome some innate tendencies of capitalism such as conjecture fluctuation, unemployment, etc.