JOSEPH SCHUMPETER AND THE BUSINESS CYCLE: AN HISTORICAL SYNTHESIS.

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In this essay, Simon Mee examines the contribution of one of the 20th century's most underappreciated economists, Joseph Schumpeter. Through a mixture of humorous anecdotes from his eccentric life to a more sober analysis of his contribution to business cycle theory, a picture develops of a flawed man, both personally and academically. The author uses Keynes, Schumpeter's contemporary, throughout to demonstrate the futility and frustration that clearly haunted the man, but also shows a determination to give him his rightful place in the history of economic thought.

Introduction

"Capitalism is a form or method of economic change and, not only never is, but never can be, stationary."[1]

A telling anecdote occurred during a seminar in Harvard organised by Joseph Schumpeter's students in 1939. It was arranged with Schumpeter so they could discuss and debate his monumental two-volume work, *Business Cycles*, which had recently been published (McCraw, 2007). During the seminar, however, it quickly transpired that nobody had actually read the text. One of the students later recalled that 'in the discussion everyone talked about Keynes, whose *General Theory* had recently appeared, and not about Schumpeter's work'. Afterwards, several students said that they had never before seen Schumpeter as furious as he had been on that occasion. At the end of the seminar he said to them, 'whether you agree or disagree is up to you, but I wish you would have at least read it' (ibid.: 271).

This story serves as a useful analogy for the work of Schumpeter, a man still thought of as one of the greatest economists of the 20th century, commonly bracketed with such giants as Keynes, Hayek and Friedman (Skidelsky, 2007), but whose work has failed to gain the recognition it deserves. While he is best known for his theory of 'creative destruction' – the idea that the capitalist system progresses by constantly revolutionising its economic structure – Schumpeter was one of the most brilliant and original of the five Continental writers who originated nearly all of the basic ideas in modern business cycle theory (Hansen, 1951).

This paper will assess the viability of Schumpeter's business cycle theory. It will first offer a brief biography of the man and the formation of his thought. Secondly, this paper will offer a critical analysis of his theory and highlight the importance of history throughout his work. In conclusion, it will find that, while his seminal vision was never in doubt, its eventual failure came by means of the underlying gap that lay between this vision and the construction of his theory.

Joseph Schumpeter and history

'Read no history: nothing but biography, for that is life without theory.' – Benjamin Disraeli

Joseph Alois Schumpeter was a compelling character. Born in 1883, the year Karl Marx died, his family origins were solid Catholic bourgeoisie in Moravia, now part of the Czech Republic. In his student days, he cut a reputation as a brilliant *enfant terrible* of the Austrian school, and this spark never left him. In his later years, Schumpeter was a man who would often comment that his three youthful ambitions were to

[1] Joseph Schumpeter, quoted in (Schumpeter, 1987: 82).

become the greatest lover in Vienna, the greatest horseman in Austria, and the greatest economist in the world. Alas, he would then say, he had only achieved two of them.[2]

As McCraw (2007) observes, Schumpeter would reinvent himself over the years, thinking not of the past but how he might move forward. In this sense, he was well suited to grasp the mindset of the entrepreneur. Schumpeter realised that one's identity in a rapidly changing world might come more from innovation than inheritance; this is all the more evident when one looks at his eventful life. Though many years were dedicated to academic endeavour, there were forays into many other fields. Schumpeter practised law in Cairo, managed the finances of an Egyptian princess, briefly became Minister of Finance in Austria's first Republican government in 1919, and attempted a career in banking. Thereafter, he retired to academic life for good, and eventually settled at Harvard in 1932 (Samuelson, 1951). Skidelsky (2007) even argues that the theme of creative destruction appears against the background of Schumpeter's own family uprooting, the dissolution of the Austrian empire and the turmoil of the interwar years. These biographical details are important as they allow us to understand why, when faced with certain social and economic phenomena, Schumpeter's mind was more easily disposed to accept some hypotheses rather than others.

Schumpeter wanted to create an 'exact' economics. While he acknowledged that the 'childhood of every science is characterised by the prevalence of 'schools', bodies of men, that is, who swear by bodies of doctrine, which differ *toto cælo* from each other', Schumpeter hoped that economics could one day be 'confined within clear-cut questions of fact and analytic machinery, and capable of being settled by exact proof' (1927: 286). In all of his work, whether in books or articles, he took a fundamentally historical approach. For Schumpeter, economics was a unique process in historic time; in *History of Economic Analysis*, he would assert that of the three basic building blocks of economics - theory, statistics, and history – the last 'is by far the most important' (1981: 12-13).

Schumpeter was wont to observe that the whole of a man's intellectual work is usually foreshadowed by what he had done by the age of thirty (Haberler, 1951). So it was no surprise that his first major work, *The Theory of Economic Development*, was published in 1912 when Schumpeter was twenty-nine. It was a path-breaking study of the process of economic change - as opposed to standard economic analysis based on static assumptions. He longed for a dynamic analysis free from the straitjacket of comparative statistics. When Schumpeter observed the capitalist process, it was the speed of the transformation, and the extent of the ensuing dislocation, which led him to reject the static equilibrium models of British economics, derived from a society where economic change was evolutionary and institutions were rather stable (Skidelsky, 2007). With the above in consideration, it is now necessary to turn to Schumpeter's business cycle theory.

The business cycle

'Cycles are not, like tonsils, separable things that might be treated by themselves, but are, like the beat of a heart, of the essence of the organism that displays them.'[3]

The static and dynamic: giving credit where it is due

Schumpeter starts his analysis from a stable equilibrium, but his aim is to identify the economic factors emanating from within the economy that destroy this existing equilibrium and lead to evolution. These real economic processes can be divided into two different and in practise clearly discernable classes: static and dynamic. Schumpeter (1983: 145) presents these two processes as the distinction between the 'circular flow' and 'development'. The latter constitutes the pure economic evolution: those changes in the economy that arise from itself. From here on, it is perhaps best to view the circular flow condition as a special case of the dynamic movement. In the circular flow, Schumpeter (1912) believes that there is a constant tendency towards an equilibrium (an assumption Keynes would no doubt disagree with) which, under competitive capitalism, tends to keep available capital and labour in optimal allocation. Thus, equilibrium describes the *absorption* of change, while development accounts for the *nature* of change.

[2] Only the decline of the Austrian cavalry, he claimed, had thwarted the fulfilment of all three.
[3] Joseph Schumpeter, quoted in (Joseph Schumpeter, 1939: v).

The departure from the static economy is made possible by introducing a more complex concept of money, and in Schumpeter's theory this takes the form of credit. Schumpeter notes that 'money has, in the circular flow, no other role than that of facilitating the circulation of commodities' (1983: 53). Since credit supplied by banks depends crucially on entrepreneurial demand, Schumpeter regards the money supply not as an independent variable, but as one that varies endogenously in response to entrepreneurial action. The money borrowed from the banks provides the innovator with the funds to employ the factors of production required to set up his business. Given the initial assumption of full factor employment, these factors will have to be diverted away from old businesses. The economy thus becomes dynamic in that disequilibria and fluctuations are now possible.

The ebb and flow of innovation

In his interpretation of capitalism, it is the entrepreneur who innovates and applies new combinations of factors of production (Heertje, 2008). These innovations are usually introduced by new men rather than old and by new firms rather than by those who already occupied prominent niches in the circular flow. For Schumpeter, the entrepreneur is no ordinary businessman; rather, he seeks his profits outside the convention-bound circular flow by introducing new products and production techniques.[4] In order to innovate, the entrepreneur must 'raid' the circular flow and divert labour to his novel uses. Because resources are already optimally allocated in equilibrium, this 'raiding' of the circular flow by the entrepreneur also explains the instability of industrial capitalism. As a result, 'the history of capitalism is studded with violent bursts and catastrophes' (1939: 100-102).[5]

Schumpeter defines innovation as the setting up of a new production function, to denote the application of new ideas to the production process. The "perennial gale of creative destruction," whereby new products and processes displace old ones, is far more important than price competition among existing firms and products. Indeed, the problem was not "how capitalism administers existing structures," but how it "creates and destroys them" (ibid.). Interestingly, innovational activity tends to come in 'clusters' or 'bunches'. This is an endogenous process; the action of the first entrepreneur will be followed by a herd-like swarm of imitations. While Schumpeter may not refer to Keynes' 'animal spirits', he saw a dynamic society that was 'constantly being drawn away from neighbourhoods of equilibrium by reason of the pioneering activities of daring innovators whose lightning successes entice a swarm of imitators into a wild outpouring of new investment activity' (Hansen, 1951: 130).

Thus, business cycles are recurrent fluctuations in the rate at which innovations are introduced into the economy. However, this implies that the business cycle is a discontinuous process. Beneath the rate of innovation, the intensity of entrepreneurial endeavour, and the bunching of innovations, lays the *distribution* of entrepreneurial ability. This ability to dare and to initiate, to overcome obstacles to innovations is, like many other abilities, endowed to the pioneering few, suggesting that Schumpeter saw the discontinuous endogenous change erupting from the supply side, and not the demand side. Innovation wells up in a great tidal wave and then recedes. This 'wave-like movement' occurred because, as new processes are introduced, real time must elapse before they either reduce costs or generate new goods (ibid.: 131).

The cycles of economic life: the three-cycle schema

Schumpeter's theory of the business cycle comprises three successive approximations to reality. The first approximation - also known as the primary model - has two phases: prosperity, which is a movement away from, and recession, which is a movement towards, a new equilibrium. The second approximation - conditions under which entrepreneurial activity takes place in reality - are also be considered. Factors such as errors of forecast, speculative tendencies of individuals, peculiarities of economic institutions, are all likely to prolong and exaggerate a movement in the business cycle.

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[4] Whereas the average businessman, who seeks his profits within the existing structure, will earn a profit as small as his risk.

[5] Schumpeter emphasised that the destructive part of creative destruction has always been quite real. Those whose interests are being destroyed will, understandably, fight hard to preserve their culture and status.

For our purposes, however, we are interested in the third approximation. Schumpeter uses a three-cycle schema in an attempt to synthesise his business cycle theory with the nature of history itself. In order to account for cycles that can be observed historically and statistically from the late 1700s onwards, Schumpeter distinguishes three types of cycles: long waves of about fifty years in duration (Kondratieffs); intermediate waves of about nine to ten years in duration (Juglars); and short waves of about forty months in duration (Kitchins).[6] It is important to note that Schumpeter lays no theoretical claim for the third approximation; rather it serves primarily as a descriptive device, a method of interpreting an observed reality (1939: 174). Schumpeter writes, 'Each Kondratieff should contain an integral number of Juglars and each Juglar an integral number of Kitchins' (1939: 172).[7] The key to a Kondratieff is not a cyclical movement in the absolute level of aggregate output, but instead a large scale clustering or sequence of innovations, the appearance and absorption of which require half a century or more.

An historical synthesis

Having laid out Schumpeter's basic model of capitalist behaviour, it is now fitting to bring his theory together with an historical example. The core of *Business Cycles* is its copious detail about the flowering of business systems in Britain, Germany and especially the United States. While the Industrial Revolution might seem obvious, another prime example of innovation and the business cycle was the 'railroadization' of the United States, which thrived in the late 1800s (1939: 291-292). The more railroads that were built, the cheaper and faster transport became. A unified domestic market soon arose for an unprecedented variety of industrial products and consumer goods. In addition, as railroads cost huge sums of money and took lengthy periods of time to build, entrepreneurs of the railroad industry needed more capital than their own funds and revenues from their business could allow. Thus, construction was 'mainly financed by credit creation' (1939: 328-330). Meanwhile, the vast array of construction programs undertaken by railroads stimulated a host of other industries; railroads vastly increased the use of coal, steel, machinery and fuel. Across the country, railroads created new communities such as Chicago, Denver and thousands of other small towns (McCraw, 2007). For Schumpeter, the pattern of railroad finance exemplified for investors the tumultuous business cycles typical of capitalist economies. The ups and downs of railroading had made it clear that the process of 'liquidation, absorption, adaptation' was going to be 'an unusually long and painful affair' (ibid: 328-330). 'Railroadization,' then, was Schumpeter's 'standard example by which to illustrate the working of our model' (ibid: 303-304), and neatly demonstrates the ebb and flow of innovation.

All tidal waves recede: the gap between Schumpeter's vision and theory and the dawn of Keynesian economics

Business Cycles has outstanding merits as economic and business history, but judged by Schumpeter's aim of explaining complex cyclical patterns, the book was not a success, and its tepid reception disappointed him bitterly. There were several reasons for this turn of events. Throughout *Business Cycles*, it cannot be said that Schumpeter confined himself to 'clear-cut questions of fact and analytic machinery' (1927: 286). He took many liberties in constructing his cycles, such as adjusting his numerical data to reflect outside events. If a war or a natural disaster had interrupted a period's prosperity, he still counted that period as part of a prosperous cycle. As McCraw (2007) notes, this alteration, while logical, was a slippery slope leading away from exactitude. Schumpeter's inability to put his ideas about the development of economic life into a mathematical form further hindered his analysis, and as a consequence, his entrepreneurial insights have seldom been embraced by academic economists. Unlike the idea of equilibrium, the phenomenon of entrepreneurship is almost impossible to model through the use of equations yielding mathematical proof.

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[6] Clement Juglar, Joseph Kitchin, and Nikolai Kondratieff were prominent business cycle theorists.

[7] Schumpeter dates the first long-wave Kondratieff from the 1780s to 1842, the second from 1842 to 1897, and the third from 1898 to the end of the 1930s. The first of these waves he associates with the Industrial Revolution, the second, with 'railroadization', the third, with a broader set of innovations in the chemical, electric power, and automobile industries.

Furthermore, Schumpeter's relation between the distribution of entrepreneurial ability and the bunching of innovations is tenuous. He merely asserted rather than explained the cumulative nature of innovation. What precisely is the necessary connection between scarcity at any given time of entrepreneurial talent and the bunching of innovations? Schumpeter failed to describe the succession of events insofar as he does not provide a detailed analysis of the mechanisms that link the scarcity of entrepreneurial talent to the 'swarm-like' appearance of imitators and to the diffusion of innovations at any given point in time (Kuznets, 1940).

There was another reason for the disappointing reception of Schumpeter's theory. *Business Cycles* happened to appear soon after Keynes's landmark *General Theory*, at a time when most economists' minds were focused on the more immediately relevant issues raised by the Great Depression. A capitalist to the last, Schumpeter often stressed that the long term material gain capitalism offered outweighed any short term cost of inequality and turbulence. After the 1930s, however, people were far more receptive to Keynes's oft-quoted dictum that 'in the long run, we're all dead'.[8] In contrast to *Business Cycles*, Keynes's *General Theory* offered a new explanation for the Great Depression and prescribed a way in which the world economy might be rescued. Furthermore, in Keynesian and other macroeconomic models, individual entrepreneurs, companies, and industries simply vanish from the scene. No mention of a single business firm can be found in the entire work of *General Theory*; instead, Keynes took a path directly opposite from Schumpeter's and proceeded from a top-down view based on government policies (McCraw, 2007). It is somewhat ironic that, writing in 1931, Keynes described himself as a Cassandra whose 'croakings could never influence the course of events in time' – a statement which Schumpeter could, more accurately, have made about himself at any time.[9]

Conclusion

Thus, it is here we must return to the seminar room in Harvard in 1939. Schumpeter's furious reaction is all the more understandable when placed in its context. Despite his seminal contribution to economics, the theorist of innovation and creative destruction failed to bridge the obvious gap between his theory and vision of the capitalist process. Instead, he found himself swimming against the tide of academic opinion at the dawn of the Keynesian age. Yearning for an 'exact' economics, Schumpeter instead found himself at the mercy of a profession still characterised by the prevalence of 'schools' of men, who swore by their bodies of doctrine. Ironically, for all the emphasis Schumpeter placed on historical analysis, it is somewhat poignant that his theory, flaws notwithstanding, should fall victim to the events of history itself.

Schumpeter's two greatest insights were that innovation was the driving force of not only capitalism but also of economic progress in general, and that entrepreneurs were the agents of innovation. Sometimes, as in *Business Cycles*, the combination did not work so well, where Schumpeter tried to embed his central message about the dynamics of capitalism within a plausible, though admittedly troubled, framework. However, he provided a tentative answer to the question of how to integrate innovation with the study of business cycles. In 1936, Keynes wrote, 'Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slave of some defunct economist.' While in 2009 there is no defunct economist more prominent than Keynes himself, this paper hopes the reader will consider the fragments of wisdom offered by Schumpeter, a Cassandra whose croakings could never influence the course of events in time.

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[8] The American economist Robert L. Heilbroner recalls his days in the classroom as a Harvard student during the Great Depression: 'Schumpeter arrived in his famous riding habit and great cloak, of which he divested himself in a grand gesture. He greeted us in a typically Schumpeterian way: 'Gentlemen, a depression is for capitalism like a good, cold douche.' The remark shocked us for two reasons: First, was a depression a good thing? Second, few of us knew that a douche was the European term for 'shower.'' Quoted in (Heilbroner, 1996:46-49).

[9] Quoted in (Keynes, 1932: preface).

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