Joseph Schumpeter (1883—1950) from Routledge Key Guides: Fifty Major Economists

For Joseph Schumpeter (pronounced SHUM-PAY-ter) economics was all about change; studying economics meant studying change. Schumpeter studied short-run and long-run economic fluctuations, or the phases and causes of business cycles. He also examined the future of capitalism and the factors contributing to its rise and decline.

Schumpeter was born in 1883 to middle-class parents in Triesch, Moravia (then part of the Austro-Hungarian Empire, now part of the Czech Republic). His father, who owned a textile factory, died when he was very young. His mother soon remarried and moved to Vienna, where Schumpeter attended high school with the aristocratic elite. He received an excellent education in the humanities, but inadequate grounding in mathematics and science. As a law student at the University of Vienna, Schumpeter took several economics courses. A seminar taught by Böhm-Bawerk sparked his interest in the long-term future of capitalism.

After receiving a doctorate of law in 1906, Schumpeter went to Cairo to practice law and manage the finances of an Egyptian princess. In 1909 he accepted a teaching job at the University of Czernowitz (then in the Austrian Empire, now in the Ukraine), and two years later was appointed to a chair in political economy at the University of Graz.

Schumpeter then got heavily involved in politics. In 1918 he became a member of the German Socialization Commission, which sought to socialize German industry and make it more efficient. In 1919, he became Finance Minister of Austria. His political career, however, was short and unsuccessful. He proposed an unpopular tax on capital to control inflation. A remark attributed to Schumpeter concerning the Austrian dollar ("a crown remains a crown"), made as rampant inflation destroyed people's wealth, was viewed as insensitive to the plight of most Austrians (see Stolper 1994, pp. 227, 267). And his plan to nationalize Austrian firms was roundly criticized.

Unable to handle the pressures of political life, Schumpeter resigned after just seven months in office (Shionoya 1955, p. 18). He then became President of the Biedermann Bank in Vienna. Shortly thereafter, the bank became insolvent. At the same time Schumpeter invested in highly speculative
activities and lost his shirt while incurring massive debts, which it took him many years to repay.

Unable to succeed in the real world, Schumpeter decided to return to academic life. In 1925, he accepted a position as Professor of Economics at the University of Bonn. Seven years later he accepted a job offer from Harvard, where he taught until his death in 1950. In 1949, Schumpeter served as President of the American Economic Association, becoming the first non-American to be so honored.

According to Schumpeter, capitalist economies had two prominent characteristics — they were unstable and they experienced rapid growth. His work sought to understand these key features of capitalism.

Schumpeter (1939) was one of the first economists to study business cycles, the regular fluctuations that economies experience. He identified three different cycles occurring simultaneously. There were short-run fluctuations of three to four years, which he called “Kitchin Cycles,” after economist Joseph Kitchin, who first discovered them. These cycles arose due to changes in business inventories. For one to two years, businesses would expand their inventories in order to keep ahead of rising sales. But when the growth of sales slowed, inventories would begin to pile up in warehouses. As a result, businesses would cut back production for a year or so in order to reduce their inventory backlog. When inventories returned to more desirable levels, and sales picked up, businesses would again seek to expand their inventories.

A second cycle, associated with changes in business investment in new plant and equipment, lasted eight to eleven years. Schumpeter called these “Juglar Cycles,” after Clement Juglar, who first discovered them. They are the economic fluctuations people usually refer to when speaking of the business cycle. Expansions lasting four to five years, Schumpeter thought, were due to the desire of businesses to expand and modernize their capital equipment. After most businesses have done this, there was little need for new investment, and spending on plant and equipment would be cut back over the next four to five years. During this period, existing capital equipment wears out and becomes outdated, setting the stage for another investment boom.

Finally, there are long-run cycles, or Kondratieff waves, lasting 45 to 60 years. Schumpeter named these cycles after Russian economist Nikolai Kondratieff, who first noticed them but could not explain what caused them (see Kuznets). Schumpeter saw invention and innovation as the driving force behind these long-run cycles. During times of slow economic growth, businesses were hesitant to introduce new innovations. New discoveries and ideas would pile up for several decades. When rapid economic growth finally begins, recent innovations get employed in the production process and economies grow rapidly. Schumpeter regarded the Industrial Revolution, which introduced many innovations such as the steam engine and the spinning jenny, as the beginning of one long-term economic expansion. Railroad construction in the mid-nineteenth century began a second Kondratieff wave. In the early twentieth century, electricity, automobiles, and chemicals sparked a third Kondratieff wave.

In his early work, Schumpeter (1911) held that invention was determined by non-economic forces and could not be understood by studying economics. In later work, he (Schumpeter 1942) held that innovation was shaped by economic forces inside the large firm. Yet, throughout his life, Schumpeter refused to believe that innovation was a rational activity; instead he thought it was a creative activity that could neither be explained nor understood as the result of rational thinking processes. The agent of innovation and invention was the entrepreneur.
Unlike his contemporaries, Schumpeter did not believe that entrepreneurs merely hired resources to produce goods and meet consumer demand at minimum cost. Rather, like Cantillon, he thought that entrepreneurs were individuals willing to take risks and were the key force causing capitalist economies to grow. When there are many entrepreneurs, capitalism thrives; on the other hand, if the entrepreneurial spirit is destroyed or hindered, capitalism will stagnate.

Schumpeter held that if entrepreneurs were to succeed, they had to be able to mold and shape consumer tastes. In contrast to other economists, who saw firms responding to consumer tastes, Schumpeter (1939, vol. 1, p. 73) held that “the great majority of changes in commodities consumed has been forced by producers on consumers who, more often than not, have resisted the change and have had to be educated up by elaborate psychotechnics of advertising.” Consumer preferences do not lead to production and innovation; rather, innovation leads to new goods and services that consumers either reject or develop tastes for.

For Schumpeter (1911), invention and innovation by the entrepreneur were the main driving forces behind long-run economic cycles. Invention, backed by bank credit, leads to innovation and growing prosperity. This soon attracts imitators, and the original innovation leads to economic prosperity. But imitators are always less effective than innovators, and many arrive too late in the expansion cycle. Miscalculation and tighter credit push some firms into bankruptcy, leading to recession or depression. Bankruptcies weed out inefficient firms, thus correcting the errors of the past expansion. Inventions accumulate during the contraction, when entrepreneurs cannot find the funds to convert them into new products and processes. They remain dormant, but are available to start a new cycle of growth when the time is right and the economy begins to rebound.

In Capitalism, Socialism and Democracy, Schumpeter (1942) took an even broader perspective on economic change. Rather than study the cyclical changes that capitalist economies go through, he examined the very future of capitalism. The big question he asked was “Can capitalism survive?” The answer he gave was “No. I do not think it can” (Schumpeter 1942, p. 61). In essence, he thought that Marx was correct in believing that socialism would replace capitalism. But rather than being destroyed by its failures, as Marx predicted, Schumpeter thought capitalism would be destroyed by its many successes.

For Schumpeter (1942, p. 83) creative destruction was a main reason for the success of capitalism. Capitalism is not only about successful innovation; it is also about destroying old and inefficient processes and products. Cars replace the horse and buggy; Amazon.com replaces the local bookstore. This process makes capitalism dynamic and causes incomes to grow rapidly. Problems arise, however, because small firms are being replaced by larger firms. Managerial bureaucrats, rather than innovative entrepreneurs, come to run the firm. These managers are employees rather than owners. They prefer a steady income and job security to innovation and risk-taking. As a result, capitalism loses its dynamic tendency towards innovation and its spirit of continual improvement and change.

Schumpeter (1942, pp. 121—25) also saw potential problems stemming from the fact that capitalism requires rational calculation and logical decision-making from all participants. This leads people to develop a skeptical and critical frame of mind. In addition, because capitalism is so successful at increasing incomes, it can support a large number of middle-class intellectuals. With much free time on their hands, these individuals will criticize the capitalist system and advocate a greater economic role for government. Resentment against the income inequality that makes capitalism possible will also be
strong among intellectuals, and they will push for measures that try to keep incomes more equal. These actions will also reduce the incentive to take risks and innovate.

Finally, capitalism undermines the family (Schumpeter 1942, pp. 160—61). It is about satisfying individual wants, while the family requires sublimating one's desires and compromising. If people focus only on satisfying their own wants, it is hard to see how long-term relationships can last. One such relationship, the family, is important for capitalism because it is a main source of savings to finance innovation. Families save so that if anything should happen to the main breadwinner, other family members will be provided for. By undermining the motivation to save, capitalism destroys its own foundation — the capital needed for future growth.

Long-term economic growth has always been a central economic concern. Adam Smith and most classical economists saw capitalism as the best way to achieve rapid growth. By the late nineteenth century, however, economists came to focus more on economic efficiency and lost interest in the issue of growth. Schumpeter redirected the attention of economists to the issue of long-term economic growth.

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