Schumpeter's Model of Economic Growth

Joseph Schumpeter was a famous Austro-Hungarian economist, but never followed Austrian school of thought. His famous book was the *Theory of Economic Development* (1912), in which he first outlined his famous 'theory of entrepreneurship'. He argued that only daring entrepreneurs can create technical and financial innovations in the face of competition and falling profits, and that it was these spurts of activity which generated economic growth. After the World War I, Schumpeter joined the German Socialization Committee in Berlin - which then was composed of several Marxian scholars, and the Kiel School economists.

In 1919, Schumpeter became the Austrian Minister of Finance - unfortunately, presiding over the hyperinflation of the period, and thus was dismissed later that year. Schumpeter migrated in 1921 to the private sector and became the president of a small Viennese banking house. Ill luck dogged him: his bank collapsed in 1924. He drifted once again back into academia - taking up a teaching position at Bonn in 1925. In 1932, Schumpeter took up a position at Harvard, succeeding the Marshallian F.W. Taussig. Schumpeter ruled Harvard during the period of the 'depression generation' of the 1930s and 1940s - when Samuelson, Tobin, Heilbroner, and Bergson were his students. His famous publications include *Theory of Economic Development* (1912), *Business Cycles* (1939), *Capitalism, Socialism and Democracy* (1942) and *History of Economic Analysis* (1954).

In order to understand the Schumpeter's theory of economic development, it is necessary to understand the theory of evolutionary economics. The concept of evolution is an offspring of late 18th and early 19th century debates within philosophy and the social sciences. The theory of evolutionary economics is much more inspired by the Darwinian theory of natural selection. The general definition of evolution is the self-transformation process over time of a system. Such a system may be a population of living organisms, a collection of interacting individuals as in an economy or some of its parts, or even the set of ideas produced by the human mind. Therefore, 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.

Schumpeter defines 'economic evolution' as the changes in the economic process brought about by innovation, together with all their effects, and the response to them by the economic system.

Schumpeter's theory of economic development is considered as a radical theory. It is considered radical in the context that it described the capitalist system as an evolutionary system. According to Schumpeter, capitalism is the system that internally generates changes and technological progresses. According to him, the process of economic development is inherently dynamic, as opposite to static nature of the theory of equilibrium. This does not mean that Schumpeter is against the theory of equilibrium. On the contrary it is the underlying base for his own capitalist dynamic model.

Schumpeter's model of economic development is not a substitute for the theory of equilibrium but rather a necessary complement. Without it, it is impossible to understand the functioning of an economic system. Schumpeter started through the 'circular flow' as an essential block for building dynamic model. Schumpeter describes the circular flow with the following assumptions:

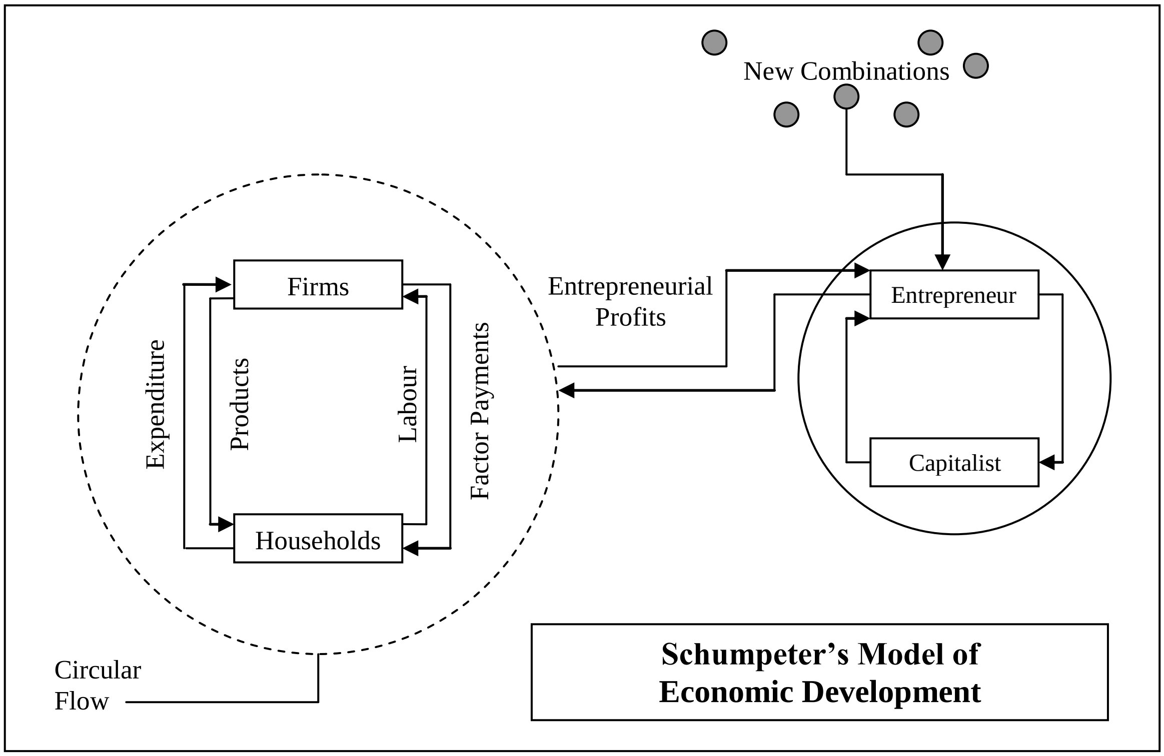
- somewhere in the economic system a demand is ready awaiting every supply, and
- nowhere in the system are there commodities without complements.

Under these conditions, all goods find a market, and the circular flow of economic life is closed. In a steady state, costs in this closed system are the price totals of the services of the production factors. Prices obtained for the products must equal these price totals. The ultimate logical consequence of this ideal model of the clearing market is that production must flow on essentially profitless – profit is a symptom of imperfection.

Schumpeter defines production as the combinations of materials and forces that are within our reach. The producer is not an inventor. All components that he needs for his product or service, whether physical or immaterial, already exist and are in most cases also readily available. The basic driving force behind structural economic growth is the introduction of new combinations of materials and forces, not the creation of new possibilities.

Development in the Schumpeterian sense is defined by the carrying out of new combinations. 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 organisation of any industry***, like the breaking up of a monopoly position.



The basic structure from Schumpeter's model of economic development has two distinctive spheres. On the one hand is the semi-closed system of the circular flow that is either in equilibrium or striving for it. And, on the other hand, is the symbiotic pair of the entrepreneur and the sponsor that is always looking for ways to induce change in the peaceful yet boring routine-life of the circular flow. Both spheres function within an endless reservoir of new combinations, for example, scientific knowledge and technological inventions, but it is only the entrepreneur – backed by the capitalist – who is able to introduce new combinations and new routines in the circular flow.

According to Schumpeter, 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. Schumpeter regarded the entrepreneur as something of a social deviant and noted that migrants or aliens in any society have great potential to behave entrepreneurially. Schumpeter noted that increases of taxes, public policies favouring 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.

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. Economic growth cannot proceed without structural changes, i.e., economic development. Most technological progress is a result of activity specifically undertaken to develop new products, reduce costs, improve quality, or develop new markets.

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.

Business cycle refers to regular fluctuations in economic activity. In the 19th century, business cycles were not thought of as cycles at all but rather as spells of "crises" interrupting the smooth development of the economy. In later years, economists and non-economists alike began believing in the regularity of such crises, analysing how they were spaced apart and associated with changing economic structures. Schumpeter divided a business cycle into four process – boom, recession, depression and recovery. He also classified the business cycles in the following classes:

(a) ***Seasonal cycles*** – for a year
(b) ***Kitchin cycles*** – covering a period of 3 years
(c) ***Juglar cycles*** – covering a period of 10 years
(d) ***Kuznets cycles*** – covering a period of 15 to 20 years
(e) ***Kondratiev cycles*** – covering a period of 48 to 60 years, for example, Industrial Revolution (1787 – 1842), Bourgeois Kondratiev (1843 – 1897), and Neo-Mercantilist Kondratiev (1898 – 1950) with the expansion of electric power and the automobile industry