Creative Destruction's Reconstruction: Joseph Schumpeter Revisited

By J. BRADFORD DELONG

My guess is that average literate Americans know of three 20th-century economists: John Maynard Keynes, Milton Friedman, and Alan Greenspan. Perhaps they also know of Paul Samuelson (but as textbook author, not economic theorist), of Friedrich Hayek (but think that he is the father of an actress), and of John Kenneth Galbraith (as William F. Buckley Jr.'s friend who appeared on TV). The rest of us disappear into a blur of gray suits, spectacles, and, usually, baldness — an assemblage of personalities too bland to be successful accountants.

In Prophet of Innovation: Joseph Schumpeter and Creative Destruction (Belknap Press/Harvard University Press, 2007), Thomas K. McCraw, an emeritus professor of business history at Harvard Business School, tries to add another name to the list — Joseph Schumpeter. From the start, you should know that I am partial to Schumpeter; McCraw quotes me and Larry Summers saying that if Keynes was the most important economist of the 20th century, then Schumpeter may well be the most important of the 21st. McCraw's fascinating book details why that is so, but McCraw, too, is so partial to Schumpeter that he fails to fully explain how Schumpeter tripped himself up over a political understanding as clumsy as his economic understanding was brilliant.

Schumpeter was born in 1883 in what is now the Czech Republic, and died in America in 1950. When he was four, his father died. When he was 10, his mother remarried and moved to Vienna, where his aristocratic stepfather helped him enter elite schools. He was a star: youngest professor in the empire at 26, finance minister of Austria (briefly) at 36, a bank president, and then a professor again. His mother, wife, and newborn son died in rapid succession in 1926 — an awful and tragic shock. He was important enough for Harvard to pluck him from Europe in 1932 to make him one of its superstars. And, after his move to America, he was one of the most famous American economists.

But as fascinating as his life was, it is Schumpeter's economics that sing to me, because he tried to set long-term economic growth — entrepreneurship and enterprise — at the top of the discipline's agenda.

Over the previous two and a half centuries, three different economic worldviews, in succession, reigned. In the late 18th and early 19th centuries, Adam Smith's was the key economic perspective, focusing on domestic and international trade and growth, the division of labor, the power of the market, and the minimal security of property and tolerable administration of justice that were needed to carry a country to prosperity. You could agree or you could disagree with Smith's conclusions and judgments, but his was the proper topical agenda.

The second reign was that of David Ricardo and Karl Marx. Their preoccupations dominated the late 19th and early 20th centuries. They worried most about the distribution of income and the laws of the market that made it so unequal. They were uneasy about the extraordinary pace of technological, organizational, and sociological change, and about whether an ungoverned market economy could produce a distribution of income — both relative and absolute — fit for a livable world. Again, you could agree or disagree with their judgments about trade, rent, capitalism, and machinery, but they asked the right questions.

The third reign was that of John Maynard Keynes. His agenda dominated the middle and late 20th century. Keynes's theories centered on what economists call Say's Law — the claim that except in truly exceptional conditions, production inevitably creates the demand to buy what is produced. Say's Law supposedly guaranteed something like full employment, except in truly exceptional conditions, if the market was allowed to work. Keynes argued that Say's Law was false in theory, but that the government could, if it acted skillfully, make it true in practice. Agree or disagree with his conclusions, Keynes was in any case right to focus on the central bank and the tax-and-spend government to supplement the market's somewhat-palsied invisible hand to achieve stable and full employment.

B ut there ought to have been a fourth reign, for there was a set of themes not sufficiently explored. That missing reign was Schumpeter's, for he had insights into the nature of markets and growth that escaped other observers. It is in that sense that the late 20th and early 21st centuries in economics ought to have been his: He asked the right questions for our era.

He asked those questions in a book he wrote while working at the University of Czernowitz in his mid-20s: the Theory of Economic Development. Previous first-rank economists (with the partial exception of Marx) had concentrated on situations of equilibrium. In that model, development is a gradual process, in which competition keeps goods high-quality and affordable, and the abstemious owners of capital await the long-term rewards of deferred gratification.

Schumpeter pointed out that that wasn't how market economies really worked. The essence of capitalist economies was, as Marx had recognized before him, the entrepreneur and the innovator: the risk taker who sets in motion new and more-efficient ways of making old or new products, and so produces an economy in constant change. Marx saw that the coming of capitalist economies destroyed all feudal, traditional, and patriarchal relationships and orders. Schumpeter saw farther:

that market capitalism destroys its own earlier generations. There is, he wrote, a constant "process of industrial mutation — if I may use that biological term — 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."

In a later book, Capitalism, Socialism, and Democracy, Schumpeter wrote that the traditional view of competition must be abandoned. "Economists," he said, "are at long last emerging from the stage in which price competition was all they saw. ... However, it is still competition within a rigid pattern of invariant conditions, methods of production and forms of industrial organization ... that ... monopolizes attention. But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization — competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives."

Entrepreneurs innovate new ways of manipulating nature, and new ways of assembling and coordinating people. It is important to stress that a Schumpeterian entrepreneur is not an inventor, but an innovator. The innovator shows that a product, a process, or a mode of organization can be efficient and profitable, and that elevates the entire economy. But it also destroys those organizations and people who suddenly find their technologies and routines outmoded and unprofitable. There is, Schumpeter was certain, no way of avoiding this: Capitalism cannot progress without creating short-term losers alongside its short- and long-term winners: "Without innovations, no entrepreneurs; without entrepreneurial achievement, no capitalist ... propulsion. The atmosphere of industrial revolutions ... is the only one in which capitalism can survive."

Schumpeter's ideas lay waste to economists' smooth graphs of long-run growth trends and economic evolution. Growth produces progress and wealth, but in unforeseeable ways and in discrete lumps that create many small winners (for example, the people who can now buy their shirts at Wal-Mart for $8.99 as opposed to $12.99 at its less-efficient competitors), a few huge winners (for example, the Walton family of Bentonville, Ark.), and notable substantial losers (the Main Street merchants of the Mississippi Valley, the Great Plains, and the Sun Belt).

Schumpeter, like his contemporary Karl Polanyi, feared for the long-term survival of capitalism. Bureaucrats and ideologues threatened by creative destruction would resist it. The challenge for the government in managing the market thus becomes not just the Adam Smithian task of securing property rights, enforcing contracts, and providing civil order, but also the tremendously difficult job of managing the creative destruction so that capitalism does not undermine and destroy itself for essentially political reasons. Schumpeter did not think the beast could be managed, because democracy is hostile to great inequalities, and socialism even more so.

Capitalism, however, inevitably generates these mammoth inequalities through creative destruction. The combinations of market economies and political democracies that we see today in the richest countries in the world were, Schumpeter thought, unlikely to be stable. No country that wanted to see rapid economic growth could afford to remain a political democracy for long.

He did not think governments could maintain enough social insurance to counter the destructive part of capitalism without strangling the sources of rapid growth. But why Schumpeter's Capitalism, Socialism, and Democracy places so much blame on "democracy" is unclear to me: Oligarchs fear change at least as much as democratic electorates do.

All told, Schumpeter's economic theorizing was keen, but his political judgment was abysmal. Franklin D. Roosevelt was not a communist aiming to abolish elections and turn himself into a dictator — but Schumpeter thought he was. Efforts to boost demand and employment in 1933 via deficit spending, abandoning the gold standard, and trying to keep interest rates as low as possible were not counterproductive and destructive — but Schumpeter argued that they were. He was, to put it mildly, unsuccessful as finance minister for the brand-new post-World War I Austrian Republic. He erred greatly in his assessment of Germany: A strong Germany was not a stabilizing bulwark against Bolshevism and a source of peace, order, and strength in Europe — at least not in Schumpeter's day.

Moreover, truth be told, even Schumpeter's academic judgment was not that great. His Theory of Economic Development is genius. Much of Capitalism, Socialism, and Democracy is superb. His pre-World War I essay "The Sociology of Imperialism" is also very fine. It argues that imperialism and empire were from an older political tradition given new power and energy by modern capitalism's explosion of wealth, but that in the long run, market capitalism was unsympathetic to imperial domination. Why pay to rule when you can get almost all of what you want through trade? Nevertheless, there are many dry holes and detours in Schumpeter's academic work.

Indeed, Schumpeter's writing late in his career is, in my view at least, not worth reading. The signal-to-noise ratio is simply too low. For instance, the dull, posthumous History of Economic Analysis grades thinkers of the past depending on how closely they were able to approach what Schumpeter regarded as the proper vision and analytical tools of his present.

I think he had decided that he was a Great Man, and that Great Men write Great Books, and so anything that was not a Great Book was beneath him. But the two Great Books written in economics while Schumpeter was working on his were written by people who were not trying to write Great Books but who had something important to say. Keynes's The General Theory of Employment, Interest and Money says that demand management through fiscal and monetary policy can make Say's Law true in practice even though it is false in theory. Samuelson's Foundations of Economic Analysis says that mathematics is a superbly useful language for economics.

Thus Schumpeter's influence was limited. He died half a decade later than Keynes, but Keynes's reputation put Schumpeter's in near-total eclipse for more than a generation. McCraw greatly prefers Schumpeter's Business Cycles to Keynes's General Theory, which he scorns as having no mention of any individual businesses in its 400-odd pages.

McCraw is thus too devoted to his subject to see one essential strand of Schumpeter's story: the academic undervaluation that resulted from his political delusions. This is not the place to write about the rhetorical excellence and the analytic diamonds in Keynes's General Theory (that place is Paul Krugman's introduction to Keynes's book). But I can say that General Theory develops, justifies, rationalizes, extends, applies, and shows economists how to use what had by then become the author's standard themes and approaches in a way that Business Cycles, the History of Economic Analysis, and even Capitalism, Socialism, and Democracy do not. Back in 1970, the economist Harry G. Johnson pointed out that all successful founders of schools not only are geniuses with profound insights but also provide a road map that tells their followers and successors what to do to make a successful academic career within the school. Schumpeter did not do that second part.

Perhaps this next century will give Schumpeter's work its proper place as the power of innovation to transform, create, enrich, and destroy makes itself manifest globally. And while we marvel at how much he got right, we can hope Schumpeter was wrong in his political analysis. One great test of our era will be whether creative destruction can flourish alongside public order and political liberty. If not, we're in big trouble. But if so — and I'm an optimist on the point — the results could be a marvel.

J. Bradford DeLong is a professor of economics at the University of California at Berkeley.