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20 March 2011

Online at <https://mpra.ub.uni-muenchen.de/69973/>
MPRA Paper No. 69973, posted 21 Mar 2016 15:50 UTC

The Schumpeter Legacy

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March 19, 2016

Abstract

This is a biography of Joseph Aloïs Schumpeter, the father of the concept of creative destruction and the elite theory of democracy. The influence of his works has gone beyond the economics field. He has influenced both economists through his explanations of business cycles and innovations and political scientists through his theories of democracy.

Keywords: Schumpeter, creative destruction, innovation
JEL: B31

1 Introduction

Joseph Aloïs Schumpeter (1883-1950) was an Austrian born American economist renowned for his theories on capitalism, *vertical innovations* and *creative destruction*. Vertical innovations are the introduction by capitalists of new and better quality consumer goods and means and methods of production that render the previous ones out-of-date. They, consequently, end the monopoly rents generated by previous innovations. That is what he termed creative destruction: new and improved goods and ideas constantly displacing old ones (Schumpeter, 1942). He sustained creative destruction was the essence of capitalism and believed this economic system would be destroyed by its successes. He was not though a Marxist but a liberal. He is seen by economic historians as an heterodox economist, *i.e.* his analytical approach differs from that of contemporary economists involved in conventional macroeconomic, microeconomic, and econometric analyses.

Schumpeter's creative destruction inspired some of the most popular *endogenous growth* theories ¹ commonly referred to as Schumpeterian models of quality ladders (Aghion and Howitt, 1992, 1998, 2009; Barro and Sala-i Martin, 2004).

Schumpeter is called the father of creative destruction or the grandfather of evolutionary Economics by some commentators and the prophet of innovation by others. His evolutionary vision of economic and political systems is still of interest and, in 1986, an association called the International Schumpeter Society (ISS) was founded in Germany with the aim of furthering research in the spirit of Schumpeter.

There are already several books and articles dedicated to the life and works of Schumpeter (see for instance McCraw, 2007, Wikipedia, or the Concise Encyclopedia of Economics). Some of these treatments are too long to read and the others are too short to be informative enough about the man. This paper is somewhere in between. Truly speaking, it does not say anything new about Schumpeter. Its merit is to ally

¹Endogenous growth theories are theories that seek to explain the origins of the main sources underlying economic growth: technological knowledge and the accumulation of skills by households.

concision with precision. Most information herein has been collected from the above mentioned sources. Personal comments and views have been, of course, added.

The rest of this paper is organized as follows. The next section relates the life of Schumpeter: his family and educational background, his career, and the major events of his life. It appears that Schumpeter owed much to the resolve of his mother and to the social status of his stepfather who gave him the opportunity to attain prestigious schools. He also traveled a lot and held various tenures as a lawyer, minister, private investor, and professor.

Section 3 presents how economic history shaped the destiny of Schumpeter and how he, in his turn, influenced economic history. Schumpeter could have ended up as a politician, had the Austro-Hungarian Empire survived World War I (WWI). Moreover, the influence of his works goes beyond the Economics field. His 1942 famous monograph, *Capitalism, Socialism, and Democracy* is a reference also for some political scientists.

2 The Life of Schumpeter

Joseph Aloïs Schumpeter was born on February 8, 1883 in Triesch, a small Austro-Hungarian town currently located in the Czech republic. His father, Joseph Aloïs Karl Schumpeter (1855-1887), a clothing manufacturer passed away when he was four.

In the same time, his mother, Johanna Gruener (1861-1926), lost her parents. In 1888, he and his sorrowful mother left Triesch, his hometown, to start a new life far-away in Graz, a much bigger city. Graz was, at that time, the retreat of high-ranking Austro-Hungarian army officers. There, his mother met and later in 1893 married at age thirty-two a sixty-five-year-old retired General called Sigmund von Kéler.

Thanks to his stepfather, Schumpeter entered the Theresianum, one of the best high schools at that time in Vienna where they moved. Vienna was one of the two capital cities of the Austro-Hungarian Empire. He completed his preparatory education in 1901. He later on embarked on a doctorate program in Law at the University of Vienna and graduated in 1906. At university, he was introduced to Economics by the pioneers of the Austrian School of Economics: Friedrich von Wieser (1851-1926), and Eugen von Böhm-Bawerk (1851-1914).²

Schumpeter worked as a lawyer, professor, minister, private investor in various places around the world.

Between study trips (seminars delivered at the University of Berlin and the London School of Economics) and a teaching position in 1909 at the University of Czernovitz (Ukraine), Schumpeter worked as a lawyer in Cairo (Egypt). He later on came back to Graz, the city he grew up, and taught, between 1911 and 1918, at the University of Graz. While at the University of Graz, he was appointed invited professor at the University of Columbia, New York between 1913 and 1914. He moved to the University of Bonn in Germany in 1925 to teach public finance. He started teaching at Harvard University in 1927 and definitely settled in the US in 1932. He retired in 1949 after becoming President of the American Economic Association in 1948.

Schumpeter had a successful career as a professor. He was prolific and taught brilliant and promising students including future Nobel laureates Paul Samuelson (1915-2009), Robert Solow, and James Tobin (1918-2002), Wolfgang Stolper (1812-2002),³ and Paul Sweezy (1910-2004). But his experience outside the academia was not that successful. In 1919, he was, for half a year, minister of finance of the dislocated Austro-Hungarian Empire in a coalition government. Then, from 1920 to 1924,

²The Austrian School of Economics is a heterodox school of thought that was influential in the late 19th and early 20th century. It *inter alia* contributed to the individual subjective preference theory. It also advocated economic theory should be derived from basic human action principles and criticized the use of mathematics, statistics, and experiments in economics.

³Stolper was the founder of the International Schumpeter Society.

he was private investor and speculator in the Biedermann bank in Vienna. He went bankrupt and was fired in 1924.

Schumpeter was married three times. His first wedding was after graduation, when he sojourned in London, England. It was in 1907 with Gladys Ricarde Seaver, an English lady said to be twelve years older than he. This marriage failed and he left England for Egypt. His second wife was Anna Josefina Reisinger, a daughter of the concierge of the apartment building in which Schumpeter grew up in Vienna. She was twenty years younger than he and Schumpeter knew her since her childhood. They married in 1925 and she died in 1926 in labor with their new born child. The same year, Schumpeter lost his mother, Johanna Gruener.⁴ Schumpeter's third wife was Elizabeth Boody (1898-1953), an American economist, he married in 1937. He became American citizen two years later. Elizabeth Boody who also has an academic career at Harvard University assisted Schumpeter in his research and writing. Both stayed together until his death from a cerebral hemorrhage on January 8, 1950 at age 66 in Salisbury, Connecticut.

3 Economic History and Schumpeter

Economic history and Schumpeter mutually influenced each other. One of the goals Schumpeter set himself was to become the greatest economist in the world.

3.1 The Influence of Economic History on his Destiny

Schumpeter's father and grandfather were clothing manufacturers. Many of his biographers did not hesitate to link this to his research interests in innovations and entrepreneurship. Given that Schumpeter lost his father when he was only four and soon after left his hometown, there is no evidence that his family background indeed influenced his economic analyses. Psychologi-

cally, it might be likely that he remembered his father in a idealized manner: "the entrepreneur".

Without any doubt, WWI and the dislocation of the Austro-Hungarian Empire influenced Schumpeter's destiny. He missed his political career due to the dislocation of the Austro-Hungarian Empire and had unwillingly to come back later into the academia. Besides, after WWI, Schumpeter was a member of the German Socialization Committee in Berlin. This might have influenced some views he developed in his famous *Capitalism, Socialism, and Democracy*. In the first fifty-eight pages of this book, Schumpeter praised the Marxian doctrine.

Founded, after a compromise in 1867, Austria-Hungary was the union of the Austrian Empire and the Kingdom of Hungary. This union lasted fifty-one years. On June 28, 1914, Franz Ferdinand, a prince of the Austro-Hungarian Empire, visiting Sarajevo (Bosnia) was assassinated by some nationalists of *Mlada Bosna*. Mlada Bosna, which means Young Bosnia, was a secret revolutionary movement whose members are predominantly Serb, Bosniak, and Croat students. Austria-Hungary then declared war on Serbia in July 1914. This would lead to WWI with mainly Russia, France, Italy, the UK, and the US (the Allied) on one side and Austria-Hungary and Germany on the other side.

Defeated, the Austro-Hungarian army signed an armistice on November 3, 1918 in Padua (Italy). Right before that, the Austro-Hungarian union collapsed. Hungary unilaterally quited officially the union on October 31, 1918. It was followed shortly by the minority nationalities: the Czechs, Slovaks, South Slavs who also were part of the union declared their independence.

Left liberal political parties opposing the monarchy came to power in Austria. But Schumpeter was a conservative supporting the emperor and he was seeking a high political position. Unexpectedly, he was appointed minister of finance in 1919. Unfortunately, his political career was too short

⁴This death series reminds his childhood when he lost in the same time his father and maternal grandparents.

because he was on the wrong political side. WWI and the dislocation of the Austro-Hungarian Empire therefore compromised Schumpeter's political career. After his tenure as minister, he hesitated for long to come back into the academia.

3.2 The Contributions of Schumpeter

Schumpeter worked on various subjects including business cycles and economic growth, statistics, and the history of economic thought. Some of his monographs including posthumous publications are:

- 1912 *The Theory of Economic Development*, translated by R. Opie, Cambridge, Harvard University Press, 1934.
- 1939 *Business Cycles*, New York, McGraw-Hills, 2 vols.
- 1942 *Capitalism, Socialism, and Democracy*, New York, Harper and Brothers.
- 1951 *The Great Economists*, New York, Oxford University Press.
- 1954 *History of Economic Analysis*, edited by E. Boody, New York, Oxford University Press.

His most influential work is *Capitalism, Socialism, and Democracy*. In this book, he dealt with political and economic systems. He presented the Marxian doctrine, socialism, the classical doctrine of democracy and put forth a new theory of democracy. He also dealt with innovations distinguishing these latter from inventions.⁵ He argued that innovations are undertaken by big companies who have the adequate means to invest in research and development. He went on arguing that innovations occasion creative destruction, which in its turn improves the living standard of individuals. He further sustained that some degree of monopoly could be beneficial for innovators. Schumpeter's interest in innovations goes back as far as his 1912's monograph, *The Theory of Economic Development*, where he

defined the entrepreneur, as opposed to a business manager, as a skilled and daring individual who innovates. Schumpeter's pioneering work on innovation and creative destruction inspired such growth theorists as Aghion and Howitt in the development of what are now referred to in the literature as the Schumpeterian models of quality ladders or the Schumpeterian approach to endogenous growth.

The basic Schumpeterian model of quality ladders as proposed by Aghion and Howitt (1992) consists of three sectors: the consumption good, the intermediate good, and the research sectors. All the sectors are perfectly competitive except the intermediate sector. The consumption good is produced using both raw labor supplied by unskilled households and the most recent intermediate good. The most recent intermediate good is designed by a successful research firm using skilled labor and its production is licensed to the intermediate monopolist who rents it to the consumption sector. Innovations occur randomly. Each innovation ends the monopoly position of the previous innovator and increases by a constant multiplicative factor the level of technology.

According to Schumpeter, business cycles are caused by innovations. He distinguished between what are later called breakthrough innovations and incremental innovations. A breakthrough innovation generates a temporary monopoly rent. It is soon followed by incremental innovations, which are imitations or continuations of the breakthrough innovation. This wave of innovations leads to a period of economic expansion due to an increase in investment and in the demand for the improved or differentiated goods. A period of slowdown or recession will then follow due to the accumulation of inventories, the excessive number of profit-driven firms engaged in incremental innovations, and a fall in the monopoly rent. The economy will remain in this situation until the next wave of innovations. In *Business Cycles*, Schumpeter suggested that economic fluctuations can be explained

⁵The kind of innovation Schumpeter dealt with is what has been later called, in the industrial organization literature, vertical innovation.

by the conjunction of three cycles. These cycles are: Kitchin cycles, which last three to five years, Juglar cycles, which last seven to eleven years, and finally Kondratieff cycles, which last forty-five to sixty years.⁶

In *History of Economic Analysis*, Schumpeter delivered his personal judgment on some economists. He considered Léon Walras (1834-1910) as the greatest economist of all time. Surprisingly, according to him the greatest economist of the 18th century was not Adam Smith (1723-1790) but the French Anne-Robert Jacques Turgot (1727-1781) who was an early advocate of economic liberalism.

Recently, the financial crisis of 2008 led such economists as Otter and Siemon (2010) as to revisit Schumpeter's thesis on the self-destruction of capitalism.

The influence of Schumpeter's work has gone beyond the sphere of Economics. His analysis of democracy in *Capitalism, Socialism, and Democracy* inspired in Political Science many prominent scholars of the elite school of democratic thought (Medearis,

1997). In this book, Schumpeter questioned the classical doctrine of democracy that he viewed as a form of elite competition, the rule of the politician rather than mass participation and popular rule.

4 Conclusion

The works of Schumpeter keeps rousing interest in Economics and Political Science. He is a reference for many economists particularly those working in the field of economic growth where his concept of creative destruction inspired some endogenous growth models named after him.

In Political Science, his new doctrine of democracy generated a large echo and his classic *Capitalism, Socialism, and Democracy* is still furthered by researchers. For instance, Medearis (1997, 2001) pointed out that Schumpeter also thought of democracy as a powerful transformative tendency leading toward the establishment of a democratic socialism.



Joseph Alois Schumpeter (1883-1950)

⁶These three cycles are respectively named their authors Joseph Kitchinn (1861-1932), Joseph Clément Juglar (1819-1905), and Nikolai Kondraatieff (1892-1938).

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