The Contribution of Joseph Schumpeter to Economics

Economic development and institutional change

Edited by Richard Arena and
Cécile Dangel-Hagnauer

London and New York

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This collection constitutes an examination of Schumpeter's legacy that is wider than most of those attempted up to now. As one of the key economists of the twentieth century, Schumpeter's theory is viewed in relation to his important contributions to areas as diverse as the history of economic analysis, economic methodology and economic sociology, as well as to the theories of entrepreneurship, competition, innovation, business cycles, money, banking and finance. These wide-ranging contributions reveal Schumpeter's adherence to a unified analytical and methodological approach. Rather than evolutionary, this approach clearly forms part of the theoretical tradition in economics for which institutions and institutional change are key aspects.

This timely book is an authoritative and original study into the Schumpeterian legacy and will be welcomed by historians of economic thought. It will be essential reading for economists interested in institutionalist, evolutionary and Austrian economics.

Richard Arena and **Cécile Dangel-Hagnauer** are both at the University of Nice - Sophia Antipolis, France.

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Preface

More often than not, volumes such as this serve the purpose of trying to save a particular author or debate from oblivion. This is most definitely not the purpose of this book for the simple reason that Joseph A. Schumpeter has never fallen into oblivion. Since his death in 1950, his work has never ceased to attract the attention of economists, even when focused on very different aspects of his thought. The timeless nature and unremitting relevance of Schumpeter's ideas and analysis is directly related to their diversity encompassing, as they do, the theory of competition, of entrepreneurship, of development and of innovation, monetary theory, the history of economic thought, economic methodology and economic sociology – and even this list is by no means exhaustive!

Such diversity has also encouraged varied and, at times, contradictory interpretations of Schumpeter's work (Arena 1992). In the last two decades, however, this situation has undergone a gradual but pronounced change. Even though disagreements continue, there now exists a predominant, if not wholly undisputed, interpretation of Schumpeter's contribution to economics. The emergence of this interpretation is closely related to the rise and development of modern evolutionary economics. Originally perhaps most closely associated with the seminal contribution by Nelson and Winter (1982), evolutionary economics is, in fact, frequently labelled 'neo-Schumpeterian', and its advocates welcome Schumpeter's legacy as the cornerstone of an alternative modern economic theory.

Put briefly, under this perspective Schumpeter is credited with having constructed an entrepreneurial theory of competition that, or so goes the argument, has two distinctly evolutionary features. First, it is based on the idea that a process of natural selection among firms is a central feature of the market mechanism. Second, at the level of the economic system as a whole, it implies the operation, with the passage of historical time, of a process of 'creative destruction'. This process is seen to ensure the elimination of some firms through competition, as well as the creation of new ones managed by entrepreneurs who introduce new products, techniques, markets or forms of organisation to the economy. 'Creative destruction' is then equated or associated with biological evolution, implying an organic transformation of the economic system.

This interpretation is not wholly misleading. However, it is certainly reductionist in that it ultimately restricts Schumpeter's contribution to the analysis of the relation between competition and innovation in a market economy. This view suffers from two important shortcomings.

On the one hand, it underestimates Schumpeter's contribution to economics. One main purpose of this book is to show that, while Schumpeter's analysis of competition and innovation certainly deserves a central place in modern theory, his contributions to other subject areas are not only extensive but also no less important. In order to argue this point, it is of course necessary to take account of *all* his writings, including those less familiar to the majority of economists, not least because, in some cases, English translations are still not available. What emerges from such an encompassing reading of his work is that Schumpeter not only dedicated considerable time and effort to a wide range of subjects, producing a number of important and detailed contributions, often containing original insights and results, but it is, moreover, difficult to maintain that the theory of competition and innovation can be seen to be the sole central and unifying theme of his work.

On the other hand, these wide-ranging contributions clearly reveal Schumpeter's adherence to a unified analytical and methodological approach. Far from being evolutionary, this approach clearly forms part of the institutionalist approach to economic theory. This is the second main insight emphasised in the book and discussed in more detail in our introductory chapter.

For the moment, it suffices to clarify briefly what we mean by 'institutionalist'. Essentially, our point is not that Schumpeter should be viewed as an inheritor of the German Historical School or as having worked in the tradition of American institutionalists. Rather, our meaning is a broader one: in our view, Schumpeter attempted to build a general theory of the relations between institutional change and economic development. Such a theory required attention to history, and Schumpeter complied with this requirement by developing a specific and original approach that attributes to economic sociology a role of intermediary between history and economic analysis. This theory also assigned an important role to the institutions of money and credit within a broader framework of the analysis of the workings of a capitalist economy. It therefore rejected the device of an abstract barter economy in which money does not matter. This is in direct contrast to a large part of modern evolutionary economics that tends to underestimate the importance of money and credit in favour of a strong (or over-) emphasis on the role of technology. Furthermore, in the analysis of development, Schumpeter also gave pride of place to the concepts of self-organisation and social leadership, thus outlining a mode of relations between men and society that has little in common with standard interpretations of methodological individualism. Finally, Schumpeter's work highlighted the need for a theory of economic dynamics that differs substantially from the pure economic theory of exchange, focusing instead on the actual impact of institutions on the workings of the economic system, including social norms and behavioural rules.

This alternative institutionalist interpretation of Schumpeter's contribution to economics runs through this book, albeit to varying degrees, naturally depending on the specific focus of the different chapters. We begin with an introduction that provides a more detailed discussion of the overarching theme of the book as it has just been outlined. The bulk of the book is organised in five parts, each taking up a specific topic in the following order: the history of economic analysis; methodology; economic development and social change; entrepreneurship and competition and money, banking and finance.

Part I is devoted to Schumpeter as an historian of economic analysis, using the marginal revolution as an illustration. The three chapters that make up this part examine how Schumpeter perceived and interpreted this revolution and describe the ways in which he drew inspiration for his own theoretical scheme from early marginalist contributions. The first chapter is concerned with Schumpeter's relationship with the 'old' Austrian school. As Sandye Gloria-Palermo reminds us, Schumpeter is the initiator of the historiographic approach, predominant to this day, that considers Menger, Jevons and Walras as the three protagonists of the so-called marginal revolution. This suggests that Schumpeter appears to have underestimated the originality of the Austrian tradition. Gloria-Palermo analyses how Schumpeter, the historian of economic analysis, interpreted the contribution of each of the three founders of the Austrian tradition. She also identifies aspects of this tradition that Schumpeter integrated into his own analytical work – namely, Menger's analysis of the role of institutions in the process of economic evolution, Böhm-Bawerk's concept of production as a time-consuming process, and Wieser's analysis of the role played by leaders in the process of economic change. More specifically, she attempts to explain why Schumpeter tends to overlook these ingredients when he accounts for the Austrian authors' contribution, despite the use he makes of them in constructing his own theory of economic development.

The second chapter deals with Schumpeter's contribution to Walrasian historiography. Richard Arena shows that one of Schumpeter's important achievements was to rehabilitate Walras's contribution to economic theory, especially in the English-speaking world. However, his interpretation paved the way for the standard interpretation of the Walrasian system endorsed by modern general equilibrium theorists, whereas Arena provides evidence that this interpretation hardly qualifies as a faithful representation of Walras's intellectual project. He also shows that, notwithstanding the constant tribute he paid to Walras, Schumpeter also pointed to important limitations and shortcomings of the latter's approach. This led him to consider the Walrasian system as a construct of limited validity and to try to develop a more general conception of the dynamics of capitalist market economies.

In the third chapter, Nathalie Duval examines how Schumpeter reconstructs Marshall's contribution to what he considers 'progress' in economic thought, i.e. the building of static equilibrium theory. This led him to purge Marshall's thought of what he considers as ‘non-scientific’, illustrative, empirical and historical digressions. This might seem paradoxical given that Schumpeter himself paid considerable attention to history. In fact, he is especially critical of what he considers a recurrent methodological bias in Marshall’s work, i.e. a tendency to treat what he himself regards as the qualitatively different phenomenon of economic development as a mere extension of static analysis by introducing historical time into the framework of static analysis. Even so, Schumpeter was, of course, well aware of Marshall’s ‘evolution-mindedness’, but considered that Marshall’s understanding of dynamic analysis was flawed in that he failed to understand that in order to deal with the dynamic aspects of economic development a totally different theory is required.

Part II of the volume focuses on predominantly methodological issues. André Legris explores the boundaries between ‘pure’ economic theory and economic sociology. In Schumpeter’s framework, the former provides a self-contained theoretical framework for the analysis of the mechanism leading to equilibrium – that is, of the economy of the circular flow. However, when Schumpeter turns his attention to the process of development, he broadens his area of investigation to what he calls economic sociology – that is, the analysis of institutions. Accordingly, he explores the economic sociology of innovations and examines the institutional environment that encourages the emergence of a specific actor-type, the entrepreneur. He emphasises, in particular, that credit and the institution of banking play a key role in allowing entrepreneurial aspirations to come to fruition.

In Chapter 5, Anne Châteauneuf-Malclès deals with the question of time and rationality in Schumpeter’s writings. She begins by reminding us that, although he never addressed the question of time directly, it was of pivotal importance to Schumpeter’s work, economic change having been his main concern. Two models of time underlie his work. Retrospective time is characteristic of the circular flow, meaning that it is past-oriented. By emphasising that the passage of time creates permanent conditions which are favourable to the emergence of routines, the author shows how Schumpeter transforms the timeless Walrasian model into the model of the circular flow. Prospective time is the distinctive feature of development where future-oriented entrepreneurs have the skills needed to confront the discontinuities and uncertainty generated by innovative activity. Interestingly, the two forms of temporality generate different forms of institutions. Retrospective time leads to the emergence of well-functioning networks that encourage coordination and reduce uncertainty, while the appearance of credit institutions is directly related to prospective time.

Part III of the book is concerned with Schumpeter’s important contributions to the theory of economic development and social change. Agnès Festré highlights the originality of Schumpeter’s conception of the business cycle, tracing it back to his unconventional conception of dynamics. First, dynamics is opposed to statics as described by the ‘pure’ circular flow model. Second, dynamics excludes growth factors such as saving or increases in population, which

Schumpeter also accounts for within the framework of the circular flow. Rather, for Schumpeter, dynamics is synonymous with development, of which innovation is the only cause. Having reminded us of these basic distinctions, Festré analyses the mechanisms and phases of the business cycle. She examines the role of credit, the dissemination of innovations, the behaviour of prices, the importance of sectoral as opposed to aggregate features of the dynamic process. Festré also points to the weaknesses of Schumpeter's theory of business cycles as perceived by a number of economists. Whether or not well-founded, these criticisms have stimulated modern research on industrial innovation and R&D, thereby complying with Schumpeter's desire to see his ideas scrutinised in the light of further evidence.

The chapter by Odile Lakomski discusses Schumpeter's view of the long-term perspectives of capitalism. Like Marx, Schumpeter was convinced of the inevitability of an eventual 'march into socialism' However, Schumpeter did not believe that the threat to the capitalist system was to be found in economic instability and the development of crises. Quite the opposite, he considered that capitalism becomes ever more stable, from an economic point of view, as a result of both increasing industrial concentration and the more bureaucratic organisation of innovation-related activities. Ironically, it is precisely economic success that leads to socialism in that this success produces a gradual transformation of cultural and political values, of the role of the bourgeoisie within the political system and, more generally, of the institutions characterising capitalism. Thus, Schumpeter provides an original view of what may be in store for capitalism by combining the analysis of institutional change with the theory of economic development.

Entrepreneurship and competition are the focus of attention in Part IV of the volume. It begins with a chapter on Schumpeter's theory of entrepreneurship, in which Richard Arena and Paul-Marie Romani show how Schumpeter applies his methodological approach, consisting in combining economic theory with history and economic sociology, to entrepreneurship. For Schumpeter, entrepreneurship is a specific form of social leadership. Entrepreneurs are social leaders whose function is to carry out innovations. They are thus the instigators of economic change, which explains why their function is only transitory – a claim Schumpeter substantiates by making use of both historical analysis and economic theory. Schumpeter's historical analysis of entrepreneurship puts specific emphasis on institutional and social change, that is, on the rise and decline of institutions, sets of values and forms of organisation. Arena and Romani also discuss the economic aspects of entrepreneurial rationality, thereby providing an explanation of Schumpeter's scepticism as regards the Walrasian conception of the entrepreneur. The stance the authors take in this chapter contrasts with the more conventional interpretation, especially within evolutionary economics, according to which Schumpeter stresses entrepreneurial competition as a process of natural selection. Instead, the authors suggest that the methodology underlying Schumpeter's analysis of economic dynamics, by relating economic development with institutional change, enables him to account for change as an endogenous process.

Schumpeter believed in the dynamic efficiency of monopolistic structures, as Alain Raybaut and Franck Sosthé remind us in their chapter on Schumpeter and competition. However, the authors emphasise that Schumpeter's theory of competition is also concerned with innovation, prices and the formation of market equilibria. First recalling Schumpeter's assessment of how competition is treated in the history of economic analysis before 1914, Raybaut and Sosthé then proceed to study Schumpeter's conception of competition both within the circular flow and in the context of development. When analysing the circular flow, Schumpeter highlights the role played by routines and adaptive behaviour in order to explain how competition leads to equilibrium. Such routines are disturbed when economic development enters the picture. As new combinations emerge alongside older ones as a result of innovation, prices for new products are determined according to the principle of monopoly pricing and the uneven movement of the economic system makes calculations based on experience impossible. Schumpeter, however, believed that the economy will eventually settle in the neighbourhood of a new competitive equilibrium. What then prevails is some kind of hybrid competition. On these grounds, Schumpeter views pure competition and pure monopoly as limiting cases, although his appraisal of the emerging theory of imperfect competition is rather reserved.

The fifth and final part of the book is devoted to Schumpeter's theory of money and credit. The first chapter deals with Schumpeter's conception of money as an institution that is explained in his treatise on money and banking, first published posthumously in German in 1970. In this chapter, Cécile Dangel-Hagnauer suggests that the theme Schumpeter develops in this treatise is one that is located at the frontier of economic theory, economic sociology and history. Thus, because Schumpeter considers money as an institution, he begins by constructing a stylised institutional framework within which he embeds the concept of money. Schumpeter's point of departure is, therefore, economic sociology. But money is also the focus of economic theory. The bridge Schumpeter builds between economic theory and economic sociology is what allows him to explain the 'essence' of money. This he accomplishes quite straightforwardly when he considers the working of the institution of money in the economy of the circular flow. Difficulties crop up, however, when he turns to the analysis of money within the context of economic development. The problems that arise are dealt with by analysing the actual working of and the historical forms taken by the institution of money when the economy is subject to change. It is also at this point that credit enters the picture, providing the monetary system with some degree of flexibility.

In the following chapter, Agnès Festré highlights the common Wicksellian origin of Schumpeter's and Hayek's conceptions of money and banking. This contrasts with the differences in these authors' approaches to the mechanisms underlying economic dynamics. In Hayek's analysis, the inability of the banking sector to ensure that the natural and real rates of interest coincide leads to a redistribution of purchasing power from consumers to producers and, thus, to forced saving. The resulting excessive investment expenditures during the upswing are detrimental to the economy in that they prompt it to deviate from its natural tendency towards equilibrium, resulting in economic crisis and the eventual return to equilibrium. In Schumpeter's approach, the increased activity in the investment goods sector during the upswing is triggered by a spurt of innovations financed through new bank loans. The ensuing redistribution of purchasing power from traditional producers to innovators is another instance of forced saving, albeit of a different nature. Banking institutions here are essential players in the development process. The instability to which the actions of banking institutions contribute through the business cycle is thus, for Schumpeter, the very vehicle of progress.

The chapter by Eric Nasica contains a comparative study of Schumpeter's and Keynes's views on the financing of economic activity. Nasica points to the similarities in the two authors' approach to money and finance. First, in both Keynes's 'co-operative' economy and in Schumpeter's circular flow – that is, in their respective static models – money is essentially a technical device. Second, both Keynes and Schumpeter introduce a more complex concept of money: the former when he deals with the 'entrepreneurial' economy in which instability and fluctuations tend to develop; the latter when he introduces innovation and dynamics in the form of economic development. Third, their analyses lead them to reject the quantity theory of money. However, their approaches also exhibit important differences. Whereas Keynes places strong emphasis on the role played by financial markets and the long-term interest rate, Schumpeter insists on the role of credit and banking and considers the short-term interest rate to be the more relevant variable for the analysis of the working of banking and financial markets. While preceding Keynes's contribution by more than twenty years, Schumpeter's theory also contains a more in-depth analysis of the working of banking institutions. For Schumpeter, financial institutions are typically entrepreneurial organisations insofar as they are constantly striving to innovate and to increase profits.

This preface would not be complete without our thanks to Michel Rainelli, Françoise De Bandt, Sylvain André, Muriel Destailleur, Elisabeth Duruisseau, Pierre Goursaud, Muriel Mathéry, Martine Naulet and Katia Rolland for their invaluable help in the making of this book. We would also like to thank Stephanie Blankenburg for the work she put into the initial versions of the articles that make up this volume. Her interaction with the authors contributed not only to an improvement in the style of the articles, but also to the clarification of many passages. Her help was particularly crucial in the translation of quotes from Schumpeter's 1908 and 1970 contributions for which no English translation from the original German exists as yet.

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List of abbreviations

BC	*Business Cycles*
CSD	*Capitalism, Socialism and Democracy*
DW	*Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie*
HEA	*History of Economic Analysis*
TED	*The Theory of Economic Development*

Introduction

Richard Arena and Cécile Dangel-Hagnauer

Today, most scholars share the view that J.A. Schumpeter was not only a great economist but also one of the main founders of modern economic evolutionary theory.[1] In this view, Schumpeter's approach to economic change, as it is generally understood, led him to build a theory in which innovations emerge as the result of a process of selective competition. This contrasts with the traditional and static conception whereby competition constitutes an end-state.

In this book we argue that this conventional interpretation of Schumpeter is both reductionist and misleading. It is certainly reductionist in that it tends to limit Schumpeter's contribution to economics to what we will argue is but one aspect of his much wider analytical construct. It is also misleading since, far from looking favourably on evolutionary approaches, Schumpeter always regarded the possibility of borrowing from biology with scepticism. It is our belief that an evolutionary interpretation of Schumpeter's contribution not only minimises its profound originality, but also misrepresents it. To prove our point, we will start from the fundamental distinction that Schumpeter makes between the various 'Techniques of economic analysis' in his *History of Economic Analysis* (*HEA*).

The essential importance of economic sociology amongst Schumpeter's techniques of economic analysis

It is worthwhile to recall Schumpeter's characterisation of the role of economic sociology as a complementary technique, alongside the three techniques of economic analysis he lists at the beginning of the *HEA*, namely, history, statistics and 'theory':[2]

> The schemata of economic theory derive the institutional frameworks within which they are supposed to function from economic history, which alone can tell us what sort of society it was, or is, to which the theoretical schemata are to apply. Yet, it is not only economic history that renders this service to economic theory. It is easy to see that when we introduce the institution of private property or of free contracting or else a greater or smaller amount of government regulation, we are introducing social facts

> that are not simply economic history but are a sort of generalized or typified or stylized economic history. And this applies still more to the general forms of human behaviour which we assume either in general or for certain social situations but not for others … To use a felicitous phrase: economic analysis deals with the question how people behave at any time and what the economic effects are they produce by so behaving; economic sociology deals with the questions how they came to behave as they do. If we define human behaviour widely enough so that it includes not only actions and motives and propensities but also *the social institutions* that are relevant to economic behaviour such as government, property inheritance, contract, and so on, that phrase really tells us what we need.
>
> (Schumpeter 1954: 20–1, emphasis added)

In this passage, Schumpeter explains the relationship between economic analysis and economic sociology. To get the full picture, however, it is necessary to complement this statement with Schumpeter's remarks on this question in *Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie* (*DW*) as well as in his sociological writings.[3] These texts do, in effect, add considerable substance to Schumpeter's statement in the above passage. Careful reading reveals that Schumpeter regarded the 'science of organisation' as part of economic sociology (Schumpeter 1908: 133). Thus economic sociology includes:

> the science of state forms but also the science of the forms of law and of the remaining social relations and structures and, thirdly, the science of economic organisation as such: on the one hand, the division of labour and on the other hand, the formation of cartels, of labour associations, etc.
>
> (*ibid.*)

What Schumpeter asserts in the *HEA* is that, for the economist, history provides the raw material that consists of empirical sets of diverse institutions and forms of organisation. However, this raw material requires further work in order to produce the assumptions that are made when the economist sets out to build an economic theory. First, economic sociology must 'generalise', 'typify' and 'stylise' the empirical forms of institutions and organisations so as to transform the historical set from which they are drawn into a more abstract set of ideal types on which the economist can then build his analytical assumptions.[4] Second, referring to the example of fiscal sociology, Schumpeter (1918 [1991]: 177 fn. 18) emphasises that the historical order according to which institutions and organisational forms emerge, develop and decline *must not* be confused with the analytical process by which sociology provides a logical explanation of these changes. Seen thus, historical chronology is partially arbitrary whereas economic sociology must respect the necessary requirements of consistent analysis. Third, economic sociology must extract from history what is strictly economic, and this obviously presupposes a relative autonomy or 'self-containment' of the economic sphere (Schumpeter 1908: 135). Schumpeter provides an illuminating example of this when he argues that the legal aspects of the institution of credit (namely, the strict requirement for the borrower to repay the lender) must be distinguished from – but also determine – its economic aspects (namely, the implications of this requirement for the expectations and economic behaviour of agents) (Schumpeter 1917/18 [1956]: 155–7). Finally, if we consider economic activity from the point of view of dynamics, it can also create feedback effects on institutions, organisation or law. A case in point is Schumpeter's analysis of taxation and, more specifically, his emphasis on the limitations of fiscal impositions arising from the need not to squeeze profits beyond a certain point (Schumpeter 1918 [1991]: 112).

Economic sociology, according to Schumpeter, can thus be defined as the science of the emergence, maintenance and decline of societal institutions and forms of organisation that influence economic behaviour.

Social motives and social classes

For Schumpeter, human motives are never strictly individual. Rather, they are always embedded in a social context and related to the historical circumstances under which they have emerged. From this point of view, two main concepts are essential.

On the one hand, following Wieser's conception of economic sociology, Schumpeter argues that, whatever the social environment, men are always divided into two categories: leaders and followers.[5] It should, however, be noted that Schumpeter does not regard leaders as superior or 'great men' (Schumpeter 1927 [1951]: 216). They are not in possession of special intellectual qualities that would lead them to play a pre-eminent social role. Nor do they have a conscious concept of social optimality that they would strive to put into practise (*ibid.*). Rather, '[w]e are content to say that social leadership means to decide, to command, to prevail, to advance. As such it is a special function, always clearly discernible in the actions of the individual and within the social whole' (*ibid.*: 217).

Leaders' motives are related to their 'instinctive urge to domination' (Schumpeter 1919 [1951]: 15), an 'excess of energy' (*ibid.*: 34) or 'activity urges springing from capacities and inclinations that had once been crucial to survival, though they had now outlived their usefulness' (*ibid.*: 44). These 'urges' (or this *Trieb*, *ibid.*: 83) are defined by Schumpeter as human inclinations that have more to do with 'instinct' than with reason (*ibid.*: 83–4). They involve creativity and entail permanent changes to the sphere in which they appear (be this the arts, science, economic activity, etc.). Shionoya neatly summarises this when he writes that

> In the first place, creative activity cannot be predicted by applying the ordinary rules of inference from pre-existing facts. It is so unique that the mechanism of the modus operandi must be examined on a case-by-case basis. Second, creative activity shapes the whole course of subsequent

> events and their long-term outcome, and causes discontinuity from preceding situations. Third, creative activity is an enigma of human beings and has something to do with the distribution of talent and therefore with the phenomenon of leadership.
>
> (Shionoya 1997: 175)

Like Wieser, Schumpeter regards followers as playing a more passive role in that they are the mere recipients of leaders' decisions, acting to diffuse them. They can reinforce these decisions and contribute to their social generalisation through the adoption of imitative behaviour or the manifestation of trust. But they can also resist them, slowing down the process of diffusion or sometimes even preventing the mechanisms of social diffusion from working.

On the other hand, however, leadership is not independent from the social context in which it appears. Schumpeter strongly stresses this aspect of social behaviour. First, the *Trieb* or 'urge' provides only part of the social explanation of leaders' motives. Referring to warlike societies, Schumpeter argues that

> [t]he explanation lies, instead, in the vital needs of situations that molded peoples and classes into warriors – if they wanted to avoid extinction – and in the fact that psychological dispositions and social structures acquired in the dim past in such situations, once firmly established, tend to maintain themselves and to continue in effect long after they have lost their meaning and their life-preserving function.
>
> (Schumpeter 1919 [1951]: 83–4)

Second, the social scientist must also take account of what the 'subsidiary factors that facilitate the survival of such dispositions and structures' (*ibid.*) could be. That is, s/he must pay attention to the interests of social classes and of those individuals whose interests are being served by maintaining a state of war. In other words, the second concept that needs to be introduced at this stage of our discussion is the concept of social class. For Schumpeter, a social class is defined as a set of individuals who, in a specific social context, are able to perform a given and specific social function:

> The ultimate foundation on which the class phenomenon rests consists of individual differences in aptitude. What is meant is not differences in an absolute sense, but differences in aptitude with respect to those functions which the environment makes 'socially necessary' – in our sense – at any given time; and with respect to leadership, along lines that are in keeping with those functions.
>
> (Schumpeter 1927 [1951]: 210)

Schumpeter, therefore, does not seem to think that it is possible to define social classes from either a purely individualistic or holistic methodological point of view:

> We cannot help those who are unable to see that the individual is a *social* fact, the psychological an *objective* fact, who cannot give up toying with the empty contrasts of the individual *vs.* the social, the subjective *vs.* the objective.
>
> (*ibid.*: 211, emphasis in the original)

This characterisation of social classes explains why class interest exists as such and why the fact that an individual belongs to a given social class influences this individual in a way that does not solely depend on his or her own free will but also on what Wieser called social 'compulsory forces'. As Shionoya has pointed out:

> At the outset of his 1927 article on social classes, Schumpeter noted that the concept of classes he was going to use related to historical and social entities, not to a conceptual artifact like landowners and workers constructed in economic theory. A class is more than a mere aggregate of its members and has its own peculiar life and characteristic spirit. This specification clearly means that a theory of social classes is a sociology dealing with institutional and environmental conditions that circumscribe the behavior and thought of individuals and that methodological individualism does not hold in this discipline.
>
> (Shionoya 1997: 226)

What then is the relationship between leadership and social classes? It is clear that, for Schumpeter, these two ideal typical concepts must be carefully distinguished. In a market economy, for instance, leaders – that is, entrepreneurs – do *not* form a social class (Schumpeter 1912 [1934]: 78 and 1939: 104). Although they exert a strong influence on social order through their innovative role, thus contributing to the evolution of social structure, this does not imply that 'the entrepreneurial function will *lead* to certain class positions for the successful entrepreneur and his family' (*ibid.*: 78). Moreover, the entrepreneurial function cannot be inherited (*ibid.*: 79). Finally, leaders use the social structure to achieve their ends. For instance, in ancient Egypt kings used the military aristocracy to organise society according to their own objectives (Schumpeter 1919 [1951]: 165).

Institutions and forms of organisation

Entrepreneurs are the economic leaders of the market economy. This represents 'a fundamental truth of the sociology of industrial society' (Schumpeter 1939: 96) in that entrepreneurs create the 'institutional patterns' of economic development. The excess energy that characterised the leaders of ancient societies based on aristocratic hierarchies and military objectives now turns into what Schumpeter calls 'energetic' – as opposed to 'hedonistic' – rationality or egoism in *DW* as well as in the first German edition of *The Theory of Economic Development* (*TED*). [6] In modern societies,

> [t]here is much less excess energy to be vented in war and conquest than in any precapitalist society. What excess energy there is flows largely into industry itself, accounts for its shining figures – the type of the captain of industry … In a purely capitalist world, what was once energy for war becomes simply energy for labor of every kind.
>
> (Schumpeter 1919 [1951]: 90)

In market economies, excess energy is channelled into the introduction of innovations, such as new products or new productive techniques. These innovations do not result from exogenous shocks or endogenous mechanisms of technology creation generated by firm managers or owners. Rather, they are introduced by what Schumpeter called 'New Men' (Schumpeter 1939: 96). In other words, they presuppose the emergence of leaders who use their excess energy to promote the transition from the circular flow to economic development. Therefore, innovations and economic development appear to be the natural consequences of the particular new form of leadership that prevails in a market economy.

However, innovations do not last forever. Gradually, they are diffused throughout the economic system and transformed into routines or 'habitual economic methods' (Schumpeter (1912 [1934]: 8). As they come to prevail, these individual routines and the resulting network of social rules or norms eventually produce the 'institutional patterns' that pervade the markets and influence the internal organisation of the firm.

Money and credit form the second fundamental institution to be found in market economies. To carry out new technical combinations firms must invest, and this investment must, in turn, be financed:

> Another [problem] exists for us: the problem of detaching productive means (already employed somewhere) from the circular flow and allotting them to new combinations. This is done by credit, by means of which one who wishes to carry out new combinations outbids the producers in the circular flow in the market for the required means of production. And although the meaning and object of this process lies in a movement of goods from their old towards new employments, it cannot be described entirely in terms of goods without overlooking something essential, which happens in the sphere of money and credit and upon which depends the explanation of important phenomena in the capitalist form of economic organisation, in contrast to other types.
>
> (*Ibid*.: (1912 [1934]: 71)

According to Schumpeter, money is an institutional device and a logical prerequisite of the market economy. This is why Schumpeter was so insistent on the idea that money could not be seen as a particular good or commodity. Instead, ‘the monetary circulation is, in its nature and main function in the market economy … nothing but a [social] clearing system’ (Schumpeter 1917/18 [1956]: 155). This does not mean, however, that money is a creation of the state or of law as, for instance, Knapp had argued:

> [M]oney is as little and in no other sense a creature of the law than is any other social institution such as marriage or private property. The comparison is instructive. … [T]he essential nature of marriage relations explains the legal provisions which regulate them, but the legal provisions do not explain the essential nature and causes of marriage relations. Similarly, money transactions are regulated or shaped by the legal system, but as an object of regulation they retain a separate existence apart from the legal system itself and can be explained only by their own nature or by the inner necessities of the market economy.
>
> (*ibid.*: 160–1)

Money is thus analysed by Schumpeter as a ‘claim ticket’ and ‘receipt voucher’ recognised by every agent in the economy as socially valuable. In this sense, Schumpeter’s analysis of the existence of money provides us with another example of how he builds a ‘bridge’ between economic sociology and economy theory, or between money as an institution and money as the basis of income circulation.

Financial markets are another important institution of capitalist economies. As we know, Schumpeter did not consider financial markets as fundamentally speculative.[7] For him, they participated, together with banks, in the process of transforming the financing of innovation into more permanent funding. Thus, Schumpeter did not ascribe to financial markets the role that Keynes assigned to them.[8] According to Schumpeter, financial markets are neither as autonomous nor as predominant as they are in Keynes’s approach. However, they play a key role in the transformation of saving into investment. This is why Schumpeter characterises them as the ‘heart, although [… not …] the brain’ of capitalist economies (Schumpeter 1939: 127).

The purpose of economic sociology is not only to define the main institutional patterns of capitalism but also to analyse its prevailing forms of organisation. A very good example is provided by the Schumpeterian approach to firms and competition.[9] For Schumpeter, the analysis of market forms is an objective not only of economic theory but also of the ‘science of organisation’ and, therefore, of economic sociology. This, of course, explains why the analysis of the evolution of forms of productive organisation received such considerable attention in his writings, be it in the context of his discussion of entrepreneurship, of capitalism’s tendency to ‘trustification’, or of their respective impact on innovations. From this point of view, a significant example of Schumpeter’s approach is contained in *Business Cycles* (*BC*). Chapter 3 of the first volume (Schumpeter 1939: 72–123) is devoted to the analysis of ‘How the economic system generates evolution'. In this chapter, Schumpeter formulates his 'Theory of innovation' (*ibid.*: 87–102). Apart from defining the notion of innovation, this theory of innovation – containing the essence of what Schumpeter calls 'the sociology of industrial society' – explains the emergence of innovations (*ibid.*: 96). Far from explaining innovations in terms of some kind of stochastic process or as the result of a purely economic transition from old to new production functions, Schumpeter locates them in economic sociology. This is precisely what he means when he notes that 'innovations are always associated with the rise to leadership of New Men' (*ibid.*). He justifies this view by invoking a methodological argument that directly reflects his interpretation of the relation between economic theory and economic sociology:

> The main reason for introducing this assumption [the assumption of the relation between 'innovations' and 'New Men'] into a purely economic argument not primarily concerned with the structure of society is that it provides the rationale for the preceding assumption.
>
> (*ibid.*)

More precisely, the emergence of entrepreneurs or the transition from 'competitive' to 'trustified capitalism' is described as a change in the forms of organisation. This change is the result of the emergence of new men or new leaders who, through their innovative activity, generate 'a process subject to institutional change'. Changes in the forms of organisation are therefore primarily sociological rather than economic in nature. Entrepreneurs are the new leaders who replace the owners in the circular flow and, in particular, the old leaders. At some point in historical time, and as the result of organisational change, the managers of giant firms become the 'new' leaders, replacing individual entrepreneurs who have become 'old' leader-types. Here again, the sociological distinction between leaders and followers appears to be the key to organisational transformations.

The specific interest that Schumpeter took in the study of institutions and forms of organisation also sheds some light on his view of economic rationality. Contrary to conventional economic analysis as well as modern neo-institutional theories, Schumpeter did not rely only on the assumption of utility maximisation. Instead, he held the view that human motives were diverse and multi-faceted. Schumpeter was, thus, not a methodological individualist. For him, individual behaviour was not independent of institutions and social forms of organisation. Entrepreneurial competition, for instance, cannot exist in a warlike society. But individual behaviour – whether 'hedonistic' or 'energetic' – can, through social interaction, prompt the emergence of new social rules or institutions that appear a posteriori, that is, independently from a priori existing individual wills.

History and institutional change

The relation that Schumpeter established between history, economic sociology and economic theory was instrumental in shaping his approach to institutional