BOOK REVIEWS

PROPHET OF INNOVATION:
JOSEPH SCHUMPETER AND CREATIVE DESTRUCTION
John K. McCraw
Belknap Press of Harvard University
2007 / 791 pp. / $35.00

Reviewed by Robert Formaini
Quantecon Consulting

While it is true that the phrase “creative destruction” is widely recognized, its author would no doubt have preferred that the body of his theoretical work in economics and political economy be better known than his two-word, famous phrase about capitalist process. But Schumpeter, like Adam Smith, Marx, Keynes, and so many other giants in the field of economics, is today a well known name who is generally no longer read. Most of us think we know what these classic works in economics say without having to take the time to read them. We have a “Cliffs Notes” version in our heads. That is the fate of most classics in all fields, and Schumpeter is no exception. How many people know which of his works contains the phrase that has made him immortal?

He was born in 1883 in Triesch, a small town south of Prague in Moravia where his family had lived for four centuries. Schumpeter had, from the beginning, an entrepreneurial role model to learn from: his class-conscious, social-climbing mother whose decisions on how to change her own life were always tied to the idea of advancing her son’s lifetime prospects. Whether it meant moving to larger cities to expand his educational opportunities or marrying an older, prosperous man, Schumpeter’s mother did what was necessary to ensure her son’s rise in Austria’s academic and social circles. His primary and secondary education was first rate, done first in Graz, then in a famous preparatory school—The Theresianum—in Vienna. Given this background, he had little trouble being accepted into the University of Vienna. There, under the tutelage of giants such as Eugen von Boehm-Bawerk, Schumpeter matriculated in the young field of economics, which then was taught in Austria under the auspices of the department of law, by professors who were members of the civil service.

He thrived and much loved the intellectual “coffee house” atmosphere in Vienna, drinking in the arts, politics, and general availability of mental stimulations along with all his formal academic training. He learned the twin gifts of witty conversation and the open mindedness of coffee house-style argumentation that would be features of his life thereafter. He preferred the company of smart people with whom he disagreed to boring people who allegedly agreed with him. He once said that, after listening to some of the people
who professed to agree with his rather sophisticated (and very European) conservative views, he was probably wrong. But whether he was right or wrong, it was in Vienna that Schumpeter’s ambitions to be a world class scholar and international economic authority took shape. And it was in Vienna where Schumpeter, perhaps inevitably, came to be influenced by the Austrian School, particularly its founder Carl Menger, the aforementioned Boehm-Bawerk, and eclectic Fredrich von Wieser. Although never a thoroughgoing advocate of total laissez-faire, like Ludwig von Mises and the modern strain of Austrianism that passed from Mises to the late Murray Rothbard, Schumpeter’s Austrian pedigree in economic and political questions was always in evidence. As for his life goals, he claimed three: becoming the world’s best economist, lover, and horseman. “I am having some trouble with the horseman part,” he quipped.

Two theoretical features of the neoclassical marginal revolution deeply affected Schumpeter: marginal utility and decreasing returns. The first he summed up as follows: “Marginal utilities do not depend on what society as such has, but on what individual members have. Nobody values bread according to the quantity of it which is to be found in his country or in the world, but everybody measures the utility of it according to the amount that he has himself.” (p. 51). The second idea, that marginal costs determine (or ought to) selling price, and that economies of scale drop average and marginal costs to the point where large volumes sell at lower rates, suggested (for Schumpeter) that previous pricing ideas were all wrong and no longer applicable to a growing, evolving capitalist system. The dynamics of capitalism were to become, basically, the linchpin of his entire academic career.

His dissertation research became his first book, The Nature and Content of Theoretical Economics. It was not a great success nor the rocket boost to his career for which he had hoped while writing it. He had visited many countries during this part of his life, and had spoken with many of his famous contemporaries, especially in England, prior to tackling this treatise on where his chosen profession stood. But the book was noticed, and Schumpeter was able to receive an offer of an academic position, which was difficult at the time due to the scarcity of openings in the professoriate and the always present, sometimes subtle, European anti-Semitism. And so, after graduating from Vienna and returning from his multi-nation travels, he accepted a rather obscure teaching post several hundred miles away from Vienna in Czernowitz, a city now in the Ukraine, then at the edges of the Austrian empire. He planned to be there but a short time, the escape vehicle being his Theory of Economic Development, published in 1909. It is a remarkable book and one that, according to McCraw (p. 69) “turns Marx on his head,” transforming Marx’s evil, rapacious capitalists into modern entrepreneurs, the bringers of economic plenty. They also, along with the money markets which provide the engine with necessary economic fuel, (p. 71) “craft the future.” The entire idea of using stable circular flow models or even general equilibrium constructs becomes problematical if one adopts the Schumpeterian framework.
Freedom from Czernowitz came two years later when Schumpeter moved to a position at the University of Graz. Having married an Englishwoman (against his mother’s wishes), he watched as the world slipped into the Great War and away from the entrepreneurial capitalism that had gone such a long way towards creating globalization prior to 1914. War-related circumstances separated him from his new wife for six years after she returned to England at its outbreak. Schumpeter never bothered with the legality of securing a divorce, which came to haunt him later in his life when he decided to marry for the second time. Another thing that would haunt him was his rise to prominence in Austria, becoming a finance minister in the government, then a partner in a lucrative investment bank. Many of his intellectual, political and academic enemies would raise questions about the appropriateness of his financial arrangements with the bank, even though an unexpected Austrian depression in 1924 caused its collapse, along with Schumpeter’s personal financial fortune. A man of principle, it would take him many years to pay off all his personal debt, but while so many others simply took bankruptcy or never repaid, he did not. Two short years later, his second wife Annie died in childbirth, and his mother died shortly thereafter, a personal tragedy that would color his outlook for the rest of his life. Just as his career was taking off, he began losing his closest loved ones. Daily, he wrote long diary entries addressed to his Hasen, (dear ones, or more specifically, rabbits), a strange but perhaps understandable habit.

By 1927, Schumpeter had begun commuting to Harvard to lecture, a precursor of his full time employment opportunity there which came finally to fruition in 1932. In the interim, he had co-founded the Econometrics Society, along with Ragnar Frisch and Irving Fisher of Yale. It was peculiar for an economist who did not use mathematics much in his own work to co-found such an organization, but his views on math in economics never varied throughout his life. That attitude, somewhat strangely for an Austrian, might be summed up in parody: “I am not a mathematical economist myself, but I hang out with them, praise them, share ideas with them, and encourage them in their endeavors every day!” It was a lifelong and unrealized goal of Schumpeter’s that economics should become a “precise” science. That methodological and epistemological bias is clear when reads Schumpeter’s scholarly masterpiece, the History of Economic Analysis, finished by his third wife, Mia, after his death. Most praise in that work is reserved for thinkers who developed abstract models or who employed, or attempted to employ, mathematical methods in economic theorizing.

Schumpeter’s days at Harvard were, for him, a mixture of very good times and great despair. He hated the daily bureaucratic details of academe, the internal politics and, generally, wasting any precious time on any endeavor that did not create more output. During the second World War, he and Mia were investigated by the FBI, Mia for her scholarly work on Japan both prior to and during the war, and Schumpeter for his geopolitical views regarding Europe and the Soviet Union. J. Edgar Hoover recommended strongly to subordinates that they both be prosecuted, but no case could be made against them, and they
were not bothered other than being investigated in the first place.

Another personal annoyance was the acclaim Keynes received for his General Theory of Employment, Interest, and Money, published in 1936. Business firms and entrepreneurs are completely absent (p. 273) from Keynes’s book, and Schumpeter felt the praise unwarranted and sought to return these elements to macro theory for the rest of his life. It was not that there was personal animosity between the two famous economists, but it certainly was the case that Schumpeter felt his work slighted by the profession relative to the lavish praise poured upon the very serious errors he claimed that he found in Keynes’ writings. In a letter to Oscar Lange he wrote, regarding The General Theory: “But what I find so difficult to understand is that so obviously bad workmanship is so readily condoned by people who know what good workmanship is.” (p. 275) He was equally frustrated that he could not seem to reach younger colleagues when it came to refuting Keynes.

In 1942, Schumpeter wrote the work for which he is most known, Capitalism, Socialism and Democracy, the book in which he first uses his immortal phrase “creative destruction.” McCraw’s analysis of this book in his biography is long and provocative, the author arguing that Schumpeter—far from defending socialism, as many casual readers wrongly assumed—stacked the deck against it, writing his criticisms as faint praise in an “ironic style.” Schumpeter methodically goes about demolishing Marx (he “relied too much on Ricardo,” p. 349) and his doctrine of the increasing misery of the workers under capitalism.

In elegant prose, Schumpeter demonstrates that it is precisely capitalist process that raises the living standards of those who work under it. In unforgettable passages, he examines the evolution of capitalism and despairs that its future is bleak precisely because it is so dynamically successful: “Capitalism stands in the dock of history, the judges have a sentence of death in their pockets. A successful defense results merely in a change in the indictment.” And, Schumpeter believed, if capitalism is thrown away, so too goes democracy: “Modern democracy arose with capitalism, and in causal connection with it” (p. 369). Based on his 1930s and 1940s experiences with Japan, Germany, Russia, and Italy, Schumpeter became convinced of the incompatibility of any form of collectivism with democracy. He argued that democracy cannot be an end in itself but is simply a process (p. 368) and dynamic capitalism must be its concomitant foundation.

Space does not permit a full overview of all the interesting, important and provocative material in this biography, so to close, here is a question for ARED readers: What relevance does it have for regional analysis and/or planning?

In one sense, no one venerated economic history more than Schumpeter, and no one did more to support it even as it continues to decline in influence and personnel throughout academe. History of Economic Analysis, despite its biases, remains one of the great intellectual and scholarly efforts in the history of the development of economics or any other field. But how many economists have actually read even part of it, let alone all of it? Many more non-economists read Capitalism, Socialism and Democracy
than economists, and few people, whether economic practitioners or otherwise, have delved into the pages of Schumpeter’s other book offerings. So what can he tell us today of interest or importance?

First, development and growth are the products of capitalist modes of financing coupled with the vision and energy of entrepreneurs. This dynamic process never rests, so general equilibrium models simulating it are pointless. The man who all his life sought to make economics a rigorous, pure science denies, fundamentally with his assertions elsewhere in his writing, that such a thing is possible at all. We should tread lightly on markets and, if we must tread, we need to try and remember how best to structure interventions so as not to minimize entrepreneurial energy and enthusiasm. Incentives should be a given to lure such activity if growth is sought. But it needs to be remembered that growth is destabilizing and, for some, troublesome. Yet there really is no reasonable alternative to the long term trends of the marketplace, especially now that the world trade is becoming more integrated and globalized. Far from worrying about cycles and the influence of large firms, we should welcome both as central to capitalist process.

Second, we can take from Schumpeter humility. Not personal humility necessarily, but an intellectual humility that tells us we don’t know as much as markets and we cannot predict where things are—or should—be going. Certainly, we cannot choose the correct technologies or resource uses in the long run since dynamic markets will invalidate all such rigidities. To try and prevent such changes requires rigid central planning, an approach to development and growth that is clearly empirically discredited.

Finally we can, along with Schumpeter, always appreciate the need to educate economic practitioners in the history of their field. We need to do this so the foundations upon which we build today’s models and policies can be clearly understood for their initial insight and brilliance, but also—and perhaps more importantly—for their real and/or potential shortcomings. We need to understand, thoroughly, our own biases which animate, but also potentially cloud, our work as Schumpeter so eloquently spelled out in his 1948 presidential address to the American Economic Society. If we do these things we will be—whether we realize it or not—honoring one of the greatest thinkers our field has yet produced.
The reviewer

Robert Formaini was trained in economics at Virginia Commonwealth University, the University of Virginia and the University of Texas at Dallas. Before teaching at the University of Dallas, Oxford College of Emory University and Reinhardt College, he was Vice-president for Public Policy at the Cato Institute, where he founded and edited The Cato Journal. He heads Quantecon Consulting and continues to teach at Dallas area colleges where he is Instructor of Economics at the University of Texas at Dallas and Collin County Community College. He recently retired after eleven years as Senior Economist/Economic Writer at the Federal Reserve Bank of Dallas.

• 972 612 5905
• rformaini@ccccd.edu