Schumpeter 's vision: why *Capitalism, Socialism and Democracy* partly missed its target

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Capitalism, Socialism and Democracy contains two forecasts. The first of these was that capitalism would destroy itself due to internal decay, and the second was that it would be replaced by socialism. Schumpeter was right about the decay of capitalism but wrong about socialism replacing it. What follows is a reflection on this contrast which starts from a concept of his own, which is the 'vision' of scholars and writers. This is how he defined it in his posthumously edited *History of Economic Analysis*:

> Obviously, in order to be able to posit to ourselves any problems at all, we should first have to visualise a distinct set of coherent phenomena as a worth-while object of our analytic efforts. In other words, analytic effort is of necessity preceded by a pre-analytic cognitive act that supplies the raw material for the cognitive effort [and this] will be called Vision ([1954] 1986: 4).

The vision of most authors changes throughout their working lives according to their learning and experiences. The direction is usually towards broadening of their vision, and Schumpeter was no exception to this. In his case, however, the economist's vision from which he started was an unusually narrow one. He saw economics as a self-contained system, which was why he campaigned for having more mathematics in it and was a founder member of the Econometric Society. This conviction weakened as he learned more, but much of it still influenced the writing of *Capitalism, Socialism and Democracy*. He was then able to see that capitalism as he knew it would decay but was not what would take its place. This was not socialism, as he thought, but financialization, made possible by the progressive capture of laws of property, especially those relating to money, by relevant interests.

Ultimately, there are two basic visions of, or approaches towards understanding economic life. One is the long western tradition of seeing it as depending upon cultural values expressed in laws and institutions, especially insofar as these relate to ownership. This is summed up by Keynes at the end of the *General Theory* as 'soon or late, it is ideas, not vested interests that are dangerous for goodor evil.' Marx's writings express the opposite view, that ideas, laws and institutions are no more than reflections on a psychic plane of economic realities.

Schumpeter is not considered, nor would he have considered himself to be a card-carrying Marxist, but Professor Esben Sloth Andersen (2006) has commented on the extent to which the theoretical parts of Schumpeter's *Business Cycles* had roots going back to his student days, influenced by the German Historical School and the neo-Marxists.

He certainly shared the view of Marx that economic life is powered from the bottom up rather than from the top down. For example, he wrote about the 'energy inherent in the economic system,' which fits in with his early ambition to develop economics as 'a scientific discipline distinct in kind from political economy... logical and mathematical' (McCraw 2007:49) If this could beachieved, it would of course have to be free from influence from any exogenoussource.

The contrasting 'visions' of Schumpeter, Keynes and Adam Smith

Schumpeter illustrates what he means by 'vision' by reference to Keynes, whose *General Theory* was published in 1936. This, Schumpeter wrote,

> reflected 'an English intellectual's vision of the characteristics of England's ageing capitalism'. The process stands out in this case with such unsurpassable clearness, because we can read a formulation of the vision, as yet analytically unarmed, in a few brilliant pages of Keynes's *The Economic Consequences of the Peace* (1919). So far as this line of endeavour of a man of many interests was concerned, the whole period between 1919 and 1936 was then spent in attempts, first unsuccessful, then increasingly successful, at implementing the particular vision of the latest ([1954] 1986: 42).

Schumpeter and Keynes approached economics from opposite poles, and their visions were quite different, Nevertheless, *The Economic Consequences of the Peace* includes a passage which anticipates the main theme of *Capitalism, Socialism and Democracy* in a remarkable way:

> We are thus faced in Europe with the spectacle of an extraordinary weakness on the part of the great capitalist class, which has emerged from the industrial triumphs of the nineteenth century and seemed a very few years ago our all-powerful master. The terror and personal timidity of the individuals of this class is now so great, their confidence in their place in society and in their necessity to the social organism so diminished, that they are the easy victims of intimidation ... They allow themselves to be ruined and altogether undone by their own instruments, governments of their own making and a press of which they are the proprietors. Perhaps it is historically true that no order of society ever perishes save by its own hand. (222).

The last word on Schumpeter's 'vision' should perhaps be left to a great student of his work; Mark Perlman:

> In the absence of any other specification, it seems to me that he was groping for some paradigm of fundamental social morality. He was easily side-tracked, and spent too much effort decrying ideology... My suggestion is that the vision Schumpeter really sought was something akin to a theological paradigm - integrating fundamental non-changing, ethical and social values and the dynamic working of an evolutionary economy... Thus, I conclude that Schumpeter wanted a vision which embraced and bound together the permanent and exogeneous with the sociological-transitory and indigenous, *and he failed to find it* (1986: xxiii, xxxv) emphasis added.

Not alone did he fail to find such a wider 'vision,' he never fully outgrew his desire as a young man to see economics as a science in which causality was insulated from external influences. This meant that even when writing *Capitalism, Socialism and Democracy* he still believed that in respect of

> new factors which determine any business situation ... act from outside the economic sphere ... we must try to abstract from [them] when working out an explanation of the causation of economic fluctuations ... which are inherent in the working of the economic organism itself.

Such a self-imposed restriction meant that Schumpeter was trying to explain activities caused by human agents in terms of a concept which is only partially human, that of *Homo Economicus*. He did outgrow his early enthusiasm for econometrics. so that he eventually became disillusioned with mathematical economics, with its need to disregard so many variables in real-life business situations in order to get the equations to work. As Professor Andersen noted,

> when he came to write *Capitalism, Socialism and Democracy* he expanded the boundaries of his analysis beyond those which had made *Business Cycles* such an inadequate attempt to explain long-term economic fluctuations.

It also seems that Schumpeter was little troubled by the questions which were of concern to the founder of his profession, Adam Smith. Smith's *The Wealth of Nations* is a treatise on economics written by a moral philosopher whose 'vision' had been earlier expressed in *The Theory of Moral Sentiments.* As a result, Smith's economics is capable of taking in a wide range of human factors which Schumpeter discounted. Paramount amongst the consequences of those human factors are the institutions which people shape for their own public good, and which establish the rules of the game for economic activity. Smith gave pride of place to the market, but in contrast to Schumpeter, he understood that markets only exist because of laws which grant and enforce property rights.

Schumpeter's Economics as Revealed in *Business Cycles*

Schumpeter set out his standpoint at the outset of this very large (1100 page) book:

> Among the factors which determine any business situation there are some which act from without the economic sphere.... [W]e must try to abstract from [these external factors] when working out what is inherent in the working of the economic organism itself. (1939: 7)

This is a strange view of economics, which is the science of *voluntary* exchanges. These are only possible within the context of the exogenous source of respected property rights, which is law, exogenously produced and enforced by the State; otherwise only might is right.

Schumpeter's dismissal of any need for legally enforceable rights, because they are exogeneous to economics as he understood it, is particularly evident in his massive 1939 book, *Business Cycles.* It is worth paying some detailed attention to this, because it illustrates components of his thinking before these were somewhat relaxed in the writing of *Capitalism, Socialism and Democracy*.

Business Cycles has as its subtitle 'A Theoretical, Historical, and Statistical Analysis of the Capitalist Process.' It is history of technology superimposed on cyclical economic theory as developed by the Russian economist Kondratieff. In his 1911 book Schumpeter had noted that 'innovations do not emerge regularly but are more in evidence at certain times than at others.' (223 ff.) Reflecting this, his account of three long cycles shows each to begin with a 'cluster' of innovations. These cycles were the Industrial Revolution; the Age of Steam and Steel; and Electricity, Chemicals and Motors. Significantly the last cycle ended in 1929, the year of the great Crash.

In studying these, Schumpeter paid only passing attention to their monetary aspect. Consequently, it was his student, Hyman Minsky (1982) who applied the cyclical theory to which Schumpeter had devoted so much attention, to booms and slumps in finance.

Business Cycles was criticised (especially by Kuznets in AER) for its reliance on these 'clusters' as the *originators* of economic upturns, because Schumpeter offered no reason why they should come into existence at all, much less why they could actually bring about economic development. By trying to abstract from 'exogenous factors that act from without the economic sphere,' Schumpeter was ignoring causality, as Kuznets pointed out. Clusters of innovations were an effect, not a cause.

In fact, the exogenous factor of property rights can be shown to explain the economic fluctuations Schumpeter described. His first cycle, 'the industrial revolution,' is perfectly explained by the coming of real property, that is, ownership not subject to arbitrary interference from rulers (Landes 1939); and the second one, 'the age of steam and steel,' reflects the crucial change in the law which delivered limited liability to investors in joint stock companies.

Mandel (1975) studied long economic cycles from a Marxist perspective and found it 'astonishing' that Schumpeter should have overlooked the importance of any institutional change that brings with it the prospect of a steep rise in the rate of profit. Limited Liability for investors in joint-stock companies increased their anticipated rate of profit so much that when the State of New York introduced it in 1811, every other State had to follow suit quickly as investment flooded to where it could be better protected.

The spread of similar legislation throughout Europe, following Britain in 1854, may even be the reason why the revolution called for in the *Communist Manifesto* in 1848 never happened in capitalist countries. It led to so much investment, profit and employment in the second half of the 19th century as to falsify the claim to workers 'that they had nothing to lose but their chains.' What Schumpeter identified as 'creative destruction,' whereby it was innovation or the lack of it which decided which firms should live or die, was a crucial component of this unprecedentedly dynamic process.

It is astonishing that Schumpeter could write that the Limited Liability Acts 'only codified and enhanced business practices that had already been developing' (*Business Cycles* 323). It seems that his belief in the autonomy of the economic process was so strong that he could not see the impossibility of businesses giving themselves a privilege such as limited liability. This is something which could only be done by the undeniably exogenous factor of legislation.

Similarly, Schumpeter's third long cycle, 'electricity, chemicals, motors,' came about through patents. Abraham Lincoln said of these that 'they added the fuel of interest to the fire of genius,' and Wernher Siemens actually went into politics in Germany to get a patent law like that of the United States there (Kingston 2023).

The combination of laws which made possible the industries which are based upon brands, that is, those of mass-market consumer goods, could have given Schumpeter a fourth cycle. Although the fastest growth of the markets for these was a phenomenon of the post-World War II period, the legal changes which made them possible were much earlier. The first of these laws was that of trademark *registration*, through which brands are made into legal monopolies. This became effective internationally from 1883 through the signing of the Paris Convention on the Protection of Industrial Property.

Registration was an enormous improvement on the protection of reputation available previously. This had required proof in Court from members of the public that they identified a mark on a product as clearly indicating its source, and this proof was expensive to search for and almost impossible to obtain. Worse, even if a judgment could be obtained against one copier, there were invariably others to be pursued, so that many firms abandoned litigation as means of protecting their products' reputations. In contrast, once national Trademark registers were in place, this settled the question of ownership of a brand once and for all, and made copying a dangerous business.

Nor is it by any means only the industries which are characterised by branded products, particularly those of fast-moving consumer goods, which depend largely for their existence on trademark registration law. The range of services which support these products, such as advertising and market research, amount to large industries in themselves. These would simply collapse if there were no brands in the modern sense, that is, those which depend upon having a legally granted trademark monopoly.

To-day, too, the media obtain most of their revenue from advertising, and professional sport is so largely financed by sponsorship that it also would be impossible without the advertising value it can offer to brands. Franchised businesses, from hotels to hamburgers, depend completely on the simple piece of positive law which delivers trademark registration. For them, it is essential that ownership of a brand can be legally separate from ownership of the associated physical assets. It is even possible to credit quite a proportion of the modern haulage industry's existence to the same property right, since its cargoes are often close to being identical at the physical level, but differences in the public perceptions of brand names still make the goods worth moving, often over very long distances.

The Broader vision of *Capitalism, Socialism and Democracy*

It is hard to imagine that as Schumpeter worked through the heavy task of writing *Business Cycles*, it was not progressively borne in on him that the capitalism he had known was close to death. It had been characterised by the formation of new firms which produced a constant stream of technological innovations. Firms which failed to continue to innovate were replaced by new firms which did, in the process which he was to label 'creative destruction' in *Capitalism, Socialism and Democracy*.

As he did indeed forecast, the capitalism that Schumpeter wrote about did not survive, but it was not replaced by socialism as he thought it would be. Instead, the laws and institutions which he discounted, but which are the main sources of all economic change, were captured by interests. The dynamism of capitalism as he so well identified it, was creative destruction, in which the more innovative firms survived in competition with less innovative ones. Limited liability enabled firms to grow and merge to sizes that cannot be challenged any more in this way. Similarly, patent law was changed worldwide so that is it could only be used to strengthen the largest firms. Creative destruction was not compatible with this ubiquitous growth in market power.

When we leave *Business Studies* for *Capitalism, Socialism and Democracy,* we find a book that is almost one of political economy, which is just what Schumpeter had all along turned his back on. It touches on a number of factors which he had explicitly excluded from consideration in his earlier work. This explains the book's success in discussing the decay of capitalism, but not why he thought that socialism would replace it.

It may be worth speculating briefly as to why he should have chosen this particular option, since he offers only assertion, not reasons why capitalism's replacement should be socialism rather than anything else. On page 169 of *Capitalism, Socialism and Democracy* he asks the question 'Can socialism work?' and then goes on to reply to this, 'Of course it can!' A few pages later (172) he asserts that 'there is nothing wrong with the pure logic of socialism.'

One possible explanation is that a socialist state is a bureaucratic one, and Schumpeter had great admiration for the bureaucracies he had known in Europe. These were all clones of Napoleon's reform in France followed by Hardenberg's in Prussia. Although the one he knew personally was that of Austria, from his time as Finance Minister there, his ideal was Prussia's, which he described as 'supremely competent, utterly incorruptible, completely independent of politics' (*Capitalism, Socialism and Democracy* 346).

The civil servants who managed these were efficient because they had a significant degree of independence of their political masters, coming, as Schumpeter pointed out, from

> a social stratum of adequate quality and corresponding prestige... Not too rich, not too poor, not too exclusive not too accessible (1997 [1942]: 294).

Because he was writing *Capitalism, Socialism and Democracy* after moving to the United States, he may well have failed to advert to the unfortunate reality that this social stratum had been wiped out everywhere in Europe by World War One. American bureaucracy did not have the same tradition and roots, and he thought very little of it (1939:1048).

Whatever the reason, the role of law and institutions still did not rank highly enough in Schumpeter's vision for him to be able to grasp why socialism would not replace capitalism as he had known it. What did progressively take its place was the capture of lawmaking by interests, especially in relation to property rights, and within these, above all in respect of money.

Governments and the laws they make exist because of visions of the kind referred to by Perlman in the quotation above, a vision he claimed Schumpeter was seeking but never found. The work of making, enforcing and maintaining laws, especially laws of property, has to be done in the face of pressures from self-serving interests which work to bend the outcomes to suit themselves rather than the public good. The extent to which these pressures can be resisted, depends upon the strength of this *public* vision. Schumpeter sensed this in what is probably his least-known work. *The Crisis of The Tax State*. This was published in Germanin 1918, though not translated into English until 1951. It contains an insight which he seems to have discarded when he went on to work on *Business Cycles,* whichis his comment on the State that

> It is part of its nature that it opposes individual egoism as the representative of a common purpose. Only then is it a separate indistinguishable Entity ([1951] 1918: 110).

This holds the key to why capitalism as Schumpeter knew it, came to an end. Traditionally, those who dealt in money were particularly heavily constrained by laws, such as those which made them individually responsible for their dealings 'to their last coin and their last acre.' Inevitably, their 'individual egoism' stimulated them to exercise all possible power on governments to escape from these.

Their first step in this direction was to seek to get limited liability extended to banks. The first known Act of this kind, that of the Dublin parliament of 1782, ended with a clause denying its privilege to those who dealt in money. The next such Act, that of New York State in 1811, also applied only to manufacturers. Eventually however, after long resistance was overcome, bankers obtained limited liability in Britain in 1879, and from then on it was ubiquitous.

The next objective was to obtain central banking, so that there would be a source of funding of last resort to prevent bank failures, and this was first achieved and the Federal Reserve Bank of the United States in 1913.The accounting profession also persuaded governments they should be allowed to regulate themselves.

These and other successes also explain why capitalism was replaced, not by socialism, but by financialization.

Schumpeter was ill-equipped to take account of these interactions because his dismissal of the relevance of law to economics was expressed with particular force in relation to money. He had always regarded money as important and had early identified that the process of banking is ‘creating purchasing power out of nothing’ ([1911] 1934: 73). This, he wrote, means that

> In real life total credit must be greater than it could be if there were only fully covered credit. The credit structure projects not only beyond the existing gold basis, but also beyond the existing commodity basis. (ibid.: 95).

In *Capitalism, Socialism and Democracy*, he would further discuss

> ‘the practice of financing enterprise by bank credit, i.e. by money (notes or deposits) *manufactured for that purpose’* 1997 (1942]: 167, emphasis added).

As to Schumpeter’s explicit view of the relationship between money and law, this is cited by Arena and Dangel-Hagnauer (2002) and its source in translation is found in Andersen (2006):

> Money…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.

This is a truly astounding statement from an economist, considering that fiat money depends completely on the laws that make it legal tender and acceptable for tax payments. However, it is of a piece with his more general dismissal of factors exogenous to what he considered to be the independence of economics as a science.

Capitalism and innovation

The capitalism that Schumpeter wrote about in 1911 was responsible for the greatest advance in economic development the world had ever seen. Capitalism is the modern variant of the systems of individual property rights which made the Western world uniquely rich, because they enable individual human creativity to be directed into economic channels. Such rights force us to serve social ends in following our own interest. Civil society can emerge from the social space and the opportunities to generate wealth which they provide. The unique value of property rights, therefore, is that they can *civilize* self-interest.

Without adverting to the cause of this advance, which in any event he would not accept, Schumpeter described the results in the first two of his business cycles; the industrial revolution, and the age of steam and steel. He rightly grasped that it was due to economic innovation, but because of his unwillingness to accept exogenous causes of economic change, he did not see that the crucial element in it was legislation which gave limited liability to investors in joint stock companies.

It is of the greatest interest that for Schumpeter, the key actor in the innovation process, the entrepreneur, is not the individual who actually carries out the task of turning an idea into working reality, but the person who *finances* it, and of course he was right. The key invention of the industrial revolution, James Watt's separate condenser, which transformed the efficiency of Newcomen's steam engine, would have been stillborn without the backing of Boulton, the rich Birmingham button manufacturer.

For any investor, the key question is the risk of failure, which is highest with anything new. Before limited liability law, this could be disastrous, since he could be liable for debts of a project right up to the limit of everything he owned. Once that law came into being, all that he could lose was what he had invested in the project. Moreover, he could now have a portfolio of projects, whose risk as a whole was lower than that of any individual stake.

The beneficial effects of limited liability were greatest before bankers were granted it. Once this happened, fruitful innovation was harmed in two ways, The first of these was when money could be created from nothing without limit, firms found that they could obtain and use it to grow and merge without having to take the risk of radical innovation. In 1910, a year before Schumpeter's book, Rudolph Hilferding in *Finance Capital*, had adverted to how technological innovation was increasingly being driven, not by newly founded entities, but by large, established firms on the dual basis of in-house research and development with banking finance.

In *Capitalism, Socialism and Democracy,* Schumpeter called this 'trustified capitalism' and referred to research being 'routineized.' He did not advert to the fact that the research and development such firms do has a strong tendency towards being incremental, limited to relatively small improvements in their existing products rather than in radical innovations. Secondly, the larger such firms become, the more impregnable their position is, so his concept of 'creative destruction' no longer applies to them. Moreover, their 'routineized' innovation practices cannot provide the radical innovations needed today, for example to deal with with climate change.

The second harmful effect only became apparent later. The more financial interests were able to escape from constraints, as touched upon above, the more profitable they became. Their share of total corporate profits in the US, for example, increased from around five percent in the immediate post-war period, to almost fifty per cent just before the 2009 crisis (Philippon and Reschef 2009). This could not fail to have brainpower, talent and energy sucked away from technological innovation into finance, to the detriment of genuine economic development (Kingston 2020).

There is another aspect of the capture of the laws of property by interests that is directly related to *Capitalism, Socialism and Democracy.* This is Piketty's empirical demonstration of the inevitable result that return on capital must outstrip the growth of economies as a whole, and lead to corresponding growth in inequality. At least since Bismarck's introduction of social welfare in Germany in the 1880s, Governments have been trying to temper this by redistribution, but another of Schumpeter's remarkable insights in *The Crisis of the Tax State* is that they would eventually be unable to keep up with the demand of their populations for this (97). Both the French and Russian revolutions show that people will put up with high levels of inequality as long as those at the top are seen to be performing socially productive functions, but not otherwise.

The growth of populism in all democratic societies is evidence that today's wealthy are not seen positively from this aspect, which is further confirmation of the first forecast in Capitalism, Socialism And Democracy. We can only regret, therefore, that Schumpeter did not develop the other insight in his 1918 book. This was the need for States to resist 'unconstrained individual egoism,' It was the results of their failure to do this, not socialism, that replaced capitalism. Had he done this, Capitalism, Socialism and Democracy could have been completely successful instead of almost so. It was his wish for an economics without exogenous factors in the form of legal institutions, that stood in the way of such a triumph.

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