

REVIEW OF THE THEORY OF ECONOMIC DEVELOPMENT: SOME SHUMPETRIAN INSIGHTS

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Abstract

In this paper theory of economic development of economic thinker Schumpeter is going to be refined and analyzed. In order to get begin the process of economic development, Schumpeter believes that he need an approach to innovation and changes. According to him, entrepreneurs are the central figure in the economic development dynamics. In terms of scientific thought about innovation, Schumpeter also builds a theory of business cycles in capitalism, which is known as the innovative theory of cycles. Namely, Schumpeter has a special place in the development of economic thought. Among economists there is no single view of his work. For example, US economist Schumpeter Haberler says is closer to Marx than to any others economists, others considered him as a neo-marginalist, third of economist who does not belong to any direction of economic thought. In this paper, hypothesis related to *the main features of Schumpeter's theory of economic development are as follows: circular flow; innovation and the role of entrepreneur; business cycles; end of capitalism.*

Keywords: theory of economic development, innovations, entrepreneur, business cycles, capitalism.

JEL Classification: B0, B3, O1

1. Introduction

Schumpeter's work was influenced by various schools and authors, representatives of the Austrian Subjectieve School, representatives of the Lausanne school of economic balance (especially Walras), representatives of the German cultural-historical school, the Marxist school and others. According to Walras, there are three major entities in the societies: customers, suppliers of factors of production, and entrepreneurs. He pays special attention to these factors and their functions. According to Walras the function of the entrepreneur consists of connecting different markets, in the procurement of production services, organizing the production and taking care of the realization of finished products. He gets a reward in the form of profit for the services he makes. Besides the reward for effort, Walras also considered that profit as a reward for a risk which the entrepreneur is exposed to. When explaining the profit Walras makes a mistake, arguing that in the conditions of economic equilibrium there is no profit. According to Marx in such conditions there is not exist extra profit.

Namely, a literature on the history of economic thought and economic theories was consulted in the process of writing of this paper. Precisely, the economic thoughts and theories of economic thinker Schumpeter are investigated. For this purpose, the subject of analysis was his scientific contribution in writing books and course papers in the appropriate field.

Table No. 1. Schumpeter's core works [1]

1908	Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie	Wesen analyzes 'The Essence and Main Contents of Theoretical Economics'. It focuses on the essence and limits of Walrasian equilibrium economics and it uses these limits to emphasize the necessity of developing the complementary evolutionary economics as a fundamental field of economics.
1912	Theory der wirtschaftlichen Entwicklung	Entwicklung presents on 548 pages the essence of Schumpeter's Mark I evolutionary economics with heavy emphasis on the personality of the Innovative entrepreneur. Chapter 7 includes a sketch of a general theory of socioeconomic evolution (Mark SC). Translations of core parts are now available. (Schumpeter 1910, 1912a, b)
1934	The theory of economic	Development is the translation on the 255 pages of the

	development: an inquiry into profits, capital, credit, interest and the business cycle	radically revised and shortened 2nd edition of <i>Entwicklung</i> (Schumpeter 1926). Its focus on the basic Mark I modelling of economic evolution am obtained by concentrating on the entrepreneurial function and by removing the last chapter of <i>Entwicklung</i> .
1939	Business cycles: a theoretical, historical, and statistical analysis of the capitalist process	<i>Cycles</i> presents a Mark I theory waveform economic evolution that is used for a sketchy analysis of 200 years of capitalist economic evolution. For most purposes many of the 1077 pages can be skipped by reading the Rendigs Fels's excellent abridged edition. (Schumpeter 1964)
1942	Capitalism, socialism and democracy	<i>Capitalism</i> has, in the 1950 edition, 425 pages. Part 2 can be read as relating to the last chapter of <i>Entwicklung</i> as well as to some of the arguments in <i>Business Cycles</i> . Thereby it becomes clear that we are facing a Mark II extension of the theory of economic evolution as well as the applications of a general theory of socioeconomic coevolution (Mark SC)

2. Theory of Economic Development

While creating his theory of economic development Schumpeter starts from the point of Leon Walras' learning for the general economic equilibrium, i.e. a doctrine which can't explain the development process. Specifically, it starts from a hypothetical state of rest, which he calls "economic circle movement" or "turning round" and then approaches the study of economic dynamics. Schumpeter believes that in conditions of a circular motion in the economy there is no chance for profits and interest, and the income is divided into wages and rent. Therefore, in such circumstances there is no growth and development, but repeating of the current situation.

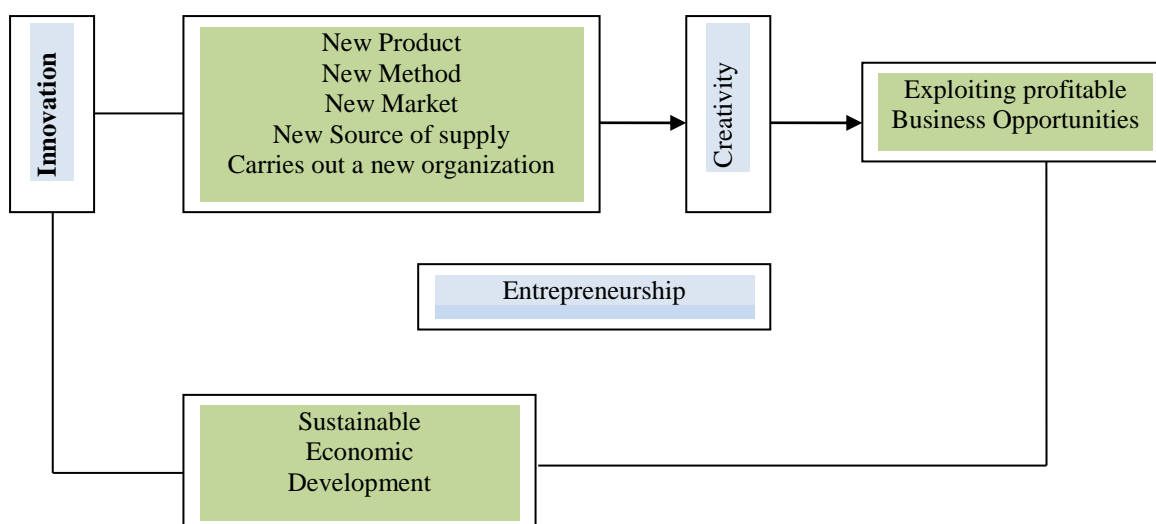
This explanation is similar to the teachings of Karl Marx for simple reproduction of social capital and similar to Leon Walras' learning for static economic equilibrium (turning circle). In order to get out of the economic situation of circular motion and to begin the process of economic development, Schumpeter believes that he needs an approach to innovation and changes. In *The Theory of Economic Development* he mentions the following innovations:

1. Production of new goods that were not known to the consumers, or producing the same goods with a new quality.
2. Introducing new unknown method of manufacture or sale.
3. Open a new market or a good breakthrough on the market that did not have access to such goods.
4. Gaining new sources of raw materials or semi-finished products
5. Introducing a new organization either by creating a monopoly or by breaking an existing monopoly situation.

Schumpeter emphasizes that those entrepreneurs who will be able to introduce some of the mentioned innovations will achieve high profits. Those people will be the most daring, dynamic and energetic, which expose themselves to the possible risk. Later, other entrepreneurs is going to join them and thus begins the process of extracting the economy from a state of economic circular motion and at this point starts business dynamics [5]. The concept of the changes that an entrepreneur brings:

1. Expansion of goods, products.
2. Productivity of factors of production such as finance, labor, material.
3. Innovation in production such as, technology, process changes and increase in human resource productivity.
4. Innovation in marketing area such as the composition of the market, size of the market and new markets.

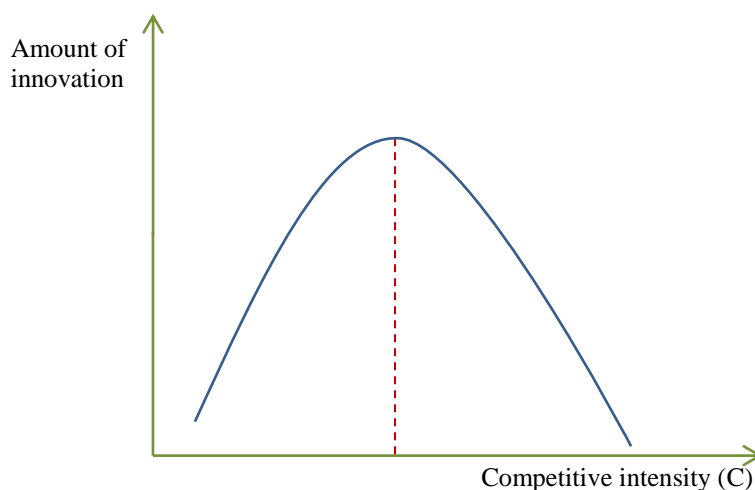
Figure 1: Innovation Theory of Entrepreneurship



Thus, Schumpeter blames on entrepreneurs as the central role in the economic development dynamics. Their role is to introduce innovations and overcome various resistances against their introduction. According to him, the development of capitalism increases the role of entrepreneurs, because the resistance to innovation grows. By emphasizing the role of the entrepreneur and the entrepreneurial spirit Schumpeter reckoned among theorists of entrepreneurship.

Schumpeter's first hypothesis was that companies with larger market shares should innovate more. Namely, large market share gives more certainty about recouping returns to R&D once innovation occurs. It also implies more current profits to finance the expenditure on R&D. This hypothesis has led to substantial theoretical and empirical work on the relationship between market structure, competition and innovation. Possible there is an inverted U-shaped relationship, but economists cannot yet identify the optimal degree of competition.

Figure 2: Inverted U-shape between innovation and competition



About, the importance of absolute size, Schumpeter's second hypothesis was that larger companies should innovate more. Large size implies diversification of R&D risks and ability to finance. Empirical evidence on this second hypothesis is mixed: large companies are more likely to do R&D; smaller companies that are R&D.

Evidence of private rates of return to R&D: Investigated using either market value or productivity approaches. Namely, both approaches suggest private rates of return to R&D are higher than for standard, tangible investment projects. Also, excess returns may be reward for higher risk. Exist high rates of return also suggest that there is not free entry into R&D. Furthermore, could be due to barriers, e.g. raising finance, lack of skilled labour. Also possible R&D requires complementary assets e.g. tacit knowledge and skilled labour.

Evidence on social returns: The productivity approach can also be used to estimate the social returns to R&D. Do this either by investigating the interactions between companies or by using industry data to observe aggregate returns to

R&D. Exist, many studies have suggested that the social returns are higher than private returns. And, this implies that there are positive externalities to R&D from spill overs of technology.

Evidence on interaction between competition and innovation: Absolute company size is not necessarily beneficial to innovation. Larger market share has been found to increase the returns to R&D, but those with very high degree of market dominance may become complacent. Also, recent evidence relating rates of patenting to degree of product market competition supports the inverted U-shape.

2.1.1 Business cycles

In terms of scientific thought about innovation, Schumpeter also builds a theory of business cycles in capitalism, which is known as the innovative theory of cycles. This very issue exhaustively considered in his work business cycles. According to him, the prosperity or the release of the economy of the state of economic circular movement begins in a way that one or several most daring entrepreneurs introduce certain innovations and secures high profits. They achieved that by overcoming various resistances to innovation, and with the help of bank loans. They are followed by other entrepreneurs and thus begin the phase of prosperity cycle. During prosperity, there are loans and purchasing power is increased. But later prosperity turns to depression. Namely, the increased demand leads to higher prices, to inflation, which above a certain limit has a negative impact on new investments [5].

Table No. 2. Business cycles

Economic cycles series	
Cycle Name	Years
Kitchin inventory	3-5
Juglar fixed investment	7-11
Kuznets infrastructural investment	15-25
Kondratiev wave	45-60

On the other hand, increased competition leads to a loss and a general decline in prices. Also the repayment of loans should be added to that. Depression will last until other innovations are introduced and they will lead to prosperity. Schumpeter explains the cyclical nature of capitalist economy with the discontinuity of technical progress, i.e. with the uneven distribution of innovations. He believes business cycles as a way of development of the capitalist economy and its characteristics. In his writings he mentions three types of business cycles: long, medium and short.

2.1.2 The role of the entrepreneur and innovation

Schumpeter distinguishes two stages in the development of capitalism: the first is called competitive capitalism and the second capitalism trusts. Characteristic for the first phase are small enterprises in which the introduction of innovations are made by start-ups, and the role entrepreneur is played by the owner of the company who is interested in the growth and development of the company. In the second phase the character of the entrepreneur is changing in the sense that as entrepreneurs occur managers, especially paid professionals who run big corporations. Thus arises the separation of functions: capital ownership and the function of management of the company. While stressing upon the innovative function of the entrepreneur, Schumpeter ignored the risk-taking function, which is equally important. When an entrepreneur develops a new combination of factors of production, there is enough risk involved. In spite of these lacking, the theory supports the “enterprising spirit” of entrepreneur to innovate. It is the act that endows resources with a new capacity to create wealth. Drucker says, “Innovation, indeed, creates a resource. It endows it with economic value.” Schumpeter’s views are particularly relevant to developing countries where innovations need to be encouraged. The transformation of an agrarian economy into an industrial economy required a great deal of initiative and changes on the part of capitalist and managers.

According to Schumpeter about the relationship between specific phases of capitalist development and types of entrepreneurship may be summarized as follows, schematically displayed in Table 3. Also, Schumpeter highlighting the institutional structure of competitive and "trusts" capitalism, which is reflected in certain types of entrepreneurship, patterns of innovation and procedures of selection. In particular, Schumpeter characterized competitive capitalism in terms of a competitive behavior of heroic entrepreneurs, who would reorganize the productive organism in the direction of ever-increasing efficiency by the means of competing down unfit enterprises [2].

Table No. 3. Schumpeter’s scheme of the varieties of entrepreneurship in the phases of capitalist development [2]

	Competitive Capitalism	Trusts Capitalism
Style of Kondratieff cycle	Bourgeois	Neo mercantilist
Type of enterprise	Family enterprises	Corporations and trusts
Type of entrepreneur	Merchant	Corporate director
Mode of innovation	Individual impulse	Organizational routine
Mode of behavior	Intuitive creativity	Professional calculation
Selection mechanism	Market competition	Political compromise
Type of income	Entrepreneurial profit	Employee salary

Schumpeter clearly differentiated process of finding and process of innovation. He points out that only a few innovative people in business are able to realize the potential of new invention and to use to achieve personal gain. But their profit is economic gain. After the presentation of successful innovation by the entrepreneur, other business people would follow her new product or technology will take a full area in the economy. Thus, economic growth is supported by the institutional environment that rewards and supports the activities of entrepreneurs.

According Landreth & Colander (2002), with the disappearance of the entrepreneur and his substitution with managers and shareholders creates a space for interference of the state in the economy. It assesses negatively as a sign that capitalism is nearing its end. So, contrary to Keynes, he believed that the state can save capitalism from collapse [4].

Schumpeter believes that capitalism is falling and because of the disappearance of a private property and the free bargaining, which are replaced by big capitalist ownership and large state influence in the economy. Schumpeter explains the collapse of capitalism with the changes in the character and role of the bourgeois family in society. According to him, in modern family life and parenthood for men and women mean less than it meant before. Therefore parents less influence on the formation of attitudes of their children. Schumpeter considers the collapse of protectionist authority and justice as the reason that directly affect the collapse of capitalism. The social structure of capitalism is a symbiosis of remains of feudalism (royal) and elements of capitalism (bourgeois) and through it capitalism is alive. With the development of capitalism gradually destroys the Crown, which breaks the symbiosis and is not yet invented 'ideal new protective organs of the system.

Therefore, capitalism is exposed to decay. According to Schumpeter socialism cannot provide greater rationality in comparison to capitalism and in this respect between these systems are no differences. He imagines socialism as a socio-economic system in which the central authority managing the means of production and economic activity has a public character. Therefore he names this system centralist socialism. He doubts in terms of achieving economic democracy and personal freedom in socialism.

According Landreth & Colander (2002), in Schumpeter's analysis of capitalism, he used some of these earlier views on economic growth. Although ideologically conservative, Schumpeter predicted the ultimate transition from capitalism to socialism because of the successes of capitalism [4]. He believed that the entrepreneurial spirit is eliminated by the prudent managers of large, successful firms and that as the intellectuals supported by this highly productive capitalistic system turn against the system that makes their unproductive lives possible, the dynamic of capitalism will fade and ever-increasing governmental intervention and ownership will become the norm. Ironically, socialism then replaces capitalism not because of capitalism's failures, as Marx had envisioned, but because of its successes. And as capitalism dies, so will the dynamic that brought about high rates of economic growth.

3. Short review of historical perspectives on entrepreneurship

The distinctive features of entrepreneurship over the years are:

1. Innovation,
2. A function of high achievement,
3. Organisation building,
4. Group level activities,
5. Managerial skills and leadership,
6. Gap filling activity
7. Entrepreneurship – an emerging class.

Table No. 4. Short review of historical perspectives on entrepreneurship

Time	Development of Entrepreneurship Theory
Eighteenth Century	<ul style="list-style-type: none"> Richard Cantillon (economist) coined term entrepreneur (“go between” or “between-taker”) Entrepreneur bears risks and plans, supervises organizes and owns factors of production
Nineteenth Century	<ul style="list-style-type: none"> Jean Baptiste Say (economist) proposed that the profits of entrepreneurship were separate from profits of capital ownership Distinction made between those who supplied funds and earned interest and those who profited from entrepreneurial abilities
Eighteenth Century	<ul style="list-style-type: none"> Joseph Schumpeter (economist) described entrepreneur as someone who is an innovator and someone who “creatively destructs” Peter Drucker (Management author) described the entrepreneur as someone who maximizes opportunity
Twenty First Century	<ul style="list-style-type: none"> As technology changes and global connectivity improves, entrepreneurship means that the entrepreneur not only has to ensure profits for all stakeholders, he has to fix problems, tap new markets, bring cutting edge ideas to the table, and lead cross-cultural teams. Entrepreneurship has taken on new meaning and greater challenges in the last decades. The real skill is learning how to influence through commitment, loyalty and trust.

4. Conclusion

In order to get begin the process of economic development, Schumpeter believes that he need an approach to innovation and changes. According to him, entrepreneurs are the central figure in the economic development dynamics. In terms of scientific thought about innovation, Schumpeter also builds a theory of business cycles in capitalism, which is known as the innovative theory of cycles. According to Robbins (1998), he combined a grasp of equilibrium theory, social formations, and socioeconomic evolution which made one recall the earlier work along these lines by Weber and Pareto. Schumpeter developed a multi-cycle model of instability and his own analysis of the transformation of capitalism into socialism. His was probably the broadest and most heterogeneous paradigm of any mainstream twentieth-century orthodox economist [6].

From Schumpeter’s work is the argument that balance is the central problem of the economy (as we consider classicists and neo-classicists) but its main problem is the changes in the institutional structure. He distinguishes two types of structures: "movement in a circle," which is characteristic of petty goods producers in slavery and feudalism and structure as a characteristic of a market economy, in which the entrepreneur has a main word. The second structure is characterized by "dynamic equilibrium", and the main holders of the economic process are innovation and entrepreneur.

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