Peter F. Drucker, "Schumpeter and Keynes," Forbes May 23, 1983, pp.124-128

Joseph Schumpeter, b. Feb. 8, 1883 - d. Jan. 8, 1950

John Maynard Keynes, june 5, 1883 - April 21, 1946

124 Politically K's views were quite similar to what we now call neo-conservative

passionate attachment to the free market and to keeping politicians and government out of it

in contrast, S. had serious doubts about the free market: he that an intelligent monopoly -- e. g., U. S. Bell Telephone -- had a great deal to commend itself, because it could afford to take the long view instead of being driven from from transactiion to transaction by short-term expediency

125 Economics for K was the equilibrium economics of Ricardo's 1810 theories, which dominated the 19th century

As the 19th century economists, so for Keynes the key question was: How can one maintain an economy in equilibrium and stasis

Similarly, as the 19th century economists, so Keynes conceived the real economy (goods and service) and the veil over the real (money)

The macro-economy of individuals and firms determined; and government could at best correct minor discrepancies.

Again, the nation state was everything: individuals and fir[illegible] had neither the power to infleunce, let alone direct, the economy nor the ability to make effective decisions counter to the major determinant

Economic phenoemena (capital formation, productivity, and employment) were functiojns of demand.

By now we know, as fifty years ago Sch. knew, that every one of these answers is the wrong answer. At least they are only special cases, and within fairly narrow ranges.

126 For instance, K stressed that the turnover velocity of money is constant, and not capable of being changed over the short term by individuals or firms. Sch. pointed out fifty years ago that all the evidence negates these assumptions. Drucker adds that in the last few years the Federal Reserve attempted to control the eocnomy by controlling the money supply, but has been defeated by consumers and businesses who suddenly and almost violently shifted deposits from thrifts into money-market funds and from long-term investment into liquid assets... to the point where no one can tell what the money supply is or even what it means.

Peter Drucker, Schumpeter and Keynes, Forbes May 23 1983, 124-8

But his (Schumpeter's) doctoral dissertation (The Theory of Economic Development 1911 German) starts with the assertion that that the central problem of economics is not equilibrium but structural change. This then led to S's famous theorem of the innovator as the subject of economics.

Classical economics sonsidered innovation to be outside the system, as Keynes did too, innoation belonged to the "outside catastrophes" like earthquakes, cliamte or war, which everybody 1 have profound effects of the economy but are not part of economics. Schumpeter insisted that, on the contrary, innovations, that is, entrepreneurship that moves resuurces from old and obsolescent to new and more productive employment -- is the very essence of economics and most certainly of a modern economy.

[While S acknowledged that he derived this view from Marx, still he used it to disprove Marx.] S's Economic Development does what neither the classical economics nor Marx nor Keyness was able to do.: It makes profit fulfil an economic function.

In the economy of change and innovation, profit, in contrast to Marx, is not a Mehrwert, a surplus value stolen from workers. On the contrary, it is the only source of jobs for workers and of labor income. The theory of economic development shows that no one except the innovator makes a genuine profit, and the innovator's profit is always short-lived. But innovation is also, in S's famous phrase, "creative destruction." It makes obsolete yesterday's cappital equipment and capital investment. The more an economy progresses, the more capital formation will it then need. Thus what the classical economist

127

-- or the accountant or the stock exchange -- considers profit is a genuine cost, the cost of staying in business, the cost of a future in which nothing is predictable except that today's profitable business will be tomorrow's white elephant. Thus capttal formation and productivity are needed to maintain the wealth producing capacity of the economy and, above all, to maintain today's jobs and/tomorrow's jobs/ to create/

S's "innovator" with his creative destructione" is the only theory so far to explain why there is something we call profit. The classical economists knew very well that their theory did not give any rationale for profit. Indeed, in the equilib- economics of a closed economic system there is no place for profit, no justification for it, no explanation of it. If profit is, however, a genuine cost, and especially if profit is the only way to maintain jobs and to create new ones, then "capitalism" becomes again a moral system.

Morality and profits. The classical economists had pointed out that profit is needed as the incentive for the risk taker. But is this not a bribe and thus impossible to justify morally? The dilemma had drivedn the most brilliant of 19th century economists, John Stuart Mill, to embrace socialism in his later years. It had made it easy for Marx to fuse dispassionate analysis of the "system" with the moral revulsion of an Old Testament prophet against the exploiters. The weakness on moral grounds of the profit incentive enabled Marx at once to condemn the capitalist as wicked and immoral and assert "scientifically" that he serves no function and that his speedy demise is inevitable. As soon however as one shifts from

the axiom of an unchanging closed, self-contained economy to Schumpeter's dynamic growing moving changing economy, what is called profit is no longer immoral. It becomes a moral imperative.. Indeed the question is no longer the question the classicists, and still agitated Keynes: How can the economy be structed to minimize the bribe of the functionless surplus called "profit" to keep the economy going? The question in S. economics is always: Is there enough profit? Is there adequate capital formation to provide the costs of the future, costs of staying in business, the costs of creative destructione?

agitated

This alone makes S's economic model the only one that can serve as the starting point for the economic policies we need. Clearly the Keynesian -- or classicist -- treatment of innovation being outside and in fact peripheral to the economy and with minimum impact on it, can no longer be maintained if it ver could be! The basic question of economic theory and economic policy must be: How can capital formation and productivity be maintained so that rapid technological change as well as employment can be sustained? What is the minimum profit needed to defray the cost ~~of the cost~~ of the future? What is the minimum profit needed, above all, to maintain jobs and to create new ones?

S. gave no answer. He did not much believe in answers. But 70 years ago, as a very young man, he asked what clearly is going to be the central question of economic theory abd economic policy in the years to come.

And then, during World War I, S. realized, long before anyone else -- and a good ten years before Keynes -- that economic reality was changing. He realized that WW I had brought about the monetarization of of the economies of all the belligerents . Country after country, including his own, still fairly backward, Austria-Hungary, had succeeded during the war in mobilizing all the entire liquid wealth of the community, partly through taxation,, but mainly through borrowing.. Money and credit, rather than goods and services, had become the real economy.

In a brilliant essay published in a German periodical in July 1918... S. had argued that, from now on, money and credit would be the lever of control. What he argued was that neither supply of goods, as classicists had argued, nor demand for goods , as some of the earlier dissenters had maintained, was going to be controlling any more. Monetary factors -- deficits, money, credits, taxes -- were going to be determinants of economic activity and of the allocation of resources.

This is, of course, the same insight on which Keynes later built his <u>General Theory</u>. But S's conclusions were radically different from those Keynes reached. K. came to the conclusion that the emergence of the symbol economy of money and credit made possible the economist-king, the

scientific economist, who, by playing on a few simple monetary keys -- government spending, the interest rate, the volume of credit or the amount of money in circulation -- would maintain permanent equilibrium with full employment, prosperity and stability. But S's conclusioj was that the emergence of the symbol economy as the dominant economy opened the door to tyranny abd, in fact, invited tyranny. But above all, he saw that it was not going to be economists who would exercise the power, but politicians and generals.

And then in the same year in which WW I ended, Schumpeter published The Tax State... Again, the insight is the same Keynes reached 15 years later (and, as he often acknowledged, thanks to Schumpeter): The modern state through the mechanism of taxation and borrowing, has the power to shift income and, through transfer payments, to control the distribution of the national product. To Keynes this power was a magic wand to achieve both social justice and economic progress, and both economic stability and fiscal responsibility. To Sch. -- perhaps because he unlike Keynes was a student of both Marx and history-- this power was an invitation to political irresponsibility, because it eliminated all economic safeguards against inflation. Now the only safeguard against inflation would be political, that is, self-discipline. And Schumpeter was not very sanguine about the poiitician's capacity for self-discipline.

S's work as an economist since WW I is of great importance to economic theory. He became one of the fathers of business cycle theory.

But S's real contribution during the 32 years between the end of WW I and his death in 1950 was as a political economist. In 1942 when evryone was scared of a world wide inflationary depression , S published his best known book, Capitalism. Socialism and Democracy, still, and deservedly, read widely. In this book he argued that capitalism would be destroyed by its own success. This would breed what we now call the "new class": buseaucrats, intellectuals, professors, lawyers, journalists, all of them beneficiaries of capitalism's economic fruits and, in fact, parasitical upon them, and yet all of them opposed to the ethics of wealth production, of saving and of allocating resources to economic productivity. The 40 years since this book appeared have surely proved S to be a major prophet.

And then he proceeded to argue that capitalism would be destroyed by the very democracy it had helped create and made possible. Fir ub a democracy, to be popular, government would increasingly become the "tax state," would increasingly shift income from producer to nonproducer, would increasingly move income from where it would be saved and become capital for tomorrow to where it would be consumed. Government in a democracy would thus be under increasing inflationary pressure. Eventually he prophecied inlfation would destroy both capitalism and democracy.

When he wrote this in 1942, almost everybody laughed. Nothing seemed less likely than an inflation based on econ-

omc success. Now 40 years later this has emerged asthe central problem of a democracy and of a free market economy, just as Schumpeter had prophesied.

in/

The Keynesians in the Forties ushered in their "promised land,"/which the economist-king would guarantee the perfect equ9ilbrium of an eternally stable economy through control of money, credit, spending, and taxes. S. however increasingly concerned himself with the question of how the public sector could be controlled and limited so as to maintain political freedom and an economy capapble of performance, growth, and change. When death overtook him at his desk, he was revising the presidential address he had given to the American Economic Association only a few days earlier. The last sentence he wrote was: "The stagnationists are wrong in their diagnosis of the reason why the capitalist process should stagnate; they may turn out to be right in their prognosis that it will stagnate -- with sufficient help from the public sector.

Keynes' best-known saying is surely, "In the long run we are all dead." Of course, in the long run we are all dead.... But Keynes in a wiser moment, remarked that the deeds of today's politicians are usually based on the theorems of long dead economists. And it is a total fallacy that, as Keynes implies, optimizing the short terms creates the right long-term future. Keynes is in large measure responsible for the extreme short-term focus of modern politics, of modern economics, of modern business.

S. also knew that policies have to fit the shrot term. He learned this lesson the hard way -- as minister of finance in the newly formed Austrian republic in which he, totally unsuccessful, tried to stop inflation before it got out of hand. He knew he had failed because his measures were not acceptable in the short term -- the very measures that two years later a non-econonomist, a politician and professor of moral theology did apply to stop the inflation, but pnly after it had all but destroyed Austria's economy and middle class

But S also knew that today's short-term measures have long-term impacts. They irrevocably make the future. Not to think through the futurity of short-term decisions and their impact long after we are all dead is irresponsible. It also leads to wrong decisions. It is this constant emphasis in S on thinking through the long-term consequences of the expedient, the popular, the clever, and the brilliant, that makes him a great economist and the appropriate guide for today, when short-run, clever, brilliant economics -- and short-run brilliant politics -- have become bankrupt.

In some ways K and S replayed the best known confrontation of philosophers in the Western tradition -- the Platonic dialogue between Parmenides, the brilliant, clever, irresitible sophist, and the slow-moving and ugly but wise Socrates. No one in the inter-war years was more brilliant, more clever than Keynes. S by contrast appeared pedestrian -- but he had wisdom. Cleverness carries the day. But wisdom endureth.