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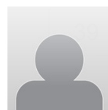

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Schumpeter And Keynes

THE TWO GREATEST economists of this century, Joseph A. Schumpeter and John Maynard Keynes, were born, only a few months apart, a hundred years ago: Schumpeter on Feb. 8, 1883 in a provincial Austrian town, Keynes on June 5, 1883 in Cambridge, England. (And they died only four years apart — Schumpeter in Connecticut on Jan. 8, 1950, Keynes in southern England on Apr. 21, 1946.) The centenary of Keynes' birth is being celebrated with a host of books, articles, conferences and speeches. If the centenary of Schumpeter's birth were noticed at all, it would be in a small doctoral seminar. And yet it is becoming increasingly clear that it is Schumpeter who will shape the thinking and inform the questions on economic theory and economic policy for the rest of this century, if not for the next 30 or 50 years.

THE TWO MEN WERE NOT ANTAGONISTS. Both challenged long-standing assumptions. The opponents of Keynes were the very "Austrians" Schumpeter himself had broken away from as a student, the neoclassical economists of the Austrian School. And while Schumpeter considered all of Keynes' answers wrong, or at least misleading, he was a sympathetic critic. Indeed, it was Schumpeter who established Keynes in America. When Keynes' *General Theory* came out, Schumpeter, by then the senior member of the Harvard economics faculty, told his students to read the book and told them also that Keynes' work had totally superseded his own earlier writings on money.

Keynes, in turn, considered Schumpeter one of the few contemporary economists worthy of his respect. In his lectures he again and again referred to the works Schumpeter had published during World War I, and especially to Schumpeter's essay on the *Rechenpfennige* (i.e., money of account) as the initial stimulus for his own thoughts on money. Keynes' most successful policy initiative, the proposal that Britain and the U.S. finance World War II by taxes rather than by borrowing, came directly out of Schumpeter's 1918 warning of the disastrous consequences of the debt financing of World War I.

Schumpeter and Keynes are often contrasted politically, with Schumpeter being portrayed as the "conservative" and Keynes as the "radical." The opposite is more nearly. right. Politically Keynes' views were quite similar to what we now call" neoconservative." His theory had its origins in his passionate attachment to the free market and in his desire to keep politicians and governments out of it. Schumpeter, by contrast, had serious doubts about

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the free market. He thought that an "intelligent monopoly" — the American Bell Telephone system, for instance — had a great deal to recommend itself. It could afford to take the long view instead of being driven from transaction to transaction by short-term expediency. His closest friend for many years was the most radical and most doctrinaire of Europe's left-wing socialists, the Austrian Otto Bauer, who, though staunchly anticommunist, was even more anticapitalist. And Schumpeter, while never even close to being a socialist himself, served during 1919 as minister of finance in Austria's only socialist government between the wars. Schumpeter always maintained that Marx had been dead wrong in every one of his answers. But he still considered himself a son of Marx and held him in greater esteem than any other economist. At least, so he argued, Marx asked the right questions — and to Schumpeter questions were always more important than answers.

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The differences between Schumpeter and Keynes go much deeper than economic theorems or political views. The two saw a different economic reality, were concerned with different problems and defined "economics" quite differently. These differences are highly important to an understanding of today's economic world.

Keynes, for all that he broke with classical economics, operated entirely within its framework. He was a "heretic" rather than an "infidel." Economics, for Keynes, was the equilibrium economics of Ricardo's 1810 theories, which dominated the 19th century. This economics deals with a closed system and a static one. Keynes' key question was the same question the 19th-century economists had asked: "How can one maintain an economy in balance and stasis?"

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For Keynes, the main problems of economics are the relationship between the "real economy" of goods and services and the "symbol economy" of money and credit; the relationship between individuals and businesses and the "macro-economy" of the nation-state; and finally, whether production (that is, supply) or consumption (that is, demand) provides the driving force of the economy. In this sense Keynes was in a direct line with Ricardo, John Stuart Mill, the "Austrians" and Alfred Marshall. However much they differed otherwise, most of these 19th-century economists, and that includes Marx, had given the same answers to these questions: The "real economy" controls, and money is only the "veil of things"; the micro-economy of individuals and businesses determines, and government can, at best, correct minor discrepancies and, at worst, create dislocations; and supply controls, with demand a function of it.

KEYNES ASKED the same questions that Ricardo, Mill, Marx, the "Austrians" and Marshall had asked but, with unprecedented audacity, turned every one of the answers upside down. In the Keynesian system, money and credit are "real," and goods and services dependent on, and shadows of, the "symbol economy"; the macro-economy, the economy of the nation-state, is everything, with individuals and firms having neither power to influence, let alone to direct, the economy nor the ability to make effective decisions counter to the forces of the "macro-economy"; and economic phenomena, capital formation, productivity and employment are functions of demand.

By now we know, as Schumpeter knew 50 years ago, that every one of these Keynesian answers is the wrong answer. At least they are valid only for special cases and within fairly narrow ranges. Take, for instance, Keynes' key

theorem: that monetary events — government deficits, interest rates, credit volume and volume of money in circulation — determine demand and with it economic conditions. This assumes — as Keynes himself stressed — that the turnover velocity of money is constant and not capable of being changed over the short term by individuals or firms. Schumpeter pointed out 50 years ago that all evidence negates this assumption. And indeed, whenever tried, Keynesian economic policies, whether in the original Keynesian or in the modified Friedman version, have been defeated by the "micro-economy" of businesses and individuals, unpredictably and without warning, changing the turnover velocity of money almost overnight.

WHEN THE KEYNESIAN PRESCRIPTIONS were initially tried — in the U.S. in the early New Deal days — they seemed at first to work. But then, around 1935 or so, consumers and businesses suddenly sharply reduced the turnover velocity of money with-in a few short months, which aborted a recovery based on government deficit spending and brought about a second collapse of the stock market in 1937. The best example, however, is what happened in this country in the last few years. The Federal Reserve's purposeful attempt to control the economy by controlling money supply has largely been defeated by consumers and businesses who suddenly and almost violently shifted deposits from thrifts into money market funds and from long-term investments into liquid assets — that is, from low-velocity into high-velocity money — to the point where no one can really tell any more what the "money supply" is or ever what the term means. Individuals and businesses seeking to optimize their self-interest and guided by their perception of economic reality will always find a way to beat the "system" — whether, as in the Soviet bloc, through converting the entire economy into one gigantic black market or, as in the U.S. in the last few years, through transforming the financial system overnight despite laws, regulations or economists.

This does not mean that economics is likely to return to pre-Keynesian neoclassicism. Keynes' critique of the neoclassic answers is as definitive as Schumpeter's critique of Keynes. But because we now that individuals can and will defeat the system, we have lost the certainty that Keynes imposed on economics and that has made the Keynesian system the lodestar of economic theory and economic policy for 50 years. Both Friedman's monetarism and supply-side economics are desperate attempts to patch up the Keynesian system of equilibrium economics. But it is unlikely that either can restore the self-contained, self-confident equilibrium economics, let alone an economic theory or an economic policy in which one factor, whether government spending, interest rates, money supply or tax cuts, controls the economy predictably and with near-certainty.

That the Keynesian answers were not going to prove any more valid than the pre-Keynesian ones that they replaced was clear to Schumpeter from the beginning. But to him this was much less important than that the Keynesian questions — the questions of Keynes' predecessors as well — were not, Schumpeter thought, the important questions at all. To him the basic fallacy was the very assumption with which Keynes had started out: the assumption that the healthy, the "normal," economy is an economy in static equilibrium. Schumpeter, from his student days on, held that a modern economy is always in dynamic disequilibrium. Schumpeter's economy is not a closed system like Newton's universe — or Keynes' "macro-economy." It is forever growing and changing, and is biological rather than mechanistic in nature. If Keynes was a

"heretic," Schumpeter was an "infidel."

Schumpeter was himself a student of the great men of Austrian economics and at a time when Vienna was the world capital of economic theory. He held his teachers in lifelong affection. But his doctoral dissertation — it became the earliest of his great books, *The Theory of Economic Development* (which in its original German version came out in 1911, when Schumpeter was only 28 years old) — starts out with the assertion that the central problem of economics is not equilibrium but structural change. This then led to Schumpeter's famous theorem of the innovator as the true subject of economics.

CLASSICAL ECONOMICS considered innovation to be outside the system, as Keynes did, too. Innovation belonged in the category of "outside catastrophes" like earthquakes, climate or war, which, everybody knew, have profound influence on the economy but are not part of economics. Schumpeter insisted that, on the contrary, innovation — that is, entrepreneurship that moves resources from old and obsolescent to new and more productive employments — is the very essence of economics and most certainly of a modern economy.

He derived this notion, as he was the first to admit, from Marx. But he used it to disprove Marx. Schumpeter's *Economic Development* does what neither the classical economists nor Marx nor Keynes was able to do: It makes profit fulfill an economic function. In the economy of change and innovation, profit, in contrast to Marx, is not a *Mehrwert,* a "surplus value" stolen from the 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 quite short-lived. But innovation in Schumpeter's famous phrase is also "creative destruction." It makes obsolete yesterday's capital equipment and capital investment. The more an economy progresses, the more capital formation will it therefore need. Thus what the classical economist — 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 become tomorrow's white elephant. Thus, capital formation and productivity are needed to maintain the wealth-producing capacity of the economy and, above all, to maintain today's jobs and to create tomorrow's jobs.

SCHUMPETER'S "INNOVATOR" with his "creative destruction" is the only theory so far to explain why there is something we call "profit." The classical economists very well knew that their theory did not give any rationale for profit. Indeed, in the equilibrium 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? This dilemma had driven 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, self-contained, closed 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 then is no longer the question that agitated the classicists and still agitated Keynes: How can the economy be structured to minimize the bribe of the functionless surplus called "profit" that has to be handed over to the "capitalist" to keep the economy going? The question in Schumpeter's economics is always: Is there sufficient profit? Is there adequate capital formation to provide for the costs of the future, the costs of staying in business, the costs of "creative destruction"?

THIS ALONE makes Schumpeter'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 as being "outside" and in fact peripheral to the economy and with minimum impact on it, can no longer be maintained (if it ever could be). The basic question of economic theory and economic policy, especially in highly developed countries, is clearly: 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 costs of the future? What is the minimum profit needed, above all, to maintain jobs and to create new ones?

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

And then, during World War I, Schumpeter realized, long before anyone else — and a good ten years before Keynes did — that economic reality was changing. He realized that World War I had brought about the monetarization of the economies of all belligerents. Country after country, including his own still fairly backward Austria-Hungary, had succeeded during the war in mobilizing 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 economic journal in July 1918 — when the world Schumpeter had grwon up in and had known was crashing down around his ears — he argued that, from now on, money and credit would be the lever of control. What he argued was that neither supply of goods, as the classicists had argued, nor demand for goods, as some of the earlier dissenters had maintained, was going to be controlling anymore. Monetary factors — deficits, money, credit, taxes — were going to be the determinants of economic activity and of the allocation of resources.

This is, of course, the same insight on which Keynes later built his *General Theory*. But Schumpeter's conclusions were radically different from those Keynes reached. Keynes 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 Schumpeter's conclusion was that

the emergence of the “symbol economy” as the dominant economy opened the door to tyranny and, in fact, invited tyranny. That the economist now proclaimed himself infallible, he considered pure hubris. But, above all, he saw that it was not going to economists who would exercise the power, but politicians and generals.

And then, in the same year, just before World War I ended, Schumpeter published *The Tax State* (“The Fiscal State” would be a better translation). Again, the insight is the same Keynes reached 15 years later (and, as he often acknowledged, thanks to Schumpeter): The modern state, through the mechanisms of taxation and borrowing, has acquired 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 Schumpeter — 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. In the past the inability of the state to tax more than a very small proportion of the gross national product, or to borrow more than a very small part of the country’s wealth, had made inflation self-limiting. Now the only safeguard against inflation would be political, that is, self-discipline. And Schumpeter was not very sanguine about the politician’s capacity for self-discipline.

Schumpeter’s work as an economist after World War I is of great importance to economic theory. He became one of the fathers of business cycle theory.

BUT SCHUMPETER’S REAL contribution during the 32 years between the end of World War I and his death in 1950 was as a political economist. In 1942, when everyone was scared of a World-wide deflationary depression, Schumpeter 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 would now call the “new class”: bureaucrats, intellectuals, professors, lawyers, journalists, all of them beneficiaries of capitalism’s economic fruits and, in fact, parasitical on them, and yet all of them opposed to the ethos of wealth production, of saving and of allocating resources to economic productivity. The 40 years since this book appeared have surely proved Schumpeter 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. For in a democracy, to be popular, government would increasingly become the “tax state,” would increasingly shift income from producer to non-producer, 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 prophesied, inflation would destroy both democracy and capitalism.

When he wrote this in 1942, almost everybody laughed. Nothing seemed less likely than an inflation based on economic success. Now 40 years later, this has emerged as the central problem of democracy and of a free-market economy alike, just as Schumpeter had prophesied.

The Keynesians in the Forties ushered in their “promised land,” in which the economist-king would guarantee the perfect equilibrium of an eternally stable

economy through control of money, credit, spending and taxes. Schumpeter, 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 capable 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 the capitalist process should stagnate; they may still 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." This is one of the most fatuous remarks ever made. 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 term creates the right long-term future. Keynes is in large measure responsible for the extreme short-term focus of modern politics, of modern economics and modern business — the short-term focus that is now, with considerable justice, considered a major weakness of American policymakers, both in government and in business.

SCHUMPETER ALSO KNEW that policies have to fit the short 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 that he had failed because his measures were not acceptable in the short term — the very measures that, two years later, a non-economist, a politician and professor of moral theology did apply to stop the inflation, but only after it had all but destroyed Austria's economy and middle class.

But Schumpeter 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 the wrong decisions. It is this constant emphasis in Schumpeter 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, clever, brilliant politics — have become bankrupt.

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