



Magadh Mahila College
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M A Economics
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Topic: Schumpeter's model

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Introduction

J.A. Schumpeter's theory of development assigns paramount role to the entrepreneur and innovations introduced by him in the process of economic development. According to Schumpeter, the process of production is marked by a combination of material and immaterial productive forces arise from the original factors of production - land, labour, capital, etc, while the immaterial set of productive forces are conditioned by the "technical facts" and "facts of social organisation". The Schumpeter production function can be written as $Q = f(K, \sigma, I, u, v)$, where Q stands for output, K for the produced means of production, σ = Natural resources, I = employed labour force, u = society's fund of technical knowledge, v = facts of social organisation, i.e, socio-cultural relation within which the economy operates.

u, v = immaterial set of productive forces

Schumpeter regards trade cycles as the offspring of economic progress in a capitalist society. Cyclic fluctuations are inherent in the process of industrial production. When there are internal changes taking place on account of innovation, the development process begins. The term "innovation" should not be confused with inventions. Inventions, in ordinary parlance, are discoveries of scientific novelties.

Factors affecting theory

Schumpeter's theory is based on three economic factors -

- i) Circular flow
- ii) Development or innovation
- iii) Growth

i) Circular flow - Schumpeter starts his analysis of development process with the concept of circular flow. It implies a condition where economic activities produces itself continuously at constant rate through time. Thus, it means a continuous activity and no destruction.

Features of Circular flow -

1. All economic activities are essentially repetitive and follow a familiar routine course.
2. The firms working in a system are in a state of competitive equilibrium.
3. Under the stationary equilibrium, the prices are equal to the average cost of production and profits are zero. Interest rates tend to zero and there is less possibility of involuntary unemployment of resources.
4. The economic system has the optimum level of output and its maximum use and there is no possibility of wastage of resources.

ii) Innovation or Development - It may be defined as a change in existing production system to be introduced by the entrepreneur with a view to make profits and reduce cost. Any innovation may consist of -

- (i) the introduction of a new product.
- (ii) the introduction of a new method of production.
- (iii) the opening up of a new market.
- (iv) the conquest of a new source of supply of raw materials or semi-manufactured goods.
- (v) the carrying out of the new organisation of any industry like the creation of a monopoly.

⇒ Role of Entrepreneurs - Entrepreneur is the key figure in Schumpeter analysis of the process of development. He occupies the central place in the development process. He initiates development in a society and carries it forward. An entrepreneur is also different from a capitalist. The capitalist simply furnishes the funds while the entrepreneur directs the use of these funds.

The entrepreneur is motivated because of -

- (i) the desire to find a private commercial kingdom.
- (ii) the will to conquer and prove his superiority.
- (iii) the joy of creating, getting things done or simply of exercising one's energy and ingenuity.

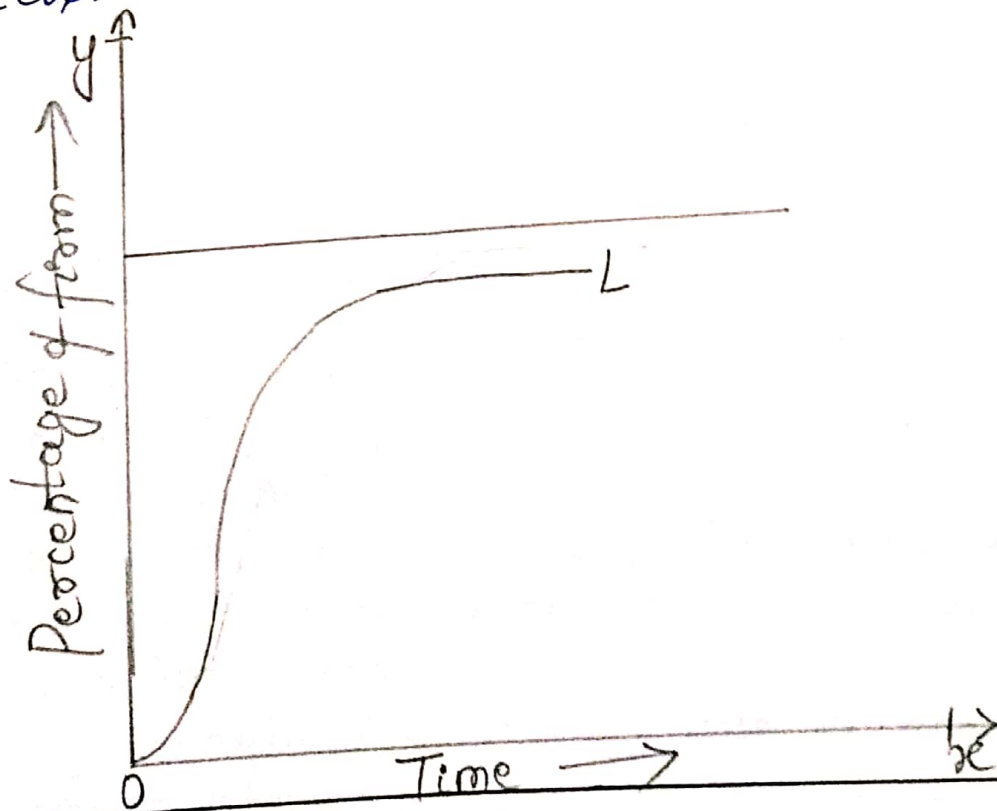
It is the capital resource which can enable the entrepreneurs to have command over factors of production. For this, he needs purchasing power in the form of credit and capital which he can borrow from banks and other financial institutions.

⇒ Role of profits - An entrepreneur innovates to earn profits. Profits are conceived "as a surplus over costs: a difference between the total receipts and outlay - as a function of innovation."

"Under Competitive equilibrium, the price of each product just equals its cost of production and there are no profits. Profits arise due to dynamic changes resulting from an innovation. They continue to exist till the innovation becomes general."

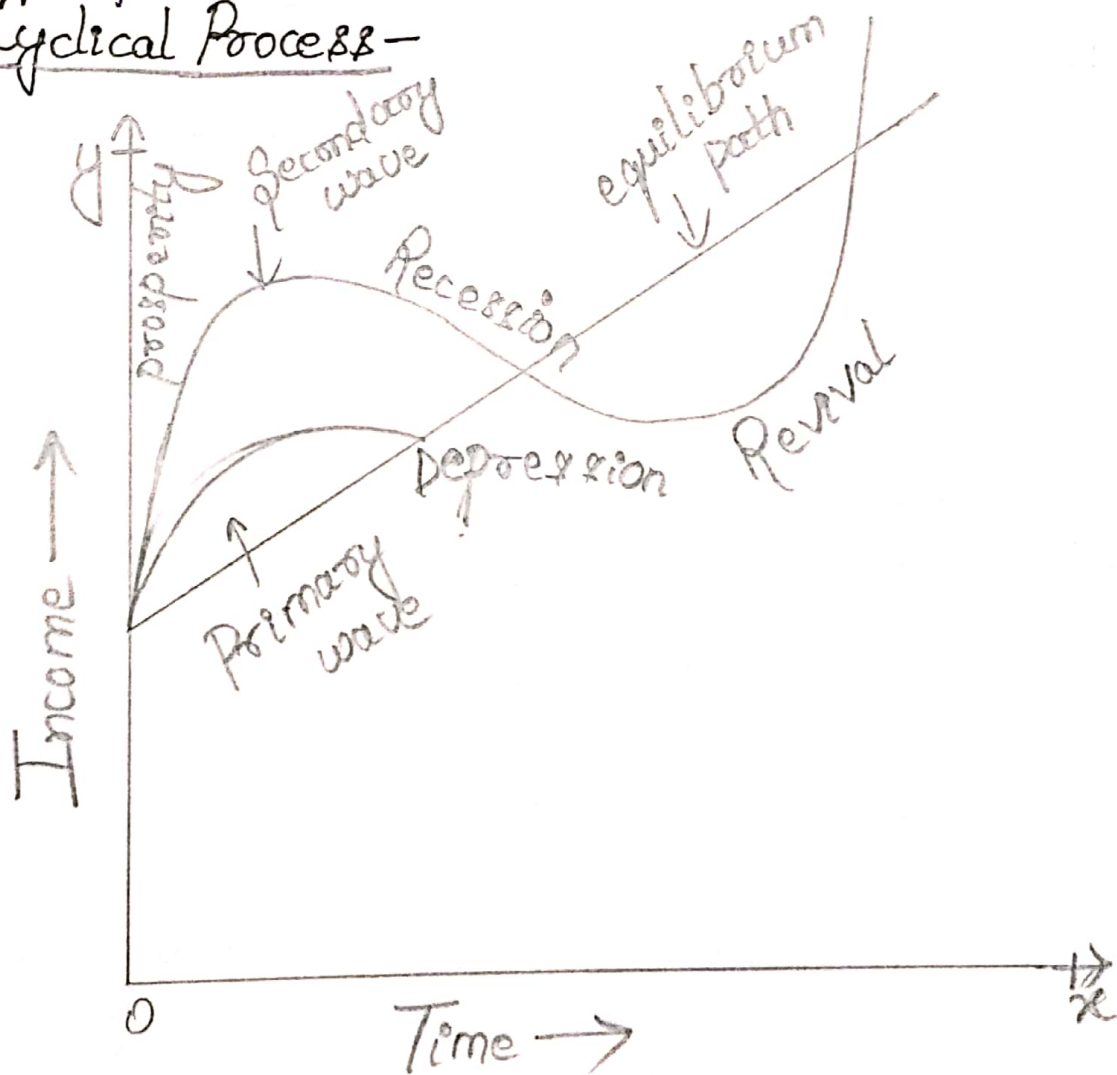
— Prof. Schumpeter

⇒ Breaking the circular flow — Schumpeter regards economic development as a dynamic and discontinuous process. The society progresses through trade cycle, that is why, the entrepreneurial activity appears in a swarm like fashion. In order to break the circular flow, the innovating entrepreneurs are financed by bank credit expansion. Since investment in innovations is risky, they must be paid bank interest on it. Once the innovations becomes successful and profitable, other entrepreneurs follow it in swarm like fashion/ clusters.



The curve OL represents that from adopts an innovation slowly to start but soon the adoption of innovation gains momentum but it never touches 100% adoption level.

→ Cyclical Process -



Since investment is assumed to be financed by creation of bank credit. It increases money income and helps to create a cumulative expansion throughout the economy. The increase in purchasing power of consumers increase the demand for products. Price rise, profits increase and old industries expand by borrowing from banks. It replaces a secondary wave of credit inflation which is superimposed on primary wave of innovations.

Over optimism and speculation at further to boom. After a period of gestation, the new products starts appearing in the market. The demand for old products decreases and there is fall in prices. The old firms contract output. As the innovators start repaying bank loans out of profits, the quantity of money is decreased and prices tend to fall and profits decline and as a result, uncertainty and risks increase, the impulse for innovation is reduced and eventually comes to an end and depression begins.

There are always ups and downs in the natural events similarly, there are ups and downs in economic activities too. The forces that cause boom ultimately gets exhausted and create counterforces. A competition occurs between original and counterforces. At last, ultimately counterforces gain sufficient strength to overcome the original forces. This is how the boom starts fading away giving place to depression.

Schumpeter cyclical process of development is illustrated by the given figure - The secondary wave is superimposed on the primary wave of innovation. With over optimism and speculation, the development proceeds more rapidly in prosperity phase. When recession starts, the cycle continues downward below equilibrium level to depression phase and ultimately another innovation begins revival.

Thus, entrepreneurs play a key role in the Schumpeterian analysis. They bring economic development in a spontaneous and discontinuous manner.

cii) The decay of Capitalism or 'Crisis' - Schumpeter concludes that crisis is the process by which economic life adapts itself to the new economic condition.

Capitalism can maintain itself only so long as entrepreneurs behave like pioneers. Schumpeter holds a very pessimistic view about the survival of capitalism. He advocated Capitalist system of production yet he was not unaware of the weakness of the system. Due to its drawback, Capitalism disintegrates and he is placed to socialism. Schumpeter gives the following reasons for the disintegration of Capitalism.

a. The obsolescence of entrepreneurial function - Prof.

Schumpeter observes that the success of early captains of industry have made innovation, a routine activity. It tends to degenerate into a dis-personalised, routine activity carried on in a big business through highly-trained managers.

b. Destruction of institutional framework of Capitalist -

Another factor responsible for weakening the foundations of capitalism is the destruction of its institutional framework. The entrepreneur by his own success tends to destroy not only his economic and social functions but also the institutional framework within which he works.

c. Destruction of protecting political strata - The destruction

of protecting political strata will administer the last blow to capitalist system. With the progress of capitalism, not only the functions of the entrepreneur and the institutional framework of capitalism crumble but the group that protected early capitalism politically is also destroyed.

Criticism

1. Role of Innovator Emphasized.
2. Role of Savings Ignored.
3. Analysis of Capitalist process not convincing.
4. Emergence of Socialism not based on sound Reasoning.
5. Circular flow not based on Say's law of market.
6. Analysis of Cyclical process is wrong.
7. Undue importance to Bank Credit.
8. Innovations is not the main cause of economic development.
9. Little relevance for underdeveloped countries.

Conclusion

Despite all these drawbacks, Schumpeter's theory contributes much to the theory of economic development. His analysis is very useful in understanding the historical development of capitalist economies. Schumpeter's theory provides great importance to inflationary financing and innovations in economic development. His analysis is relevant to UDCs from point of view of long range increase in productivity and absorption of surplus labour in gainful employment as a result of innovations. Though it analyses the problems of western capitalism, it can give certain clues to problems that may arise in UDCs, once the process of industrialization begins as well as provide a lesson for avoiding waste and extra hardships that attend an unplanned unco-ordinated development.