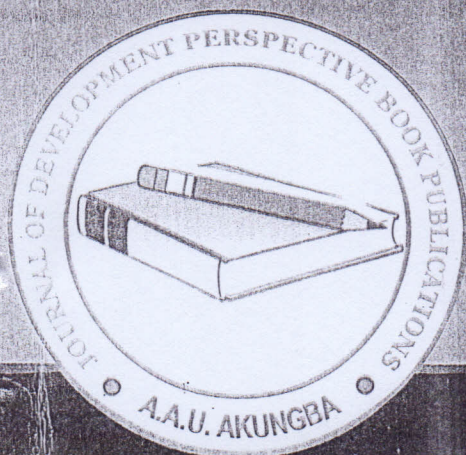


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CHAPTER SIX

THE SCHUMPETERIAN THEORY OF ECONOMIC DEVELOPMENT

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- 6.0 Introduction
- 6.1 The Main Features of Schumpeterian's theory of Economic Development
- 6.2 The Schumpeterian Model
- 6.3 A Critical Appraisal
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6.0 Introduction

Joseph Aloes Schumpeter in his classic book entitled "The Theory of Economic Development" analyze the working of the capitalist system in order to demonstrate that significant advances in real income occur by disequilibria transition from one configuration of economic balance (or circular flows in Schumpeter's usage) to another. Schumpeter's theory underscores the importance of inflationary financing and innovations as the main factors in economic development. The integral parts of the development model are presented below.

6.1 The Main Features Of Schumpeterian's Theory Of Economic Development

The most important figure in Schumpeter's analysis of the development process is the entrepreneur. He is the innovator, the one who introduces new production function in a stationary economy. In this economy, there is a circular flow of goods and services on one hand and that of money on the other. According to Schumpeter, the circular flow is "a stream that is fed from the continually flowing springs of labour-power and land, and flows in every economic period into the reservoir which we call income, in order to be transformed into the satisfaction of wants". Introduction of one cause of change in the form of innovation breaks the circular flow.

An innovation may comprise of (1) the introduction of a new good; (2) the use of a new method of production; (3) the opening of a new market; (4) the conquest of a new source of raw material supply; and (5) the reorganization of any industry.

According to Schumpeter, the existence of innovation possibilities is a necessary but not sufficient condition for development. Entrepreneurial activity is central to the continual improvement of existing innovation possibilities. It should be recognized that Schumpeter's theory is a heroic attempt to emphasize the key role that entrepreneurship plays in the development process. The nature of entrepreneurial economic function shows the dynamic nature of Schumpeter's vision of economic development.

Entrepreneurship is not ordinary managerial activity. In a climate of risk and uncertainty, the entrepreneur does not hesitate to introduce something entirely new in order to increase the size of his operations. Besides, this is also done with the aim of reaping profits. Profit occurs due to dynamic changes resulting from an innovation. To effectively perform his vital economic functions, the entrepreneur needs debt financing.

To put in another way, entrepreneur needs free capital-loanable funds. Therefore, credit is made an integral part of the process of development. Schumpeter alluded to the fact that though innovation may occur; continuously but their utilization takes a wavelike form. The success of one innovator smoothed the paths for others in whom the entrepreneurial characteristics were less highly developed. The success of this innovation brings in a wave of similar innovations in a "swarm like clusters". The clustering of innovations causes a serious disruption in the circular flow; therefore the adjustment process involves upheavals in the economy.

Another salient feature of Schumpeter's analysis is the assumption of the existence of cyclical swings. Each of these cycles is supposed to be roughly periodic in length. He identified three distinct series: (1) a kitchen cycle of about forty months long; (2) a Juglar cycle of about ten years in duration; (3) and the very long "Kondratieff" cycle. Such a long cycle happens about once in half a century. The first long wave, began in 1780 and ended in 1840 when England completed its industrial revolution. These cycles are conceived as independent entities, combining in various ways to yield the aggregate cyclical pattern.

6.2 The Schumpeterian Model

Schumpeter starts with the assumption of a purely competitive economy in a stationary state. In such an economy, there is no uncertainty, no economic profit, stable money supply, stable income velocity of money, stable price level, and no economic growth. There is no interest rate; savings are pooled toward investment, but only to replace depreciated capital. Besides, there is a circular flow of goods and services on the one hand and that of money on the other. All the events in the stationary economy are repetitive. There are opportunities for the introduction of new techniques. To this circular flow, Schumpeter introduces an exogenous factor in the form of innovation. Entrepreneurs introduce innovations whenever it seems that action would yield a surplus over costs. It was out of this surplus that interest would be paid. Schumpeter opines that in a dynamic economy entrepreneurial profit is the only source of interest payments. When a path to profits is successfully opened, other entrepreneurs follow with a great rush in a "swarm-like clusters".

The clustering of innovation increases the demand for labour and new combinations of the factor of production. Innovators are assumed to be financed and able to secure bank-credit for investment. This increases incomes as the upward movement of business progressed. Prices also rise, shifting purchasing power from those whose incomes are relatively fixed to those who are sharing in the gains accruing from the expansion process. Old firms join in the general expansion and with new firms imitating the original innovators. Over-optimism and specialization add to the boom. Competition increases significantly to make business less profitable. Credit becomes tighter. Money incomes decrease, prices tend to decline, profits also fall. The boom was over and the repayment of bank loans accompanied declining business activity. Inventions ceased to be utilized, not because there were no new ideas but because, in the environment of depression, the risks affecting their utilization appeared to be great.

It is important to understand that Schumpeter views cyclical fluctuations as an integral part of capitalistic development. According to him, each upswing in economic activity is due to application of new inventions. Once the upswings end, the downswing

start. When recession begins, the natural forces of recovery bring about a revival. Once equilibrium is restored, the stage is then set for a new wave of innovations and a repetition of the cycle. Entrepreneurs with bold spirit introduce new production techniques, imitators follow and a new upswing begins. Schumpeter regards this process of development as one of "creative destruction" wherein "the old economic structures of society are being continually destroyed and the new structures are being continually created in their place"¹

Schumpeter contends that 'cyclical swings are the cost of economic development under capitalism'. The very success of capitalism in the economic realm breeds changes in social attitudes and institutions that destroy the system.

6.3 A Critical Appraisal Of Schumpeterian's Theory

Schumpeter's contention that developments do not occur through a smooth, continuous process but due to temporary interruptions in economic reality is not far from reality. His praiseworthy attempt to attach great importance to the exceptional role of entrepreneurship in the development process is highly commendable. There is convincing evidence that his brilliant contributions have greatly influenced development themes. Despite these merits, it has certain weaknesses.

1. The nature of entrepreneurial function in modern market economy is quite different from the one described by Schumpeter's model. In the modern world, large corporations carry out innovations in routine manner and not by an individual entrepreneur as noted by Schumpeter.
2. The assertion in his theory that the cause of the downswing in economic activity is the maladjustments created by a wave of innovation is inadequate. Several other causes of cyclical fluctuations have been identified in economic literature. These include; psychological, natural and financial causes.
3. The assumption that solely borrowing from credit-creating banks finances innovations may not be realistic. Solely credit-creating banks nowadays cannot finance most innovations. Almost all innovations are financed by retained earnings or by floating shares in the stock market.
4. To jumpstart development process and make it sustainable, apart from innovational investments as shown in Schumpeter's analysis, combination of several other factors like trained manpower, organizational structures and incentives are required.
5. The fact that Schumpeter's analysis solely depends on the existence of an entrepreneurial class casts doubt on its applicability to countries where adequate entrepreneurship is lacking.

6.4 Review Questions

1. What does Schumpeter mean by the assumption of a "purely competitive economy in a stationary state"?
2. How important is the creation of bank-credit in Schumpeter's model of development?
3. Who is the central figure in Schumpeter's analysis of the development process? And what is the role Schumpeter picture as the major functions of this central figure?
4. How do entrepreneurs spark the process of economic development?

5. What meaning did Schumpeter attach to the concept of "circular flow"?
6. According to Schumpeter, how did the wave of innovations cause upward movement of the cyclical swings?
7. State the various forms of innovation mentioned within the Schumpeterian model.
8. From what basic assumptions or positions do Schumpeter's theory of development spring?
9. Identify the three types of cycles a capitalist society might likely face according to Schumpeter.
10. Did Schumpeter believe the capitalist system would crumble even though no revolutionary groups sought its downfall?

6.5 Solved Questions

1. What does Schumpeter mean by the assumption of a "purely competitive economy in a stationary state"?
To Schumpeter, a "purely competitive economy in a stationary state refers to a stationary state in which there is perfect competitive equilibrium, where there is no uncertainty, no profits, no interest rates, no investments, no innovation going on and no economic growth.
2. Who is the central figure in Schumpeter's analysis of the development process? And what is the role Schumpeter picture as the major functions of this central figure?
The central figure in Schumpeter's analysis of the development process is the entrepreneur. The entrepreneurial function is to disturb the stationary state, to create change, to both create and thrive in conditions of uncertainty, to seek new profit opportunities and to try to establish monopoly positions in the market
3. What meaning did Schumpeter attach to the concept of "circular flow"?
According to Marx, the circular flow is "a stream that is fed from the continually flowing springs of labour-power and land flows in every economic period into the reservoir which we call income, in order to be transformed into the satisfaction of wants".
4. State the various forms of innovation mentioned within the Schumpeterian model.
An innovation may manifest itself in five different ways namely:
 - 1) The introduction of a new good
 - 2) The introduction of a new method of production
 - 3) The opening of a new market
 - 4) The conquest of a new source of supply of raw materials
 - 5) The reorganization of any industry.
5. Identify the three types of cycles a capitalist society might likely face according to Schumpeter.
According to Schumpeter, the three types of cyclical fluctuations in business activity under a capitalist economy are:
 - (i) Existence of a Kondratieff long wave in economic activity. Schumpeter identified this long wave with the development in England between 1780 and 1840.
 - (ii) A shorter ten-year cycles named after Juglar.

- (iii) The kitchen 40-month cycle.
These cycles revolved around each other simultaneously in time.

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