

## **Business cycles, growth and economic policy:**

### **Schumpeter and the Great Depression**

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#### *Abstract*

Joseph A. Schumpeter's theory of economic development analyzes how growth and cycle dynamics intertwine. The process of Creative Destruction plays an essential role in that dynamics: embodying a cleaning effect, it has a clear beneficial impact on long-run development. For that reason, and also for some of his famous (and provocative) non-interventionists statements, Schumpeter is generally interpreted as a pure *liquidationist*. This paper contests this rather simplistic view and shows that Schumpeter not only expressed much more nuanced positions as far as practical economic issues were concerned but also that his views on economic policy were rooted in his earlier contributions before the Great Depression, attesting to a stronger time-consistency of his contributions.

*Keywords:* business cycles, growth, short run, long run, creative destruction, cleansing effect, productive recessions, economic policy, Schumpeter.

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## 1. Introduction

It is well-known that Joseph Alois Schumpeter always explained that “[a]nalyzing business cycles means neither more nor less than analyzing the economic process of the capitalist era” (Schumpeter 1939: V). Consequently, his *Theory of Economic Development* - which later became his theory of economic evolution<sup>3</sup> - naturally embodies what today we would consider an integrated growth and cycles analysis.

Starting with his early contributions on crises theory and business-cycle theory (Hagemann 2003), Schumpeter strived continuously to understand the fundamental elements in the explanation of economic fluctuations. From his *Theory of Economic Development* (1911) until his monumental two volumes on *Business Cycles* (1939) and *Capitalism, Socialism and Democracy* (1942), he mainly investigated the ways growth and cycle dynamics communicate. He identified two main interaction channels. Business cycles first are interpreted as the unavoidable joint-product of economic development dynamics. Second he elaborated his famous process of creative destruction: the selective mechanism exerted in the recession and depression phases of the cycle which although it has a short-term negative impact, Schumpeter regarded as positive for long-run economic dynamics. It is clear then that for Schumpeter growth and cycle dynamics are mutually influencing.

Creative destruction although certainly the most famous Schumpeterian concept is also rather complex, *i.e.* the outcome of a liquidation process and a reallocation of productive resources during a recession, and particularly a depression phase. Both mechanisms can have rather damaging economic consequences in the short run. For that reason, and also because of his earlier position on lack of justification for intervention to help the economy to escape the Great Depression, Schumpeter is generally considered a non-interventionist, which in our view should be nuanced. His notion of fluctuations as the outcome of growth-cycle interactions led to his detailed approach to the structure of these cycles and deep reflection on the nature of the depression. In that context the possible need for economic policy to correct it emerges, and is treated by Schumpeter quite differently from the discussion on economic policy in normal times.

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<sup>3</sup> See Hagemann (2008).

The present paper focuses on Schumpeter's conclusions about economic policy in the context of his business cycles, crises and economic development theories. Careful investigation of his contributions reveals that whereas on the theoretical side Schumpeter is reluctant to favor any government intervention, as a practitioner he has a much more nuanced opinion. We show not only that Schumpeter admitted to the possible necessity for economic policy, even in other contexts than the Great Depression, but also that his view is consistent over time since there were similar elements present in his writings before the Great Depression.

The paper is organized as follows. Section 2 is based on Schumpeter's theoretical contribution to the analysis of economic development and to the status of business cycles theory in that framework. We examine the way(s) business cycles and growth dynamics may interact. From this perspective, the mechanism of creative destruction is of fundamental importance but we show also that Schumpeter's comprehensive analysis of the phases of the cycles as well as the specific nature of depressions nevertheless leads him to express much more subtle views than those generally credited to him by economic interpreters, particularly modern authors but sometimes also historians of economic thought. We pay specific attention to Schumpeter's conviction that the recuperative powers of capitalism are at work during a depression. Section 3 analyzes how Schumpeter's theoretical construction was affected by the demands of the Great Depression. We examine his views on three main questions debated intensively during the 1930s and linked strongly to the role associated to economic depression, namely: the liquidationist view which is based on the part played by the process of creative destruction, (the danger of) austerity policy Schumpeter emphasized if depressions are pathological, and finally his rejection of the stagnationist interpretation of the Great Depression. Section 4 discusses Schumpeter's views on economic policy. We argue that far from the usual idea that Schumpeter did not systematically oppose government intervention, his views on economic policy were time-consistent throughout all of his contributions.

## **2. Schumpeter's analysis of growth-cycles interaction and the necessity or not to implement economic policies: the theoretical point of view**

Despite the number of papers referring to Schumpeter's growth-cycles analysis<sup>4</sup> there is one point which has not received systematic attention: its consequences in relation to economic policy. This would imply that depression phases play a fundamental role. More explicitly, their destructive effect has a negative impact on growth and advocates for countercyclical economic policies, while their cleansing effect is proof of the capacity of capitalism to adapt and self-correct its excesses. Historians of economic thought<sup>5</sup>, as well as the authors of modern Schumpeterian literature, usually focus on the process of creative destruction and then uphold the interpretation of Schumpeter as a pure liquidationist, an interpretation which of course is easily reinforced by Schumpeter's provocative statements. In order to develop our arguments we need first to explain the status of business cycles dynamics in his development theory, their different phases and their respective roles. We then return to the well-known creative destruction process but focusing here on the detailed comments Schumpeter introduced on the different natures that depression phases can take.

### *2.1. The dynamics of capitalist economic development*

From the outset Schumpeter (1914-15) emphasized the wave-like movement of economic development and the important role of innovations: "Analyzing Business cycles means neither more nor less than analyzing the economic process of the capitalist era... Cycles are not, like tonsils, separated things that might be treated by themselves, but are, like the beat of the heart, of the essence of the organism that displays them" (1939: V). This statement which forms an overture to Schumpeter's *Ring of Business Cycles* makes it fairly clear that he considered capitalist development as a succession of four phases of economic fluctuations: prosperity, recession, depression and recovery. While the Kitchin and Kondratieff cycles had yet to be discovered when Schumpeter wrote his *Theory of Economic Development*, in his *Business Cycles* he constructed a three-cycle schema, in which Kondratieff long waves constituted the framework combined with the classical Juglar and the shorter Kitchin cycles.

### *2.2. The role of recessions /depressions*

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<sup>4</sup> Other papers investigating this question include Rostow (1975), Date (1991) and Hagemann (2008).

<sup>5</sup> We can identify a few exceptions. First, the pioneering paper on that question by Klausinger (1993). More recently, Boianovsky and Trautwein (2010) analyze Schumpeter's views on unemployment and identify in his various contributions an opportunity for public spending policies in certain circumstances, while Potier (2015) who in discussing Schumpeter's views of Stagnation, provides some interesting hints about the possible nature of Schumpeterian economic policies.

The process of Creative Destruction was identified by Schumpeter as “the essential fact about capitalism”. Indeed, according to him, the process of liquidation and reallocation of productive resources taking place in the recession and particularly in the depression phase is not only an essential and unavoidable characteristic of capitalist evolution but is also necessary, and finally, beneficial for long-run development. He believed firmly in the “*recuperative powers of capitalism*” (1934: 110). In chapter VII on ‘The Process of Creative Destruction’ in his *Capitalism, Socialism, and Democracy* Schumpeter states that “Capitalism ... is by nature a form or method of economic change and not only never is but never can be stationary” (Schumpeter 1942, p. 82). Creative destruction is an integral part of the evolutionary process in a capitalist system and affects business cycles and economic growth alike. Schumpeter considered the process of Creative Destruction as “the essential fact about capitalism” since the Industrial Revolution: “The process as a whole works incessantly however, in the sense that there always is either revolution or absorption of the results of revolution, both together forming what are known as business cycles” (Ibid: 83).

In 1931 Schumpeter was still convinced that the severity of the depression resulted from the coincidence of the trough phase of all three types of cycles: the Kondratieff long wave, the Juglar and the Kitchin<sup>6</sup>. Schumpeter explained the severity of the 1930s' depression, which he had expressed in his contribution to the meeting of the American Economic Association in Cleveland on December 27, 1930 (Schumpeter 1931a) and most clearly in a letter dated January 8, 1931 to Arthur Spiethoff in which he pointed out the superposition of the troughs in three-year and nine-year-cycles with the downswing of a long wave<sup>7</sup>: “[D]epressions of such severity have repeatedly occurred – roughly once in fifty-five years” (Schumpeter 1942: 64). Schumpeter had always emphasized the wave-like movement of capitalist development as characterized by the succession of prosperity and depression<sup>8</sup>. “There was nothing unprecedented in this breakdown in 1929-1932 ... the intensity of the depression will be in some way proportional to the intensity of the preceding progress”, Schumpeter ([1941] 1991: 351) still argued in his March 1941 lectures delivered at the Lowell Institute in Boston in. Whereas the recession is a physiological process leading towards equilibrium, which

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<sup>6</sup> See, e.g., Schumpeter (1931a) in Clemence (1951: 96-97), and Schumpeter (1931/32) in Stolper/Seidl (1985: 208-9).

<sup>7</sup> See Schumpeter (2000: 184).

<sup>8</sup> See also Hagemann (2003).

Schumpeter considered as “the normal working of the evolutionary mechanism,” “the excesses of speculation and loose banking methods make the thing much worse than it otherwise would be” (Ibid: 350). These excesses are at the root of the pathological processes in an overshooting boom which cause the depression, leading the economy far away from an equilibrium position. However, throughout the decade following the outbreak of the Great Depression Schumpeter showed he was not afraid of becoming unpopular and continued to emphasize “that in the breakdown there was promise of a harvest” (Ibid: 351). He pointed out repeatedly the functionality of the crisis consisting of a *spring cleaning*, i.e. the precondition of a new recovery.

Finally, our cases teach unmistakably that, futile as it is to hope for miraculous cures, it is exactly as wrong to believe that the evils of depression are all of them inevitable and that the only sound policy consist in doing nothing. There is no single and simple remedy. (...) The kind of activity which is clamored for in such situation is likely to make matters worse. But all those features of depressions, which spell widespread suffering and needless waste, can yet be taken care of. Especially if a country has steadily improved its public finance during prosperity as the United States did in the decade which preceded the present crisis, enough means are available, and other means can be procured, for an expenditure which will not blot out the worst things without injury to the economic organism, *provided only* that action on this line is taken promptly and followed up by equally sound fiscal habits as soon as recovery gets under way? (Schumpeter 1934b, reprinted in Clemence (1951) p. 117)

### 2.3. *The recuperative powers of capitalism*

“There is no reason to despair”, Schumpeter [1934] (1989: 116) stated in 1934, four years after the onset of the Great Depression. How did Schumpeter arrive at such a conclusion when the United States and other countries had yet to overcome the depression and its disastrous economic and also political consequences? Schumpeter’s reasoning is clear:

This is really at the bottom of the recurrent troubles of capitalist society. They are but temporary. They are the means to reconstruct each time the economic system on a more efficient plan. But they inflict losses while they last, drive firms into the bankruptcy court, throw people out of employment, before the ground is clear and the way paved for new achievement of the kind which has created modern civilization and made the greatness of this country. (Ibid: 113)

Schumpeter believed in the “*recuperative powers of capitalism*” (Ibid, p. 110). In his view it is a main function of the economic cycle in capitalist development that both prosperity and depression are beneficial from an evolutionary perspective of capitalism. Depression periods despite their negative concomitants, exert a selective, i.e. positive function. Whereas in a boom period even the most stupid businessman can make a profit i.e. “errors and misbehaviour should be abnormally frequent in prosperity”, “everything that is unsound for either reason shows up when prices break and credit ceases to expand in response to decreased demand for it” (Ibid: 113).

Interestingly, Schumpeter’s reasoning has much in common with that of Werner Sombart, his life-long rival who blocked Schumpeter’s appointment to Professor at the University of Berlin in 1931/32. When the third volume of Sombart’s *Modern Capitalism* was published in 1927, Schumpeter immediately wrote a long review praising Sombart for being one of the first economists who had recognized the business cycle as the essential phenomenon of capitalist development and for considering the importance of credit creation for pioneering entrepreneurs without capital but criticizing his lack of distinction between interest on capital and entrepreneurial profit. In volume III of his *Modern Capitalism* (MK) Sombart (1927) focuses on high capitalism<sup>9</sup>. Here he emphasizes the selective role of economic crises which only the fittest entrepreneurs will master: “However, a mustering among entrepreneurs and firms takes place: Only the strongest remain alive, everything rotten, idle, weak, which was floating along in times of prosperity, disappears, the able, viable is preserved”<sup>10</sup>.

There is a remarkable parallel between Schumpeter and Sombart not only in their Darwinian view of the survival of the fittest entrepreneurs in periods of depression but also in their emphasis on the beneficial role of economic fluctuations for long-run development. Thus Sombart writes: “Blessing over blessing which flows for capitalism from the presence and the process of the expansion conjuncture”<sup>11</sup>.

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<sup>9</sup> For a more detailed investigation of Sombart’s analysis of capitalist development see Hagemann and Landesmann (1996).

<sup>10</sup> “Aber gleichzeitig findet eine Musterung unter den Unternehmern und den Unternehmungen statt: nur die Kräftigen bleiben am Leben, alles Morsche, Faule, Schwächliche, das in den Aufschwungszeiten mitgeschwommen war, verschwindet, das Tüchtige, Lebensfähige wird erhalten” (MK III [1927] 1987, p. 585).

<sup>11</sup> “Segen über Segen, der für den Kapitalismus aus dem Dasein und Ablauf der Expansionskonjunktur fließt.” (Ibid, p. 586).

### 3. Schumpeter and the Great Depression

#### 3.1. Uniqueness of the Great Depression?

In 1934 Schumpeter did not acknowledge the uniqueness of the Great Depression but recognized its severity as similar only to the two earlier ones - in Britain in 1825 and in the United States in 1873 - with which he makes the comparison. Schumpeter recognized that special historical circumstances can aggravate a crisis which otherwise is endogenous to the capitalist system: “that what we are faced with is never simply a depression but always a depression *moulded and made worse by forces not inherent to the working of the economic engine as such*” (Schumpeter [1934] 1989, p. 114). Among the non-economic causes, great wars, such as the Napoleonic wars, the Civil War in the United States and World War I, in particular can play a dominant role<sup>12</sup>.

In the case of the beneficial role of depressions Schumpeter set out his position in his normal controversial style which gave his students at Harvard the impression, noted later by Robert Heilbroner (1980, p. 311) in his *Worldly Philosophers*:

But the students who attended his classes in the late 1930's were regularly shocked to hear this expositor of capitalist growth declare, with obvious enjoyment, that depressions, far from being unmitigated social evils, were actually in the nature of “a good cold douche” for the economic system!

With regard to economic policy Schumpeter takes a clear anti-interventionist stance to its consequences, siding more with his Austrian compatriots Hayek and Mises, and less with the Keynesians or New Dealers. However, Schumpeter elaborates his economic policy conclusions on the basis of his theory of economic development/evolution in which the recuperative powers of the capitalist system play a decisive role:

[D]epressions are not simply evils, which we might attempt to suppress, but – perhaps undesirable – forms of something which has to be done, namely, adjustment to previous economic change. Most of what would be effective in remedying a depression would be equally effective in preventing this adjustment. (Schumpeter [1934] 1989, p. 115)

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<sup>12</sup> See also Kurz (2016).



Any artificial stimuli applied with the best moral intentions to remedy the crisis, finally would make things worse because they would interfere with the work of the depression to correct maladjustments, and would instead create their own maladjustments. According to Schumpeter, not only in the cases of the 1825 and 1873 depressions but also in *all* other depressions “recovery came of itself” (Ibid, p. 117).

Whereas Schumpeter repeatedly points to this quasi-automatic return to an equilibrium position, this does not hold for the prosperity phase as a movement away from equilibrium which requires the stimulus of innovation. Schumpeter does not give a substantive explanation of the lower turning point of the cycle but relies upon the recuperative powers of capitalism, and trusts in the ‘natural recovery’ (Schumpeter 1939, p. 995). On the other hand, the modern neo-Schumpeterian Gerhard Mensch, who in his *Stalemate in Technology* invented the term *basic innovations* for major technological breakthroughs, indicates in the subtitle of this successful book that only *Innovations overcome the Depression* (Mensch [1975] 1979).

### 3.2 Long-run policies, the danger of austerity policy and pathological depressions

According to Schumpeter a functioning capitalism does not need a stabilization policy<sup>13</sup>. It would be better to follow a prophylactical policy to avoid severe crises by adhering to clear rules such as the gold standard, a reasonable wages policy, etc., rather than to intervene and make things worse. Whereas Schumpeter shares Keynes’s position that in a depression only an expansive fiscal policy but not an expansive monetary policy is an efficient remedy, he deviates seriously from Keynes in favoring “the ruthless principle that the budget ought to be balanced under any circumstances” (Schumpeter 1941, p. 371). While conceding that “[a]ction on that principle makes things worse in a depression” (Ibid), it might nevertheless be healthier in the long run because a too long dose of a budget deficit as a stimulant can make a country dependent on this kind of drug like a “morphinist.”

It is less known that Schumpeter, like Keynes, had made regular contributions on the relevant economic policy problems addressed to the public and characterized by a remarkable clarity of exposition. Unlike Keynes, Schumpeter focused more on the long-run consequences of economic policy measures according to his economic theory. Diagnosing an insufficient real

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<sup>13</sup> For a detailed analysis of Schumpeter’s theoretical diagnosis of the Great Depression and his views on the appropriate economic policy see also Klausinger (1993).

capital formation, aggravated by low savings due to the erosion of money wealth as a consequence of the hyperinflationary processes in Germany and Austria after World War I and ending in a currency reform, Schumpeter considered real capital formation as the prime economic policy. This comes out very clearly in his regular contributions to the economic magazine *Der deutsche Volkswirt*, edited by his friend Gustav Stolper, before and during the Great Depression.<sup>14</sup> As a consequence Schumpeter regarded finance policy as an important instrument to ensure a process of higher taxation of consumption expenditures and a general value-added tax and a less progressive income tax to promote savings.

Schumpeter (1931/32a) considered the “groping for a new equilibrium” (1985: 205) as core to what happens in depression periods. Whereas a functioning capitalist system does not require any interventions during or outside a depression, and the sufferings in depression periods are nothing more than the temporary side-effects of rapid progress, Schumpeter attributes many of the catastrophes of the Great Depression to the interference of the political sphere in the economic sphere<sup>15</sup>. He clearly regards deflationary policies as detrimental to recovery. Thus in winter 1931/32 when the World Depression was at its peak, and Schumpeter was still in Germany where Chancellor Brüning was continuing a strong deflationary policy, he emphasizes the danger of “political motor-cars” causing crashes and making things worse. Thus “it would not need a long proof to show that deflation policy must cause deflation crises” and “that under the causes operating in particular in Germany (and England) a finance policy which is incompatible with the living conditions of the capitalist engine stands at first place” (Ibid: 209-10).

While the function of the depression is to eliminate disproportionalities and rigidities which would overcome even a recession, i.e. the very necessary work of reorganization and adaptation is done, there exists the danger of a depression becoming “pathological”. As a consequence “abnormal liquidation destroys many things which could and would have survived without it” (Schumpeter 1939: 149). Whereas “the essential process is not at all catastrophic, ... the excesses of speculation and loose banking methods make the thing much worse than it otherwise would be”, Schumpeter (1941: 350) points out in his Lowell lectures.

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<sup>14</sup> See Stolper and Seidl (1985) and Klausinger (1993).

<sup>15</sup> See Ibid: 204-8.

Under such circumstances neither Schumpeter adheres to his laissez faire position derived from his theory for a functioning capitalist economy nor joins forces with the advocates of austerity policy but agrees with the (Keynesian) advocates of government deficit spending as an effective remedy to overcome the danger of a vicious downward spiral in a period of deflation when investment (and consumption) decisions are postponed in the case of elastic price expectations, as he points out in the new chapter XXVIII on 'The Consequences of the Second World War' added to the second edition of his *Capitalism, Socialism and Democracy* (Schumpeter 1947: 395-8): "The true objection is not against income-generating government expenditure in emergencies once they have arisen but to policies that create the emergencies in which such expenditure imposes itself" (Ibid: 397-8).

Schumpeter's remarkable time-consistency is indicated also by the fact that he had already argued against Cassel's free market view in 1926/27 that emergency works financed by credit expansion or consumption expenditure taxes can increase overall labor demand, and thereby help to overcome deadlock of the economy by state initiative (Schumpeter [1926/27] 1985: 158). It would ease both the situation and a possible budget deficit as the consequence of an increase in public expenditures if in a previous prosperity phase a budget surplus had been accumulated.

Schumpeter's views on monetary and credit policy are more ambiguous. His core idea is that the monetary system should make available enough credit to finance innovative investments in the recovery and prosperity phases of the business cycle. Thus it comes as no surprise that he concedes that supportive creation of credit may dampen the severity of the depression (normal or abnormal).

While Schumpeter rejected the idea of monetary neutrality, he nevertheless regarded monetary stability as an essential condition for economic development. This included currency system stability as in a gold standard system. In a 1925 article on 'Credit Control' Schumpeter had pointed out that "maintaining the stability of exchange rates ... is more important for the economy than Mr. Keynes admits" (Schumpeter 1925: 127). Nevertheless even here, years before the Great Depression started, we find Schumpeter sympathizing with Keynes's ideas for a more active monetary and credit policy in admitting to "the need for a greater or better degree of management not only of the currency but of the economy as a whole" (Ibid: 152) in case the credit system would aggravate a depression.

Schumpeter also emphasizes the asymmetric impact of interest rate policy over the different phases of the cycle <sup>16</sup> and the difficulty (impossibility) to control the cycle. In the face of this difficulty, in line with his vision of the way the different phases interact with each other, he considers that: “The most important remedy *à la longue*, and the only one which is exposed to no objections, is the improvement of business cycle prognosis” (Schumpeter [1911, 1926], 1934a: 253). Reducing the severity of the crisis may indeed consist of dampening the excesses of the expansion (prosperity for Juglar) phase<sup>17</sup>.

The downswings of Kondratieff phases, Schumpeter points out in a letter to George Garvy dated December 1, 1943 are characterized by prevailing unemployment<sup>18</sup>. In this a situation and in other less negative phases in the cycle, technological unemployment as the consequence of the introduction of new machinery (which in the long run is beneficial for workers) can become permanent rather than temporary. According to Schumpeter only free competition can guarantee successful reabsorption or compensation of workers displaced by the introduction of new technologies. However, in reality, cartels and trusts, which Schumpeter considers fundamentally important for the execution of technical progress, are focused on limiting production and thereby preventing higher levels of employment, as he argued against Cassel in 1926/27 (Schumpeter 1985:157-60), quoting an American trade unionist in saying that: “Competition is excellent but dead.” As a consequence, unemployment benefits become unavoidable.

In similar vein, Adolf Löwe argued against a deflationary wage policy in the German wage-employment debate after the outbreak of the Great Depression and during Brüning’s Chancellorship. Löwe (1930: 430) considered the solution to the monopoly problem as occupying “the key position for a successful fight against crisis and unemployment”, since the crisis had lost its capitalist sense in the age of cartels and monopolies. Cartelization had

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<sup>16</sup> “It is easier to dampen prosperity by a high rate of interest than to alleviate depression by a low one” (Schumpeter 1931/1989, p. 98 .

<sup>17</sup> It was Schumpeter who described Juglar “as to talent and command of scientific method, among the greatest economists of all times” (1954, p.1123). As shown by Dal Pont Legrand and Hagemann (2007), the opinions of Schumpeter and Juglar on the nature of the cyclical movement and the cause of depression lying in the prosperity period have much in common. Thus it seems logical that both would favor an economic policy consisting of dampening the excesses of the prosperity phase.

<sup>18</sup> Ulrich Hedtke found this letter in which Schumpeter responds to Garvy’s synthesis of the Russian critique of Kondratieff’s theory of long waves (Garvy 1943), in the Schumpeter papers held at Hitotsubashi University in Tokyo.

stabilized the sectoral disproportionalities, i.e. overcapacity in the heavy industries, resulting from World War I, prevented the elimination of unproductive firms and caused a cost dilemma for the manufacturing and consumption goods industries which were paying too high prices for their inputs. A massive reduction in the cartel rent instead of a general cut in wages would contribute strongly to lowering the costs of production and regaining international competitiveness.

### 3.3 Stagnation

“I am not a stagnationist”, Schumpeter (1946a: 10) concludes his reflections on ‘The Decade of the Twenties’. For Schumpeter stagnationism was “as old as economic thought. In any prolonged period of economic *malaise* economists, falling in like other people with the humors of their time, proffer theories that pretend to show that depression has come to stay” (Schumpeter 1954: 1172).

When Keynes’s *General Theory* was published in 1936, the theory of secular stagnation perhaps had reached the peak of its influence. Schumpeter not only agrees with Hicks’s characterization of Keynes’s theory as “the economics of depression”, but goes further by stating that “Keynes must be credited or debited ... with the fatherhood of modern stagnationism” (ibid). However, Schumpeter, who identified in the recovery process after 1932 only a “disappointing Juglar”<sup>19</sup>, attributed the origin of Keynes’s vision of the modern stagnation thesis to the *Economic Consequences of the Peace* (Keynes 1919) of which the *General Theory* is only “the final result of a long struggle to make that vision of our age analytically operative”(Schumpeter 1946b: 501).

Schumpeter was more generous towards his Harvard colleague Alvin Hansen, who had made the stagnation thesis the central topic of his 1938 Presidential address ‘Economic Growth and Declining Population Growth’ (Hansen 1939) delivered at the annual meeting of the American Economic Association in Detroit. Modern stagnationism according to Schumpeter (1954: 1172), “rose to scientific importance under the brilliant leadership of Professor Alvin H. Hansen, who amplified and expanded the doctrine of the mature or stagnating economy in

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<sup>19</sup> See Schumpeter (1939, Ch. XV G).

part on different grounds than Keynes.” Hansen’s two main arguments were a declining rate of technical progress and a decline in the population growth rate<sup>20</sup>. Hansen first aired his arguments in “The Consequences of Reducing Expenditures”, a paper he published in 1938 to which Schumpeter (1939) reacted critically. For Schumpeter, innovations are the main source of investment opportunities and their occurrence can only decrease gradually, so clearly they cannot be responsible for stagnation. He used a similar argument to dismiss an explanation of stagnation based on a *sudden* decline in the rate of population growth. In 1939 Hansen elaborated his arguments supporting his stagnationist thesis which provoked a second volley of criticism from Schumpeter which began in the famous *Lowell Lectures* and was developed further in chapter 10 of *Capitalism, Socialism and Democracy*. As Potier (2015) rightly points out, in those years Hansen was no longer the only representative of the stagnationists. There were two main interpretations of stagnation in existence: the Keynesian understanding supported initially by Hansen, and the Marxist interpretation. Among the most famous economists involved in this debate were Sweezy and Higgins<sup>21</sup>., nevertheless Schumpeter still contested the stagnationist thesis as if it was a single view<sup>22</sup>. Most of his arguments are similar to those developed earlier but were elaborated<sup>23</sup> both theoretically and empirically.

Although Schumpeter shares their pessimism, it is easy to understand why he cannot be considered a proponent of the stagnationist thesis. Indeed, Hansen’s Keynesian roots led him to consider secular stagnation as a sort of long-run underemployment equilibrium: Schumpeter never addressed the question this way. Schumpeter considered that the essence of capitalism is its relative instability (for instance driven by competition) associated as a counterpart, with the stability of the capitalist –economic and social - order. Thus his analysis of the decline of capitalist economies refers to a totally different concept from Hansen’s stagnation approach: it is rooted in the process of degeneration of capitalism. Schumpeter identifies three main factors which affect the superstructure of the system and then are

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<sup>20</sup> Furthermore, Hansen highlighted the closing of the Western frontier as contributing considerably to new capital formation in the United States in the past, similar to the effect of the opening of a new territory for England and France.

<sup>21</sup> For a detailed view of Sweezy’s contributions and of the debates on stagnation with contemporary authors see Dockès (2015). For a survey of how the stagnation thesis influenced debate after WWII, and especially Hansen’s students and colleagues, see Backhouse and Boianovsky (2015).

<sup>22</sup>For instance, despite his recognition of the great value of Sweezy’s work, Schumpeter never really entered into a debate with him, and never discussed his theory publicly. For a discussion of their verbal exchanges at Harvard in 1946, see Dockès (2015).

<sup>23</sup> See Potier (2015) for a detailed presentation of those debates.

responsible for the degeneration of capitalism (Potier 2015: 1000-1). The first is the obsolescence of the entrepreneurial function in firms where innovation activities are driven progressively by routine, at least when Schumpeter recognizes that entrepreneurship still exists; nevertheless, it is no longer a concept based on a single person, i.e. the entrepreneur, but refers explicitly to collective action. The second factor is the weakening of the bourgeoisie provoked by excessive competition which progressively destroys all barriers but also all sorts of protections. Finally, the third element identified by Schumpeter is the (endogenous) destruction of the institutional framework of capitalist societies due to the progressive concentration which gives the main power to big firms. For Schumpeter those firms are suffering from two governance issues: on the one side their shareholders do not behave as real firm owners, i.e. as entrepreneurs, and on the other side the managers do not always behave as shareholders might expect. All those elements are the (direct) consequences of the functioning of capitalism and are responsible for an increasing stability of capitalism and increasing instability of its order.

For all those reasons and additional social elements, capitalism cannot survive and Schumpeter - without being really precise about his agenda - predicts that Socialism (a centralized or a decentralized version) progressively will substitute capitalism. As already mentioned, this view is quite different from the one defended by the stagnationists *à la* Hansen who, because of their Keynesian influence, developed what Schumpeter considered a “static” analysis, *i.e.* they focused on the capacity of a system to satisfy (or not) the full-employment condition. In this perspective, the instability of the economy is seen as an element explaining the persistency of under-unemployment. In contrast, Schumpeter adopts a long-run (and dynamic) analysis and analyzes the process of stabilization of capitalism induced by its own development as announcing the end of such a system. The two views are definitively irreconcilable.

#### **4. Conclusion: Schumpeter’s views on economic policy**

Schumpeter “was such a bad depression macroeconomist. Indeed he was a very bad one, as bad as 1931 Hayek. At the prime age of 51, in the ludicrous book by several Harvard senior professors Schumpeter praised the great depression as a “healthy catharsis” of the economic

system. This was a garish “uncreative” version of what 1942 Schumpeter later called “creative capitalist destruction” judges the late Paul Samuelson (2015: 33) in one of his last contributions.

Wolfgang Stolper, co-author of the Stolper-Samuelson theorem and a long-time student of Schumpeter at Bonn and Harvard, who co-edited Schumpeter’s German essays on economic policy (Schumpeter 1985) had a more nuanced view. Thus in one of his main contributions in the Marx-Keynes-Schumpeter year 1983 Stolper (1984) pointed out the continuity in Schumpeter’s views. He shows that Schumpeter, like Keynes, considered budget deficits in a depression as necessary. It is therefore “wrong to believe that the evils of depression are all of them inevitable and that the only sound policy consists in doing nothing” (Schumpeter 1934b: 117). Schumpeter concludes his 1934 article on depressions with the statement:

Especially if a country has steadily improved its public finances during prosperity as the United States did in the decade which preceded the present crisis, enough means are available, and other means can be procured, for an expenditure which will blot out the worst things without injury to the economic organism, provided only that action on this line is taken promptly and followed up by equally sound fiscal habits as soon as recovery gets under way. (Ibid)

As Stolper (1984: 30-35) and Stolper and Seidl (1985: 45-48) show, Schumpeter’s later views correspond widely with his writings on public finance during the Weimar Republic<sup>24</sup>. Schumpeter consistently prioritized economic policy measures which would be best for the long-run development of the capitalist economy. This development - or evolution (the term he ultimately preferred) - unavoidably required a permanent process of structural change which might be enhanced during a depression. Stolper identifies in Schumpeter’s emphasis on innovations, growth and structural change, the fundamental difference with Keynes. Schumpeter regarded accumulation of a modern real capital stock and the associated increase in productivity as the core problem of economic policy.

Whereas workers would benefit from such productivity increases in the long run, they would be among the greatest losers from “unnatural” or “pathological depressions”:

But the losses and destruction which accompany the abnormal course of events are *really* meaningless and functionless. Justification of the various proposals for a prophylaxis and therapy of crises chiefly rests with them. The other sound

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<sup>24</sup> See the reprint of Schumpeter’s contributions in Stolper and Seidl (1985: 53-150).



starting point for remedial policy is the fact that even the normal - still more the abnormal - depression implicates individuals who have nothing to do with the cause and the meaning of the cycle, above all the workers. (Schumpeter [1911, 1926], 1934a: 253)

In the penultimate paragraph in the 1934 English edition of *The Theory of Economic Development* Schumpeter emphasizes:

The phenomena of the normal and of the abnormal course of events are not merely distinguishable conceptually. They are in reality different things; and with a sufficiently deep insight, concrete cases even to-day may generally be recognised immediately as belonging to the one or to the other. Such a policy would have to distinguish, within the mass of businesses threatened by disaster in any given depression, those made technically or commercially obsolete by the boom from those which appeared to be endangered by secondary circumstances, reactions, and accidents; it would leave the former alone, and support the latter by granting credit. And it might be successful in the same sense as that in which a conscious policy of racial hygiene might lead to successes unobtainable as long as things are left to work out automatically. In any case however, crises will disappear earlier than the capitalist system, whose children they are. (ibid: 254-5).

Thus it is most important to distinguish between a *normal* depression and an *abnormal* or pathological depression which will not be an easy job in practice. This holds especially since the functioning of the capitalist engine in modern economies is disturbed by monopolies and many other political interferences. However, it is clear that for Schumpeter in contrast to Keynes, the Great Depression did not change his views on economic policy significantly. This is indicated also by the fact that the penultimate paragraph in his *Theory of Economic Development* (quoted above) was written not in the wake of the Great Depression but appeared already in the second German edition which was published in 1926 (pp. 368-9).

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