

# **A Comparison of the Theories of Joseph Alois Schumpeter and John Maynard Keynes**

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Joseph Alois Schumpeter and John Maynard Keynes were the two greatest economists in the 21<sup>st</sup> century. They were incidentally born a few months apart, Schumpeter was born on February 8 1883 and Keynes was born on June 5 1883. They both contributed a monumental amount of work to economic theory, but their most famous masterpieces are, *The General Theory of Employment, Interest and Money* (by Keynes) and *Theory of Economic Development and Business cycles* (by Schumpeter). In these great works, both Schumpeter and Keynes conveyed problems with classical economics. Keynes, especially in the *General Theory*, explicitly attacks the classical framework, Schumpeter on the other hand, implicitly accepts it and uses it to explain his own models. Both Schumpeter and Keynes had different views on how capitalism works. Keynes, in respect to the *General Theory*, believed governmental actions are essential to sustain a capitalistic economy. Schumpeter, however, believed the fundamental impulse that sets and keeps a capitalist economy in motion comes from the introduction of so called new combination through innovation initiated by the entrepreneur (Schumpeter, 1942).

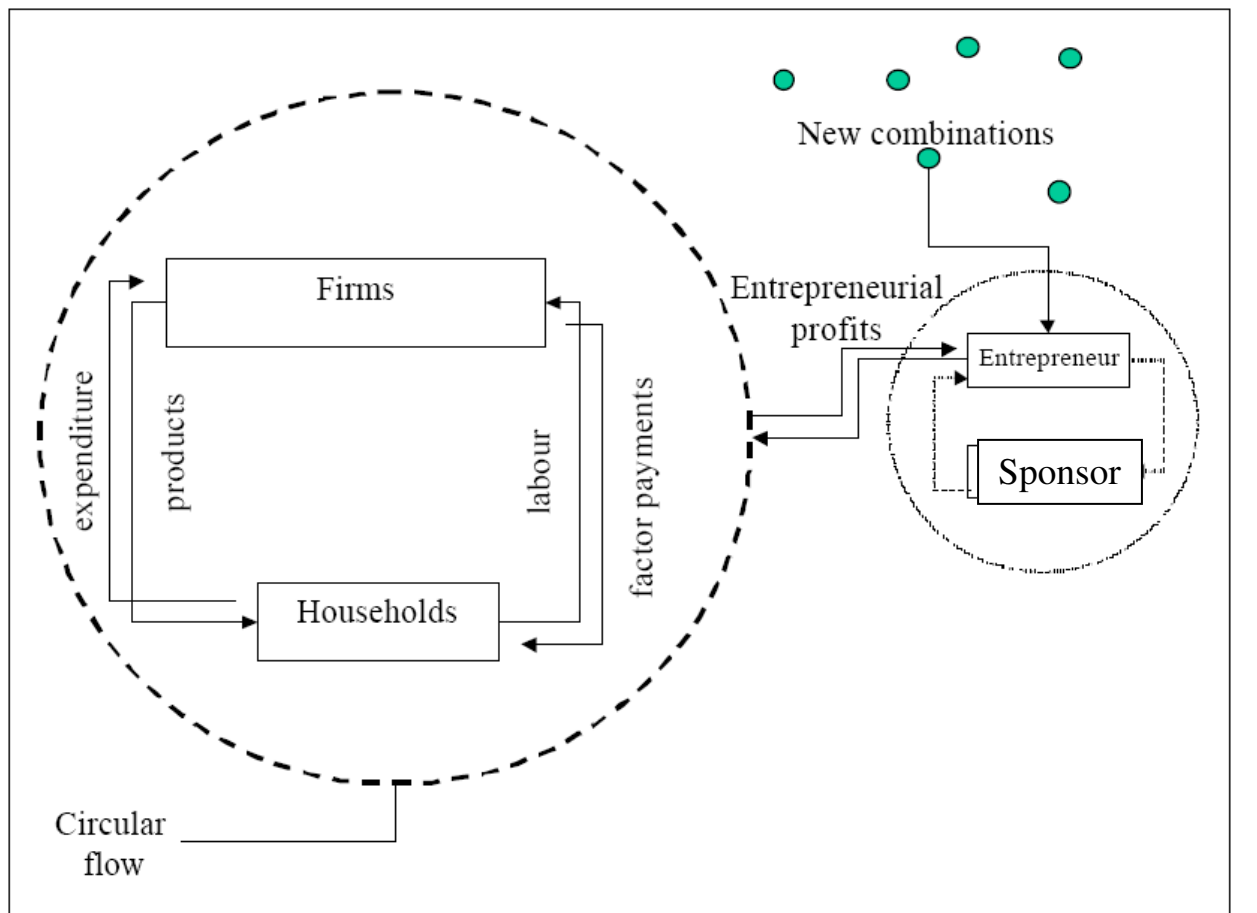
In essence, they were both intellectual opponents to each other but it was Schumpeter who explicitly attacked Keynes in his work. Schumpeter disagreed with Keynes' assumption that techniques of production remain unchanged, he believed a changing production function is an essential process to capitalistic development (Smithies, 1951). But, Schumpeter's main charge against Keynes was that he was a strong advocator of government policies. Like most Austrian economist. Schumpeter disapproved government intervention because he believed it would

impair capitalistic development (Smithies, 1951). Although the negative judgment that Schumpeter expressed about the General Theory testifies to the distance between the theories of Keynes and Schumpeter, they do have similarities in their works (Bertocco, 2006). In terms of monetary theory, they both share two common points of view. Firstly, in contrast to mainstream monetary theory, both Keynes and Schumpeter believed that the diffusion of money induces a radical modification into the way in which the economic system works (Bertocco, 2006). Secondly, both Keynes and Schumpeter justify why money and financial aggregates are not neutral, they both highlight the crucial role of the credit market and the banks; in contrast with mainstream monetary theories, who do not consider the credit market to crucial role in the economy (Bertocco, 2006).

In respect to the Theory of Economic Development, Schumpeter believed that the process of economic development was inherently dynamic, as opposed to the static structure of the theory of equilibrium, which is the central theme in classical theory (Velde, 2001). Schumpeter described the classical world, where supply always creates demand (Say Law), in term of a diagram called the circular flow (figure 1). In this world, all goods would find a market and the behaviour of producers and consumers are merely routine (Velde, 2001), but Schumpeter does acknowledge that the production decisions are influenced by consumer's preferences. Also, the economy would always tend to replicate itself unchangingly and even if the changes do occur, Schumpeter believed the factors that cause the change would not be enough to alter the structure of the economy (Bertocco, 2006). In essence, the economy is always at full employment. However, Schumpeter did not reject the classical theory of equilibrium explicitly as Keynes did, essentially he implicitly accepted and used it as a base to explain his own dynamic model (Velde,

2001). Therefore, the model of economic development is not a substitute for the classical theory of equilibrium but rather a necessary complement to it (Velde, 2001).

**Figure 1**



Keynes, on the other hand, explicitly rejected the classical proposition. Firstly, Keynes denied the classical model in respect to saving and investment always being in equilibrium (Ekelund & Hebert, 1975). According to the classical model, the interest rate is always flexible and this means that any changes in investment or saving would never cause overproduction or underproduction in an economy (Ekelund & Hebert, 1975). However, to Keynes, saving and

investment were determined by a complex host of factors, such as the marginal propensity to consume and marginal efficiency of capital, in addition to the interest rate and also there was no guarantee that the two would necessarily be equal at a level of economic activity which produced full employment (Ekelund & Hebert, 1975). But, what Keynes objected to most strongly in the classical reasoning was the notion that unemployment would disappear if workers would just accept a lower wage rate (Dillard, 1948). Keynes repudiated this classical assumption because he believed the rigidities in the economy, such as labour unions and minimum wage law, thwarts this classical fluid movement of wages and prices, which bring about an adjustment of the economy to full employment (Ekelund & Hebert, 1975). Also, he believed that labour behaviour was related to money wages, not the real wage. Therefore, labourer would refuse to take cuts in their money wage and this refusal, Keynes believed, was a direct denial of the classical wage rate adjustment mechanism (Ekelund & Hebert, 1975).

To initiate economic development in a capitalist economy, Schumpeter believed that a disruption must occur in the static equilibrium world (circular flow). The main driver of the disruption, he believed, was the entrepreneur and the person who sponsors the entrepreneur, most commonly the bank (Velde, 2001). Therefore, the basic structure of Schumpeter's model of economic development has two distinctive spheres, where on one hand it is static system that is either in equilibrium or striving for it (Velde, 2001), while, on the other hand, it is the symbiotic pair of the entrepreneur and the sponsor, who is always looking for ways to induce change in the peaceful yet boring routine life of the circular flow (Velde, 2001). Both spheres function within an endless reservoir of new combinations, but it is only the entrepreneur backed by the sponsor who is able to introduce new combinations and new routines in the circular flow (Velde, 2001). However, Schumpeter is realistic enough to see that the carrying out of new combinations

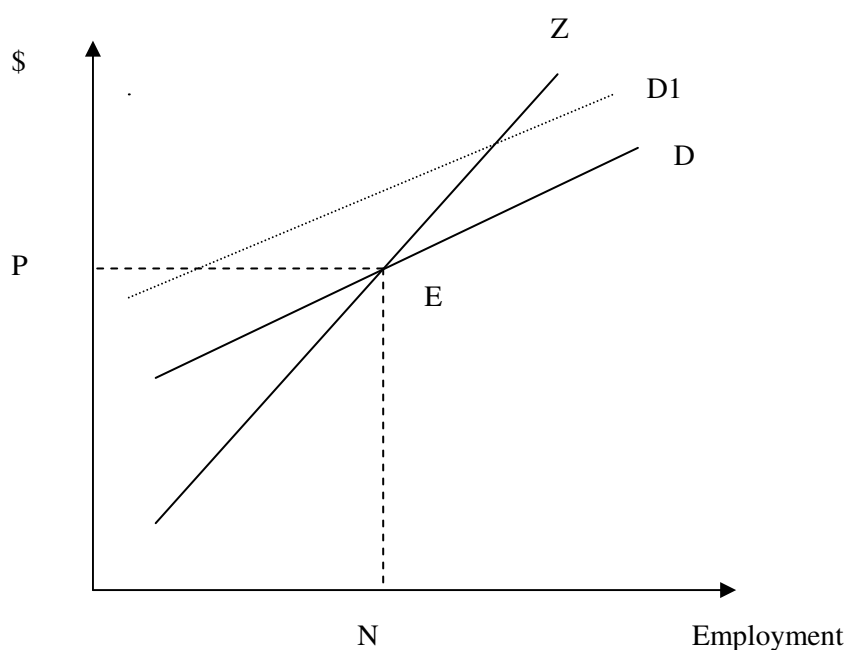
involves more than an act of will, a command over means of production is necessary (Velde, 2001). Schumpeter argued that, innovations are carried out especially by new entrepreneurs, who do not own factor of production and he highlights the role of credit created by the banks as a key process to facilitate factor resources to them (Bertocco, 2006).

Keynes, however, unlike Schumpeter did not envisage a theory of capitalistic development. In essence, the General Theory is a theory of employment, Keynes believed that unemployment could still exist even if all the conditions necessary to restore perfectly free or thorough going competition among wage earners were to be realised (Dillard, 1948). He contended that the volume of employment is determined by effective demand, not by the wage bargains between workers and employers (Dillard, 1948). Demand to Keynes mean aggregate demand which is made up of consumption and investment (Dillard, 1948). The factor that affects consumption is the marginal propensity to consume, which is the proportion of income spent on consumption, while investment is determined by the marginal efficiency of capital, which is the expected return of new investment, and the interest rate (Dillard, 1948). Keynes normally assumed the marginal propensity to consume is relative stable and therefore, the level of employment is determined by the volume of investment (Dillard, 1948).

Keynes' aggregate demand is very different to the traditional demand curve, which slants down toward the right, indicating that the quantity sold would increase as the price falls (Dillard, 1948). In his opinion, the aggregate demand (represented by DD in Figure 2) is upward sloping and it is a schedule of the proceeds expected from the sale of output resulting from varying amounts of employment (Dillard, 1948). In other words, as more labour is employed, more output is produced and the total proceeds are greater. Aggregate supply (represented by ZZ in Figure 2), on the other hand, closely resemble the traditional supply curve and to Keynes, it is a

schedule that detail the minimum amounts of proceeds required to induce varying quantities of employment (Dillard, 1948). As the amount of proceeds increased, a greater amount of employment would be offered to workers by employers. But Keynes does not dwell into aggregate supply as much as aggregate demand. He normally assumed that aggregate supply is fixed.

**Figure 2**



At point E in figure 2, aggregate demand intersects with aggregate supply and according to Keynes, the point of interaction determines the actual amount of employment at any time (Dillard, 1948). This is the crux of Keynes' theory of employment. At this point, the entrepreneurs maximise their expected profits and if either more or less employment were offered, profits would be less (Dillard, 1948). Thus at any one time, there is, according to Keynes' theory, a uniquely determined amount of employment which would be most profitable for entrepreneur to offer to works (Dillard, 1948). However, Keynes does state that, at this point it is not necessarily at full employment, for instance full employment may be at point B. There

could be, Keynes concluded, an equilibrium level of income in an economy, but at less than full employment (Ekelund & Hebert, 1975).

In order to achieve this full employment point (point B figure 2), Keynes believed, investment demand must be equal to the gap between the aggregate supply price corresponding to full employment and the amount which consumers in the aggregate choose to spend for consumption out of income at full employment (Dillard, 1948). If an increased investment is equal to this gap, a multiplier effect would occur and drive the economy to a full employment point. Essentially this means, in order to have sufficient demand to sustain an increase in employment there must be an increase in real investment equal to the gap between income and consumption out that income (Dillard, 1948). In other words, employment cannot increase unless investment increases. However, according to Keynes, a typical investment demand would be inadequate to fill this gap and therefore, aggregate demand and aggregate supply intersects at a point less than full employment (Dillard, 1948). As a result, involuntarily unemployment arises and government actions, such as fiscal policy, Keynes believed, would relieve unemployment and underproduction in the economy (Ekelund & Hebert, 1975).

Both Schumpeter and Keynes were the most prominent economists in the 21<sup>th</sup> century and would have likely to come across each other works. Both had opposing view points but it was Schumpeter who explicitly attacked Keynes in his work. The first critique Schumpeter made in relation to Keynes' General Theory was the unchanging production function that Keynes based his analysis on (Smithies, 1951). Schumpeter criticised the static structure of Keynes analysis based on the assumption of the existence of time invariant production functions, which allowed Keynes to convey the existence of a strict relationship between variation in production and in employment (Bertocco, 2006). Schumpeter believed that a static theory was wholly unsuitable to

describe how a modern capitalist economy works (Bertocco, 2006) and he stated this disagreement in his review of the General Theory, *“But disregarding this, reasoning on the assumption that variations in output are uniquely related to variations in employment imposes the further assumption that all production remain invariant. Now the outstanding feature of capitalism is that they do not but that, on the contrary, they are being incessantly revolutionized.”* (Schumpeter, 1936)

In terms of unemployment, Schumpeter, especially in *Business Cycles and the Theory of Economic Development*, did not set forth a theory of employment, as Keynes did in his *General Theory*. Although it was probably not intended, Schumpeter did provide an explanation when unemployment would occur. His explanation of unemployment is totally different than Keynes' explanation of unemployment and in essence, it is based on the changing production function (Bennion, 1943). He emphasized unemployment more importantly in his business cycles. Firstly, he states that a given level of unemployment could have occurred at the start of the upswing. This may be the result of monopoly or imperfect competition; some of it will be cyclical and inherited from the preceding cycle (Bennion, 1943). However, Schumpeter does state, once innovation has occurred and fueled the upswing, unemployment could still occur because the emergence of innovation (Creative Destruction) can spell 'economic death' to other firms (Bennion, 1943). Also, Schumpeter does not guarantee that other firms would instantly reemploy these factors of production, which has become unemployed due to creative destruction (Bennion, 1943). Ultimately, temporary saturation of certain market sets in and it becomes increasing difficult to plan new things and the risk of failure increases greatly. Hence a recession occurs and it is during this period, Schumpeter believed that the emergence of unemployment steadily increases (Bennion, 1943). The high level of liquidation of businesses eventually forces the



economy below the equilibrium and into the depression phase. It is the depression phase, Schumpeter believed that unemployment would feed upon itself and he states *“Each addition to unemployment will cause further and further unemployment”* (Bennion, 1943)

The main objection Schumpeter had over Keynes works, was that he was a strong advocator of governmental policy (Smithies, 1951). Like most Austrian economists, Schumpeter disapproved of government intervention because it impairs capitalistic behaviour (Smithies, 1951). Both Schumpeter and Keynes were brought up with different influences and this was the main reason why Schumpeter has so much hostility to Keynes work (Smithies, 1951). Keynes was a lineal descendant of the English Utilitarian and Schumpeter was not. Thus, Smithies 1951 states *“Keynes regarded worth while theory as a basis for program of action. Schumpeter theory led him to look with foreboding upon action to which such theories and programs might lead”* With his Utilitarian views, Keynes believed that both distribution of income and the level of effective demand should be control by the state (government) (Smithies, 1951). But Schumpeter could not comprehend this, his view was that if production and distribution were exposed to government actions, anti-capitalistic program such as high progressive taxation or heavy death duties would occur (Smithies, 1951).

In addition, Keynes’ General Theory is based on the short run and it encourages governments to take a short run point of view (Smithies, 1951). In essence, his views were that if the government looks after the short run, the long run would after itself. Again, Schumpeter believed this idol of Keynes, promotes anti-capitalistic behaviour. Even if governments short run policies were based on some notion of the common good rather than on the flow of the political tides, Schumpeter believed, it would still be anti-capitalistic (Smithies, 1951). Also, Schumpeter believed, the rich entrepreneur profit that is essential to capitalistic success does not conform to Utilitarian

standards of equity in the short run (Smithies, 1951). However, Schumpeter main charge against Keynes was not that he pursued governmental actions for the common good, but that he made it intellectually respectable that these action, which Schumpeter saw as anti-capitalistic, could work in the economy (Smithies, 1951). In essence, he tore down the barriers, imposed by the classical economics and the Benthamite tradition, that had restrained the advocates of intervention in the past and had provided effective intellectual opposition to it(Smithies, 1951). In Schumpeter words, Keynes destroyed “*The last pillar of the bourgeois argument and made it possible for his followers to justify almost any policy provided it increased the propensity to consume.*”(Schumpeter, 1946)

Although both Schumpeter and Keynes great works are primarily concerned with two different things, they do have similarities on how the economy works. In terms of monetary theory, both share two common points of views, and Schumpeter acknowledges Keynes’ work in money, in his review of the General Theory he states “*I wish however to welcome his purely monetary theory of interest, which is, as far as I can see, the first to follow upon my own*” (Schumpeter, 1936) Firstly, both Schumpeter and Keynes share a common viewpoint that the diffusion of money radically changes the structure of the economy (Bertocco, 2006). Keynes maintains this point by distinguishing between a real exchange economy and a monetary economy. In a real exchange economy, Keynes believed money is just an instrument that makes it possible to reduce the costs of the exchange (Bertocco, 2006). In a monetary economy, however, fluctuation in money can induce changes to the economic system (Bertocco, 2006). Schumpeter, on the other hand, like Keynes, maintains this point by also distinguishing between a pure exchange economy and a capitalist economy. The pure exchange economy is essentially the classical economy, where money is only an instrument to facilitate trade, which is obtained in exchange for goods or

services (Bertocco, 2006). In capitalist economy it includes the entrepreneur and the sponsor (bank) in addition to a pure exchange economy, where money is created by the banks to initiate economic development (Bertocco, 2006).

Secondly, both Keynes and Schumpeter justify that money is not neutral, they both highlight the importance of the credit market and the banks in the economy (Bertocco, 2006). They both use different arguments to support this claims, Keynes for example, uses the term monetary economy which refers to an economy in which Say's Law does not apply to justify that money is not neutral (Bertocco, 2006). He believed in this economy the level of income is subject to fluctuations that depend on oscillations in aggregate demand (Bertocco, 2006). In turn, these fluctuations are made possible by the presence of money and Keynes explicitly states "*the fluctuations in effective demand can be properly described as a monetary phenomenon*" (Keynes, 1933B) Schumpeter, on the other hand, highlights the creation of credit as a key role in the process of economic development (Bertocco, 2006). He argues that credit becomes a necessary factor for development because innovations are made by new entrepreneurs who do not own means of production (Bertocco, 2006). Therefore, the creations of credit by the banks supply the innovators–entrepreneurs with the purchasing power necessary to divert the resources to them.

In conclusion, both Schumpeter's and Keynes' famous masterpiece contained problems with classical economics. Keynes explicitly attacks the classical framework (Dillard, 1948), Schumpeter on the other hand implicitly accepts it and uses it as a base to explain his own dynamic model (Velde, 2001). They both share two different views on how capitalism operates,

Keynes believed government policies are essential to sustain a capitalistic economy (Dillard, 1948). Schumpeter, however, believed that the process of capitalistic development is initiated by the introduction of new combination through innovation created by the entrepreneur, backed by the sponsor (Velde, 2001). Essentially, both of them were intellectual opponents but it was Schumpeter who explicitly attacked Keynes directly in his work. Schumpeter disagreed with unchanging production function that Keynes' based his analysis on in the General Theory (Smithies, 1951). Schumpeter believed a changing production function is essential to capitalistic development. In the General Theory, Keynes strongly advocates for government policies and Schumpeter, like most Austrian economist, disagrees with this assumption. He believed any form of government intervention would impair capitalistic behaviour (Smithies, 1951). Although both Schumpeter and Keynes theories are primarily concerned with two different things, they do have similarities in their work. In terms of monetary theory, they both share two common points of view. First, in contrast to mainstream theory, both state that the diffusion of money induces a radical modification into the way in which an economy works (Bertocco, 2006). Secondly, they both describe reasons why money and financial aggregates are not neutral, they highlight the crucial role of the credit market and the banks (Bertocco, 2006).

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