WEBER, SCHUMPETER AND MODERN CAPITALISM: TOWARD A GENERAL THEORY

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Conclusion: Toward a General Theory of Modern Capitalism

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The present work seeks to explore and bring together the contributions of two of the greatest theorists of modern capitalism, Max Weber and Joseph Schumpeter. It further attempts the ambitious task of laying the foundations for a General Theory of Modern Capitalism. In constructing a General Theory we seek to account for the preconditions, essential features and operational dynamics of capitalism wherever it is present in the modern world regardless of national peculiarities.

It has variously been claimed that Weber is the most cited authority in all of sociology and Schumpeter the most cited in all of economics, but hitherto there have been few attempts to compare their work on capitalism and no serious attempt to integrate their respective contributions. The present work addresses this deficiency. Its underlying rationale is the view that the writings of Weber and Schumpeter in combination and appropriately integrated can provide a comprehensive theory of the modern capitalist system that is superior to what is available in competing theoretical frameworks.

We argue there are important theoretical connections between Weber and Schumpeter via the influence of Austrian economists such as Carl Menger and the so-called Austrian Marginalist School. Biographically there are also notable points of contact between Weber and Schumpeter that warrant attention. The present work will first give an account of the respective contributions of Weber and Schumpeter with regard to the nature and workings of capitalism, a topic that is a central focus for both of them. In doing this we shall explore the compatibility and complementarity of the two approaches. We argue that the full significance of the contributions of both writers has not been adequately appreciated. Weber’s work on law, the city and the state and Schumpeter’s analysis of business cycles are explored in detail. Both writers insist on the rationality of the price mechanism under competitive market conditions and explain how this underpins the prosperity of modern economies. Finally, we attempt to lay the groundwork for a synthesis of the contributions of Weber with those of Schumpeter as the basis for a General Theory of Modern Capitalism.

Weber became well-known and even celebrated in the English-speaking world for The Protestant Ethic and the Spirit of Capitalism, which became a classic and one of the most influential works in all sociology. Schumpeter is well known for his Capitalism, Socialism and Democracy. We shall accordingly comment at length on these works but they represent only a small portion of the contributions the two thinkers made on capitalism. Therefore, the present work shows how many other writings of Weber and Schumpeter need to be considered to fully appreciate the value of their contributions. Wherever relevant we shall also relate the work of Weber and Schumpeter to more recent research and offer criticisms where needed.
INTRODUCTION

The student of modern society is struck by the fact that in the world of today capitalist economic relations and capitalist economic structures appear all but dominant.¹ This is the case not simply because Western Europe, the United States, Canada, Japan, Australia and the so-called “Asian tigers” (South Korea, Taiwan, Hong Kong, Singapore) have shown themselves to be enduring and highly prosperous capitalist economies—admittedly despite of some recent difficulties—it is also indicated by the emergence of many new or emerging capitalist economies. This latter development has been largely a consequence of the end of the Cold War following the collapse of the Soviet Union and the worldwide communist movement sponsored by it. For since 1989, there has arisen in the space of the old socialist/communist systems an array of nascent capitalist economies as well as what might be termed various quasi- or neo-capitalist systems. And these embryonic or neo-capitalisms have arisen not only in Russia and the states that were once under the direct control of the Soviet Union, such as Hungary or the Czech Republic, but also in other nations that were once socialist in orientation, such as India and Israel, or avowedly communist, like China and Vietnam. Furthermore, many if not most of the so-called developing countries of Africa, the Middle East and South America, appear to have embarked upon courses of development that are oriented, at least in part, towards bringing about a capitalist system in some form, such as is occurring in societies as various as Turkey, South Africa, the Gulf States, Mexico, Indonesia, Malaysia and Chile. In some instances this transformation is well under way, as with the case of Brazil that has already emerged as a major economic power.

All these developments suggest that today there is no longer a serious socio-economic alternative to capitalism—that is, if a country seeks to prosper and develop economically—as the counter examples like Myanmar, North Korea, Libya, Cuba and others seem to confirm. Even in the case of China, which remains officially a communist state, a virulent strain of capitalism has emerged, which is largely responsible for its recent economic progress and the huge improvement in living standards. Of course, the evident dominance of capitalist and quasi-capitalist institutions in the modern world does not prove we are approaching “the end of history”, as Fukuyama might have it, nor does it imply that capitalism as a system is immune from fundamental criticisms and/or reforms. It goes without saying that problems and difficulties remain, some of which are no doubt intrinsic to this mode of arranging economic affairs. And, of course, there are many aspects of capitalist modernity that invite critical reflection and are concerning from a range of points of view.² But here we shall

¹ David Hale has referred to the present as the “Second Great Age of Capitalism”, a phrase that refers to the fact that the world is experiencing economic change on a scale not seen since the Industrial Revolution. The phrase is quoted in Robert Gilpin, The Challenge of Global Capitalism: The World Economy in the 21st Century, Princeton University Press, 2000, p.15.
² But with a focus on Weber, we note the contributions on the character of modernity by commentators such as Wilhelm Hennis, Max Weber, Essays in
not be focused on these broader cultural, political and philosophical concerns, important though they are. Rather, in what follows we shall seek to explore the causes and structural configurations underlying the extraordinary success of the capitalist system in its modern guises, a phenomenon that cannot be easily denied.

Despite recognition that the far-reaching changes referred to are directly connected with the phenomenon of capitalism, we think it is questionable whether either mainstream economics or, alternatively, radical neo-marxist approaches adequately account for the advent of these economic formations, let alone their present operation. The pace of change and the complexity of developments occurring in such societies as those of the Modern West, the newly developing nations like Brazil and the Asian Tigers, Russia, China and elsewhere are such that accounting for all these socio-economic formations, never mind comprehending their interrelationships and their global ramifications, is clearly a formidable task. Hitherto there has been one notable theory that purported to provide a “general theory” of the rise, mechanism and future course of capitalism, namely Marxism. But, with the collapse of the world communist movement and the intellectual ramifications of this failure, Marxist theory seems no longer capable of generating a convincing overall perspective on contemporary economic tendencies, let alone a compelling worldview. And mainstream economics and academic sociology have all but retreated from projects of grand theory, as they focus increasingly on narrower technical or practical policy matters. Undeterred by this state of affairs the present work will attempt the ambitious task of addressing the challenge of a grand theory of the contemporary socio-economic situation by offering a broad-ranging framework for comprehending modern capitalism in all its manifestations and vicissitudes.


I make this claim recognizing that there have been efforts by Marxist or neo-Marxist thinkers to up-date Marxist theory or to develop theories building on Marxist foundations—for example, the writings of Jürgen Habermas, Knowledge and Human Interests, Beacon, 1971 or the “world systems” approach of Immanual Wallerstein, The Modern World System; Capitalist Agriculture and the Origins of the World-Economy in the Sixteenth Century, Academic Press, 1974. But I do not regard these as having saved Marxist theory as a whole from fundamental failings, which in our view remain unrectified. Marxism as a general theoretical system, in our view, has not recovered from the devastating critique of Weber as advanced particularly in his methodological essays. This is not to deny that Marxism has been a significant influence in diverse ways on both Weber and Schumpeter and that to a degree many of the Marx’s contributions, especially to economic sociology, have been incorporated into their works.
The idea of a General Theory of Capitalism has numerous resonances within economics and social theory generally, but three thinkers are perhaps most associated with this notion. At the birth of modern economics is the figure of Adam Smith, whose works perhaps provided the first full-scale treatment in a sophisticated and scientific fashion of the operation of a capitalist system as well as providing an account of the reasons for its success. A second figure that stands out is, of course, Karl Marx who attempted to show not only why capitalism had become ascendant but also why, contrary to its apparent ascendency, it would sooner rather than later give rise to a “higher stage” of society, namely communism. And thirdly, John Maynard Keynes must be listed, as the thinker who, as is known, employed the concept of “the general theory” as a key notion in his celebrated work The General Theory of Employment, Interest and Money, and who sought to give his specific theses wide application in accordance with the idea. For various reasons that will become clear in what follows, the present author does not regard the writings of any of these pre-eminent thinkers as adequate for the purposes of a general theory of modern capitalism today, however much they may be said to have contributed to our understanding of the issues involved. Nonetheless, the notion of “the general theory” is not for that reason to be abandoned, and the effort to bring together the available knowledge in the various interrelated fields remains a worthwhile and, we believe, necessary task for social theory.

There are numerous reasons for the difficulty of comprehending the economic character of post-communist and developing societies. In the case of Russia, there are complications arising from the fact that under Yeltsin an attempt was made to introduce a liberal-capitalist system by direct means, “from above” as it were, but this has had very mixed results and led to chaotic and unintended outcomes and to the financial crisis of 1998. Then, under Putin an authoritarian state re-emerged with the reassertion of aspects of a centrally controlled economy alongside the hegemony of the so-called “oligarchs”. The result is that some features of a free market along the lines of a typical capitalist system were instituted, though in many respects the system falls short of being fully capitalist such as we find elsewhere, say, in Europe or America.¹

In the case of China a quite different set of events has led to a strikingly novel outcome, namely, what appears to be a highly productive and rapidly expanding capitalist sector of the economy within a state that remains avowedly communist in its political structure and ideology. Few commentators foresaw such a contradictory development, and even today it is not easy to give an account of what this means. But tendencies along these lines wherein a socialist

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¹ Mention at this point should be made to the work of Talcott Parsons, which is in some ways an attempt to integrate aspects of Weber’s work with his structural/functionalist theory and deals explicitly with economic theory. But we shall not pursue this approach in what follows because in our view, and that of other commentators, Parsons’ reading of Weber is highly questionable in key respects and leads in unproductive directions. Parsons’ contribution is particularly deficient in respect of Weber’s economics.

² With other former Soviet states such as Belarus it would appear that little has changed from Stalinist times.
government embraces a capitalist-like market system are appearing in several other former communist societies, such as Vietnam, Laos, Ukraine, the former Yugoslavia and Kazakhstan.

On the other hand, recent history has also been witness to perplexing developments in the so-called advanced capitalist West. Both in Europe and America we have witnessed events that have shaken the confidence of many as to the stability and on-going prosperity of these economies hitherto regarded as “bullet proof”. The “sub-prime debacle” and the collapse of Lehman Brothers in America that precipitated the so-called Global Financial Crisis demonstrates not only that an economic super power has vulnerabilities but also that the world economy as a whole in not immune from a serious crisis on the scale of the Great Depression. We are yet to see how these developments will play out, though indications are that America and the western economies generally will somehow cope with their present difficulties. In Europe we have also seen extraordinary developments in the most recent past surrounding the virtual bankruptcy of Greece, Cyprus and Ireland and the demise of the economies of southern European. Even France and the United Kingdom face real difficulties owing in part to the exposure of their banks to the debt crisis. Finally, Japan’s economy continues to struggle to maintain dynamism, now made more intractable in the wake of the natural and nuclear disasters of 2011. For over a decade Japan has failed to consistently register significant economic growth, in contrast to its impressive record in the 1970s and 1980s. Yet despite all these difficulties, none of these societies seem remotely likely to cease being capitalist in their basic economic institutions, and indeed the recommended “cure” for most of the supposed ills, according to many commentators, is more capitalism not less.

The problem of comprehending these developments in their multi-faceted complexity as well as grasping the future trajectory of the advanced capitalist societies is daunting and no doubt beyond the capacity of a single theoretical effort. Nonetheless, the present author believes that there are existing bodies of research that are available to ground such an enterprise and it is to these I turn in what follows. I shall argue that in the seminal works of Max Weber and Joseph Schumpeter are to be found the fundamental elements necessary for just such a project. In what follows I shall attempt to explicate their key theoretical achievements and work up a synthesis in the effort to produce a “general theory” of the worldwide phenomenon of capitalism as it manifests today in various guises.

The Rationale of the Present Work

The underlying premise of the present work is the view that the writings of Max Weber together with those of Joseph Schumpeter contain most, if not all, of the essential elements necessary to construct a general theory of modern capitalism and its accompanying social forms. The reason why I regard both of these writers as so fundamental is because of their unique status and outstanding achievements within the fields of social science in which they practised. Of course, there are other important thinkers on the topic of capitalism, and indeed
one could argue that the entire field of economics and a good deal of sociology are addressed to this topic in one way or another, and of course we shall not be unappreciative of any contribution that merits consideration. Yet many of the efforts of earlier writers are unfortunately now of limited value because of the time in which they wrote, or their contributions are already subsumed in the works of our two key thinkers. Though their legacy remains important and in some cases they cast a long shadow, we say their accounts of capitalism are no longer completely adequate for us today.

If we come to a later period and the problem of understanding contemporary capitalism, there are a number of classical thinkers other than Weber and Schumpeter whose contributions remain of interest. Around the turn of the century, in Germany there were important theorists such as Karl Knies, Georg Simmel, Gustav von Schmoller and Werner Sombart who addressed the nature of capitalism at length. In Austria we find a number of economic thinkers of note such as Carl Menger, Friedrich Wieser, Eugene Böhm-Bawerk, Ludvig Mises, Rudolf Hilferding, and Frederick Hayek all of whom wrote extensively on the topic. In England there have been many economists of note including as Stanley Jevons, Francis Edgeworth, Alfred Marshall, Edward Chamberlin, Joan Robinson, F. H. Kahn and John Maynard Keynes. And in America one can cite John Clark, Wesley Mitchell, Irving Fisher and Thorstein Veblen. Elsewhere one must mention the eminent figures Knut Wicksell, Léon Walras and Vilfredo Pareto. But regardless of the undoubted importance of all these thinkers, it is the present work’s contention that only with the combination of Weber and Schumpeter that we have contributions capable of forming the basis of an adequate general theory of modern capitalism considered as a total socio-economic system.

So the question arises as to why the focus of the present work should be solely on Weber plus Schumpeter? It might be suggested that a better combination for such an enterprise would be, say, Marx plus Schumpeter, or perhaps Weber plus Keynes, or Weber plus Simmel, or possibly other combinations altogether. In selecting Weber and Schumpeter the author of the present work expresses his clear preference for those two thinkers, and it goes without saying that, if he sees in these thinkers intellectual achievements of a unique and superior kind, he correspondingly regards others as of lesser value and in some ways deficient. In the case of the works of both Weber and Schumpeter one finds an extraordinarily impressive range of commentary and penetrating analysis on most if not all of the major aspects of capitalism that an enquiring mind may wish to address. For example, both thinkers were steeped in historical understandings concerned with the immediate origins of capitalism and the period of pre-capitalism, and as well made contributions that relate to aspects of European antiquity and even beyond. This is very evident in the case of Weber who wrote several works dealing with Ancient Mediterranean civilisations. But it is also true of Schumpeter who in his *History of Economic...*  

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6 A sympathetic, though critical, treatment of Schumpeter, but from a Marxist point of view, has been advanced by Tom Bottomore in his study *Between Marginalism and Marxism: The Economic Sociology of Joseph Schumpeter*, Harvester Wheat sheaf, 1992.
Analysis discussed at some length ancient and mediaeval forms of thought in relation to the economic field, and in other writings addressed the period of European feudalism and pre-modern conditions generally. Also, both thinkers wrote significant pieces on non-western civilisations. This is especially the case with Weber who wrote extensive essays dealing with Indian and Chinese civilisation, and throughout his writings made reference to these cultures and to other civilisations as well. He could also be said to have made a modest contribution to anthropology, though this should not be over-stated. Likewise Schumpeter offered commentaries on non-western civilisations and from time to time addressed aspects of Egyptian or Indian culture and was very familiar with the broad sweep of world history. Interestingly, both Weber and Schumpeter became quite preoccupied with America, even though they emerged from the heart of European civilisation and were very much products of it. Of course, Schumpeter emigrated to America and lived there for most of his later years and naturally became extremely familiar with American society, writing extensively about its economic history. In the case of Weber there is a fascinating association with America, brought about in part by his visit to America for the World’s Fair in St. Louis, which gave rise to several essays dealing with America; and reflections upon American cultural phenomena appear regularly in his writings from that period onwards. In some ways it is apparent that Weber saw America as marking out a future course of capitalist civilization in general, though this is never explicitly stated.

These background features suggest that the writings of Weber and Schumpeter on the nature of the capitalism should be understood via a comparative approach to the study of socio-economic systems. Showing how this can be achieved is part of the present work’s rationale. It is our view that there are few, if any other, theorists of capitalism who have matched the depth of understanding of history and society of these two thinkers. Of course, there have been other thinkers who were extremely erudite and in their own way could be said to approach the level of Weber and Schumpeter in terms of historical understanding. One could refer to Hegel, Marx or Mill, and there are other figures one might mention as outstanding thinkers of their generation. However, in the cases just referred to we are dealing with individuals who belong to a previous era. They did not witness the full development of capitalism, as did Weber and Schumpeter. For instance, the three figures just mentioned did not live to see the development of the modern corporation with all its special institutional features nor the fully developed market economy, the stock market, consumerism and so on. As it happens, the lives of Weber and Schumpeter coincided from around 1905 until 1920 when Weber died. In this period, both thinkers were highly productive and deeply involved in interpreting and understanding the capitalist order of their day. And in this time, the

7 On Weber’s relationship to America, see now the interesting book by Lawrence Scaff, Max Weber in America, Princeton University Press, 2011.
8 The broad significance of Weber’s work for a comparative understanding of civilizations has been the focus of S. Kalberg, especially his Max Weber’s Comparative Historical Sociology, University of Chicago Press, 1994.
capitalist system had already advanced to a degree that could be said to have “matured” and even have become “high capitalism”.  

So in our view Weber and Schumpeter were both uniquely situated to comment upon and interpret the capitalist system of the early and middle twentieth century, and we shall maintain this economic system, admittedly with some modifications, is in essence that which we have today. Of course, there have been important developments since the time of Schumpeter and Weber, and it will be a concern of the present work to indicate possible limitations and lacunae in the contributions of our two thinkers where changes have occurred that have outstripped their purview and to point to important recent contributions that provide valuable additional perspectives. But at the same time it will set out to show how their thought remains vital to grasping the tendencies and trends at work in the present era of capitalist development. There are numerous topics on which Weber and Schumpeter addressed the same basic issues and came to similar conclusions. Whilst Weber is generally regarded as a sociologist and not considered an economist of significance, and Schumpeter is known for the opposite professional achievements, in economics as against sociology, both thinkers were in fact deeply engaged in both sociology and economics and this we believe makes their integration a more plausible exercise.

In the case of Weber, as we shall see, the concept of economic action played a very important part in his thinking about capitalism. We shall have occasion to explore at some length the way in which the theory of marginal utility was considered by Weber, and we argue that to a degree he builds his sociology of economic action in recognition of such principles. At least in his early self-understanding, Weber actually considered himself an economist, or strictly a “political economist”, and had a high appreciation of the contributions of theoretical economics which he knew at first hand. Of course, Weber eventually became famous for his sociology and did not pursue economic theory as a major focus. On the other hand, Schumpeter appears to have begun and remained primarily an economist, being fundamentally preoccupied with the workings of the economic system per se. Yet increasingly, especially in his last writings, he felt obliged to explore the sociological dimensions of the capitalist system, and he progressively expanded his horizons to write about a number of aspects of the social world within which a capitalist economy operated. So we take it for granted in what follows that Weber and Schumpeter were each passionately interested in both the sociology and economics of capitalism. More than this, both thinkers sought to go beyond purely scholarly contributions to understanding the capitalist system. That is, they are both in

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9 The concept of “high capitalism” goes back to the work of Sombart who conceived it as a second stage of capitalism involving white-collar workers, state intervention and technical innovation. It has more recently been employed primarily by neo-marxist theoreticians (especially the so-called Frankfurt School) for the capitalism of the post war era in recognition that the economic system that was Marx’s focus was not superseded by socialism and indeed has proven to be much more enduring, prosperous and stable than was envisaged by the first generation of socialist revolutionaries.
one way or another offering interpretations of the whole of the modern capitalist civilisation, and attempting, sometimes overtly sometimes indirectly, to provide a kind of philosophy of modernity as a whole. In this regard it is notable that they each wrote quite extensively not just on the methodology of their respective disciplines but also on the nature of science, politics and philosophy. A reading of Weber and Schumpeter discloses that they commented upon an extraordinarily broad range of issues in relation to the world in which they lived. Their writings touch on aspects of psychology, aesthetics, statistics, ethics, religion, literature, jurisprudence and music, to name but a few of the more prominent fields covered.

Despite the evident sharing of some perspectives, the question remains as to whether a combination of the contributions of Weber and Schumpeter would be fruitful or is otherwise justified. What is be achieved by a synthetic combination of the respective achievements of Weber and Schumpeter? Are the contributions of Weber and Schumpeter perhaps antithetical? The present writer does not deny that there are some points of serious incompatibility between the two approaches. Nonetheless, we shall argue that there remains a great deal of common ground between the two thinkers, and, as we shall see, on some topics they even collaborated. Although they did not appear to have a close relationship during the time in which they were contemporaries, as I shall explain below, they shared many concerns. The rationale of the present work is that a synthetic combination of these two thinkers work is feasible because their separate contributions are of great value yet they conveniently complement and support each other. That is, there are aspects of Weber’s writings on capitalism that are of value in improving and developing perspectives that Schumpeter advanced, and vice versa.

A key point to be noted at the outset is that in Weber’s work there would appear to be no equivalent to a theory of the economic system that is an account of the functioning of a capitalist economy as a systematic whole. For Weber’s Protestant Ethic Thesis does not amount to a general theory of the capitalist economic system, however insightful it might be as to its origins and ethos. But the present writer will argue that something along the lines of a general theory of capitalism, though not explicitly developed by Weber, is nonetheless in the background to much of his theorizing. But Weber clearly did not make it his task to embark on a full-scale treatment of the capitalist system from an economic theory point of view— unlike Marx for example who attempts to do just this in his Capital. On the other hand, by contrast Schumpeter in his work provides a theory of capitalism that in many ways corresponds to the theoretical achievement of Marx, at least to the degree that it attempts to explain the long-run functioning and developmental tendencies of the capitalist system. Accordingly, we shall maintain that the Schumpeterian system is a potentially a complement to Weber’s account of origins and institutional underpinnings of capitalism.\textsuperscript{10}

\textsuperscript{10} We are in complete accord with Randall Collins when he states that Weber’s account of capitalism although “alone in accounting for the emergence of the full range of institutional and motivational conditions for large-scale, world-
Looking at the matter from Schumpeter’s side, we note that, although he provides a rudimentary sociology of capitalism in conjunction with his economic theories, he did not develop a sociology with the depth and sophistication that one finds in Weber (which is not to say his sociological contributions are insignificant and not worth considering). For Weber not only provides a masterful theoretical framework that accounts for the way in which social institutions come into being and function, as well as a sophisticated methodology for understanding and interpreting social action, he also provides detailed accounts of key social phenomena like law, religion, administrative structures, political institutions and so on, all of which are extremely valuable as an interpretative framework for understanding the capitalist order, its origins and institutional supports. We shall maintain that here Weber adds value to and complements Schumpeter.

Although Weber never embarked on a full-scale economic theory of capitalism, we shall argue he largely accepted the economic theory being developed by the Austrian school and to some extent elsewhere. That is, we surmise he left the field of economic theorising in the strict sense to others in the emerging discipline of economics, so that when he embarked on his editorship of the *Grundriss der Sozialökonomik* (a kind of social science encyclopaedia about which we shall comment below) he engaged both Schumpeter and Wieser to provide the economic theory sections while he developed the sociological perspectives.

The rationale of Weber’s editorship of the *Grundriss der Sozialökonomik* and his approach generally to the relationship of sociology to economics is the subject of a very detailed and scholarly account by Richard Swedberg in his important book *Max Weber and the Idea of Economic Sociology*. Swedberg is concerned to show that Weber’s central task in treating economic phenomena was to set out the basis for sociology of economic action, and that he deliberately limited himself to those aspects of economics that were relevant to transforming capitalism. . . . is incomplete. It needs to be supplemented by a theory of the operation of mature capitalism, and of its possible demise.”


12 As regards Weber’s contribution to the origins of capitalism, we are in agreement with Randall Collins when he concludes that Weber’s last theory as set out in the *General Economic History* “is still today the only comprehensive theory of the origins of capitalism.” *Weberian Economic Theory*, Cambridge University Press, 1986, p. 44.

13 At this point we must take issue with the view of Randall Collins that in inviting Schumpeter to write a history of economic doctrines for the *Grundriss* Weber was not indicating his assent to Schumpeter’s point of view but merely offering a mouthpiece for the “opposing camp of economics” to that of the “Historical School” of Schmoller. *Weberian Economic Theory*, Cambridge University Press, 1986, p. 120. As we argue below, Weber embraced aspects of both schools.
this purpose. He suggests that Weber was concerned in his own contributions to the *Grundriss* and as regards its overall structure not simply to follow the approach of the previous work to which it was a successor, namely Gustav Schönberg’s *Handbuch der Politischen Ökonomie*. Weber, “... did not want the *Grundriss* to be either dominated by historical economics or by theoretical economics. But the *Grundriss* . . . contains no general work in economic history. He also states that the *Grundriss* will not contain more economic theory than is necessary to understand the social economy.”

To an extent the rationale of the present work is at odds with Swedberg’s approach, because he is concerned to show that Weber was primarily focused on developing economic sociology as a distinct discipline, which only here and there overlaps its concerns with the science of economics. While we do not disagree that this is largely correct, we nonetheless believe that Weber’s economic sociology can be more directly integrated with the science of economics than Swedberg seems to allow, as we shall see.

As already noted, the question as to whether or not the Schumpeterian system is fully compatible with Weber’s approach is a question that will require investigation and will be discussed at some length below. There are reasons to believe that Weber would not have accepted all of Schumpeter’s account of the functioning of capitalism, and indeed there may well be other discrepancies between their respective perspectives, as we shall see. Nonetheless, it is the present writer’s view that, despite possible divergences, there are many points of intersection between the two approaches that warrant bringing their contributions together, and hopefully a synthesis of them will supply the basis for a General Theory of Capitalism.

The present writer seeks to achieve a comprehensive synthesis of the contributions of Weber and Schumpeter. That is, I wish to show that Weber’s

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14 Swedberg (1998), p. 155. The entire Chapter Six of Swedberg’s book provides a most useful account of the rationale of Weber’s *Grundriss* as well as the historical background to its production.

15 The following analogy may assist to explain the rationale underlying the present writer’s intentions. I refer to the work by Julian Huxley *Evolution: the Modern Synthesis* published in 1942. This book, a minor classic in its own right, sets out to provide a synthesis of the two most significant contributions to evolutionary theory of the day, the first of course being that of Charles Darwin and the second being that of Gregor Mendel. As is known, Darwin’s theory pre-dated the discoveries of genetics and thus was unable to fully account for phenomena such as variation and mutation, phenomena that became readily explicable with the understandings given by the new discoveries of genetics. Only in the combination of Darwin and Mendel is it now believed there is a complete theory of speciation, and Huxley was concerned to show just how this synthesis was possible. Huxley’s work has of course been superseded and in various ways improved by further research. (A more up to date statement of the theory of evolution that incorporates recent research is Ernst Mayr’s *The Growth of Biological Thought: Diversity Evolution and Inheritance.*) Of course, I do not intend to suggest the nature of scientific advance is the equivalent in all respects
contribution by itself does not provide a fully adequate theory of the functioning of the capitalist system but in combination with Schumpeter’s most of the key elements for such a theory are to be found. Of course, from this starting point, subsequent achievements in the fields of history, economics and sociology also need to be brought in, and some corrections, modifications and revisions of the founders will be required. The present work seeks to make a beginning in carrying out this task. To a large extent it is thus introductory in nature and seeks to sketch the contours of a project that is possibly too large for one writer to bring to completion in the space of a single work. Perhaps the sub-title of the present work should read “A Prolegomenon to a General Theory” in view of this introductory character. I should also like to make clear that the present work is oriented to the task of understanding the basic, underlying structures of capitalist development and is not attempting either a detailed history of the modern capitalist system, nor is it primarily concerned to evaluate the “success” or “worth” of particular capitalist systems from a value perspective, though we make some observations in this connection.  

Recent Scholarship on Weber and Schumpeter

It has to be recognized that the study of Weber and also of Schumpeter has undergone a kind of renaissance in recent times. I refer in this respect especially to the works of thinkers such as Randall Collins, Lawrence Scaff, Wolfgang Schuchter, Wolfgang Mommsen, Joachim Radkau in relation to Weber and to Yuichi Shionoya and Richard Swedberg among others in relation to Schumpeter.  

This body of work testifies to the enduring significance of the work of both Weber and Schumpeter. There has been little discussion in the secondary literature, however, of Weber’s relation to Schumpeter. There have been a few analyses of Weber’s relation to orthodox economic theory and with the Austrian marginalist school in particular. Several commentators have remarked on the fact that Weber would appear to have accepted the concept of marginal utility and some have even gone so far as to suggest that Weber basically accepted orthodox economic theory as a given. For example, Talcott Parsons claimed that, ”Weber on the whole accepts the view of the functions of the competitive price system current in ‘orthodox’ economic theory.”  

On the other hand, some commentators have suggested that Weber does not rely upon

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16 As to the task of a history of modern capitalism there are excellent works such as Jeffrey Frieden’s *Global Capitalism: Its Rise and Fall in the Twentieth Century*, Norton, 2006. As to the issue of a critical evaluation of contemporary capitalist systems, I shall only mention the perceptive recent work of Geoff Mulgan *The Locust and the Bee: Predators and Creators in Capitalism’s Future*, Princeton University Press, 2013.

17 We shall be referring to these authors in detail below at which point references to their writings of relevance to the present work shall be provided.

marginal utility theory as a basis for his economic sociology. For example, Richard Swedberg writes, “Weber’s sociology is not based on ‘marginalist foundations’ in any meaningful sense of this expression and Weber makes no analytic use whatsoever of the notion of declining utility in his general sociology.”\(^{19}\) These comments are not necessarily at odds, however, as Swedberg is considering the theoretical basis of Weber’s economic sociology in the strict sense, so his remarks do not deny the importance of marginal utility to Weber’s thinking indirectly.

An assessment of Weber’s relation to marginal utility theory must consider his various references to it and in particular to the discussions in his *Critique of Stammler* of 1907 and the essay “Marginal Utility Theory and ‘The Fundamental Law of Psychophysics’” of 1908. In both of these writings it is evident that he had more than a passing acquaintance with the concept of marginal utility and in fact it would appear he embraced the basic ideas of the framework more or less completely. In the *Critique of Stammler*, for example, he argues that the principle of marginal utility has at least two functions. In the first place it provides actors with a principle upon which they can regulate their action. As such it forms what Weber calls an “ideal rule” or “norm” which an individual can adopt if they intend to act in accordance with the idea of purposive action.\(^{20}\) More than this, Weber thinks marginal utility theory can be of considerable value for theoretical investigation. In this case Weber says the notion can be used to establish how an isolated individual would behave if they followed “the principle of marginal utility”. This is what economic theory does generally, according to Weber. Economic theory typically investigates how economic behaviour in the broad sense would unfold on the assumption that individuals act in line with the logical implications of their intentions. Economic theory can posit how individuals would act if they follow the principle of marginal utility to its logical end point, and it can then analyse what outcomes result.

In discussing these issues Weber refers at one time or another to a number of figures belonging to the Austrian marginalist school beginning with Carl Menger but also including Eugene von Böhm-Bawerk, Friedrich von Wieser and Ludvig von Mises. These connections have not gone un-noticed by commentators in the past. For example, Simon Clark in his *Marx, Marginalism and Modern Sociology* refers at some length to the relationship of Weber to marginalism, but he discusses this only in a fairly general way. Other commentators who have discussed the relation of Weber to the Austrian School include Robert Holton in several of his writings.\(^{21}\) But few commentators have addressed themselves specifically and in detail to the issue of the relation of

\(^{21}\) See his *Economy and Society: An Outline of Interpretative Sociology*, Bedminster, 1968 (ES), passim.
Weber to either economic theory or more specifically to marginalism and the Austrian School.  

However, the matter has now been addressed at some length and sophistication by Steven Parsons in his *Money, Time and Rationality in Max Weber*. Parsons’ work is specifically concerned with the relation of Weber to the Austrian Marginalist School and the implications of this for Weber’s interpretation of economic action. He argues that Weber adopted the approach of the Austrian School as against that of Walras and the so-called Lausanne School. This was because he recognized with Menger and his colleagues the importance of the time factor and “uncertainty” in the course of economic exchange. This approach means that prices do not necessarily cause equilibrium outcomes, whereas Walras had assumed that perfect knowledge and instantaneous adjustments would generally lead the economy toward equilibrium. This is a view similar to that argued previously by Robert Holton and Bryan Turner:  

Walras had likened the market to a process of “tatonnement,” that is to the role of an auctioneer in clearing the supply of commodities offered in an auction. In this model equilibrium prices could be reached between utility-maximizing buyers and sellers following rational choice strategies based on perfect knowledge, such that the market reached an equilibrium end-state. For Walras there was no fundamental interest in the time dimension in market adjustments. For the Austrians, on the other hand, perfect knowledge is impossible in principle. Economic relations are characterized by uncertainty and risk-taking, with action often producing unintended consequences. From this viewpoint, the market-place is conceptualised as

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22 At this point it is worth mentioning several other commentators who have addressed Weber’s writings on the sociology of economic action, some of whom we shall discuss below. From a neo-Marxist point of view there are critical essays by Bryn Jones, “Economic Action and Rational Organization in the Sociology of Weber”, in B. Hindess (ed), *Sociological Theories of the Economy*, MacMillan, 1977 and Michael Bittman, “A Bourgeois Marx? Max Weber’s Theory of Capitalist Society: Reflections on utility, rationality and class formation”, *Thesis Eleven*, 15, (1986), pp. 81-91. From a conservative perspective, mention should be made of Friedrich von Hayek and in particular his writings in criticism of socialism and socialist movements, such as his *Individualism and Economic Order*, University of Chicago, 1996. The most general analysis of Weber’s economic sociology, however, is the excellent book by Richard Swedberg *Max Weber and the Idea of Economic Sociology*. Swedberg refers to the fact that Weber recommended to his students in the course he gave on economic theory that they should consult the works of Marshall, Walras and Jevons, a fact that invites further consideration. Of course, there are many commentaries on Weber’s general approach to capitalism, both to his historical account in *The Protestant Ethic and the Spirit of Capitalism* as well as to his other contributions on the subject. The most significant are those of Anthony Giddens in his *Capitalism and Modern Social Theory*, Cambridge University Press, 1975; Karl Löwith, *Max Weber and Karl Marx*, Allen & Unwin, 1982; and Gianfranco Poggi, *Calvinism and the Spirit of Capitalism*, University of Massachusetts, 1984.
a dynamic process of search for equilibrium over time, rather than an entity
tending to a series of equilibrium end-states."
We shall argue in what follows that Weber’s precise position on these questions
cannot be ascertained with any confidence because he did not directly address
the issues concerned. And as we shall argue below, Schumpeter takes a more
complex position than that described by Parsons, as he combines aspects of
both the Austrian and Walrasian Schools.

As Parsons is also interested in Weber’s analysis and critique of socialism,
much of the former’s work is concerned with the way in which the latter
developed a critique of central planning, especially in the chapter of *Economy
and Society* entitled “Sociological Categories of Economic Action”. Parsons is
at pains to point out how Weber developed ideas that were already implicit or
partly developed in the Austrian School’s approach, particularly the ideas of
Menger in regard to the superiority of a liberal capitalist economy over any
possible socialist economy. Parsons thus goes on to explore the way in which
the Austrian School developed the critique of socialism, in part through the
work of Böhm-Bawerk and then later in that of Mises and Hayek. He argues
that Mises’ approach in many ways can be seen to have developed approaches
that are already to be found in Weber’s work. But oddly Mises did not appear
to recognise the significance of Weber’s contribution, and in fact he thought
Weber lacked crucial understandings of relevance to the key issues. Parsons
wants to set the record straight on this by showing that the seminal ideas of
Mises are actually very close if not identical to those of Weber. Parsons is
also concerned with other issues in social theory in relation to the problem of
rationality in economics, and in this regards he has a discussion of the work of
Jürgen Habermas.

But surprisingly from the present writer’s point of view at no point in his
book does Parsons discuss or even mention Schumpeter. There is a connection
with Schumpeter, however, in Parsons’s discussion that comes via some
references to the work of Walras, who of course as we shall see was highly
regarded by Schumpeter. Parsons wants to argue that there is a fundamental
difference between the approach of the Austrian School as against those of
Walras and the school of thought developed in England by Jevons. He argues
that Weber effectively adopted a position close to the Austrian School and
implicitly rejected the approaches of the Walrasian and Jevonian Schools. This
is a highly questionable conclusion, however, because it would appear that
Weber had little engagement with the writings of Walras or Jevons, so one

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24 Mises developed his ideas on socialism especially in his work *Socialism: An
Economic and Sociological Analysis*, originally published in 1922, the second
edition of which was published in 1932. An enlarged edition was published in
English in 1951. Many of the problems he raises are touched on in
Schumpeter’s historical account of these issues in his *History of Economic
Analysis* to which we shall refer.
cannot presume that Weber would necessarily have rejected their ideas. To be sure, there are certain discussions of Weber which suggest that he has an appreciation of aspects of economic activity that relate to the phenomenon of equilibrium pricing, but it is difficult to draw any hard conclusions as to what his view would have been as to the more advanced notion of equilibrium as developed by Walras and subsequent orthodox economic theory. Nonetheless, we see no intrinsic reason why the Schumpeterian approach to equilibrium would be at odds with Weber’s methodological presuppositions.

The Relationship of Weber to Schumpeter

As indicated above, the present work seeks to bring the contributions of Weber and Schumpeter together in a theoretical synthesis. As also noted above, hitherto there have been few, if any, attempts to compare and contrast their work; nor has there been any serious attempt to integrate their respective contributions or provide a synthesis. The rationale of the present work derives from the view that in the writings of Weber and Schumpeter, in combination and suitably integrated, are to be found the basis for a new and comprehensive General Theory of the Modern Capitalist System and its accompanying society.

There are some obvious points of contact and common concern between Weber and Schumpeter that invite comment at the outset. First, they knew each other and collaborated on some projects in the time of Schumpeter’s early career but when Weber was reaching the height of his. For example, Weber commissioned Schumpeter to write the section on the “History of Economics” in the Grundriss der Sozialökonomik of which he was the editor. Second, both were focused in their work on the phenomenon of modern capitalism, though in original and unique ways. Third, both were pioneers and leaders in their respective fields and were steeped in, and indeed masters of, the relevant scientific literature. Fourth, their approaches overlapped in important ways: Weber, though not an expert economic theorist, was deeply interested in economics as a scientific discipline; and on the other hand, Schumpeter though primarily an economist made considerable contributions to sociology in general and to “social economics” in particular. Fifth, both Weber and Schumpeter were extremely innovative, and each may indeed be credited with being founders of new disciplines—“econometrics” in the case of Schumpeter, “sociology” in Weber’s case. Finally, both in a certain sense recognized the

25 Weber’s engagement with these writer’s would appear to be limited to his treatment of them in courses he gave on political economy in his early career, but there is little or no actual commentary.
27 On the background to these events see Swedberg (1998), Chapter 6.
significance of the other, though this must be qualified by the fact that Schumpeter’s major contributions were made years after Weber’s death in 1920, so the latter could not have known just how significant Schumpeter was to become for economic thought. Schumpeter, on the other hand, after Weber’s passing spoke highly of him on several occasions and readily acknowledged his greatness; yet Schumpeter did not take a great deal from Weber directly and was moderately critical of Weber in certain respects as we shall see.

In the remainder of this chapter I shall first seek to explore in some detail the nature of the interconnections between Weber and Schumpeter, both theoretically as well as to a degree biographically. I shall attempt to give a brief account of the respective contributions of Weber and Schumpeter with regard to the theory of capitalism that is central to both. But my major task is to begin to show how an integration of the theories of the two thinkers is possible with a view to developing a better overall theory of capitalism than has hitherto been available. In the discussion below I will not attempt to systematically examine the empirical truth of what the two thinkers have claimed in their respective works, a task that would be beyond the scope of a single work in any event. I adopt this approach in part because the task of empirically testing the theories of Weber and Schumpeter is so vast and probably an unending one, and it is something that has engaged a veritable army of scholars over the years and continues to do so. But I am also not pursuing a detailed empirical investigation because I am of the view that the strength of the contributions of Weber and Schumpeter lies in their purely theoretical cogency. That is, both thinkers utilize the methods that have been classically elaborated by Weber under the rubric of the “ideal type,” and this means that they have sought in the first place to produce conceptions of phenomena that are abstracted from reality and are “utopias” in the sense that the aspects of the world they seek to describe and analyse do not exist in pure form in concrete actuality. Both are concerned to build models of complex social and economic structures that they well know do not correspond exactly with the world as it is. The purpose of research for them is not to directly copy the real world or even to be an approximation of it, for this is strictly not possible. Rather, the purpose of concept formation, theory construction and model building is heuristic and perspectivist, and ideally provides a set of tools that the individual interested in knowing the world empirically can employ for interpretation and causal explanation.

It has long been recognized that both Weber and Schumpeter, though both Europeans and steeped in German social thought of the early twentieth century, became well known and even celebrated in the English speaking world for their contributions on capitalism. Weber is of course best known for his work The Protestant Ethic and the Spirit of Capitalism, which was translated into English by Talcott Parsons in 1930 from when it became a classic and one of the most influential works in all sociology. Schumpeter is best known for his book Capitalism, Socialism and Democracy, which was published in 1942, but he also had a considerable direct influence in America by virtue of his many writings published in English while he held a position as a professor at Harvard University. Clearly, both of the works just mentioned linked their respective authors very directly to the issue of capitalism, and we shall accordingly need to comment at length upon these texts. At the same time, these works represent
only a very small portion of the contributions the two writers made to the issue of capitalism. And, importantly from our point of view here, the significance of numerous other works of the two thinkers has hitherto not been fully recognized. Therefore, much of what I attempt in the present work is an effort to show that various other works of both Weber and Schumpeter need to be considered to fully appreciate their respective accounts of capitalism. For the entire body of work of the two thinkers is relevant to our project of advancing a comprehensive and more satisfactory theory of modern capitalism.

To understand the relation of Weber to Schumpeter, one must begin by recognizing that, although in age they were not peers, their careers took off around the same time, that is, in the first decade of the twentieth century, and both became deeply emersed in the cultural and scientific milieu of the European culture of the time. This meant that inevitably they were engaged with similar issues and moved in similar intellectual circles. After graduating at the University of Vienna in 1906, Schumpeter produced and published his first main work in 1908, Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie (The Nature and Essence of Economic Theory). By contrast, by this time Weber had already published several works in history and methodology, most notably Zur Geschichte Der Handelsgesellschaften Im Mittelalter: Nach SüdEuropäischen Quellen (The History of Commercial Partnerships in the Middle Ages) of 1899, Die Römische Agrargeschichte in Ihrer Bedeutung für das Staats- und Privatrecht (Roman Agrarian History: The Political Economy of Ancient Rome) of 1891, several important essays in methodology in 1904, 1905 and 1907, and the two essays of 1904-5 that were to become the book later published as The Protestant Ethic and the Spirit of Capitalism. But after 1909 the two men began an association owing to the appointment by the publisher Paul Siebeck of Weber to edit and partly write a new handbook of the socio-economic sciences which became known as the Outline of Social Economics (Grundriss der Socialökonomik). By 1911, Schumpeter had begun to make his name with the publication of Theorie der wirtschaftlichen Entwicklung (The Theory of Economic Development), and I assume that Weber must have been sufficiently impressed by his colleague’s work to offer him the opportunity to contribute to the prestigious compendium he had been commissioned to edit. The work that Weber contributed to the Grundriss der Socialökonomik became his magnum opus and is known now as Economy and Society: An Outline of Interpretive Sociology; whereas Schumpeter’s contribution to the Grundriss was a work of lesser scope entitled Epochen der Dogmen- und Methodengeschichte published in 1912, now translated into English as Economic Doctrine and Method: An Historical Sketch.28

Richard Swedberg has given a detailed account of Schumpeter’s relationship with Weber and the Grundriss in his Max Weber and the Idea of Economic Sociology and suggests that Schumpeter’s approach to social economics as developed in Economic Doctrine and Method: An Historical

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28 A detailed account of Schumpeter’s career at this stage is contained in Richard Swedberg, Schumpeter: A Biography, Princeton University Press, 1991, pp. 31-45.
Sketch was directly influenced by Weber. He tells us, “. . . Schumpeter more or less agreed with Weber’s position on the Methodenstreit—that the historical-empirical approach of Schmoller was as necessary as the theoretical-analytical approach of Menger . . .”29 He further says that Schumpeter continued to think of the project of social economics throughout his career and this culminated in his History of Economic Analysis written in the 1940s which was in effect an expansion of the early work.

It is worth noting the passages in Schumpeter’s Economic Doctrine and Method that show his view of the importance of marginal utility theory, passages that Weber would have known and, we surmise, accepted. There is a detailed discussion of the emergence of marginal utility theory and its relation to the classical theory that preceded it toward the end of Schumpeter’s historical survey. Reference is made to the contributions of Menger, Jevons, Wieser and Walras and the thrust of the discussion is that these theorists greatly improved the coherence of economic theory as a whole and, among other implications, rendered Marx’s economic theory and his labour theory of value obsolete.30

The fact that Weber saw fit to offer the writing of a significant section of the Grundriss to Schumpeter gives rise to at least two important conclusions. First, we can say that Weber evidently acknowledged Schumpeter’s competence by such an appointment owing to the fact that he would only have entrusted such a task to a scholar of the first rank. It needs to be realized that just prior to this in 1911 Schumpeter had published a major book, namely, The Theory of Economic Development, a work that probably made his name in academic circles, and which we must assume impressed Weber. And secondly, it is probable that Weber had by this stage in his career determined that he himself would not in future be predominantly concerned with economic theory per se, and that he did not intend to contribute directly to “economics”. I say this mindful of the fact that, though Weber evidently turned away from academic economics, he always considered himself kind of economic specialist nonetheless.

In his connection it is necessary to observe Weber’s position in the so-called Methodenstreit or “methodology controversy” of the day and his relation to key figures such as Gustav Schmoller, Menger, Wieser and Böhm-Bawerk. First, we should not assume that Weber’s apparent allegiance to the German Historical School and his admiration for Schmoller meant that he rejected the value of the contributions of the so-called Austrian School in economics or had reservations about their novel “theoretical approach”. To the contrary, Weber was deeply impressed by the work of these thinkers in the field of pure economics, and what is more, seems to have accepted the theory of marginal utility as axiomatic for an understanding of the price mechanism in a market economy. Thus in his essay dealing with marginal utility of 1908 entitled “Marginal Utility Theory and ‘The Fundamental Law of Psychophysics’”

30 Joseph Schumpeter, Economic Doctrine and Method: An Historical Sketch, Allen & Unwin, 1954, pp. 181-200. We shall return to this work in our survey of Schumpeter’s work below.
Weber speaks very favourably of Menger and Böhm-Bawerk for whom the theory of marginal utility was a given. Furthermore, it is significant that Weber also included in his *Grundriss* a contribution by Wieser entitled *Sozial Ökonomiks Wirtschaft (Theorie des Gesellschaftlichen)* (“The Theory of the Social Economy”). Wieser was undoubtedly Menger’s most significant pupil and was responsible inter alia for developing the implications of marginal utility theory beyond the original insights of Menger, especially with his important notion of “opportunity cost”.

**Weber as an Economist**

The question as to whether Weber either considered himself an “economist” or worked in some respects as an economist has been obscured owing to the reception of his later writings by the academy in the English-speaking world. For he came to be celebrated primarily as a founder of the discipline of sociology, though *The Protestant Ethic* book led to him to also have a reputation as an economic historian. The work of Scaff has now shown that in his early career Weber had increasingly thought of himself as a political economist. Scaff quotes a remark made by Weber to Baumgarten around 1891 that he had “become approximately one-third political economist.” And a perusal of Weber’s earlier writings, and the fact that he began his career as a professor of economics, suggests that he was more than familiar with economic questions in the strict sense and that he even considered himself, at this stage at least, to be an “economist”. Furthermore, there are two early texts of Weber that make his involvement with the emerging science of economics abundantly clear. One is the essay referred to above entitled “Marginal Utility Theory and ‘The Fundamental Law of Psychophysics’”. The other is a set of essays Weber wrote on the stock exchange and the stock market. I shall first briefly consider Weber’s essay on marginal utility theory.

The 1908 essay “Marginal Utility Theory and ‘The Fundamental Law of Psychophysics’” is largely concerned with the relationship between marginal

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31 A typical statement that Weber was a sociologist and not an economist is that of Thomas McGraw, *Prophet of Innovation: Joseph Schumpeter and Creative Destruction*, Harvard University Press, 2007, p. 44.
utility theory—which Weber takes as a given, a fundamental notion underlying modern economic theory—and what was known at the time as the so called “Weber-Fechner Law” (the name “Weber” in this term has nothing to do with the person of Max Weber). For the time being, we need not concern ourselves with the argument that Weber was embroiled in here, suffice it to say that he clearly takes for granted the validity of marginal utility theory and is largely concerned to attack the notion that the value theory of the so called Austrian School (i.e., marginal utility theory) is psychologically based and that this aspect is adequately explained by the so-called Weber-Fechner Law. Some idea of Weber’s self-understanding in the writing of this essay can be gained from various statements he makes towards the end. At one point he refers to himself in as many words as an economist when he writes: “At every step and on countless particular points of interest to our discipline, we economists are and must be involved in fruitful interchange of findings and viewpoints with workers in other fields. This is something to be taken for granted as common to all economists.”  

A little later in the essay Weber writes:

But further, and above all, precisely as regards the point which is decisive for the peculiar quality of the questions proper to our discipline: In economic theory (‘value theory’) we stand entirely on our own feet. The everyday experience from which our theory takes its departure (see above) is of course the common point of departure of all particular empirical disciplines. Each of them aspires beyond everyday experience and must so aspire, for thereon rests its right to existence as ‘a science’. But each of them in its aspiration ‘goes beyond’ or ‘sublimates’ everyday experience in a different way and in a different direction. Marginal utility theory and economic ‘theory’ generally do this not, say, in the manner with which the orientation of psychology but rather pretty much in opposite ways.

Continuing the argument he says,

Marginal utility theory, in order to obtain specific objects of knowledge, treats human action as if it ran its course from beginning to end under the control of commercial calculation—a calculations set up on the basis of all conditions that need to be considered. It treats individual ‘needs’ and the goods available (all to be produced or exchanged) for their satisfaction as mathematically calculable in ‘sums’ and ‘amounts’ in a continuous process of bookkeeping. It treats man as an agent who constantly carries on ‘economic enterprise’ and it treats his life as the object of his ‘enterprise’ controlled according to calculation. The outlook involved in commercial bookkeeping is, if anything, the starting point of the construction of marginal utility theory.

Weber’s main point in this discussion is that marginal utility theory does not depend upon the positing of psychic forces or drives of the kind that have been advanced by various psychological theories. Rather, it accounts for the functioning of economic life on the basis of an understanding of the manner in

36 Ibid.
37 Ibid, pp. 31-2.
which individuals operate more or less rationally in accordance with their economic interests. As he puts it further on in the essay:

The theoretical ‘values’ with which marginal utility theory works should in principal make understandable to us the circumstances of economic life, in a manner like that in which commercial book values render information to the businessman about the state of his enterprise and the conditions for its continued profitability. And the general theorems which economic theory sets up are simply constructions that state what consequences the action of the individual man in its intertwining with the action of or others would have to produce, on the assumption that everyone were to shape his conduct toward his environment exclusively according to the principles of commercial bookkeeping—and, in this sense, ‘rationally’.  

Weber was especially praising of several of the individual figures of the Austrian School. For example, in 1903 he wrote a recommendation supporting the nomination of Eugen von Böhm-Bawerk for an honorary doctorate at the University of Heidelberg, describing him in these terms: “Equally outstanding in logical stringency, stylistic refinement and in the elegant objectivity of his polemics, he is undoubtedly the most important representative of the abstract and deductive work done by the school of Austrian political economists . . .”

But, Weber reserved his highest praise for Carl Menger. According to Manfred Schön, it was Menger and not Rickert whom Weber credited with discovering the fundamental methodological distinction between law-based sciences (Gesetzeswissenschaft) and the sciences of concrete reality (Wirklichkeitswissenschaft). And in a letter to Brentano Weber wrote of Menger that he, “expresses what he wants to say, to be sure in an awkward manner, but unpretentiously, simply and clearly . . . he has very substantial merits and was right on important points of the matter at issue, even in the dispute with Schmoller.”

Further illustration of Weber’s engagement with economics in more than a passing fashion can be gleaned from other early works, in particular the two essays he wrote in 1894 and 1896 on the stock exchange and a brief work the title of which has been translated as “Outline of General ‘Theoretical Economics’” of 1898. In the works on the stock exchange, Weber provided a very detailed account of the operation of share markets and in particular of what is termed “futures trading”. Interestingly, he was concerned not merely to produce a theoretical account of these phenomena but sought to influence policy developments in Germany at that time. Further, in these essays Weber not only gives an account of the way the stock market functions, but he comments at some length how markets in general operate, and much of this

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38 Ibid, p. 32.
39 Quoted in Mommsen and Osterhammel, 1987, p. 60.
40 Ibid.
41 Ibid, p. 62.
42 Interestingly, Weber’s explanation and partial justification of the function of the stock exchange and share trading is similar to that provided recently by Robert Shiller in his Finance and the Good Society, Princeton University Press, 2012. See especially Chapter 6, pp. 57-63.
analysis constitutes what can only be described as “economic theory”. We shall consider Weber’s contributions in these areas later in this work, but for the present it merely needs to be noted that Weber was more than familiar with the economic theory relevant to these institutions, and made a significant contribution to the interpretation and understanding of their operation.

The second work referred to, “The Outline of General ‘Theoretical Economics’”, consists of a 20 page long description of a course in economics which Weber had been teaching at the University of Freiburg in the 1890’s. According to Richard Swedberg, the work included some 30 pages of notes in which many references are made to the economic theorists of the day. Swedberg says that Part One of Weber’s course dealt with fundamental concepts in economics, Part Two dealt with the relationship of the economy to nature, Part Three concerned historical developments, Part Four was devoted to the history of economic thought, Part Five dealt with the analysis of the modern market economy and Part Six concerned social and economic aspects.  

A fuller account of Weber’s early career and his involvement with economics is contained in an essay by Steven Lestition that is the Introduction to the publication of Weber’s essays on the stock and commodity exchanges. Lestition points out that Weber began his career after his university studies as a lawyer in Berlin but in 1892, whilst staying in Berlin, took an opportunity to take up a lecturing position at the university in commercial law. Then in 1894, Weber was appointed to a tenured professorship in macroeconomics (Nationalökonomie) and finance at the University of Freiburg. During his two years at Freiberg, Weber taught courses in ‘general and theoretical macroeconomics’, ‘macroeconomic policy’, ‘money, banking and stock exchange transactions’, ‘the history of macroeconomic analysis’, and ‘stock and commodity exchanges and their law’. From all this it is obviously the case that Weber was thoroughly familiar with the field of general theoretical economics, if not something of an expert in some areas.

A further aspect of Weber’s involvement in economics at this early stage was his engagement in a project between 1894 and 1896 in which he was commissioned to write a review of a report of the “Exchange Enquiry Commission”. Weber produced a 330-page analysis as well as the essays on the stock exchange, and also made recommendations on the exchange law, among other contributions at the time. These early concerns with the analysis of stock markets are particularly interesting because of the connection of such matters with economic crises and the problem of understanding economic fluctuations. Much of Weber’s analysis of the stock exchange reflects his desire to provide a kind of justification for the functioning of the stock market and futures trading in a capitalist economy, even though the phenomenon of “speculation” is in some ways integral to the activities of traders. Weber was eager to dispel the popular misconception that stockbrokers and exchange traders carry out no

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useful economic function. He argued that their activities are necessary to the rational operation of a capitalist market system. Of course, all of this relates quite directly to the work of Schumpeter, who is preoccupied with the phenomena of market fluctuations and economic crises.

Affinities between Weber and Schumpeter

There are other notable affinities between Weber and Schumpeter that deserve mention at the outset. Weber and Schumpeter emerged from the same intellectual milieu and, despite some differences to which we shall return, there is an underlying compatibility of many of their general perspectives. This point has been made by Randall Collins in an essay on Weber and Schumpeter. However, Collins says that, despite the fact that Weber and Schumpeter knew each other, there was little mutual influence and there is a certain truth in this. Weber does not, for example, cite Schumpeter in any of his own published works, though he had invited Schumpeter to make the contribution to the Grundriss as noted above. Equally Schumpeter, though an admirer of Weber and an associate of him in some of the academic debates of the day, nonetheless does not appear to draw much directly from Weber. As we have said above, Schumpeter’s interests were first and foremost in economic theory whereas Weber’s were broader and partly in other directions.

In a sense Weber and Schumpeter started on either sides of a rift that ran through German academic thinking in the late nineteenth century, but both eventually transcended the divide. This was the debate between the Historical School under the leadership of Gustav Schmoller and Marginalist School in Austria led by Carl Menger. Schmoller had launched the so-called “Methodenstreit” by attacking the Austrian School as being too theoretical and unhistorical. Weber was greatly influenced by the Historical School but at the same time was not at all opposed to theory. Indeed, as we have seen, Weber was quite receptive to the contributions of the marginalists. In his methodological writings he was eager to overcome this division within economic-historical thought, and went out of his way to find accommodations with the new ways of thinking in economics. And it needs to be recognized that Weber developed work of his own which has theoretical features not unlike those of economics. Of course, Schumpeter was primarily concerned with theory from the very start of his career but he wrote numerous essays of a sociological and historical character. His great work Business Cycles has very large sections of historical analysis to illustrate his theoretical claims.

According to Holton and Turner, Weber shared the Austrians’ rejection of organicist conceptions of institutional development and analysis in terms of aggregates. Furthermore, he adopted methodological individualism as his starting point, a notion that was according to Machlup first coined by

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Schumpeter. But Weber’s emphasis on the role of purposive action and his recognition that institutions may come into being as the unintended result of individual actions owed a good deal to the work of Menger. Weber’s conception of the “ideal type” is also influenced by Menger for whom “... theoretical investigation arrives at qualitative typical appearances that cannot be tested against full empirical reality (because ... e.g., ... an individual who pursues only economic ends. ... exist[s] only in our idea) ...”

As regards their value orientations, as we shall see, both Weber and Schumpeter shared a predilection to support the capitalist economic system of their era, and both were sceptical, and at times highly critical, of socialist movements and Marxist theory. Despite their criticism of socialism and Marxist theory, however, both were extremely fair-minded in their assessments of socialist thought and took seriously the contributions of socialists and social democrats to political and social debate generally.

Randall Collins argues there are close affinities between Weber and Schumpeter on the general issue of monopolisation. Schumpeter, on the one hand, argued that there are distinct tendencies within the capitalist system toward monopoly, and further the concept of “monopoly competition” is central to his economic theory. There are aspects of monopoly in the structure of markets and in the manner in which entrepreneurial innovations take place. Schumpeter talks at length about the monopolies that emerge and dissolve regularly within the economy. Monopolies contribute significantly to the general process of the capitalist organism. Further, Schumpeter argues that entrepreneurs make new combinations of the factors of production that lead to the appearance of new goods that did not exist previously. These new products are not always a response to existing demand but frequently create new demand. By this mechanism the successful entrepreneurs effectively make and appropriate the market opportunities and this gives them a kind of monopolistic power.

Likewise Weber sees various monopolising tendencies as being common to the capitalist system though they do not always emerge from the circumstances of market competition in the strict sense. Collins quotes the following passage from *Economy in Society*:

> When the number of competitors increases in relation to the profit span the participants become interested in curbing competition. Usually one group of competitors take some externally identifiable characteristic of another group of (actual or potential) competitors—race, language, religion, local or social origin, descent, residence, etc.—as a pretext for attempting their exclusion. It does not matter which characteristic is chosen in an individual case: whatever suggests itself mostly is seized upon. ... In spite of their

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48 Quoted in Mommsen and Osterhammel, 1987, p. 61.
continued competition against one another, the jointly acting competitors now form an ‘interest group’ towards outsiders; there is a growing tendency to set up some kind of association with rational regulations; if the monopolistic interest persists, the time comes when the competitors, or another group whom they can influence (for example, a political community), establish a legal order that limits competition through formal monopolies; from then on, certain persons are available as ‘organs’ to protect the monopolistic practices, if need be, with force.  

These monopolisations may include the establishment of licensed professions or organizations of the labour force based on educational credentials. In all these cases there are struggles between status groups and classes and given the realities of the modern world conflict is endless. In the purely economic sphere Weber argues that modern capitalism develops from a series of monopolisations. First there is the monopolisation of money capital by entrepreneurs, who make advances to labour, and then market information and sales opportunities are monopolized. Subsequently, the material means of production are monopolised by the expropriation of the workers from the means of production. And finally, there is the expropriaition of the manager and even the owner who become mere trustees of the suppliers of bank credit.

Both Schumpeter and Weber have much to say about the entrepreneur. Schumpeter does not discuss the kind of organization the entrepreneur builds in a social-psychological fashion akin to Weber, but what he says is largely consistent with what Weber has to say. As Collins puts it:

[Schumpeter’s] entrepreneur bares a strong resemblance to Weber’s puritan businessman driven by the protestant ethic. Schumpeter describes the entrepreneur as being “irrational” in the sense that his motive is not hedonistic enjoyment of life but the opposite—his sheer interest in overcoming obstacles. At the same time the entrepreneur can be described as “the most rational and most egotistical of all” because of the high level of conscious rationality involved in carrying out new plans, as opposed to the routine of running an established business. Schumpeter comments that the entrepreneur breaks up traditions—economic, moral, cultural and social. “It is no mere coincidence that the period of the rise of the entrepreneur type also gave birth to Utilitarianism.” This sounds like the sound personality type that Weber attributed to the Calvinistic reformation. Schumpeter casts it in another light, however. Its theme is not religion but politics.  

Schumpeter does not investigate the bureaucratic structure of the enterprise, nor the underlying psychological motivations and their religious origins in detail as does Weber, but the above quotations indicate that his thinking is not that far from Weber’s.

Finally, Collins comments on the organization of finance and the role of money in Schumpeter’s work. He points out how Schumpeter had stressed this factor, for new combinations to be carried out resources must be diverted from

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the “circular flow”. In order for this to occur, credit must be supplied to pay for the required resources. Money is the crucial lubrication for this process of financing innovative economic activity. This goes to the heart of Schumpeter’s theory, which defines capitalism as “enterprise carried out with borrowed money”. Banks are able to use money, which would otherwise lie idle, as credit to be lent out to enterprises, i.e., to new developments. Existing enterprises can finance their operations with their savings, but this is not possible with new combinations. The role of banks is absolutely crucial to Schumpeter’s theory because without them entrepreneurial profit is not possible. Interest on loans is, from his point of view, not really profit but a kind of tax on entrepreneurial profit. Effectively, interest payments act as a break upon entrepreneurial schemes that are insufficiently remunerative. Collins summarises Schumpeter’s position on banks as follows. “Given the power of bankers to decide among different business plans, the financial world emerges as the command centre of the economy, ‘the headquarters of the capitalist system.’”

In considering whether these views are consistent with Weber, Collins notes that Weber has relatively little to say on some of these topics. Weber is aware that capitalism in both its modern and pre-modern incarnations clearly depends on some form of money with which profit-making activities can be pursued. And clearly the monetary system of the modern era is unique in various ways, particularly in the fact that the state guarantees the value of the currency and monopolises the minting of coins and notes. But Weber is not overtly concerned with dynamic aspects of the monetary system and is merely content to discuss some aspects of contemporary monetary policy and inflation.

The Synthetic Combination of Weber with Schumpeter

There are numerous reasons why integration of the work of Weber and Schumpeter is a potentially fruitful exercise. It is clear that Weber’s work is largely oriented to explaining the origins and the sociological underpinnings of the capitalist economic system. Equally it is clear that Weber does not attempt to provide an account of the functioning of the economic system once established, say in the manner of orthodox macro- and micro-economic theory. Schumpeter, however, is primarily focussed on precisely this second task, of accounting for what he often refers to as the “mechanism” of the economic system. How does the economic system considered as a whole function? What are its primary dynamics and tendencies, and what is its underlying logic of development? Clearly there is an obvious sense in which these two approaches can be said to be complementary—Weber providing the historical and social basis, Schumpeter providing the underlying logic and long-term developmental trend of capitalism.

A preliminary matter that must be broached is whether there are inconsistencies between the approaches of Weber and Schumpeter such that their integration is rendered unworkable. In what follows I shall argue no only

52 We shall explore this concept at length below.
that there are no fundamental inconsistencies of this kind but in fact the two approaches are remarkably complementary to each other and can be made to form a coherent and convincing account of the modern capitalist world in all its complexity.

A starting point for the comparison of the two approaches that is elementary to assessing how far they can be fully integrated is to consider the definitions of capitalism Weber and Schumpeter respectively advance. For Weber, the operative definition of modern capitalism concerns the specific character of the capitalist enterprise. The modern capitalist enterprise involves the rational organization of formally free labour with a rational division of labour and the orientation of the enterprise to the pursuit of profits by the exploitation of opportunities offered by the market. All this is only possible where the market is extensive enough as to produce for the needs of the mass of the population. For Schumpeter the definition is similar but not identical. His emphasis is upon the method of enterprise wherein the pursuit of profit is pursued using the deployment of funds obtained via the credit system. This feature is absolutely critical to the task of explaining the nature of the capitalist system as a whole. Further, Schumpeter is also concerned to explain the manner in which the market/price system operates and how this necessarily gives rise to cyclical features. The obvious point of difference here concerns the differing emphasis on the role credit, not prominent in the case of Weber but altogether primary for Schumpeter. It follows from Schumpeter’s definition of capitalism that he will date the origin of the capitalist system by the advent of the extensive use of credit, a phenomenon associated with the development of banking. It is noteworthy that he is expressly critical of Weber’s emphasis on the so-called “spirit of capitalism” and the role of the Reformation and the Protestant religions in the origin of capitalism. It is debatable, however, whether Schumpeter properly appreciated Weber’s account of the origin of modern capitalism, as we shall argue. Below we shall explain, that Weber did not deny the relevance of factors other than the so-called “spiritual” ones, and he was in fact fully apprised of the need to take into account the full range of “materialist” forces as preconditions and causes.

Schumpeter’s emphasis is on the “mechanism” of the capitalist system, on the way in which capitalism is “creative destruction” because the ever-recurring quest for new markets, productive innovations, and the exploitation of opportunities for profit inevitably destroys many hitherto viable and prosperous business enterprises. Weber also accepts that the course of economic life under capitalism is far from harmonious and in fact, somewhat like Marx, he emphasises the chaotic character of market relations and recognizes that the market system inherently involves a clash of interests and the struggle of man against man. But this does not quite equate to “creative destruction” with its Nietzschean overtones. Whether Weber would have agreed with the Schumpeterian emphasis on the mechanism of credit creation and the inherently cyclical character of the capitalist economic system is a hypothetical question for which it is not possible to give a definitive answer. If Schumpeter is correct in his analysis of these matters, the question we must put is whether there is anything in Weber that is inconsistent with such a thesis. Our view is that there is no fundamental incompatibility and that much of Schumpeter’s work can,
with suitable adjustments, be combined with the account of capitalism given by Weber. It has to be realised the Schumpeter’s own work revealed the nature of the cyclical capitalist mechanism in all its dimensions only in the course of his later writings, which were produced during the 1930s well after Weber’s death. Insofar as an understanding of Schumpeter’s “mechanism” was already present as early as his *The Theory of Economic Development*, Weber does not seem to have registered its full significance.

A further question arises in relation to the way in which Weber’s mature writings on the nature of the capitalist enterprise and its rationality can be integrated with the corresponding discussions of Schumpeter. Related to this is the characterisation of the entrepreneur in the field of economic sociology. Both Weber and Schumpeter made many contributions on these topics and a comparison of their respective efforts in is instructive and of considerable interest. For example, Weber says a good deal about the way in which business organizations operate. He emphasises in particular the role of capital accounting and the way in which the factors of production are calculated and deployed in accordance with estimates of profitability based on market prices. Schumpeter likewise emphasises the orientation of the entrepreneur to the market situation and the impact of calculations of profitability. But are their separate contributions completely compatible in their specifics? One of the features Schumpeter emphasises is the way in which new production functions are created by the efforts of the entrepreneur in rationalising the process of production. He emphasises that this rationalisation is often a revolutionary step that, because of the competitive pressure of the market, involves breaking new ground, doing things in a different way than was previously the case, seizing novel opportunities to lower costs or exploit new markets. In Weber, by contrast, the process of rationalisation appears to be a more routine and mechanical on the basis of an assessment of data in the accounting records.

It is important to recognise that despite his various works concerning the origins of the capitalism and its essential features, Weber did not produce a theory of the long-term functioning and developmental tendencies of capitalism. Indeed, much of what he says about capitalism implies that it will continue more or less in the same fashion indefinitely into the future—unless perhaps a fundamental institutional change is brought about such as might occur with the advent of socialism. Thus he did not take seriously the Marxian view that capitalism is doomed to extinction because it contains fundamental contradictions, a view that Schumpeter is inclined to believe has some merit. Weber does not seem to be concerned by the prospect of periodic crises of the kind that Schumpeter made the focus of his analysis. Weber was certainly aware that crises do and will occur, and he thought that the state might well be required to intervene at critical times, to provide welfare assistance and to protect national interests in various ways. But he did not anticipate the kind of fundamental system crises that at times have emerged since his day, such as those which occurred at the time of the Great Depression and which might even be said to be occurring at the present. This is another reason it is worthwhile to address the contributions of Schumpeter.
We shall argue the works of Schumpeter and Weber are potentially suited to the project of a grand synthesis because, while Schumpeter does not address the historical origin of capitalism in detail as did Weber, he provides a compelling account of the ongoing functioning of the capitalist system once it had come into being. This is not to say there are not many fruitful insights and contributions that both make to the project that is really the focal point of the other. Weber’s insights into the nature of the capitalist firm, to the functioning of the market, to the understanding of legal and political pre-conditions, of course, go well beyond an historical concern to explain the origins of capitalism. And equally, Schumpeter made important contributions to sociology and the origins of capitalism beyond his account of the way in which a fully-fledged capitalism operates once it comes into being. It is therefore fruitful to explore the two bodies of work with a view to seeing whether a more comprehensive and overall theory of the capitalist system in all its dimensions is feasible.

Schumpeter’s ultimate significance lies, in our view, in the fact that he has provided the most compelling general account of the \textit{functioning} of the capitalist system to date. It needs to be noted, however, that to a degree Schumpeter’s strength lay in his ability to synthesize and systematize the contributions of fellow economists, and that his own unique contributions are perhaps more modest and limited in originality as compared with Weber’s. For example, apart from his thesis about credit creation and the developmental mechanism that generates capitalist progress and produces business cycles, Schumpeter makes few claims to have created fundamental new insights in regard to key phenomena such as marginal utility, monopoly competition, or the theory of price formation. Nonetheless, he provides a rich and instructive account of these phenomena and many other aspects of economic life in the course of his quite extensive writings. In addition to this in his \textit{History of Economic Analysis}, a work uncompleted at his death, Schumpeter provided a quite encyclopaedic account of the field of economic science as it had developed up until the time of his death, which in our view remains unsurpassed. Thus, when we speak of Schumpeter’s contributions we are in a sense recognizing the contributions of economic science as a whole and thus we are not limiting our approach entirely to the individual perspective that is Schumpeter’s own. This is not to say that Schumpeter’s peculiar vision is of only passing interest. Of course, this vision concerns in particular his analysis of the long-term trajectory of capitalism and the part played by business cycles that are his special contribution. To a certain extent the present work will remain agnostic as to whether we fully accept or endorse every aspect of Schumpeter’s theses as put forward in \textit{Business Cycles}. Nonetheless, we shall provisionally regard its key perspectives as valid, though any final assessment of its merits would depend on an exhaustive empirical and comparative analysis that perhaps awaits to be done.

A final area in which Schumpeter and Weber warrant comparison is on the question of socialism. Both Weber and Schumpeter regarded the basic concepts of socialism not only as theoretically cogent and that socialism is a feasible alternative to capitalism, they also regarded it as an outcome that was quite possible for the foreseeable future. Both wrote essays specifically on the topic
of socialism. And, both lived to see the advent of socialism in the Soviet Union. Weber made very detailed analyses of the situation in Russia in several writings that he devoted to the question the Russian Revolutions of 1905 and 1917. Schumpeter, of course, lived to see the Soviet Union and other attempts to create socialism more fully achieved, and addressed the question of the long-term prospect for a generalized transition to socialism at some length, particularly in his popular work *Capitalism, Socialism and Democracy*. There he provides a very detailed argument of the pros and cons of a coming socialism but, though he wants to see a future socialism as potentially benign, paradoxically the gist of his argument is that capitalism is really superior.

But whereas Schumpeter saw socialism as an outcome that was probably inevitable and therefore not to be avoided at all costs, Weber saw socialism as not only a threat to capitalist prosperity but also as potentially destructive of individual freedom, political liberty and cultural creativity. Weber was alarmed at what he foresaw as a potential new servitude, in marked contrast to Schumpeter who, whilst not exactly inviting the development of socialism, was largely unperturbed at its prospect. The different perspectives on socialism to a degree hang on the differing views Weber and Schumpeter had as regards the nature of bureaucracy. Where Weber saw excessive bureaucracy as a threat to the prospects of human freedom, Schumpeter did not fear it in the same way. Between the two perspectives there are clearly contrasting evaluations of how the modern state and business organization operates at the organizational level and the extent to which they will become bureaucratized. Below we shall address these questions at some length.

Before we embark on our attempt to synthesize Weber and Schumpeter in pursuit of a General Theory of Modern Capitalism, we must briefly consider a fundamental methodological issue. It might well be objected against our approach that Weber’s methodology precludes the effort to produce a general theory on the grounds that the question of origins is not amenable to a laws-of-history approach and that therefore the question of the origins of capitalism is only capable of being dealt with as unique and singular event. Against this objection we reply that, however much Weber may have acknowledged the value of the distinction between the ideographic and nomothetic sciences—as set out classically by Windelband and then elaborated by Rickert—he nonetheless recognized the need for generalizing theories, especially as these were being developed in the new science of economics—but also, of course, in his own sociology. Weber became increasingly engaged in “theory” in his later sociology, especially in *Economy and Society*, a work that abounds in general concepts and the construction of ideal types of broad application. Perhaps the best way to relate Weber to Schumpeter as regards their approach to general theory is via the concept of “development”, for not only does Schumpeter place

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this concept at the heart of his economic theory, as we shall see, Weber also utilizes this idea with his notion of the “developmental tendency”.  

But we must acknowledge that neither Weber nor Schumpeter sought to produce a General Theory of Modern Capitalism and commentators might well argue that such an enterprise is in some ways inimical to their respective approaches. We do not agree. While neither expressly pursued such a project, I see no reason why their works are inherently antithetical to such a goal. The purpose of a general theory in our view is to distil the basic elements of the modern capitalist system as manifest in a variety of instances, to account for it origin and subsequent world-wide expansion, to demonstrate its essential preconditions, and to show its internal structural composition and functioning. Of course, this task suggests that there are common elements in most of the major capitalist economies of the present era and that there are tendencies towards the development of this form of capitalism at work throughout the modern world. Nonetheless, we do not advocate a teleological view of the matter, nor, as we have said, do we wish to posit an end of history à la Fukuyama. The purpose of a general theory is to aid in the interpretative understanding of the forces at work in the modern socio-economic systems broadly considered, to provide a framework to assist comparative analysis, and to put these understandings together in an integrated theoretical whole.

In what follows we attempt to build a general theory from elements mined from contributions of both Weber and Schumpeter. We shall proceed methodically at the outset with a detailed exegesis of the works of Weber and Schumpeter of relevance to the theory of capitalism. To some degree we shall work chronologically, by first expounding in separate chapters Weber’s early works followed by an account and analysis of his mature writings. After this we shall turn to Schumpeter and divide his oeuvre also into early and later periods, which shall constitute two further chapters. Following these chapters, we shall bring the contributions of our two major thinkers together in an attempt to synthesize them and construct the basics of a General Theory.

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56 Wolfgang Schluchter has pointedly sub-titled his major treatment of Weber’s work on the origins of modern society *The Rise of Western Rationalism: Max Weber’s Developmental History*, University of California, 1981 with the phrase “Max Weber’s Developmental History”.

CHAPTER ONE

Weber’s Contribution to the Theory of Modern Capitalism: Part One

Weber's Writings on Capitalism

It is not well known that Weber began his scholarly career as a student of political economy and that, as we have noted, he regarded himself as an economist of a kind. And it is not generally appreciated that his first major publications were in the field of economic history. He wrote his doctorate, his first major scholarly effort, on *The History of Commercial Partnerships in the Middle Ages*. He then produced two major works on ancient society, one focussing on Roman socio-economic history, the other a comparative study of ancient civilisations. In both of these works the issue of ancient capitalism was a major theme. So it is clear that Weber embarked on his later treatment of modern capitalism with a considerable grounding in European economic history.

The first major work Weber wrote specifically on the issue of the nature of modern capitalism was, of course, *The Protestant Ethic and the Spirit of Capitalism*. The essays that formed this work, later to become the book with the celebrated title, were written in 1904 and 1905. The work, as we shall see, is primarily focussed on explaining the spiritual basis (mentality) of modern capitalistic acquisition. As is known, Weber locates that initial impulse for the modern work ethic in the peculiar form of the vocation as advanced by certain Protestant religions. The book, however, was intended to be a contribution to a larger causal analysis of the origins of modern capitalism, as Weber makes plain in his concluding remarks and his debate with critics, to which we shall return.

Subsequent to *The Protestant Ethic*, Weber embarked on a series of further studies that involved broad ranging investigations that culminated in what has been described by some as a comparative study of world civilisations. During the period from 1909 until his death, Weber produced a tremendous body of

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1 I myself was not fully aware of this orientation of Weber’s early career when I made the claim in my *Antiquity and Capitalism: Max Weber and the Sociological Foundations of Roman Civilization*, Routledge 1991 that Weber began his career as an ancient historian.
3 See my *Antiquity and Capitalism* for a detailed analysis of ancient capitalism and the issues that arise in relation to the extent and type of capitalism in that era.
work that included extensive studies of the religious cultures of India, China and Ancient Judaism. From 1909 to 1914, he was focussed on developing the work that subsequently became his magnum opus *Economy and Society*. As already noted, this work arose following the commission by his publishers for him to edit the large encyclopaedic compendium on the social sciences entitled *Grundriss der Socialökonomik*. Weber not only performed the role of editor, he also took responsibility for writing large sections of the work himself. In carrying out this task and in the course of his comparative studies of the world religions, Weber began to refine his approach to the problem of modern capitalism. Whatismore, he began to advance his ideas concerning the “rationality” of modern social life, describing the fate of the times as characterized by “the rationalisation and intellectualisation and, above all, by the ‘disenchantment of the world’”, a theme that recurs in his later writings. Capitalist enterprise is not alone in being an institution infused with highly rational features, for the economy is merely one of a number of spheres of life wherein extensive processes of rationalisation have taken place. In law, in bureaucracy, in science, and even in art and architecture, various tendencies are identified as undergoing an intensive process of rationalisation and intellectualisation. In *Economy and Society* these notions are developed into a series of propositions and theses concerning the nature of the institutional structures of the modern world. Below we shall explore in some detail the specific nature of these contributions in *Economy and Society* as they relate to our topic.

Towards the end of Weber's life after the First World War, he produced two significant writings which in some ways could be said to summarise his thinking on the whole question of the nature of capitalism and the phenomenon of rationalisation that he had begun to explore in detail in *Economy and Society*. Those writings are: (1) the so-called “Author's Introduction”, which was originally the Introduction to Weber's *Collected Works on the Sociology of Religion* that were being readied for publication in 1919; and (2) the series of lectures Weber delivered in 1919-20 under the title “Outline of Universal Social and Economic History”, subsequently published as the *General Economic History*. This last mentioned book was put together from notes students took of the lectures given at the University of Munich.

**Problems in the Interpretation of Weber’s Work**

Weber’s writings on capitalism present a number of difficulties of interpretation. His first writings that address the nature of modern capitalism at length, the essays that make up *The Protestant Ethic*, were written at the same time as two major methodological essays and a number of other discussions of philosophical questions. At this time, Weber was clearly highly exercised by the controversy raised by the so-called *Methodenstreit*. He was particularly aware of the problem of how theory can grasp the world in the light of the insights of Kant and the neo-Kantians concerning knowledge of reality. Under the influence of Heinrich Rickert and others Weber adopted a solution to these

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5 FMW, p. 155.
problems in part by resorting to the concept of the “ideal type”. The function of the ideal type in Weber’s thought is firstly to provide a simplification of the complex manifold of reality; and a secondly to facilitate a more precise formulation of conceptual elements so that apprehension of concrete phenomena can be advanced on the basis of clear and rigorous notions. But the further purpose of the ideal type is to deal with the problem that reality can be viewed from different points of view. Thus, for example, it is possible to approach religious phenomena in terms of the beliefs that certain religiously inspired individuals actually hold, or in terms of the theology that has been articulated by intellectuals claiming to articulate the beliefs of a group, or in terms of the actual practices of persons comprising a sect or church, or again, in terms of an ideal formulation of what a particular religious meaning should be—and there are other possible angles as well. The problem is the same with other historical phenomena—such as the French Revolution, the Roman Republic, the Greek state, medieval monasticism, the Reformation and so on. And, of course this problem also arises in relation to “capitalism”, “modern capitalism”, “ancient capitalism”, “competitive capitalism”, “the market system” etc. Any of these phenomena can be viewed from a variety of perspectives, and the concepts that may be employed to deal with them do not come already formulated. This latter aspect is what is embraced by the so-called problem of the “hiatus irrationalis”.

Weber sought to cope with these methodological issues by conceding that in a sense all scientific theorising involves an inherent one-sidedness, or perhaps, to use the Nietzschean notion, “perspective”. That is, any given phenomenon can in fact be grasped from any one of a number of value points of view, and the number of these is in theory inexhaustible because individuals inevitably have differing values. Further, there is no scientific or objective ground upon which one perspective can be said to be superior or preferred over any other. Weber “solved” this problem that threatened to render all scientific endeavour subjective and relativistic by developing Rickert’s notion of “Wertbeziehung” or “value relevance”. The value relevance of a phenomenon under consideration enables a selection of features to be made from the manifold of possible aspects that imposes limits on the dimensions to be
conceptualised. It follows from these presuppositions that when Weber formulated his concepts, whether of capitalism, Protestantism, the entrepreneur or whatever, he highlighted certain aspects that he believed to be of significance from value points of view that were common or that he believed were widely shared. He rejected the idea that such value points of view could be “objectively” given, but he nonetheless maintained that some value perspectives resonate widely among one’s contemporaries and will be significant for fellow researchers; and in some cases the values in question may have broader, cross cultural and even “universal significance”. Thus, for example, aspects of modern culture, especially its law, science and technology, Weber believed, possessed universal significance. Expressed in other words, this means a person from any culture given the chance might find modern law or modern science meaningful for them too.\textsuperscript{11}

Because Weber did not believe it was necessary to consider these various value points of view as having an objective basis, when he comes to formulate concepts for understanding the origin of capitalism he proceeds to construct what he terms “genetic ideal types”. These are concepts that are capable of showing the causal connections between the phenomena to be explained and those considered antecedent causes. Hence, in his classic formulation of the Protestant Ethic thesis Weber isolates certain aspects of ethically conditioned conduct associated with the religious idea of the “calling” and a disciplined attitude to work in the world and relates these to the rationalisation of labour necessary for the operation of modern capitalist enterprise. This is historical method par excellence from Weber’s point of view.

But a question arises as to the relationship between these methodological theses deriving from Weber’s early period and his later work, particularly Economy and Society and the General Economic History.\textsuperscript{12} Did Weber continue to operate with exactly the same method as that set out in those earlier writings? For example, are the final sections of the General Economic History where he provides an account of the origins of the capitalist economic system consistent with the earlier perspectives? This problem has been raised by Stephen Turner. In referring to Weber’s General Economic History Turner says in that work,

Weber reiterated what can be found scattered throughout his later writings on the ‘distinguishing characteristics of western capitalism and its causes’ by listing explanatory factors, including rational law, the rational organisation of labour, rational technology, rational accounting, free labour, the use of stock shares, the rational spirit, and a rationalistic economic ethic. The status of these lists is left vague: ‘distinguishing characteristics’ and ‘causes’ are never distinguished. The rational organisation of labour is at one moment produced by western capitalism, at another its primary

\textsuperscript{11} The concept of value relevance is discussed with considerable acumen by Hans Bruun in his Science, Values and Politics in Max Weber’s Methodology, Ashgate, 2007, passim.

\textsuperscript{12} Several commentators have considered the issue of such a discrepancy. For example, Thomas Burger in his Max Weber’s Theory of Concept Formation: History, Laws, and Ideal Types, Duke, 1976, passim.
cause, at another its distinctive feature. This ambiguity makes it difficult to
treat the lists as explanations at all and it creates a puzzle about Weber’s
intent in producing them.\textsuperscript{13}

In discussing these lists Turner goes on to say:

In themselves they are uncharacteristically schematic and mechanical,
vague as to the causal mechanisms by which the effects are produced, and
lacking a framework of logic that would give sense to a notion of them as
causes. As explanations, they appear to conflict with Weber’s opinion on
method; to the extent that they weigh factors, they conflict with the
discussion of objective possibility in the early writings.\textsuperscript{14}

Below we shall consider these types of criticisms further. For the present we
shall merely note that not all commentators see a problem here.

In a completely different vein the sociologist Randall Collins has taken
Weber’s contributions as forming the basis of a comprehensive causal
explanation of the origin of modern capitalism. Collins does not see any
particular methodological difficulties in reconstructing Weber’s work on the
assumption that it contains more or less all the basic elements for an adequate
causal account of modern capitalism. Indeed, he believes that Weber’s work
still constitutes the most sophisticated and most convincing account of the
causes of modern capitalism available. He does not discuss the issue of the
methodological framework implied in the construction of genetic ideal types
and is content to discuss the various factors that gave rise to capitalism as a
series of elements that constitute a causal chain. Each element can be placed in
a sequence of causes and be shown to have either been the cause of a later
development or to have itself been caused by previous developments. Some
causal sequences can be traced to elements that go back to the earliest period of
antiquity and even before to factors found in primitive/tribal societies.

Somewhat provocatively, Collins argues that Weber increasingly reduced
the significance of Protestantism as his account of capitalism focussed more and
more on various institutional structures which were seen to be crucial. Thus, as
we shall see, Collins highlights phenomena such as rational law, citizenship,
rational science and technology, bureaucracy, the state and the
commercialisation of life as the key elements which led to the advent of
capitalism, but these phenomena had little if anything to do with Protestantism.
Collins seems to have no difficulty in accepting the influence of various factors
or preconditions and is not concerned as to whether or not these are consistent
with the fundamental methodological prescriptions Weber had set out in his
methodological essays. Collins’s assessment of the causal significance of
Protestantism in Weber’s final version of the origins of capitalism is set out as
follows:

But in the mature Weber, the thesis is greatly transformed. Protestantism is
only the last intensification of one of the chains of factors leading to
rational capitalism. Moreover, its effect is now conceived to be largely

\textsuperscript{13} Stephen Turner, “Explaining Capitalism: Weber on and against Marx” in R.
Antonio and R. Glassman (eds.), \textit{A Weber-Marx Dialogue}, University Press of
Kansas, 1985, p. 176.

\textsuperscript{14} \textit{Ibid}, pp. 179-80.
negative, in the sense that it removes one of the last institutional obstacles diverting the motivational impetus of Christianity away from economic rationalisation. For, in medieval Christianity, the methodological, disciplined organisation of life was epitomised by the monastic communities. Although the monasteries contributed to economic development by rationalising agriculture and promoting their own industries, Weber generally saw them as obstacles to the full capitalist development of the secular economy. As long as the strongest religious motivation is siphoned off for essentially other worldly ends, capitalism could not take off. Hence, the Reformation was most significant because it abolished the monasteries. The most advanced section of the economy would, henceforth be secular. Moreover, the highest ethics of religious life could no longer be confined to monks but had to apply to ordinary citizens living in the world. Calvinism and the other voluntary sects were the most intense version of this motivation, not because of the idea of predestination (which no longer receives any mention in Weber’s last text) but only because they required a specific religious calling for admission into their ranks, rather than an automatic and compulsory membership in the politically more conservative churches.  

Contrary to the thesis of Friedrich Tenbruk, that there is an overall developmental direction at work underlying Weber’s account of capitalism, Collins argues that for Weber there is no underlying trend towards ever increasing rationality. Nor does he posit an evolutionary model in the sense of a process of selecting more advanced forms that might be said to accumulate through a series of stages. As Collins puts it, "For Weber’s constant theme is that the pattern of relations among the various factors is crucial in determining their effect upon economic rationalisation. Any one factor occurring by itself tends to have the opposite effects, overall, to those which it has in combination with the other factors". In summary, Collins argues that, “Weber saw the rise of large scale capitalism, then as a result of a series of combinations of conditions which had to occur together. This makes world history look like the result of configurations of events so rare as to appear accidental." Paradoxically, Collins concludes: “Weber’s account of the rise of capitalism, then, is in a sense not a theory at all, in that it is not a set of universal generalisations about economic change.” It is critical in Weber’s theory that no one element dominates. Each element is dependent upon individuals asserting themselves in a struggle against each other. The open market depends on a continuous balance of power. The formal equality of the law depends upon competition between citizens. And a non-dualistic economic ethic of

17 Collins (1986), p. 34. Weber occasionally uses the term “concatenation” of factors to explain his approach to dealing with causal complexity.
18 Ibid, p. 35.
19 Ibid.
tempered acquisitiveness requires compromise between the claims of in-group charity and the exploitation of those outside the group. The open market is a situation of continuous strife and struggle, which is similar to the Marxian notion of ‘the chaos of the market’. Collins quotes the following section of *Economy and Society* where this idea of struggle is emphasized forcefully:

> The formal rationality of money calculation is dependent on certain quite specific substantive conditions. Those which are of particular sociological importance for the present purposes are the following: (1) market struggle of economic units which are at least relatively autonomous. Money prices are the product of conflicts of interest and of compromises: they thus a result from power constellations. Money is not a mere ‘voucher for unspecified utilities,’ which could be altered at will without any fundamental effect on the character of the price system as a struggle of man against man. ‘Money’ is, rather, primarily a weapon in this struggle, and prices are expressions of the struggle: they are instruments of calculation only as estimated quantifications of relative chances in this struggle of interests’ . . . ²⁰

Below we shall consider these perspectives on Weber at length. For the present I shall merely indicate that I do not accept Collins’s view that Weber abandoned the strong version of the Protestant Ethic thesis in his last writings. In this I am largely in accord with the commentary of Wolfgang Schluchter, to whose work I shall now turn.

### Wolfgang Schluchter’s Interpretation of Weber’s Oeuvre

One of the most sophisticated, and in my view most satisfactory, overall accounts of both Weber’s methodological approach and his theory of the emergence of modern capitalism is that provided by Wolfgang Schluchter. Schluchter has written extensively on Weber and is one of his most informed interpreters. In what follows I shall refer in particular to his last account of Weber’s thesis on capitalist origins, which is contained in Chapter Four of his book *Paradoxes of Modernity*.

Schluchter argues that Weber’s approach has both a genetic and simultaneously a comparative aspect, and he coins the expression ‘developmental-historical perspective’ as a way of characterising Weber’s method. Schluchter locates the beginnings of a genetic explanation of the development of modern capitalism in one of the early works of Weber. He refers to Weber’s work on *The History of Commercial Partnerships in the Middle Ages* which sought to show how medieval legal conditions brought about the legal separation between the private and the business sphere. This occurred even though in the medieval world a corporation, and in particular the limited liability corporation, did not yet exist. Yet in medieval partnership the idea that the private activities of the household should be kept separate from business activities and the operations of commercial firms was first established. It was partly upon this basis that Protestantism then began to work out the

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²⁰ *Ibid*, p. 36.
ethical dimensions whereby business profit was viewed as a special form of wealth that had to be subject to restraint.

Schluchter points out that, as Weber’s thinking matured, he went beyond merely accounting for the genesis of certain aspects of capitalism in the West and developed a comprehensive, comparative analysis of socio-economic phenomena directed at showing how in non-western societies conditions were such as to inhibit or to retard the possibility of modern/western forms of society and economy. Thus Weber’s thesis about capitalism became partly an analysis of the singularity of western cultural development in the context of universal history. Schluchter argues that the more Weber developed his comparative studies the more he realised that there was something distinct about the West that required a more intensive investigation. He traces Weber’s work plans in his later years up until his death in 1920 and concludes these indicate he intended to write further studies of the western cultural complex. In particular, Weber had planned to write a detailed study of Western Christianity in its entirety. This would have included studies of Early Christianity, Talmudic Judaism and Eastern Christianity. The essay which Weber eventually published as the Introduction to his Collected Essays in the Sociology of Religion, that is, the so-called Author’s Introduction, makes it clear, according to Schluchter, that Weber now sought to focus his attention on the singularity of western development as a whole. And the project was to include analyses of political domination, law, science and art as well as religion. Whereas the analyses of China and India were important as a way of finding points of comparison, the study of Israelite and Jewish religion was relevant because it constituted the beginning of occidental cultural development. Weber had even intended to expand his studies of occidental culture to include a short depiction of Egyptian, Mesopotamian and Zoroastrian religious ethics.21

According to Schluchter, “a shift had to be made from a comparative perspective that emphasises the contrast between the Asiatic and Mediterranean-occidental world to a developmental perspective that focuses on the continuities within the Mediterranean-occidental world. . . . Questions of historical preconditions and causal attribution now move to the fore.”22 Although Weber expressly emphasised divergences between say Antiquity and the Middle Ages, he also spoke of continuities of Mediterranean-European cultural development. Of course, Weber reject utterly the idea of a one-directional linear course of development.23 Thus, in his study of Ancient

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23 Schluchter argues that Weber, despite some methodological reservations about the use of such terms as epoch, phase or stage, nonetheless avails himself of such conceptual devices on the assumption they are insulated from any Hegelian resonances. As Weber puts it on one occasion, “If we construct a ‘cultural stage’, this mental construct solely means, in terms of the judgements it implies, that the individual phenomena that we summarise conceptually by means of it are ‘adequate’ to one another, possessing—one would say—a certain degree of intrinsic affinity, with one another. It never entails, however, that they follow from one another according to any kind of lawfulness” (Cited in ibid, p.193).
Judaism Weber had begun by noting that without the Old Testament and adherence to it of the Pauline mission there would never have been a universalistic Christian church nor the Christian ethics of the everyday world. These were of world historical significance and Weber says they represent a turning point for the whole development of the West. These ideas are put very succinctly in a quote from Weber’s essay on *The Religion of India* where he says “The elimination of all ritual barriers of birth for the community of the Eucharists as realised in Antioch, was also, in terms of its religious preconditions, the hour of conception for the ‘Occidental Citizenry’, even if the latter was first to be born more than a thousand years later in the revolutionary ‘coniuratio’ of medieval cities.”

Schluchter tells us that at the time in 1919 when Weber was discussing with his publisher the structure of his collected works on religion and had the opportunity to revise his studies on Protestantism, he neither enlarged the scope of the work nor altered his original thesis. Contrary to the suggestion of Randall Collins that Weber in his later writings downplayed the significance of Protestantism and the Protestant Ethic, Schluchter argues nothing could be further from the truth. Indeed, he says Weber in fact gave further accounts of his original thesis in the revised version being prepared for publication in 1919. Even though he anticipated a study of Western Christianity to become the basis of a projected Volume Four of the *Collected Essays in the Sociology of Religion*, Schluchter says this would not have changed any part of the original Protestant Ethic thesis. The exact opposite would have occurred because Weber would have more clearly defined his argument by expanding the intra-Christian scope of comparison and by integrating Judaism and Islam into the analysis. The volume on Western Christianity would have included a more extensive discussion of the western cultural development as a whole and would have included analyses of Christian salvation movements, western territorial and urban associations, western sacred and profane law, western science and technology, western organisational forms in trade and industry, western banking and exchanges, as well as analyses of the hierocratic and political powers. Weber would thus have delivered on his projected course of study as set out in the concluding remarks in the original *Protestant Ethic* essays, developing the other, materialist side of the causal chain so to speak. In this connection Schluchter says special attention would have been given to the development of the city and the rise of the western bourgeoisie.

On the basis of these preliminary considerations Schluchter proceeds to reconstruct Weber’s explanatory model of the development of the modern West. He begins by emphasising a feature of Weber’s analysis of the origin of capitalism that is often overlooked but is made clear in his discussion in the so-called ‘Anti-critiques’. In those writings and elsewhere Weber distinguishes between the spirit of capitalism and capitalism as an economic system. As to

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24 Cited in *ibid*, p. 179.
the economic system, Weber sometimes refers to its organization or its organisational form. So the term “capitalism” sometimes stands for a certain spirit and at the same time it can stand for a certain form and these can be understood in two conceptually different ways. Schluchter says one can conceive of capitalism either as an ideal type of a general character or with an individual character. If one conceives of it as a general character, one extracts from the idea of capitalism certain features that are accentuated and brought to a conceptual purity. Thus, for example, if one contrasts capitalist economy with household economy, one stresses the element of profitability, the exploitation of peaceful opportunities for exchange in the market and capital accounting. However, if one considers capitalism in terms of its individual character, one would emphasise the specific character of capitalism as it emerged in the West, and here of course one might emphasise the role of worldly asceticism and the way in which the capitalist spirit shaped the institutional structure of capitalistic profit-making giving rise to the business enterprise based on the rational organization of formally free labour. Schluchter explains the relationship between spirit and form this way:

... different degrees of elective affinity can exist between them. The spirit can, as Weber expressly puts it, be more or less (or not at all) ‘adequate’ to the form. This is the case because neither do they necessarily share a common origin, nor is one necessarily derivable from the other. Any position that makes either of these two claims is to be considered reductionist. The respective transformations of institutions and mentalities, the revolutions from without and from within, are rarely synchronised in historical realities.

Schluchter says that these two aspects of analysis are reflected in various phases in Weber’s work on the origin of capitalism. In early works such as The Agrarian Sociology of Ancient Civilizations Weber had sought to explore the capitalism of antiquity as an economic system, whereas the studies of Protestantism were to cover the issue of the spirit of modern capitalism. Thus the studies of Protestantism were focussed on the mentality and motivation underlying the modern capitalist spirit and the purpose was to trace the origin of this spirit back to the period of the Reformation. The period just following the Reformation, the seventeenth century, is crucial because it brought about the transformation from within, that is, of mentality and motivation. It thus created one of the key preconditions for the advent of the modern capitalist spirit, though it was not the only source of that spirit. But it did provide a pattern for that spirit which was “specifically different from that of the Middle Ages and Antiquity.”

Weber’s Early Work on Modern Capitalism

In the discussions below I shall explore the complexities of Weber’s theory of capitalism. Nonetheless, I shall argue Weber’s approach has certain limitations from our point of view because he does not create a complete theory in the manner say of the discipline of economics. That is, even though Weber undoubtedly was keenly

28 Weber cited in ibid, p. 192.
aware of developments in the emerging science of economics, and recognized that it was producing important new explanatory schemata, apart perhaps from his early work on the stock exchange, he does not make direct reference to this body of theory. For he had begun to develop somewhat different concerns, and I believe he in effect largely accepted the state of knowledge already achieved in the economics of his day, especially, the contributions of the so-called Austrian School. To a degree it could be said that he left the tasks of economic theory proper to other figures, possibly those like Schumpeter, whom he regarded as more expert than himself. Hence, it cannot be said that Weber was attempting to produce a theory of capitalism in the same vein as, say, Marx, who conceived his main contribution as being essentially a “critique of political economy”. Weber makes little or no attempt to offer theorems that account for crucial economic phenomena such as the formation of prices, the functioning of the market, supply and demand, the phenomenon of monopolization, or the origins of economic crises—as, for example did classic economists like Smith, Mill, Ricardo, Menger and others. Nor does Weber set out to discover the underlying “logic” or developmental tendencies of the capitalist era, in the style of Hegel, Spengler or Marx. Rather, as I have said, Weber to a large degree takes for granted the theoretical achievements of the leading figures of modern economics, especially those of the Austrian School, and instead of criticizing their results is concerned to provide a complementary framework focused on the socio-political conditions for the existence of the capitalist world.

It is reasonable to say that broadly speaking Weber’s work in relation to capitalism is concerned with two fundamental issues that are interrelated. One is to account for the origins of modern capitalism. The second, related question is to characterise the nature of modern capitalism, to draw out its most significant cultural features, to analyse their uniqueness and to analyse their conditions of existence. This second concern is focussed on the rationality of capitalist institutions and in particular the feature of rational calculation in business operations. In this connection Weber emphasised the role of capital accounting and the orientation of the business enterprise toward the market situation and rational estimations of prospective profits. But importantly, from our point of view, Weber did not devote energy to analysing the way in which capitalism functions as a system once it has come into being. Evidently he assumes that this theoretical work has been done, or is being done, to a large extent by the modern economic discipline with its explanations of the price mechanism, the relations of supply and demand and so forth. Nonetheless, in the course of his work Weber occasionally makes remarks about the functioning of the capitalist system once it has emerged. He refers to it resting today on “mechanical foundations”, and argues that present-day capitalism no longer requires the asceticism of the early Puritans in order to maintain its ongoing functionality—but takes this no further.29

Discussion of the contribution of Weber to the understanding of capitalism, as we have already indicated, has commonly focused on, and unfortunately often gone no further than, the celebrated work The Protestant Ethic and the Spirit of Capitalism. However, this book is only one of a number of Weber’s writings that address the origins of modern capitalism and by no means does it exhaust his

thinking on the subject. Indeed, it could well be said that capitalism and its origins are a reference point, and are regularly in the foreground, throughout most of his contributions to socio/historical thought. Thus, not only is capitalism discussed at considerable length in his masterwork *Economy and Society*, but Weber also alludes to it frequently in many of his other writings, including those that deal primarily with religion. Undoubtedly the most significant work apart from *The Protestant Ethic and the Spirit of Capitalism* that deals directly with capitalism is the posthumously published set of lectures given by Weber in 1919-20 and known in English under the title *General Economic History*. This is an important work for many reasons but especially insofar as it is a corrective to the misguided impression many critics have had that Weber wished to substitute an entirely “ideological” or “idealist” theory of the origins of capitalism for a so-called “materialist” approach like that of the Marx and other economic determinists. In any event, as we shall see, a perusal of Weber’s writings such as *Economy and Society* shows that, not only was he not an “idealist” as some have claimed but he clearly was highly concerned also with “materialistic” factors. Further, he could be said to have added significantly to both idealist and materialist approaches by explaining how aspects of legal, political, geographic and urban features were crucial to the advent and development of modern capitalism.31

Weber’s general approach on these matters is clarified in the various “Replies to His Critics” (i.e., Karl Fischer and Felix Rachfahl) written in response to their criticisms of his Protestant Ethic essays of 1904-5, and it is to these writings we shall briefly refer. At one point in his Second Reply to Karl Fischer written in answer to the claim that he (Weber) has provided, or is concerned to provide, an idealist interpretation of capitalism as against the approach of Sombart, Weber says, on the contrary,

it is precisely this part of Sombart’s account—his discourse on the significance of “calculativeness” (*Rechenhaftigkeit*) and the techniques it involves—that is relatively the least disputed and as far as Sombart’s central question of whence arose the modern economic importance of capitalist industrial and commercial forms, I consider his account completely correct in all crucial respects. To be sure, fully developed manual work brings with it a certain degree of “rationalisation” of economic activity, and ancient forms of capitalist enterprise dating back to the most distant millennia known to us likewise produced “calculativeness” to a certain degree. But we can leave for discussion elsewhere the question of why “calculativeness” in the capitalist economic forms of antiquity remain so far below the level of development reached by early modern forms, despite being at times quite colossal in quantitative terms. This was so

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30 It is important to emphasize that in recognizing the role of materialist factors Weber is equally concerned to avoid the opposite error of reducing religious phenomena to a mere reflex of the former. See for instance the very clear statement in this regard in his essay


31 Weber’s most elaborate methodological discussion of the issue of materialist versus idealist approaches in history is the discussion in his *Critique of Stammler*, *Free Press*, 1977, especially the section “Stammler’s Account of Historical Materialism” at pp. 62-70.
much so that Sombart is right to speak of capitalism as an economic stage only in modern times, and to distinguish this from individual capitalistic enterprises—which have been known to exist for 4000 years. It goes without saying that for his own central question Sombart considers technical “calculativeness” the decisive characteristic of the spirit of capitalism. . . . We have both been concerned with the same phenomena, but from different angles and with myself necessarily focussing on different features. So it is a matter of terminological differences, not substantive disagreements, at least not on my side. Indeed, as far as I can see, we are entirely at one in our attitude to historical materialism. 32

In other words, Weber is claiming to have addressed only one aspect of the question of the character of early capitalism in The Protestant Ethic, and he is openly endorsing Sombart’s more general account of the nature of capitalism as being equally valid and perfectly compatible with his own thesis. 33 The question arises, then, as the relation of Weber’s account of the origins of capitalism to the question of how capitalism functions once it has become established. At various times, Weber suggests that modern capitalism after it has come into being takes on a somewhat different colour. For example, in The Protestant Ethic he refers at one point to the ethos or spirit of modern capitalism as totally lacking its original Puritan pathos such that the pursuit of wealth today tends to have the character merely of ‘sport’. 34 Weber even speculates that the ascetic basis of early modern capitalism is undone by a counter tendency set in motion by the effects of asceticism itself. This is because the wealth created by asceticism produces temptations for indulgence and pleasurable consumption. As he puts it in his Second Reply to Rachfahl,

. . . precisely that type of amassing of wealth which was conditioned by specifically “ascetic” conduct of life was what again and again tended to break the power of asceticism—as the recurrent monastic “Reformations” of the Middle Ages show . . . and as the Puritans, Quakers, Baptists, Mennonites and Pietists well knew from their own all-to-understandable experiences. It would become even rarer for the self-made man—and certainly for his sons and grandsons—spontaneously to resist the “temptations” of living for the “world” (i.e. for the pleasurable consumption of acquired goods)—rarer even for the enriched monasteries of the Middle Ages. In fact one of the achievements of ascetic Protestantism was that it combated this tendency, that it steadily opposed such tendencies to “idolatry of the flesh” as the securing of “splendor familiae” through the tying up of one’s fortune in real estate as rentier income, along with the “seigneurial” pleasures of the “high life,” intoxication with beauty and aesthetic enjoyment, excess, pomp and circumstance. And it is these tendencies, so anathema to ascetic Protestantism, which continually evoked the danger of “capitalist tranquillisation” based on the use of assets for purposes other than “active capital” and which thus worked against the capitalist “spirit” (in every sense one can connect with this term). For whenever we find them in big

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33 It has to be said that these remarks give a somewhat misleading view of Weber’s appreciation of Sombart’s work, for he is elsewhere highly critical.
34 PE, p. 182.
entrepreneurs, each one of these traits hinders the capitalist’s full development
and undermines “capitalist accumulation.”

It is not difficult to see in these remarks an anticipation of the thesis of
commentators such as Daniel Bell regarding the fate of the work ethic in advanced
capitalism. Weber is obviously registering the fact that to the extent that
individuals no longer pursue purely economic goals and cease to conduct themselves
in an ascetic fashion they are not full-fledged capitalists in the requisite sense. This
is an area I believe the work of Weber and Schumpeter offer opportunities for
synthetic integration. While Schumpeter as an economist of contemporary
capitalism is primarily concerned with developments in the new domains of
economics, Weber wants to provide the broader context for the advent of modern
capitalism and to explore its cultural implications.

Since the publication of various works dealing with Weber’s early period before
his illness, in particular Lawrence Scalf’s work on Weber’s early writings, and the
republication and English translation of some of Weber’s early writings such as his
Zur Geschichte Der Handelsgesellschaften im Mittelalter (The History of
Commercial Partnerships in the Middle Ages) and his Die Römische
Agrargeschichte in Ihrer Bedeutung für das Staats- und Privatrecht (Roman
Agrarian History: The Political Economy of Ancient Rome), it has become apparent
that Weber had from very early in his scholarly career begun to consider the whole
question of the origins and nature of modern capitalism. Study of these works shows
that many of Weber’s later concerns have their origins and genesis in studies he
undertook at this very early stage in his career.

The History of Commercial Partnerships in the Middle Ages

I have already referred to Weber’s work on the stock exchange and his early interest
in economic theory. It is not well known, however, that Weber wrote for his doctoral
thesis on medieval economic history in which he raised a number of concerns that
are absolutely central to his understanding of modern capitalism and to the question
of its origins. Actually, Weber’s dissertation formed only a part of the book that is
now available in English because he added important sections to his original
dissertation published as a pamphlet. This later version became the book that has the
German title Zur Geschichte Der Handelsgesellschaften im Mittelalter and was
published in October 1898.

The History of Commercial Partnerships in the Middle Ages is interesting
because it raises questions as to the specific character of capitalism in the medieval
period and as to whether this capitalism was the same type as modern capitalism.
Further, it addresses the issue of what if any were the causal connections between the

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36 I refer in particular to Bell’s The Cultural Contradictions of Capitalism, Basic
37 See the excellent Introduction by Lutz Kaebler to The History of Commercial
Partnerships in the Middle Ages, Rowman & Littlefileld, 2003, especially at pp. 36-38.
capitalism that had emerged in the Middle Ages and subsequent developments. Weber is particularly interested in the legal structures that are evidence for certain economic practices and that facilitated those practices. The work is focused on the development of commercial partnerships, and it is obvious from the context of his discussion that he sees these as being of theoretical interest primarily because such commercial arrangements could be regarded as precursors to a form of economic enterprise that later emerges, namely, the corporation. Weber wants to know whether there is a possible course of development between such partnerships as existed in the medieval period and the economic structures that emerged later in the form of the industrial firm oriented to profit.

Weber takes as his starting point the development of the economic enterprise connected with sea trade known as the commenda but is at pains to distinguish its mediaeval forms from those of antiquity. And throughout his discussion of the commenda and mediaeval partnership law it is apparent that Weber is concerned to draw comparisons with the limited liability corporation of the modern era. In the case of the latter type of enterprise one finds a fund of capital reserved and deployed exclusively for the operation of the business at hand. Such businesses are in continuous operation and liability is restricted to the capital fund referred to along with the assets deployed in the enterprise. Weber is acutely aware that these corporate-like structures have not been common throughout history, but approximations towards such arrangements may well have occurred previous to the modern era and in fact occurred during the period of the Middle Ages.

In his discussion of the commenda Weber assumes that the most primitive condition of maritime trade is that in which a ship owner (or patronus navis) provides the ships, purchases goods from a producer and sells them in a foreign market by accompanying the goods in person on these ships. In this way the shipowner already acts in the role of a merchant and possibly shares the proceeds of the sale with the producer. But from early in the medieval period, a division of labour had developed so that the grand merchant typically sent a fattore, who was an employee, on the voyage instead of going himself. Other possibilities were that a commission agent was employed who had knowledge of the foreign markets and received a commission or fixed remuneration for his services or possibly a share of the profits. Where there was a share in the profits Webers says we have the commenda in the strict sense.

The simplest form of commenda, referred to as the unilateral commenda, occurs where the managing partner invests no capital of his own, the risk of loss being entirely on the other partner. This type of partnership Weber says does not correspond to the limited partnership of modern German law where one partner invests money but does not participate in the venture otherwise. It is rather a form of agency. More significant for Weber is the societas maris or bilateral commenda. Here both parties contribute capital but are not always equals. Owing to the different contributions, the arrangement necessarily requires some form of accounting to keep track of the contributions and the proportions of profits that will be distributed at the end of the venture. However, Weber says, at least for the case of Genoa, there are only the beginnings of a separate fund that could be treated as such for the partnership’s relations with third party creditors. In these early forms of commenda the personal liability of the partners is unlimited. In the later part of his work,
however, in a detailed case study of Pisa Weber is able to show that the city’s commercial stipulations show the existence of a separate fund as well as business undertaken in the name of a firm. Nonetheless, there is no solidary liability among all partners, as the liability of each *socius* is limited to his contribution. This is akin to the modern form of limited partnership.

What particularly interests Weber is the case of a partnership where there is solidary liability and the operation of the business on the basis of a separate fund. He focuses on the legal status of the family household and contrasts the medieval situation with that of the Romans. In medieval law all members of the household could lay claim to the household’s assets. The household is a community of production as well as consumption. Weber emphasises that kinship is not the foundation of the household but rather it is joint residence and acquisitive activities. The relations of the household thus go beyond the immediate kin and this gives rise to a need to formalise relations between all those who are members. This is especially the case when commercial acquisition is the basic activity of the household, because some income or expenses belong to the entity as a whole while others are merely personal. Thus, there must be some form of “accounting” and this need contributes to the general trend towards formal sociation. Sociation becomes in effect a contract that binds the parties. Weber says, “the family household . . . found it necessary, if it also intended to be the basis for a commercial enterprise, to set up its bookkeeping system and to represent itself toward third parties—in short: to cover all aspects relevant to the law of property—the same way a commercial company did. Thus in both cases the legally relevant aspects coincide.”

The distinction between the business assets of the household and personal assets facilitates treating the business assets as a separate fund, and this raises the issue of the extent to which liability for debts incurred by the association extend to those assets and whether members are jointly or merely individually liable. Finally, Weber discusses the situation in Florence where he finds that the concept of the firm and of a separate fund representing the joint equity of the partners is well established. Here are the beginnings of modern general partnership.

The question arises as to how these deliberations of Weber relate to his later writings on the origins of modern capitalism. In what follows, I shall give an account both of the “Author’s Introduction” and *The General Economic History* to indicate the nature of Weber's final theory of capitalism. But first we shall briefly consider the nature of the argument of *The Protestant Ethic and the Spirit of Capitalism*.

**The Thesis of *The Protestant Ethic and the Spirit of Capitalism***

According to Gordon Marshall, with whose excellent commentary we generally agree, Weber actually produced two complementary arguments in *The Protestant Ethic and the Spirit of Capitalism*. The first is an argument as to the origins of what could be said to be the capitalist ethos. Weber argues that the neo-Calvinist ethic of the seventeenth century was crucial to the development of a capitalist spirit or ethos. However, Weber also developed in response to his critics a further argument as to

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the role of the capitalist spirit in the advent of the capitalist economic system as such. Obviously, this second argument required Weber to relate the capitalist spirit to the range of other factors that are implicated in the rise of capitalism.

Marshall begins his discussion by insisting that the object of Weber’s study in the Protestant Ethic essays is to make an investigation into the origins of the spirit of modern capitalism. He refers to Weber’s citing of Franklin’s famous text offering advice to those who seek wealth with this famous admonition—not to waste time, for to do so is to lose money, to cultivate an ability to raise credit and put it to good use, not to misuse money which would be to lose a potential fortune, to punctually repay loans, to be vigilant in the maintenance of accounts, and to be frugal in consumption. This set of attitudes is prototypical for Weber of the spirit of capitalism. The question then becomes how did it come into being. For Weber is insistent that such dispositions are not natural, and certainly do not occur universally, nor are they typical in societies prior to the seventeenth century when Protestantism emerged. Weber says that in order for a manner of life such as that implied by Franklin, so well adapted to the peculiarities of capitalism, to be selected and come to dominate others, it had to originate somewhere and it had to be spread as a way of life common to whole groups of men. It is the origin of this way of life that Weber seeks to explain.39

The problem is therefore not to explain the pursuit of profit per se, nor to explain why greed and the pursuit of unlimited gain appear and are of cultural significance. Such attitudes are found widely distributed throughout history both in the medieval and ancient periods, not to mention non-Western societies, but they are not Weber’s concern. His problem is to explain the origins of the historically peculiar form of the pursuit of gain typical of modern capitalism. The latter is characterised by the pursuit of profit and ever renewed profit by the means of continuous rational enterprise in close association with disciplined restraints on personal consumption. For, “the capitalism of to-day, which has come to dominate economic life, educates and selects the economic subjects it needs through a process of economic survival of the fittest. . . . In order that a manner of life so well adapted to the peculiarities of capitalism should come to dominate others, it had to originate somewhere, and not in isolated individuals, but as a way of life common to whole groups of men.”40

The nature of the personality that was required to underpin the new capitalist era is set out in the following passage, which we shall see bears remarkable closeness to the corresponding analysis of Schumpeter:

A flood of mistrust, sometimes hatred, above all moral indignation, regularly opposed itself to the first innovator. . . . It is very easy not to recognize that only an unusually strong character could save an entrepreneur of this new type from the loss of his temperate self-control and from moral and economic shipwreck. Furthermore, along with clarity of vision and ability to act, it is only by virtue of a very definite and highly developed ethical qualities that it has been possible for him to command the absolutely indispensable confidence of customers and workmen. Nothing else could have given him the strength to overcome the innumerable obstacles, above all the infinitely more intensive work which is

40 PE, p. 55.
demanded of the modern entrepreneur. . . . they were men who had grown up in
the hard school of life, above all temperate and reliable, shrewd and completely
devoted to their business, with strictly bourgeois opinions and principles.  

As is well known, Weber concentrates his argument first on the concept of the
“calling” and traces its emergence from Luther through Calvin and finally to the
ascetic Protestantism of the Puritans, Pietists, Methodists and Baptists. All of these
religious movements placed specific demands on their believers to act diligently in
their worldly callings (or “vocations”), to practice strict asceticism in the way they
consume material goods, and to resist the temptations of worldly pleasure. In
different ways they placed strong psychological sanctions on the individual to adhere
to a range of ethical standards that enjoined them to value worldly conduct but not to
indulge the fruits thereof. The critical point that Weber claims as his own novel
contribution is stated as follows:

the essential point is that an ethic based on religion places certain psychological
sanctions (not of an economical character) on the maintenance of the attitude
prescribed by it, sanctions which, so long as the religious belief remains alive,
are highly effective . . . Only in so far as these sanctions work, and, above all, in
the direction in which they work, which is often very different from the doctrine
of the theologians, does such an ethic gain an independent influence on the
conduct of life and thus on the economic order.  

According to Weber, this ethic originated in two sources: in the first place in the
document of predestination as this was developed by the neo-Calvinist religions, and
in the second place in the structure of the ascetic Protestant sects. In both cases there
was a necessity of proof, in the first case to prove oneself before God, in the second
before men. The major issue of empirical research for Weber concerns the
relationship between the ethos that he says was developed by ascetic Protestantism
and the form of the capitalist enterprise. As he explains,

To be sure the capitalist form of an enterprise and the spirit in which it was run
generally stayed in some sort of adequate relationship to each other, but not in
one of necessary interdependence . . . the two may well occur separately.
Benjamin Franklin was filled with the spirit of capitalism at a time when his
printing business did not differ in form from any handicraft enterprise . . . the
management for instance of a bank or wholesale export business, a large retail
establishment, or a large putting out enterprise dealing with goods produced in
homes, is certainly only possible in a form of a capitalist enterprise.
Nevertheless they may all be carried on in a traditionalistic spirit.  

Weber is well aware that the Fugger’s and North Italian merchant princes during the
Middle Ages were highly successful in business, but the important thing is that these
magnates were not the equivalent of modern capitalists. First, such individuals were
not systematically generated by the social system. They were idiosyncratic cases of
financial success that were not typical of the world in which they lived. And
secondly, they accumulated their wealth for purely selfish motives, greed and
avarice. Those who created the modern capitalist system, on the other hand,
acquired their wealth to a certain extent as a duty or an end in itself. As Weber puts
it, ‘The peculiarity of this philosophy of avarice appears to be the ideal of the honest

41 Ibid, p. 69.
43 Quoted in ibid, p. 17.
man of recognized credit, and above all the idea of a duty of the individual towards the increase of his capital, which is assumed as an end in itself. Truly what is here preached is not simply a means of making one’s way in the world, but a peculiar ethic.”

Now as we have seen, Weber’s initial thesis which focussed on the development of the spirit of capitalism led to attacks by Rachfahl, Fischer and others who accused him of advancing an unduly idealist interpretation of history. One can surmise that it was this state of the critical debate that led Weber to address the second issue, namely, what was the role of the spirit of capitalism in the development of the modern economy. That is, among the various factors that caused the emergence of the modern capitalist economy, how crucial was the role of the spirit of capitalism? Of course, Weber was not naive enough to assume that the mere existence of the “spirit” of capitalism was sufficient to conjure up the entire capitalist world. Nonetheless, he maintained that the spirit of capitalism, that is, the subjective motive complex denoted by this term, was causally significant in the development of modern capitalism: “[capitalist] enterprise has derived its most suitable motive force from the spirit of capitalism.”

Weber in part addresses the issue of the adequacy of the spirit of capitalism to capitalist enterprise in his exchange with Sombart over the question of what is unique about modern capitalism. In defining capitalism and its economic system as essentially bound up with its rationality and calculability, Weber brings the spirit of capitalism and the economic system of capitalism into close conceptual relation. Thus, he at various points refers to the spirit and form of capitalism developing an “adequacy” for each other. Elsewhere he employs the term “elective affinity”, adapted from Goethe’s novel of the same name, to indicate the nature of the relation. In the years between his early studies of the Protestant ethic and his later comparative studies in the Economic Ethics of the World’s Religions, Weber was able to explore in more detail his position concerning the role of the religion in the rise of capitalism in particular and western modernity in general. In his study of China, for example, Weber was concerned to point out that in many of the material conditions of that society the structural elements that might have led to a form of capitalism were just as favourable if not more so than in the West, yet capitalism did not appear. He attributes this in no small way to the specific belief systems of China, specifically Confucianism and Taoism, which encouraged attitudes to life that were entirely hostile to the form of capitalism that emerged in the West. Weber derived similar conclusions as to the import of ideological conditions for the prospect of rational capitalism in the cases of both India and the ancient world.

The Relation of The History of Commercial Partnerships in the Middle Ages to The Protestant Ethic and the Spirit of Capitalism

As we have seen, in The History of Commercial Partnerships in the Middle Ages Weber had suggested that certain precursors to the modern capitalist structure had developed in medieval Europe. In particular with the commenda a kind of

44 Quoted in ibid, p. 19.
45 Quoted in ibid, p. 23.
partnership superficially approximating the business firm had emerged in the form of the *societas maris* and this represented an achievement in two important respects. Firstly, there was the advantage that a special fund was established the purpose of which was to operate a business for profit, and secondly it had the benefit of being separate from the household budget. Following from this there were two particular consequences of note. One was the stimulus this arrangement gave to the advent of capital accounting and financial bookkeeping, the purpose being to keep track of business funds and to facilitate the distribution of profits at the end of each venture. The second advantage pertained to the credit worthiness of the operation, because by keeping the business assets separate from the household, creditors could be assured that there was a fund in place out of which debts would be paid in the event of failure. Associated with this were certain legal arrangements that gave rise to the notion that the partners in the *societas* were joint and severely liable and this was an advantage from the point of view of credit.

It is worth remarking how Weber emphasises these features at such an early stage in his thinking about the origins of capitalism. These reflections come from the late 1880’s and as such are considerations adopted some 10-14 years before *The Protestant Ethic*. The factors discussed are of an institutional nature and bare directly on economic phenomena, as against the largely religious/ideological focus of *The Protestant Ethic* thesis. Thus it is evident that from this early point in time Weber regarded institutional features as of central importance in explaining the origin of capitalism.

Now the question arises as to how the thesis of *The History of Commercial Partnerships in the Middle Ages* fits with Weber’s later account of the origins of the capitalism and in particular his remarks in *The Protestant Ethic*. It has first to be noted that *The History of Commercial Partnerships in the Middle Ages* is focussed almost exclusively on developments occurring in continental Europe. There are lengthy discussions of the situation as regards maritime trade and various legal structures in Spain, Sicily, Venice and Genoa. And there is a large section, comprised by entire chapters, on the situation as regards commercial partnerships in mediaeval Pisa and in Florence. But there is no discussion of England. So there is a question as to whether developments in continental Europe were preconditions, formative or influential in some way on developments in England, because in his later writings Weber clearly believes England and possibly New England America are the places in which capitalism of the modern type first evolved. But secondly, there is the related problem of why, given developments in accounting practice, law and economic enterprise went as far as they appear to have done in continental Europe, modern capitalism did not first develop there. As to the second problem, a full account of Weber’s position merits looking at his discussion of the socio-economic situation in Germany, in particular on the question of the economic “backwardness” of the “East”. A detailed discussion of the issues raised by Weber’s early study of “Developmental tendencies in the situation of East Elbian rural labours” is found in Lawrence Scaff’s several analyses of Weber’s early work, but we shall not comment further on this work for the moment as it raises numerous issues beyond the scope of our present concerns.46

In regard to *The History of Commercial Partnerships in the Middle Ages* it needs to be noted that, given its character as a doctoral thesis, it has more of the character of an exploratory work in which Weber does not attempt to arrive at firm conclusions as to the role of commercial partnerships in the advent of modern capitalism. Indeed, if there is any conclusion on this issue in the work, it is that, however advanced these partnerships were, they were not decisive for the development of the business firm in its fully modern form as typified by the modern corporation. In the course of his argument Weber does consider whether medieval partnership law could be said to constitute a precursor of modern partnership law as set out in the German Legal Code, and he points to some mixed and somewhat contradictory connections. But he at no point suggests a line of causation between developments in continental Europe in partnership law and the practice of partnerships and the advent of the modern business corporation as it emerged finally in the seventeenth century. So the question arises as to what is the precise relation in Weber’s view between these early continental developments discussed in the doctoral dissertation and the full flourishing of modern capitalism at its takeoff point in England as set out in *The Protestant Ethic*. Interestingly, Weber does not seem to have ever directly addressed this question and perhaps was not aware that there was a kind of disjunction between his early thesis on commercial partnerships and his later *Protestant Ethic* account.

Nonetheless, Weber does address this issue, albeit somewhat tangentially, in his *General Economic History* in an interesting section of Chapter XVII on Forms of Commercial Enterprise. There is no doubt that in this discussion Weber draws on work that dates from the time of his doctorate. He refers to the advent of bookkeeping and points to the role of the *abacus* and the decimal system that came from the Arabs. He refers to the early antipathy to the column system associated with Arabic numerals in Florence in the fifteenth century and points out that it was not immediately accepted. But genuine bookkeeping, he says, emerged in Italy for the first time in the late sixteenth century and grew up on the basis of trading companies. He refers to the role of the family as the oldest unit supporting a continuous trading activity, and then has a discussion of the *commenda* in which he outlines its characteristics in similar terms to those he had already explained at length in *The History of Commercial Partnerships in the Middle Ages*. Weber again makes a distinctions between southern Europe, where the *commenda* was of significance particularly sea trade, and the northern European situation, where the *socius* remained at home and entered into relations with numerous travelling *socii* with whom he invested his money. He points to the way in which the *commenda* organization gradually developed into a permanent enterprise, a feature he had not discussed at length in the earlier writings. He says accounting penetrated into the family circle due to the business connections with *tractators* who were business people outside the family, as an account was needed for each particular venture. He explains,

As late as the 16th century the Fuggers would indeed admit foreign capital into their affairs, but very reluctantly. . . . In contrast, the association of outsiders in family business spread in Italy with increasing rapidity. Originally there was no separation between the household and the business. Such a separation gradually became established on the basis of the medieval money accounting while, as we have seen, it remained unknown in India and China. In the great Florentine commercial families such as the Medici, household expenditures and capital
transactions were entered into the books indiscriminately; closing of the accounts was carried out first with reference to the outside commenda business while internally everything remained in “the family kettle” of the household community.\textsuperscript{47}

Weber then refers to the fact that the impetus for separation of the household and the business enterprise came from the need for credit. As long as such a separation did not occur, dealings were in cash only. But when transactions were conducted over long periods such as occurred with commenda trading, the problem of guaranteeing credit became more pressing. To provide security, various devices were employed, one of which was to secure the wealth of the family in all its manifestations as a way of demonstrating the credit worthiness of the borrowers. Associated with this was the idea of joint responsibility of all those who lived together in the household. Out of this situation arose the necessity for an agreed allocation of resources at the disposal of each individual for their personal use in contrast to what was the common fund for business purposes.

Weber says the situation in Italy was somewhat different to that in the north. The situation in Italy was affected in large measure by the fact of large households with numerous members, whereas in the north arrangements were made to have participants sign documents reflecting their association together. He concludes, “finally, the principle became established that each participant was responsible for every other, even if he had not signed the document. In England the same result was achieved by the common seal or the power of attorney. After the 13\textsuperscript{th} century in Italy and after the 14\textsuperscript{th} in the north joint responsibility of all the members of a company for the debts of the firm as such was fully established.”\textsuperscript{48}

Interestingly, as far as I know this is one of the few references Weber makes to the situation in England as regards the advent of the business firm and its separation from the household. And he says very little further on the situation in England in connection with these developments within the household.\textsuperscript{49} But he goes on to make the following general statement about these issues:
the final stage in the development established as the most effective means for securing credit standing, and the method which outlived all the rest, separation of the property of the trading company as such from the private wealth of the associates. This separation is found at the beginning of the 14\textsuperscript{th} century in Florence and towards the end of the same century in the north also. The step was unavoidable since to an increasing extent persons not members of the family belonged to the trading units: in addition it could not be avoided within the

\textsuperscript{48} \textit{Ibid}, p. 228.
\textsuperscript{49} At this point we note a recent work which traces the growth of financial capitalism in the early modern era is Larry Neal, \textit{The Rise of Financial Capitalism: International Capital Markets in the Age of Reason}, University of Cambridge, 1990. Neal’s book is interesting for its detailed account of the mutual influence of English and Dutch economic developments during the eighteenth century when the various East India and West India companies were promoted, and it indicates routes by which developments in Northern Europe, especially Amsterdam and Paris, influenced developments in London and vice versa.
family itself when the latter came repeatedly to employ outside capital. Expenses for the family on the one hand and personal expenses on the other were separated from business disbursements as specified money capital being allocated to the business. Out of the property of the firm, for which we find the designation *corpo della compagnia*, evolved the capital concept.\footnote{Ibid.}

Of course Weber takes for granted that the Industrial Revolution in England occurred in the context of north European economic growth generally and that the spread of Protestantism and business practices from Europe to England occurred through normal the cultural and economic intercourse. It is worth remarking that Weber recognized that Protestantism had to a degree established the capitalist spirit in “New England, German diaspora, southern France, Holland and England”, but not interestingly in Calvin’s Geneva.\footnote{Cited in J. M. Barbalet, *Weber, Passion and Profits: "The Protestant Ethic and the Spirit of Capitalism" in Context*. Cambridge University Press, 2008, p. 162.} But in Holland, which was closely associated with English developments, Weber says complex causes “were responsible for the relatively smaller extent to which the Calvinistic ethic penetrated practical life [in Holland]. The ascetic spirit began to weaken in Holland as early as the beginning of the seventeenth century . . . Moreover Dutch Puritanism had in general much less expansive power than English.”\footnote{PE, p. 273, n. 67.} This accounts for the eclipse of Dutch capitalism, which might otherwise have been the first capitalist nation. England also benefited from its island situation which insulated it from land wars and its late start in industrializing because it was able to borrow industrial technique from the continent such as cotton manufacture, which “was transferred from the continent to England in the seventeenth century.”\footnote{GEH, p. 303.}

The fact that Weber has not provided a continuous narrative of the course of history giving rise to the full flowering of modern capitalism is England should not in any event amount to a criticism because he is not attempting to achieve such a thing. As Fritz Ringer has explained in relation to the Protestant Ethic thesis, Weber is providing an ideal typical account of the key factors that are causally adequate to explain the outcome of modern capitalism. As he puts it in his study of Weber’s methodology, “… Weber never wrote anything like ‘narrative history,’ or any account of specific ‘events’ in the ordinary sense of the term. He was always primarily a (comparative) historian or historical sociologist of long-term structural change. . . . he tries to demonstrate how a set of historical conditions and human experiences gives rise to ‘tendencies’ that are then channelled into one or more particular paths by ancillary forces or intervening pressures.”\footnote{Fritz Ringer, *Max Weber’s Methodology: The Unification of the Cultural and Social Sciences*, Harvard University Press, 1997, p. 167.}

**The Definition of Capitalism: the “Author’s Introduction”**

Now as noted above, since writing his essays on Protestantism in 1904/5, Weber embarked on a series of extensive investigations of a comparative nature, in

\begin{itemize}
\item \footnote{Ibid.}
\item \footnote{PE, p. 273, n. 67.}
\item \footnote{GEH, p. 303.}
\item \footnote{Fritz Ringer, *Max Weber’s Methodology: The Unification of the Cultural and Social Sciences*, Harvard University Press, 1997, p. 167.}
\end{itemize}
particular looking into the religious and cultural conditions of the civilisation of China and India as well as into the history of ancient Judaism. Also during this period, which covers much of the second decade of the twentieth century up until his death in 1920, Weber was at work on his magnum opus *Economy and Society* and that involved very detailed comparative studies in the sociology of political structures and law. I believe these studies in some ways caused Weber to modify his perspective on the problems he had been addressing previously. For he began to see the problem of ascetic Protestantism and its connection with capitalism not only in comparative terms but also in the context of the “general rationalisation of western culture”. The change of prospective, which of course did not mean that he abandoned any of the conclusions of his earlier work, is evident in particular in the 1920 essay often referred to in the secondary literature as the “Author’s Introduction”.

The “Author’s Introduction” is significant for a number of reasons but in particular because it points to the broad thematic concerns of Weber’s full maturity. In particular it presents in summary form his attitude to, and conceptual understanding of, what he means by the concept of “modern capitalism”. Further, it relates the problems of ascetic Protestantism and modern capitalism to other rational or rationalising aspects of western society. The celebrated opening sentence of the Author’s Introduction gives a clear indication of the broader perspective from which Weber now understands the nature of his task: “A product of modern European civilization, studying any problem of universal history, is bound to ask himself to what combination of circumstances the facts should be attributed that in western civilisation and in western civilisation only, cultural phenomena have appeared which (as we like to think) lie in line of development having universal significance and value.”

Weber goes on to itemise a series of cultural achievements that he believes are unique to western civilisation and have only reached their full maturity in the modern era. He refers first to systematic theology and then to science, rational scholarship and rational jurisprudence. He mentions the development of music, in particular rational harmonious music with counterpoint and harmony, which he says was only developed in the West. He then lists architecture, the press, education, bureaucracy and even feudalism or at least its later stages. The rise of the modern state is crucial, of course, with its written constitution, rational law and administration bound by rules and carried on by trained officials. Finally Weber refers to capitalism, and here he elaborates at some length what he understands by the concept of “rational capitalism”. He again raises the problem of whether capitalism can be explained simply on the basis of reference to the pursuit of gain or money and the impulse to acquire as much of it as possible. He concedes that “capitalism is identical with the pursuit of profit, and forever renewed profit, by means of continuous, rational, capitalistic enterprise. For it must be so: in a wholly capitalistic order of society an

55 It has this short title because the essay formed the introduction to Weber’s collective works on religion that were published under the title “The Economic Ethics of the Worlds Regions”. The first two essays in this collection were the essays that constituted *The Protestant Ethic* writings of 1904/5, and these were then followed by book-length works on the other world religions.

56 PE, p. 13.
individual capitalistic enterprise which did not take advantage of its opportunities for profit making would be doomed to extinction.”\(^{57}\) However, he points out that, contrary to the common sense view that capitalism is especially associated with basic acquisitive impulses, modern capitalism is in important ways connected with the opposite, with restraint or with an irrational tempering of the impulse for gain. But having emphasized that capitalism must be associated with the pursuit of profit, Weber goes on to limit the scope of capitalistic acquisition in the following way: “We will define a capitalistic economic action as one that rests on the expectation of profit by the utilisation of opportunities for exchange, that is on (formally) peaceful chances of profit. Acquisition by force (formally and actually) follows its own particular laws, and it is not expedient however little one can forbid this to place it in the same category with action which is, in the last analysis, oriented to profits from exchange.”\(^{58}\) There follows an extended discussion of how it is possible to fully exploit the opportunities for profit in a rational way, using the most technically rational available means. He continues:

Where capitalist acquisition is rationally pursued, the corresponding action is adjusted to calculation in terms of capital. This means action is adapted to a systematic utilisation of goods or personal services as means of acquisition in such a way that, at the close of the business period the balance of the enterprise in money assets (or in the case of continuous enterprise, the periodically estimated money value of assets) exceeds the capital i.e. the estimated value of the material means of production used for acquisition and exchange.\(^{59}\) Weber points out that the crucial technical means of rational acquisition involves the use of double-entry bookkeeping:

The important fact is always that a calculation of capital in terms of money is made whether by modern bookkeeping methods or any other way, however primitive and crude. Everything is done in terms of balances: at the beginning of the enterprise an initial balance, before every individual decision a calculation to ascertain its probable profitableness, and at the end a final balance to ascertain how much profit has been made. . . . So far as the transactions are rational, calculation underlies every single action of the partners. That a really accurate calculation or estimate may not exist, that the procedure is pure guess-work, or simply traditional and conventional, happens even to-day in every form of capitalist enterprise where the circumstances do not demand strict accuracy. But these are points affecting only the degree of rationality of capitalistic acquisition.\(^{60}\)

Weber then proceeds to embark on series of comparative discussions in which he refers to various pre-modern forms of enterprise in trade and industry that he insists must be distinguished from the form of capitalism that has appeared in modern times in the Occident. In the field of industry he makes a distinction between industrial enterprises or processes of production that existed in antiquity, some of which were extensive in the use of slave labour, and the modern form of industrial organization. The latter is “attuned to a regular market, and neither to political nor irrationally speculative opportunities for profit . . . the modern rational

\(^{57}\) PE, p. 17.  
\(^{58}\) PE, pp. 17-18.  
\(^{59}\) PE, p. 18.  
\(^{60}\) PE, pp. 18-19.
organisation the capitalist enterprise would not have been possible without two other important factors in its development: the separation of business from the household, which completely dominates modern economic life, and closely connected with it, rational bookkeeping."\textsuperscript{61} These two institutional arrangements made it possible for further institutional innovations to occur such as the rational capitalistic organization of free labour. For, “Exact calculation—the basis of everything else—is only possible on the basis of free labour.”\textsuperscript{62}

Having arrived at this working definition of modern capitalism, Weber turns his attention to additional pre-conditions that are intimately associated with the rational organization of free labour. He refers to rise of the western bourgeoisie, a class that was coming into being prior to development of modern capitalism. Clearly, its characteristics are bound up to a significant degree with the development of the capitalistic spirit under the influence of ascetic Protestantism, as we have seen. Further, the possibilities of the rational form of capitalism are intimately associated with the development of various technical possibilities. The rationality of modern capitalism relies upon the calculability of the most important technical factors, and this means it is dependent on modern science, especially natural science. It is also in consequence dependent upon the development of those rational means of calculation that are associated with the use of decimals, a numerical technology originally developed in India. Related to the issue of calculability are the structures of law and administration: “For modern rational capitalism has need, not only of technical means of production, but of a calculable legal system and of administration in terms of formal rules.”\textsuperscript{63}

Weber finally goes on to relate the rationalisations he has been discussing to the peculiar rationalism of western culture in general. He does not deny that other cultures have rationalised their institutions or rationalized conduct to some degree. He notes that the rationalization of mystical contemplation had been taken to a high level by the Yogi in India, and elsewhere he refers to the rationalism of Confucianism which entails the rational adaptation of conduct in the world. But only in the West has economic rationalism become absolutely central. This form of rationalism, whilst partly dependent on external structures of rationality, is at the same time determined by the ability and disposition of people to conduct themselves in a practically rational fashion. In other cultures there have been profound spiritual obstacles to the emergence of such dispositions, but in the West ascetic Protestantism was able to clear a path to this general rationalisation of everyday life.

The \textit{General Economic History}

As we have seen, contrary to the commonly accepted view that Weber’s theory of the origins of capitalism focuses largely on its religious origins in the Protestant ethic, a much more complex, comprehensive and seemingly “materialist/institutional” account is to be found in his \textit{General Economic History}. This account could be said to complement that of \textit{The Protestant Ethic} insofar as it

\textsuperscript{61} PE, pp. 21-22.
\textsuperscript{62} PE, p. 22.
\textsuperscript{63} PE, p. 25.
provides a very detailed account of non-religious factors. But in suggesting that in his *General Economic History* Weber is concerned to give due weight to material factors, one should not assume he is intent on only recognizing the role of “economic causes” in the strict sense, for he is at the same time interested in assessing the interaction of a wide range of causal factors, which include law, science and technology, the city, citizenship as well as once again the “spirit of capitalism”.

Before we consider the content of the *General Economic History* in detail, I wish to discuss an important review of Weber’s position by Ira Cohen. In the Introduction to the 1981 Transaction edition of the *General Economic History*, Cohen sets out to situate the thesis of the book in the context of Weber’s later work as a whole. He correctly points out that the *General Economic History* must be seen in the context of Weber’s general thesis concerning the rationality of modern western society. And he refers to the work of Steven Kalberg concerning the various forms of rationality identified by Weber and their significance for interpreting Weber’s oeuvre. Cohen notes that for Weber some form of entrepreneurial activity has been present to a degree in virtually every civilisation. What is unique to the Western world, however, especially since the nineteenth century, has been the degree to which capitalism has penetrated the provision of everyday needs. Cohen refers to the important section of the book in which the general presuppositions of modern capitalism are laid out. He says the single most general presupposition of Western capitalism according to Weber is rational capital accounting as the norm for all large industrial enterprises. But rational capital accounting cannot exist without a series of other fundamental pre-conditioning factors being in place. These are, according to Weber: the appropriation of all physical means of production; freedom of the market, which means freedom from all limitations on trade or labour such as those imposed by monopolies or religion; rational technology, implying calculable technique which means in effect mechanisation; calculable law; free labour; and the commercialisation of economic life. Cohen argues, “while the conjunction of these six factors must constantly be borne in mind, what is most critical at this point is that rational capital accounting provides the lynch pin that unites them all as presuppositional foundations for the modern capitalist industrial enterprise”. Cohen cites a passage from *Economy and Society* that highlights the importance of capital accounting and is in similar terms to that which occurs in the Author’s Introduction. It reads:

Capital accounting is the valuation and verification of opportunities for profit and of the success of profit making activity by means of evaluation of the total assets, goods and money of the enterprise at the beginning of a profit making venture and comparison of this with a similar valuation of the assets still present and newly acquired at the end of the process. This occurs when a balance is drawn between the initial and final states of assets, capital is the money value of the means of profit making available to the enterprise at the balancing of the

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65 *GEH*, p. XXXIII.
books, profit and corresponding loss, the difference between the initial balance and that drawn at the conclusion of the period.\textsuperscript{66}

These key notions are further elaborated where Weber provides a definition of the economic enterprise as “autonomous action capable of orientation to capital accounting”. This orientation takes place by means of “calculation, \textit{ex ante} calculation of the probable risks and chances of profit, \textit{ex-post} calculation for verification of the actual profit or loss resulting. ‘Profitability’ means in the rational case one of two things: (1) the profit estimated as possible by \textit{ex ante} calculation or (2) that which \textit{ex post} calculation shows actually to have been earned in a given period.”\textsuperscript{67}

Cohen says it should first be noted that the norm of profitability is a decisive criteria or point of reference in regard to all operations undertaken by the enterprise. Thus in the ideal type case every aspect of the enterprise’s activities is oriented to the norm of profitability. According to Cohen, because Weber sees that every step in the operation of the enterprise is determined by reference to the profit-oriented procedures of capital accounting, the six factors listed as presuppositions are not co-equal in significance with rational accounting itself. Rather, Weber implicates these factors as analytically subordinate to the calculation of profitability by the means of the accounting procedures, which are of course those of the double-entry method. Cohen suggests that the way in which factors such as the legal system, or the administrative functioning of the state, or rational technology are operative in the development of capitalism is only insofar as they facilitate patterns of action calculated against the abstract norm of profitability subsumed to the procedure of rational capital accounting. For example, modern scientific technology manifests its own mode of formal rationality. This involves distinctive abstract principles of mechanical efficiency. Weber points out, however, that quite often the most rational technological procedure is compromised by considerations of an economic kind, hence the most appropriate technological method is calculated on the basis of an orientation to the abstract norm of profitability rather than on the basis of the abstract norm of mechanical efficiency.

Cohen says the key to understanding why Weber chooses to place such emphasis on rational capital accounting as the most general presupposition of the institutional matrix of modern capitalism is to be found in a section of \textit{Economy and Society} dealing with the principles for the maximisation of formal rationality and capital accounting and quotes the passage in its entirety.\textsuperscript{68} On the basis of this passage and others like it, Cohen says Weber’s account of the development of capitalism in the \textit{General Economic History} is focused upon those features which he can identify as having the effect of maximising the conditions of formal rationality of capitalist enterprise as set out in his economic sociology in \textit{Economy and Society}. Up to this point in his analysis we can agree with the thrust of Cohen’s account, which explains

\begin{itemize}
\item \textsuperscript{66} ES, p. 91.
\item \textsuperscript{67} Quoted in GEH, p. XXXIII.
\item \textsuperscript{68} The passage is to be found in ES, pp. 161-2. We shall discuss this passage and related remarks of Weber at length in the following chapter.
\end{itemize}
very well how the rationality of capitalism is premised on the phenomenon of capital accounting.\textsuperscript{69}

However, Cohen goes on to discuss the animating force that Weber sees as underpinning the formal structures associated with the enterprise and its conditions of maximum formal rationality. He raises the question of the real ends pursued by capitalist entrepreneurs as individuals and focuses on the issue of their inner motivation. He quotes a line from \textit{The Protestant Ethic} where Weber states that, “Man is dominated by the making of money, by acquisition as the ultimate purpose of his life.”\textsuperscript{70} In Cohen’s interpretation Weber is arguing that the cultural way of life of modern capitalist entrepreneurs is fundamentally different from that of influential groups in other civilisations in that the interest in making money is not compromised by religious, spiritual or other forms of substantive value orientation. Weber insists this unfettered impulse toward making money is a unique feature of the West. Summarizing Weber, Cohen says, “Only in the West do there exist entrepreneurs who bear an impulse that subordinates any and all enjoyment of wealth to the motivation involved in actions in pursuit of monetary gain. Only in the West has the spirit of capitalism penetrated the orientation of those who direct the economic order.”\textsuperscript{71} Cohen then quotes the following passage from \textit{The Protestant Ethic}: “The \textit{summum bonum} of this ethic, the earning of more and more money combined, with the strict avoidance of all spontaneous enjoyment of life, is above all devoid of any eudemonistic . . . not to say hedonistic admixture. It is thought of so purely as an end in itself, that from the point of view of happiness, or of utility to, a single individual it appears entirely transcendental and absolutely irrational.”\textsuperscript{72}

Thus, according to Cohen, Weber is claiming, that, at the heart of modern capitalism there is a fundamental substantive “irrationality”. Even though the action typical of the entrepreneur is infused with the character of formal rationality, the ends for which this action are pursued are entirely irrational from the point of view of what might be regarded as “natural” human values, such as enjoyment of life, happiness, wellbeing and so on. It is this “spirit of capitalism” which, of course, was the focus of the \textit{The Protestant Ethic}, and it is this spirit in combination with the institutional structure of the capitalist enterprise that explains much about the character of the modern world and its socio-economic system. The present author, however, believes this rendering of Weber by Cohen overemphasises the uniqueness of the acquisitive impulse under modern capitalist conditions. In his discussion of the spirit of capitalism at the end of the \textit{General Economic History}, Weber states that the sheer striving for economic gain is no stronger in the modern age than in other periods of history. He explains, “the moving spirits of modern capitalism are not possessed of a stronger economic impulse than, for example, an oriental trader. The unchaining of the economic interest merely as such has produced only irrational


\textsuperscript{70} PE, p. 53.

\textsuperscript{71} GEH, p. XLV.

\textsuperscript{72} PE, p. 53.
results; such men as Cortez and Pizarro, who were perhaps its strongest embodiment, were far from having an idea of a rationalistic economic life.”

Weber suggests that the economic/acquisitive impulse as such is probably universal. The real question is to see how the economic drive undergoes specific cultural modifications as a result of the impact of forces like religion and, in the case of the West, of Protestantism and the Protestant sects. In The Protestant Ethic at one point Weber contrasts the acquisitive impulse of Jacob Fugger with that of Benjamin Franklin and explains the difference in these terms: Fugger wanted to make money as long as he could and his attachment to commercial rewards was a morally neutral inclination, whereas with Franklin motivation was entirely otherwise because the impulse to acquisition took on the character of an ethically coloured maxim. The forces unleashed by this ethic were crucial in producing a cosmos comprised of endless business competition that in one way or another compelled men to adopt a specialized mode of work to ensure their economic survival.

For Weber the danger for the bourgeois type of man who has achieved vocational success by submitting to the intensive work ethic enjoined by Protestantism is that he becomes a victim of what Weber terms “mechanized petrifaction”. “The capitalist economy of the present day is an immense cosmos into which the individual is born, and . . . in which he must live. It forces the individual, in so far as he is involved in the system of market relationships, to conform to capitalistic rules of action.” But Weber does not see this outcome as inescapable, and he argues it will only arise if the trend toward unbridled capitalism is unchecked. A large part of his ethical and political writings is an attempt to articulate and encourage just such a countervailing force against the dehumanizing tendency of advanced capitalism. We shall return to Weber’s consideration of these issues at length below.

The Pre-conditions of Capitalism

In the General Economic History Weber begins his analysis of the development of modern capitalism from a consideration of features occurring first in remote antiquity—for he traces tendencies and lines of development which in some sense can be traced back at least to that era. He notes that many of the institutional arrangements of capitalism, such as markets, profit making, workshop production, monetarization, free labour, technical innovation, trade, merchant classes, even share ownership, existed well back in ancient times, and they often achieved a quite high degree of development. However, Weber locates the more immediate factors of causal significance in the late mediaeval period and shortly thereafter. But there is no suggestion of a line of development that can be traced as a continuous process of unfolding progress, as say in Hegelian-Marxist philosophies of history. As a general rule, in discussing these questions, Weber approaches the matter comparatively and looks partly to tendencies and trends that positively fostered institutional structures that were crucial for capitalism and partly to negative factors that inhibited or

73 GEH, p. 356.
74 PE, p. 51.
75 PE, p. 54.
stymied its advent or growth. We shall start our survey of Weber’s theory with his account of the capitalistic development of the manor.

Weber notes that in countries that became capitalist first such as England, and to some extent Germany and France, one of the socio-economic structures that had to be overcome was the manorial system. The manor involved a system of mutual dependence between the landowners and the peasants. This relationship bound them together in such a fashion that both were prevented from becoming suitable agents for the promotion of modern capitalism. The rupturing of these relations of dependence took various forms in different countries, but in some cases it led to the emancipation of the peasants and freeing of the land from feudal restraints. Crucial innovations that emerged in the wake of this dissolution of feudal bonds were freedom of movement of the peasants and freeing of the land from the restraints of peasant rights and other encumbrances. Of course, the most well known case of this, as classically described by Marx, was England where the expropriation of the peasants occurred. A key aspect for the dissolution of the manor was the destruction of the pre-existing agrarian communism that accompanied the economic system built on the idea of an extended household. This communism was transformed by the advent of private property, and the organization of the household shrunk to such an extent that only the father, his wife and children constitute the basic social unit. There is a further internal transformation of the unit as it ceases to have a productive function. In the wake of these changes the factory emerges.

Marx made what he thought was an important distinction between the “factory” and “manufactory”. Manufactory was described as shop industry with free labour without the use of mechanical power but with the workers grouped and disciplined. Weber claims this distinction is casuistic and of doubtful value. He says that a factory is shop industry with free labour and fixed capital. The nature of the fixed capital is indifferent; it may consist of horsepower or a water mill. The critical factor in the advent of the factory proper is that the entrepreneur operates with fixed capital and he says for this to happen rational capital counting is essential. Thus, the factory in this sense signifies the capitalistic organization of the process of production, that is, an organization of specialised and co-ordinated work within a workshop using fixed capital and capital accounting. Weber says the economic prerequisite for the existence of the factory is mass demand and steady demand: that is, a certain organization of the market. A highly volatile market is totally unsuitable to the existence of the entrepreneur because he is located at the centre of the conjuncture between supply and demand, and he cannot take the risk of pursuing a process of production oriented to mass consumption if there is no reasonable prospect of the effort being fruitful. The entrepreneur’s problem is particularly focused on his concern to cover the costs of his fixed capital which will only be paid for over a period of time when the proceeds generated by the operation of the enterprise are sufficient lay down those costs. Thus the market conditions must be sufficient to sustain a certain scale of production and must be a relatively constant. For these market conditions to exist there must be a certain level of monetarization of the economy and correspondingly purchasing power in the hands of consumers, all of which depends upon the reliability of the monetary system. The further prerequisite is that the technical process of production must be relatively inexpensive, because in

\[76\] GEH, p. 92.
order to establish himself and find a steady market, the capitalist must produce more cheaply than traditional methods of household production. Hence, at the advent of capitalism, the goods produced were generally simple items of mass consumption; only later did a more extensive capitalist system enable sophisticated innovations to occur which allowed for forms of production that would have been unthinkable before the capitalist era.

A further prerequisite for the development of capitalism is the presence of a sufficient supply of free labour. Rational capitalism is not possible on the basis of slave labour; Weber is adamant about this. Only in the West was a sufficient supply of free labour available. In this regard Weber seems to agree at least in part with Marx that it was the eviction of the peasantry from their rural holdings that provided the massive quantities of free labour required. Weber suggests that the peasantry suffered expropriation in England in part because of the country’s insular geography, which meant it did not need a standing army and thus did not require social policies designed to protect the peasantry as the basis of a national army. As early as the sixteenth century, Weber points out, the supply of free labour from the eviction of the peasantry was of such a scale as to cause policies to be implemented to deal with poor relief.

The industry of the craft guilds did not form a direct antecedent to factory production because it was largely carried on without fixed capital. The first forms of fixed capital of note were mills owned by lords or sometimes owned communally. There were various types—saw mills, water mills, oil presses, grain mills, fulling mills—but these were not directly related to capitalist developments because they were not owned by the participating groups, and unlike the stock company they were leased out as source of rent. Similar arrangements have applied to ovens and breweries. Iron foundries were to begin with owned municipally because of their significance for the production of artillery cannons. The municipal foundries were not capitalistic but produced directly for the military requirements of the princes who owned them. Only in the sixteenth century do we find the beginnings of industrial production operating capitalistically in the sense that there were establishments of a private economic character in which a single owner had possession of the work place, tools, and raw materials. At that time there arose the first establishments that involved the concentration of workers in a single room with some specialisation of function. As such they appear in many respects similar to the ergasterion of ancient and other times. In the ergasterion the workers are slaves, whereas in the early factory the workers, though not bound formally, are nonetheless subject to forces that oblige them to work. Labourers attach themselves to these establishments from a compulsion generated out of poverty, having no other choice in fear of the absolute impossibility of finding other sources of livelihood. Weber refers to the organization of a workshop in England in the sixteenth century in which there were two hundred looms in one room all belonging to an enterpriser who furnishes the raw materials. The workers worked for wages and children were also present. Interestingly, in 1555 at the behest of the guilds, the king forbade such concentrations, but by the early eighteenth century suppressing such large establishments was no longer thought of. The importance of the concentration of work in a single workplace was that it made possible control over the uniformity of the product and the quantity of output. But by concentrating in one place there was an increased risk that the entire fixed capital could be lost in a single catastrophe, and it was vulnerable to violent
reaction on the part of the employees. At the start, workshops are really little more than a concentration of a number of small productive units within a single premises. But after the sixteenth century, these establishments are progressively transformed.

A new stage in the evolution of capitalism occurred when technical specialisation and the systematic organization of work began to be combined with the use of non-human sources of power. Non-human sources of power had traditionally been available in the form of primitive animal power, and there had been prior uses of some natural forces such as water and wind. Windmills had been an early use of air power for the pumping of water, but the real impetus for the use of non-human power came with development in mining, in particular the development of devices for the pumping of water out of deep mines. As we have already said, a prerequisite for the transition from shop industry to the factory was the development of an extensive demand for the goods produced. For this reason Weber says one of the first places in which one finds an internal division of labour with fixed capital was in the political domain, the minting works of medieval princes, but of course this was supplying only one type of good. The political demand for mass-produced goods was also felt in the military area in the manufacture of weapons and uniforms for the army. The first occasions where there appeared a demand for mass consumer goods of the kind we are familiar with today, that is of goods for use by ordinary people in their every-day lives, was for various kinds of “luxury” goods. Weber points to the mass production of tapestries that became common after the crusades to cover the bare walls and floors of luxury houses. There were also establishments for the production of glass, mirrors, silk, velvet, fine cloth, soap and sugar. Only subsequently were goods produced for the broader masses, and these were in the first place imitations of luxury goods previously destined only for the rich. Those who could not buy works of art to cover their walls or tapestries had wallpaper. Also in this category were items such as glues, starch and chicory. When production was destined for the rich, the market was not sufficiently extensive to sustain a series of enterprises competing and producing on a very large scale. Hence, production was monopolistic, for the arms factories and tapestry works of the early industrial period began as a series of privileged manufacturers under royal tutelage. The legal position of these early enterprises was complicated because of the antagonism of the guilds. In order to be established, exemptions were required from the guilds so their privileges did not always cover the entire town. Consequently, factories had to be established in special domains outside guild jurisdiction. In England the guilds were municipal bodies, which meant guild law had no sway outside town boundaries; therefore many early factories were established in places that were not towns.

According to Weber, the factory did not at first develop out of simple craftwork or at the expense of it but existed alongside it. Factories developed new forms of production and new products like cotton, porcelain, coloured brocade, goods that substituted for luxury consumption items. Only later did the factories enter into the domains of the guilds. The factories did not develop out of the domestic system either but again grew up alongside it. Where fixed capital was not needed the domestic system endured, but where and when it was required factories arose. Originally communal institutions operating with fixed capital were gradually taken over by entrepreneurs and used for mass production of consumer goods. The factory was not at first, in its earliest stages, spurred on and developed because of the invention of machines. Machines originally made use of horsepower, but the
specialisation of work and labour discipline were predisposing conditions that greatly aided the use of machines—a classic example is the use of steam power.\footnote{A good account of this era of European economic history from the perspective of a contemporary historian is Jan De Vries, \textit{The Economy of Europe in an Age of Crisis, 1600-1750}, Cambridge University Press, 1976.}

The Role of the City

The role of the city in the emergence of capitalism is an aspect that has not been as widely recognized by scholars as it deserves, but it is an issue to which Weber devoted considerable attention.\footnote{A general discussion of Weber’s account the city in the context of later scholarship is R. J. Holton, \textit{Cities, Capitalism and Civilization}, Allen & Unwin, 1986.} Of course, the city is a phenomenon that dates to earliest antiquity, and cities have existed in civilisations other than the West. But Weber’s thesis is that the occidental city, especially the city as it came into being in the later Middle Ages, was crucial for the development of modern capitalism.

The medieval city, which is the focus of Weber’s attention, was not a development of the ancient city. For Weber had already explained in earlier writings such as the essay “The Social Causes of the Decline of Ancient Civilization” of 1896 that ancient culture and its urban infrastructure went into significant decline in the late Roman Empire. The medieval city is rather an outcome of the dissolution of what Weber calls the \textit{Ständestaat}, which was a political formation that arose as a consequence of the growth of corporate bodies (estates or \textit{Stände}) that emerged as a result of feudalism. When the estates degenerated in the later Middle Ages, certain corporative powers remained in tact and these became significant for medieval urban development.\footnote{On these developments see G. Poggi, \textit{The Development of the Modern State: A Sociological Introduction}, Stanford University Press, 1978, pp. 36-60.} The medieval city developed as a corporation, which included rights to impose laws, appoint officials, raise taxes and regulate commercial relations of various kinds. Some of these features existed in antiquity, but the medieval city was distinctive in regard to the basis of its autonomy and the structure of its political authority. In the classical polis of antiquity rule was based on either military factors or on religious exclusivity, whereas in the medieval case, especially in the producer cities of inland Europe, the concept of the corporation became crucial and was the basis of the political association. Nonetheless, medieval cities were not the immediate occasion for the growth of modern capitalism, because not all medieval cities were economically based and even those that were did not become capitalist in the modern sense.

Over time, mediaeval cities grew in autonomy and in autocephaly because of the weakness of the feudal lords who sought to control them. As the producer cities gained in their commercial and industrial power, the non-urban feudal authorities increasingly granted them concessions in the form of legal privileges. Bit by bit the cities that had gained a degree of autonomy sought to develop self-government and exploited the rivalries between the various contending seigniorial authorities. This had the consequence of undermining the existing relation between the town and the countryside. Weber is at pains to point out how the economic orientation of the
burghers living in the cities produced a lifestyle totally at odds with that of the feudal knights. The burghers lacked all concern with honour and heroic asceticism and had more in common with life in the Church. Christianity played an important role in the way these cities evolved largely because of its devaluation of ritual barriers of birth, a product of the Paulian victory over Jewish Christianity. This is not to say the city became a part of the Church, but membership in the city community was restricted to those who were Christians. Strangers were not prevented from gaining membership, however, but those who could not participate in the Christian Eucharist such as the Jews were unable to gain acceptance and they thus remained “guest peoples” or pariahs. Of course, fraternisation between Christian burghers did not impede the organization of various sub-associations and the emergence of status differences that eventually became highly significant.

The medieval city was by no means homogenous, but importantly for Weber the associations that formed within it were formally free and in the course of time there developed many religious, social, occupational and political groupings of various kinds. Although there were tendencies towards democracy and although citizenship rights were disseminated to a degree throughout the population, certain groups such as the guilds commonly came to have a dominant position as they sought to monopolise economic power. There were two important consequences of the guild system: although it was a system of inequality based on occupation, it nonetheless ignored status differences outside the city; and it constituted, unlike the lineage or sib group, an impersonal associational grouping. The ultimate effect of all this from the point of view of the development of modern capitalism was that the medieval city dominated by the upper guilds meant the dominance of an urban stratum who were whole heartedly engaged in largely economic activities including trade and industry. In this way they formed the germ of the modern bourgeois class. Subsequently, under pressure from the competition of the putting-out system the closed guild-system was forced to increase its rationality by orienting itself more and more to the open market. A further consequence of the emergence of the bourgeoisie was that a new principal of organization and legitimisation was borne, namely the corporate form of secular association with its democratic ethos.

Aside from these political developments the medieval city made important contributions to industry and forms of commerce. Weber says it gave rise to new legal institutions, such as the annuity bond, the stock certificate and the bill of exchange, that were important for later economic developments. It created the accounting practices that became crucial for the later evolution of double-entry bookkeeping. It also provided a precursor to the corporate form of business association in the form of the unlimited partnership. A further stage was reached in the evolution of society when the activities of the bourgeoisie were extended beyond the sphere of the immediate city and its surrounds. For this to occur it was necessary for the Ständestaat to be replaced by some kind of national state, the first form of which was the absolutist state. Under these circumstances state policy first developed in the form of mercantilism whereby economic policies were driven by the compromise in economic interests between the dominant bourgeois groups and the absolutist monarchs. This, however, was not conducive to market-oriented capitalism of the modern kind. But it did facilitate the increasing pursuit of profits of monopoly through the means of war and the provision of luxury goods. The latter phenomenon was gradually subject to a democratising influence with the advent of
mass production. In this way the urban bourgeoisie was transformed into a national bourgeoisie. Weber explains how the national bourgeoisie arose out of the unique situation of the European state system in the following graphic description:

... the modern city was deprived of its freedom ... [as it] came under the power of competing national states in a condition of perpetual struggle for power in peace or war. This competitive struggle created the largest opportunities for modern western capitalism. The separate states had to compete for mobile capital, which dictated to them the conditions under which it would assist them to power. Out of this alliance of the state with capital, dictated by necessity, arose the national citizen class, the bourgeoisie in the modern sense of the word. Hence it is the closed national state which afforded capitalism its chance for development—and as long as the national state does not give place to a world empire capitalism also will survive.\(^{80}\)

**The Advent of Modern Capitalism According to *General Economic History***

Weber turns his attention specifically to the immediate causes of modern capitalism around Chapter 22 of his *General Economic History*. He embarks on his analysis with another definition of capitalism which at first sight appears straightforward and uncontroversial: “Capitalism is present wherever the industrial provision for the needs of a human group is carried out by the method of enterprise, irrespective of what need is involved.”\(^{81}\) This definition with its reference to “enterprise” appears to coincide with that of Schumpeter, though this agreement is not as complete as use of the term suggests, as we shall see. For Weber adds a qualification that is characteristic of his later concerns. “More specifically, a rational capitalistic establishment is one with capital accounting, that is, an establishment which determines its income yielding power by calculation according to the methods of modern bookkeeping and the striking of a balance. The device of the balance was first insisted upon by the Dutch theorist Simon Stevin in the year 1698.”\(^{82}\) We note that this definition coincides more or less with that of the Author’s Introduction of 1920 discussed above. Weber then goes on to explain how his definition will be applied in research:

It goes without saying that an individual economy may be conducted along capitalistic lines to the most widely varying extent; parts of the economic provision may be organized capitalistically and other parts on the handicraft or the manorial pattern. Thus at a very early time the city of Genoa had a part of its political needs, namely those for the prosecution of war, provided in capitalistic fashion, through stock companies. In the Roman empire, the supply of the population of the capital city with grain was carried out by officials, who however for this purpose, besides control over their subalterns, had the right to command the services of transport organizations; thus the liturgical or forced contribution type of organization was combined with administration of public resources. Today, in contrast with the greater part of the past, our everyday needs are supplied capitalistically, our political needs, however through compulsory contributions, that is, by the performance of the political duties of

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80 GEH, p. 337.
82 *Ibid*.  

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citizenship such as the obligation to military service, jury duty, etc. A whole epoch can be designated as typically capitalistic only as the provision for wants is capitalistically organized to such a predominant degree that if we imagine this form of organization taken away the whole economic system must collapse.\(^{83}\)

This penetration of the provision of everyday needs by capitalism, a characteristic that is given emphasis also in Marx’s theory, is therefore a defining feature of the modern form of capitalism. From the perspective of comparative history, Weber situates modern capitalism as follows:

While capitalism of various forms is met with in all periods of history, the provision of the everyday wants by capitalistic methods is characteristic of the occident alone and even here has been the inevitable method only since the middle of the nineteenth century. Such capitalistic beginnings as are found in earlier centuries were merely anticipatory, and even the somewhat capitalistic establishments of the sixteenth century may be removed in thought from the economic life of the time without introducing any overwhelming change.\(^{84}\)

In keeping with his emphasis on the rationality of the modern form of capitalism, Weber restates his view that the key presupposition of present-day capitalism is rational capital accounting as the underpinning for all large industrial enterprises. He goes on to expound a list of factors that he maintains are crucial to the existence of capital accounting of the requisite kind. He firstly says that modern capitalism depends upon “the appropriation of all physical means of production—land, apparatus, machinery, tools, etc. as disposable property of autonomous private industrial enterprises. This is a phenomenon known only to our time, when the army alone forms a universal exception to it.”\(^{85}\) Secondly, Weber refers to “freedom of the market, that is, the absence of irrational limitations on trading in the market. Such limitations might be of a class character, if a certain mode of life were prescribed for a certain class or consumption were standardized along class lines, or if class monopoly existed, as for example if the townsman were not allowed to own an estate or the knight or peasant to carry on industry . . .”\(^{86}\) Thirdly, Weber cites rational technology, that is, technology “reduced to calculation to the largest possible degree, which implies mechanization.”\(^{87}\) A fourth characteristic is that of calculable law, by which he means a legal system that is predictable and rationally constructed. Modern capitalism depends upon calculable adjudication and administration. A fifth feature, again echoing Marx, is formally free labour: “Persons must be present who are not only legally in the position, but are also economically compelled, to sell their labour on the market without restriction. It is in contradiction to the essence of capitalism, and the development of capitalism is impossible, if such a propertyless stratum is absent, a class compelled to sell its labour services to live . . .”\(^{88}\) The sixth and final condition Weber lists is what he terms the commercialisation of economic life. By this he means the general use of commercial instruments to represent share rights in enterprise, and also in property ownership. In explaining the

\(^{83}\) Ibid, pp. 275-6.
\(^{84}\) Ibid, p. 276.
\(^{85}\) Ibid.
\(^{86}\) Ibid.
\(^{87}\) Ibid, p. 277.
\(^{88}\) Ibid.
significance of commercialisation, Weber says that it is crucial that the provision for needs is exclusively based on the exploitation of market opportunities and the calculation of net income. Commercialisation intensifies the relevance of another factor, namely speculation, which reaches its full significance only from the moment when property takes on the form of negotiable paper, that is, paper representing either shares in enterprise or rights to income in the form of state bonds and mortgage indebtedness.

Related to commercialisation is the phenomenon of credit. What Weber says about this is of considerable interest for our present concerns because it suggests a close connection to the approach of Schumpeter. He explains how the issuing of credit has a long history and only gradually became significant for commercial enterprise:

In modern economic life the issue of credit instruments is a means for the rational assembly of capital. Under this head belongs especially the stock company. This represents a culmination of two different lines of development. In the first place, share capital may be brought together for the purpose of anticipating revenues. The political authority wishes to secure command over a definite capital sum, or to know upon what income it may reckon; hence it sells or leases its revenues to a stock company. . . . The significance of this system is that in place of the original condition under which unusual state requirements were covered by compulsory law, usually without interest and frequently never repaid, loans come to be floated which appeal to the voluntary economic interests of the participants. . . . The securing of money for state purposes, and especially for war purposes, by appeal to the universal economic interest, is a creation of the middle ages, especially of the cities. Another and economically more important form of association is that for the purpose of financing commercial enterprise—although the evolution toward the form of association most familiar today in the industrial field, the stock company, went forward very gradually from this beginning.89

It is worth noting at this stage that Weber does not specifically refer to the Protestant Ethic or to the spirit of capitalism in this list of causal factors. The apparent oversight is not actual, however, because he treats these factors at length in his final Chapter 30. Furthermore, as we have seen Weber also posits as causes a number of other phenomena that are instrumental in the creation of modern capitalism, such as the modern state, citizenship and the rise of the bourgeoisie. The role of these other factors is, of course, closely related to the role of the six mentioned just above, so for example the significance of the rational state is intimately connected to the development of calculable law and administration. Clearly Weber did not intend the six preconditions referred to above to be exhaustive of the factors relevant to the causal origins of capitalism, and we surmise that he cites them summarily for the purposes of expository convenience.

Randal Collins’s Reconstruction of Weber’s Theory

89 Ibid, p. 280.
Randall Collins has produced an overview of Weber’s theory of the causes of modern capitalism. In what follows we shall briefly summarise this theory and comment upon it. Collins basically concurs with what we have said as to the nature of modern capitalism and its essential features. Just as Cohen emphasises the key element of the calculating practices of the capitalist entrepreneur, so too does Collins. The latter, however, is particularly interested in the explicating the causal chain that has led to the development of the general societal situation that gave rise to modern capitalism. He points out that in the causal change there were both positive, facilitating conditions as well as negative, destructive circumstances. Collins notes, for example, that the precondition for modern capitalism required the destruction of the obstacles to the free movement and economic transfer of labour, land and goods. In describing the causal sequence that underlies the advent of modern capitalism for Weber, Collins starts out with the elements of rational capitalism as we have described them above: the entrepreneurial organization of capital, rational technology, free labour, unrestricted markets, calculable law. He says these make up a complex, the markets for goods, labour and capital all coalesce around the orientation of the entrepreneur towards the exploitation of the opportunities for gaining profit using the techniques of mass production. The legal system is a necessary element in the pre-conditions giving rise to capitalism. It is also important that certain ethical conditions are present, in particular the lifting of the barrier between internal and external ethics. Not only must internal control of the group be loosened, the conduct of the individual in regard to outsiders must also be transformed so that cheating, price gouging and exorbitant interest charging are overcome.90

The change in the ethical circumstances of society were partly produced by the development of a rational legal system and the emancipation of labour but also by religious ethics which gave support to the propriety of pursuing moderate profits through the employment of rational economic measures. Part of the story of the development of these conditions is bound up with the coming into being of the bureaucratic state and the associated advent of universal citizenship. The state is crucial for Weber’s theory of capitalism because it is the state that breaks down the feudal system with its patrimonialism and traditionalism. It is the modern state, further, that pacifies large areas to make them suitable for trade and industry and eliminates internal barriers to market exchange. It creates predictable circumstances in its standardization of taxation and in its promotion of a reliable monetary system. But Weber does not believe that the advent of a bureaucratic state of just any kind is sufficient to bring about capitalism because in societies such as China and Ancient Egypt a bureaucratic structure emerged which in effect stifled the development of a free market economy. The kind of bureaucratisation Weber says is favourable to capitalism is that which incorporates a formalistic legal code based on citizenship. Citizenship means membership of a city and eventually membership of a state and this means individual political rights.

Collins notes that formal citizenship rights originally applied to local elites when such rights were attached to the existence of small city states, however, when these cities were incorporated into large states they provided the basis for more widely

inclusive system of adjudication. This is what had begun to emerge in the case of Rome, which introduced universal citizenship under the emperor Caracalla, but it did not survive the decline of the Empire. Citizenship emerged again later in the Middle Ages when the cities in alliance with kings lost their independence but contributed their legal structures to the constitution of these states. Weber points to the military significance of citizenship and refers to the medieval cities with their disciplined infantries. In these cases the wealth of the cities bolstered their military power and fostered democratisation and citizenship rights. Linked to these developments associated with the city were Weber’s ideas concerning religion and social ethics generally. The transformation of ancient Judaism brought about by Christianity, which changed it from a Jewish sect into a universal religion, had profound effects throughout the world. As Collins summarizes, 

. . . the Christian cities of the Middle Ages, drawing upon the institutional legacies of the ancient world, were able to establish religiously sworn confraternities which re-established a legal system based on citizenship. . . . the Christian church provided the literate administrators, the education system, and the example of its own bureaucratic organisation as a basis upon which the bureaucratic states of the West could emerge. And, on the strictly motivational side, the development of European Christianity gave a decisive ethical push toward rationalised capitalism.91

According to Collins, all these factors had to appear in precisely the form in which they did in order for capitalism to occur. Weber did not believe in a theory of capitalism in the sense of a set of universal generalisations about how epochal economic change occurs. In this sense he does not advocate a thesis such as that implied by Schumpeter that once a nascent capitalist market appears there is an inherent tendency for innovations to occur leading to on-going economic progress. Weber’s attitude to the idea of such a mechanism will be considered at length below. The present writer agrees with Collins’s characterization of the nature of Weber’s thesis where he writes, 

Weber saw the rise of large-scale capitalism, then, as a result of series of combinations of conditions which had to occur together. This makes world history look like the result of configurations of events so rare as to appear accidental. Weber’s position might well be characterised as historicist, in the sense of seeing history as a concatenation of unique events and unrepeatable complexities. Once a crucial conjuncture occurs, its results transform everything else—and not just locally but also in the larger world of competing states. This was true of the great charismatic revelations of the world religions, which shut off China, India or the West from alternative lines of development as well as determined the way which states upon these territories would interact with the rest of the world.92

Collins goes on to highlight another feature of Weber’s approach that describes the combination of factors that make up capitalism as involving balances between opposing elements. He points out that occidental culture for Weber involved a tension between various factors. No one element could predominate if rational capitalism was to persist. Collins says,

91 Ibid, p. 934.
92 Ibid, p. 935.
Since each ‘element’ is composed of real people struggling for precedence, the creation of a calculable, open market economy depends upon a continuous balance of power among differently organised groups. The formal egalitarianism of the law depends upon balances among competing citizens and among competing jurisdictions. The non-dualistic economic ethic of moderated avarice depends upon a compromise between claims of in-group charity and the vicious circle of out-group rapaciousness. The capitalist economy depends on this balance. The open market system is a situation of institutionalised strife. Its essence is struggle, in an expanded version of the Marxian sense, but with the qualification that this could go on continuously, and indeed must, if the system is to survive.\(^93\)

But Collins is of the view that Weber in his later writings effectively abandoned the positive role of Calvinism in the advent of capitalism.\(^94\) This is a conclusion that is in our view somewhat at odds with Weber’s actual position, as I shall now consider.

**The Protestant Ethic in General Economic History**

If there were any doubt that Weber retained his views regarding the role of Protestantism in the evolution of capitalism, the matter is surely put to rest by consideration of the final, Chapter 30 of the *General Economic History*. We say it is clear from this chapter that Weber confirms his previous view of the role of the capitalist spirit and of the significance of Protestantism in the evolution of that spirit.\(^95\) And he does so despite his having discussed at considerable length a variety of so-called materialist factors that he accepts as also essential in accounting for the origin of capitalism. The Protestant Ethic is again invoked as a key factor in a fashion I maintain that is completely consistent with what Weber had said in his previous writings on the subject. He again points to the fact that the mere unchaining of an economic interest from traditional or religious restraints does not give rise to the modern economic order. He refers to Cortez and Pizarro as classic embodiments of the unchaining of economic interest, but these individuals were only exemplars of irrational, adventure capitalism.

In the chapter under consideration Weber posits a fundamental proposition concerning the mentality of economic action. He says that originally early societies maintained two contradictory attitudes to the pursuit of wealth. Internally there are

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\(^{93}\) *Ibid*, p. 936.

\(^{94}\) See his discussion in *Weberian Sociological Theory*, Cambridge University Press, 1986, p. 33 where he argues that Weber reduced the role of Protestantism to a largely negative influence, “in the sense that it removes one of the last institutional obstacles diverting the motivational impetus of Christianity away from economic rationalization.”

\(^{95}\) There are other reasons why it is most unlikely Weber changed his view of the role of Protestantism in his later work. Important is the fact that in his last years he revised the early essays on the topic for the publication of his collected works on the religion scheduled for 1920, did not alter the original thesis in any respects and indeed if anything strengthened it in producing the related writings on Indian and Chinese religions.
traditionalistic and pious relations with fellow members that prohibit an unrestricted pursuit of gain between the members of the clan or household community but externally there is an unlimited pursuit of gain, every foreigner being treated as effectively an enemy to whom there is no ethical restraint in taking advantage.  

But with the course of development there are two fundamental changes.  On the one hand, calculation enters into the traditional brotherhood and displaces the old relationships of a communistic nature.  This happens as soon as accountability is established.  Simultaneously with this there is a moderation of the unrestricted pursuit of gain with the adoption of a more calculating approach within the family and this leads to a regulated economic life that operates within boundaries.  Weber says the beginnings of a change are first registered around the fifteenth century in Florence.  Up to this point the typical attitude of Catholic ethics was hostile to every form of capitalistic tendency because of the impersonality such relations implied, meaning they could not be regulated by ethical dictates.  Of course the reverse of this was that Catholicism placed economic affairs largely outside the influence of the Church.  Thus, whereas the relationship between a master and a slave could be ethically regulated, the relations between the mortgage creditor and the mortgagor or between the endorser and the bill of exchange could not be subject to moralisation.  The destruction of these ideas concerning prohibited economic activity cannot be attributed to the role of the Jews as Sombart had claimed.

We shall not recount Weber’s arguments here suffice it to say they are based on a far more sophisticated and convincing account of the Jewish religion than Sombart’s.  The one aspect of Jewish religion that Weber saw as significant for the advent of rational capitalism concerned its hostility to magic.  Ancient Jewish prophecy, according to Weber, helped to release the world from magic and lay the basis for modern science and technology.

A second basic distinction Weber makes in addition to that between in-group and out-group morality is that between virtuoso and mass religiosity.  Virtuoso religion is only significant as an example, for its claims are too high for conduct of the masses.  In Catholicism the distinction between the two realms led to a division between the monks and priests vis à vis the laity.  But this had the consequence that the more worthy individuals who lived most in accordance with the teachings of Christ, namely the monks, had necessarily to withdraw from the world in separate communities.  Thus their impact on the world in which the masses carried on their everyday affairs was necessarily very limited.  Even so, monks rationalised their lives in various ways, often by working methodically and by pursuing their goal of a holy life through systematic means of an ascetic nature, but this rationalism was restricted to monastic circles.  The Church’s effect on the average individual of the Middle Ages was merely to domesticate them by channelling their concerns about sin through the release gained by the confessional.  But this did not have a rationalising

96 This issue is the subject of Benjamin Nelson, The Idea of Usury: From Tribal Brotherhood to Universal Otherhood, Princeton University Press, 1949.
97 Sombart’s theory concerning the role of the Jews is set out in his The Jews and Modern Capitalism, Collier, 1962.
99 This question is discussed in some detail in Weber’s Ancient Judaism, Free Press, 1952.
effect and merely enforced traditional attitudes to life and work. In its desire to
maintain authority the Church spread its grace over both the just and the unjust. The
Reformation changed all this. This was the achievement of Luther. The
Reformation meant the elimination of the dualistic system of ethics, of the distinction
between a universally binding morality and a special code for the virtuosi. The
asceticism oriented to other-worldly concerns typical of the monasteries was also
ended: “The stern religious characters who had previously gone into monasteries
now had to practice their religion in the life of the world”.100

The acquisition of wealth and the religious sanction of such success led to a
dilemma. Catholicism sought to avoid the difficulty through the idea that man was
only administering what god had provided and forbade the enjoyment of riches. By
contrast, the Reformation allowed no flight from the world but regarded working in
the world in a disciplined and methodical way as a basic religious task for the
individual believer. From these ideas came the notion of the “calling” which
expresses the importance of rational activity carried on within a capitalistic world as
fulfilling god’s directions. As Weber summarises,
this development of the concept of a calling quickly gave to the modern
entrepreneur a fabulously clear conscience—and also industrious workers; he
gave to his employees as the wages of their ascetic devotion to the calling and of
a co-operation in his ruthless exploitation of them through capitalism the
prospect of eternal salvation, which in an age when ecclesiastical discipline took
control of the whole of life to an extent inconceivable to us now, represented a
reality quite different from any it has today. . . . such a powerful, unconsciously
refined organisation for the production of capitalistic individuals has never
existed in any other church or religion and in comparison with it what the
Renaissance did for capitalism shrinks into insignificance.101

Weber finishes his final chapter reflecting on the present state of the capitalist
spirit and its religious basis. He repeats the sentiments that are found at the end of
the Protestant Ethic and writes,
The religious route of modern economic humanity is dead; today the concept of
the calling is a caput mortuum in the world. Ascetic religiosity has been
displaced by a pessimistic but by no means ascetic view of the world, such as
that portrayed in Mandeville’s Fable of the Bees, which teaches that private
vices may under a certain condition be good for the public. With the complete
disappearance of all the remains of the original enormous religious pathos of the
sects, the optimism of the Enlightenment which believed in the harmony of
interests, appeared as the heir of Protestant asceticism in the field of economic
ideas; it guided the hands of the princes, statesmen, and writers of the later 18th
and early 19th century. Economic ethics arose against the background of the
ascetic ideal; now it has been stripped of its religious import.102

So a question arises as to the extent to which the spirit of capitalism as described
in The Protestant Ethic and the General Economic History still animates the
capitalist entrepreneur in the twenty first century and beyond. We shall suggest in

100 GEH, p. 366.
101 GEH, p. 368.
102 GEH, pp. 368-9.
what follows that the advent and development of the corporation, the welfare state, market regulation, and of the so-called “mixed economy” have transformed the nature of the enterprise and the motivating factors that underlie it. Nonetheless, these changes have created an economic situation that is not fundamentally at variance with the thrust of Weber’s analysis. Weber had noted the profound changes in the spiritual conditions of modern capitalism in the final passages of *The Protestant Ethic*. There he referred to the fact that religious asceticism has finished its work in transforming the everyday world, and that today:

This order is bound to the technical and economic conditions of machine production which today determine the live of all the individuals who are born into this mechanism, not only those directly concerned with economic acquisition, with irresistible force. . . . material goods have gained an increasing and finally inexorable power over the lives of men as at no previous period in history. . . . victorious capitalism, since it rests on mechanical foundations, needs its support no longer. . . . In the field of its highest development, in the United States, the pursuit of wealth, stripped of its religious and ethical meaning, tends to become associated with purely mundane passions, which often actually give it the character of sport.\(^3\)

**Conclusion**

In this chapter we have argued that Weber’s work on the origins and development of modern capitalism have only been partially understood and accepted by the scholarly community. The pre-eminence of Weber’s Protestant Ethic thesis has led many to overlook the significance of his other works and of the other causal factors to which he gave prominence. Nothing could be further from the truth than the claim that Weber developed a largely idealist account of the origin of capitalism. Indeed his total causal analysis not only contains an extensive analysis of non-religious factors but in many respects it is more complete than, for example, the so-called materialist theories of the Marxist type. Nonetheless, he does accord a very crucial role for the impact of religious ideas, religious values and religious institutions, and in our view he never retreats from this despite what some have claimed. Weber’s determination to pursue an idealist and a materialist approach simultaneously, as expressed in the concluding remarks of *The Protestant Ethic*, is affirmed throughout his later writings, which always entail analysing the complex interrelations between institutional/material and cultural/ideological aspects. Such an approach is particularly manifest in his writings on India and China wherein he set out to show not only how the religious institutions of those societies militated against the development of the capitalist economic system but also how these religions emerged from the socio-economic conditions of the day.\(^4\)

\(^3\) PE, pp. 181-2.

CHAPTER TWO

Weber’s Contribution to the Theory of Modern Capitalism:
Part Two

The Theory of Modern Capitalism in *Economy and Society*

In *Economy and Society* in the section entitled “Sociological Categories of Economic Action” Weber has elaborated an extensive array of concepts and ideal-types that are designed to provide the framework for a general sociology of economic life. And in the course of this section and elsewhere in the work Weber says a great deal about the nature of capitalism and its constitutive elements and it is this we shall address in this chapter.

Weber’s work in relation the operation of the business enterprise has not been extensively discussed in the secondary literature. It is clear that many of the features he saw as central to the operation of a governmental bureaucracy are also found at least in the larger business firms. In the business organization one finds such phenomena such as quasi judicial rules of conduct, an hierarchy of powers and set responsibilities, distinct jurisdictions, lifetime employment, payment by salary and so on. It would appear that individuals employed in firms become oriented to the organization and the related economic order in an analogous way that they are in a government bureaucracy.\(^1\) In what follows we shall present a detailed exegesis and commentary on Weber’s economic sociology and point to the value of Schumpeter’s work on entrepreneurship and business enterprise as complements to Weber’s work where appropriate. We shall in particular refer to commonalities between their respective contributions to the role of the entrepreneur.\(^2\)

A useful recent introduction to the treatment of economics and economic sociology in *Economy and Society* is an essay by Richard Swedberg entitled “Max Weber’s Economic Sociology: The Centrepiece of *Economy and Society*?”\(^3\) Swedberg argues that the section on economy is the key to Weber’s magnum opus. Perhaps this is overstating the case, as the hypothetical question mark suggests, though the proposition is certainly arguable. Swedberg first draws attention to the scope of the discussions in Chapter 2 of *Economy and Society*, which he says


constitutes the core of Weber’s economic sociology insofar it contains his most developed analysis of economic institutions. Swedberg notes that the section contains some 150 pages of text divided into 41 sections, and in some sense it could be said to be a work in its own right. In what follows we shall provide a detailed analysis of aspects of this section.

One term that is emphasized at the outset by Swedberg is the concept of “order,” in German Ordnung. He says this is a concept that has been unduly ignored by commentators, but it is one of Weber’s most important concepts for it complements his notion of social action. Swedberg says,

a social relationship may turn into an order when the maxims that infuse a social relationship acquire an independence of their own, so that actors may orient their actions to the order. Orders of this type, based on maxims that are either obligatory or exemplary, also exist in economic life, for example in the form of conventions. They are also at the core of organisations which Weber in all brevity defines as orders policed by a staff. . . . The most important economic organisation in modern capitalism is obviously the firm, whose impact on economic life Weber describes as revolutionary. A firm typically consists of an order, maintained by three types of actors; the entrepreneur, the staff (the bureaucracy), and the workers.4

Weber also implies that the market is a kind of order, undoubtedly of a special kind. In a later section of Economy and Society entitled “Legal Order and Economic Order” he defines the concept “economic order” as follows:

Sociological economics (Sozialökonomie) . . . considers actual human activities as they are conditioned by the necessity to take into account the facts of economic life. We shall apply the term economic order to the distribution of the actual control over goods and services, the distribution arising in each case from the particular mode of balancing interests consensually: moreover, the term shall apply to the manner in which goods and services are indeed used by virtue of these powers of disposition, which are based on de facto recognition (Einverständnis).5

It is unfortunate that this section is almost entirely devoted to the concept of legal order and nowhere else does Weber develop the concept of economic order at any length. This may be because in fact he often uses the term “economy” as equivalent to that of “economic order.” Nonetheless, it appears that the economic order is assumed in much of what he has to say regarding the conditions of capitalist competition, as we shall see.

“The Sociological Categories of Economic Action”

A key distinction Weber makes in his “Sociological Categories of Economic Action” is that between what he calls “economically oriented action” and “economic action” per se. “Economically oriented action” he defines as action that is concerned in some way with the satisfaction of a desire for utilities—that is, it takes that desire into account. By contrast, “economic action” in the strict sense is the use of an

4 ES, p. 130.
5 Ibid, p. 312.
actor's control of resources that is rationally oriented by deliberate planning to economic ends. Thus, any action which, though primarily oriented to other than economic ends, takes account of economic considerations is to that extent “economically oriented”; whereas action which is primarily directed to the satisfaction of economic ends, and importantly is also essentially peaceful, is what Weber calls “economic action” in the pure sense. But further, for Weber “economic action” only exists in the context of scarcity, which suggests he is concerned to relate his definition directly to known principles of economic theory. “We shall speak of economic action only if the satisfaction of a need depends, in the actor’s judgement, upon relatively scarce resources and a limited number of possible actions.”

What Weber says about the essential characteristics of “economic action”, particularly when he contrasts it with “technical action”, largely corresponds to what Schumpeter says on the same subject. Weber says, as long as the action is “purely technical” in the present sense, it is oriented only to the selection of the means which, with equal quality, certainty, and permanence of the result are comparatively most “economical” of effort in the attainment of a given end; comparatively that is, insofar as there are at all directly comparable expenditures of means in different methods of achieving the end. The end itself is accepted beyond question and a purely technical consideration ignores other wants. Thus, in a question of whether to make a technically necessary part of a machine out of iron or platinum, a decision on technical grounds alone would, so long as the requisite quantities of both metals for the particular purpose were available, consider only which of the two would in this case best bring about the given result and would at the same time minimise the other comparable expenditure of resources, such as labour. But once consideration is extended to take account of the relative scarcity of iron and platinum in relation to their potential uses, as today every technician is accustomed to do even in the chemical laboratory, the action is no longer in the present sense purely technical, but also economic. From the economic point of view ‘technical’ questions always involve considerations of “costs.”

In his ensuing discussion Weber proceeds to analyse the various modes of economic action found throughout history, pointing out that very broadly there has been long-term trend away from traditional acceptance of inherited techniques and customary social relationships towards a more rational orientation of action generally. He lists the typical measures of rational economic action as:

(a) the systematic allocation between present and future of utilities, the control of which the actor feels he can count on;
(b) the systematic allocation of utilities for various potential uses in the order of their estimated relative urgency and ranked according to the principle of marginal utility;
(c) the systematic procurement through the production or transportation of such utilities for which all the necessary means of production are controlled by the actor himself—this takes into account the irksomeness of the requisite

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6 ES, p. 339.
7 ES, p. 66. Schumpeter’s view of the distinction between “technical” versus “economic” activity is brought out especially in his discussion of the difference between invention and innovation, topics to be discussed at length below.
labour services as well as other potential uses to which the requisite goods could be put;

(d) the systematic acquisition by agreement with the present possessors, or with competing bidders, of assured powers of control and disposal over utilities. Obviously each of these are dispositions are brought to a particularly high level of development under modern capitalist conditions. Importantly from our point of view, Weber notes the possibility in item (b) above that the principle of marginal utility may serve as an ideal rule that can guide the economic action of the individual. As he puts it elsewhere:

Marginal utility theory . . . treats human action as if it ran its course from beginning to end under the control of commercial calculation—a calculation set up on the basis of all conditions that need to be considered. It treats individual “needs” and the goods available . . . for their satisfaction as mathematically calculable “sums” and “amounts” in a continuous process of bookkeeping. And, though he does not posit the operation of an historical law, Weber is of the view that,

the historical distinctiveness of the capitalist epoch, and thereby also the significance of marginal utility theory . . . for the understanding of this epoch, rests on the circumstance that . . . under today’s conditions of existence the approximation of reality to theoretical propositions of economics has been a *constantly increasingly* one. It is an approximation to reality that has implicated the destiny of ever wider layers of humanity. And it will hold more widely, as far as our horizons allow us to see.

In other words, as contemporary capitalist conduct increasingly conforms to the ideal norm of economic action, marginal utility theory is more and more relevant to the understanding of actual conditions. For instance, according to Weber, theoretically ideal conduct is approached quite closely in the phenomena of the modern stock exchange. “It is, for example, no accident that an especially striking degree of approximation to the theoretical propositions of price formation (as Böhm-Bawerk, connecting his work with that of Menger, developed them) has been represented by the fixing of the Berlin market rate . . . This Berlin situation could serve directly as a paradigm for the theoretical propositions.”

Weber accepts a view of human needs that has much in common with the assumptions of orthodox economic theory. He says, “Common experience is justified in the view that men in their conduct are, among other things, motivated also by “need” such as can be satisfied only by consumption of commodities that are at any time available only in limited supply—or by outputs of labour or the products thereof.” In other words, as one need is satisfied, others become more urgent and enter into the calculations of the individual actor. This is not to say that the individual can achieve an optimum of satisfaction either regularly or even occasionally, but a degree of calculation typically occurs.

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8 ES, p. 71.
11 *Ibid*.
12 *Ibid*, p. 29. This starting point is classically formulated by Menger in his *Principles of Economics*. 
Men—be it in ever so varying degrees—are able to act “expediently”, that is, in the light of “experience” and of “prior calculation”. This means to act in such a fashion that they allocate the quantitatively limited “goods” and “labour powers”, which they can dispose of or obtain, to the particular “needs” of the present and of the foreseeable future according to the importance they attach to this present and future.\(^{13}\)

But Weber does not assume that needs are given and always “genuine” in that they arise naturally and are not subject to “influences” of various kinds. Consumption desires can be “awakened” and may be manipulated by entrepreneurs\(^{14}\)—and as we shall see, in the work of Schumpeter this is an absolutely necessary and regular feature of capitalism flowing from the drive of entrepreneurs to achieve new avenues of profit. For Weber, despite the rationalising tendencies discussed above, the institutional structure of capitalism does not promote uniformly rational conduct on the part of every actor, and all manner of “irrationalities” may and do occur. Insofar as one can say there is a tendency toward economic progress, Weber insists this can only be claimed on the basis of given assumptions that may not generally prevail. “We may . . . speak of ‘economic’ progress towards an optimum of want satisfaction under conditions of given resources—if it is assumed that there are given wants, that all these wants and their rank ordering is accepted, and finally that a given type of economic order exists.”\(^{15}\) In broad terms what economic theory does is to state what an individual would do if they acted strictly rationally and what implications follow from this—sociology, we may assume, is concerned with the conditions under which such rationality prevails or otherwise. “Economic theory makes certain assumptions which scarcely ever correspond completely with reality but which approximate it in various degrees and asks: how would men act under these conditions, if their actions were rational? . . . It is and always will be indispensable for analytic purposes.”\(^{16}\)

Let us now turn to Weber’s discussion of various key terms that are central to economic analysis in general. First we consider “economic exchange”: “Exchange” is a compromise of interest on the part of the parties in the course of which goods or other advantages are passed as reciprocal compensation. The exchange may be traditional or conventional, and hence especially in the latter case not economically rational. Or, secondly, it may be economically rational both in intention and in result. However, every case of a rationally oriented exchange is a resolution of a previously open or latent conflict of interest by means of a compromise. The opposition of interests, which is resolved in the compromise, involves the actor in potentially two different conflicts. On the one hand there is a conflict over the price to be agreed upon with the partner in exchange; the typical method is bargaining. On the other hand, there may also be competition with actual or potential rivals, either in the present or in the future who are competitive in the same market. Here the typical method is competitive bidding and offering.\(^{17}\)

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\(^{13}\) *Ibid*, p. 29.  
\(^{14}\) *ES*, p. 92.  
\(^{15}\) *MSS*, p. 35.  
\(^{16}\) *MSS*, p. 44.  
\(^{17}\) *ES*, p. 72.
Among other points this analysis indicates Weber’s appreciation of the economic theory of price formation under conditions of market competition. We cannot determine from these and similar remarks whether he is endorsing a basically Walrasian or Mengerian perspective. The key point, however, is that Weber is clearly cognizant of the economic significance of the complex interactive processes involving the setting of prices for goods in the competitive situation that pertains in the modern economy.

We now turn to Weber’s definition of the market. He defines what he calls "the market situation" for any object of exchange as being all the opportunities of exchanging it for money that are known to participants in the exchange situation. "Marketability" he defines as the degree of regularity with which an object tends to be an object of exchange in the market. "Market freedom" is the degree of autonomy enjoyed by the parties in the market relationship in the price struggle and in competition. Clearly, under certain modern conditions, marketability and market freedom are raised to a level that approaches a maximum possible.18

We shall now consider the complex issue of the nature of the rationality of economic action where Weber introduces his fundamental distinction between “formal rationality” and “substantive rationality”. This distinction is of considerable significance in his account of the nature of modern capitalism and his approach to modernity in general. He defines the “formal rationality” of the economic action as “the extent to which quantitative calculation or accounting is technically possible and is actually applied”. By contrast "substantive rationality" is “the degree to which the provisioning of a given group of persons (no matter how delimited) with goods is shaped by economically oriented social action under some criterion (past, present, or potential) of ultimate values (wertende Postulate), regardless of the nature of those ends.”19 As regards formally rational economic action, Weber says the extent of formal rationality will be dependent upon the degree to which the provision of needs in the economy “is capable of being expressed in numerical calculable terms and is so expressed.”20 The technical form in which these calculations take place, whether in money or in kind, is not decisive, however, the highest degree of rationality certainly requires the use of money. As regards substantive rationality Weber emphasizes the fact that there are a great many substantive value points of view from which the desirability of an economy or an economic action can be judged, and there is no scientific/objective way to evaluate which is best. In principle formal and substantive rationality are in always in conflict and this means that insofar as the economy tends toward the maximization of formal rationality it must necessarily require the sacrifice of some substantive values, as we shall explain in more detail below. In our discussion of Schumpeter below we shall see that he employs the concept of “creative destruction” to characterize the contradictory significance of capitalist progress. We shall argue that this notion is in many way equivalent to Weber’s idea of the conflict between formal and substantive rationality.

At this point in the section under discussion Weber introduces an analysis of the rationality of monetary accounting. He says that from a purely technical point of

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18 See discussion at ibid, pp. 82-84.
19 ES, p. 85.
20 Ibid.
view money is the most “perfect” means of economic calculation: “it is formally the most rational means of orienting economic activity.” A completely rational monetary accounting has the following consequences: First it means the possibility of valuing all the means of carrying out a productive purpose in terms of the existing or anticipated or expected market situation. These means comprise all those things that are required in the present or are expected to be needed in the future and include all types of utilities, means of production and other economic advantages that the economic actor may think it useful to control. Secondly, it means the possibility of a quantitative statement of the prospects of any projected course of action, and once completed the actual results can be calculated in monetary terms and an estimated net profit established. Thirdly, it means the possibility of a periodical estimation of all the goods and assets controlled by a given economic unit at a given point with those at a previous period and a comparison made in monetary terms. Fourthly, it allows before and after consideration of the receipts and expenditures that are likely to be available for the use of an economic unit in a given period. And finally, it allows through the orientation of consumption to these data for the requisite utilities to be acquired in accordance with the principle of marginal utility. Obviously, the profit making enterprise of the modern type is unthinkable without the use of monetary accounting with the advantages outlined.

From these considerations Weber turns to discuss the concept and types of profit making. Profit making, he says, “is activity which is oriented at least in part to the opportunities of profit making and it is economic if it is oriented to the acquisition by peaceful methods. It may be oriented to the exploitation of the market situation.” In the latter case, of course, it becomes a form of “market capitalism” and if rational it becomes fully modern capitalism as such. Intimately related to the phenomenon of rational capitalism is a crucial business technique without which the rationality of capitalism is not possible. Weber never tires of emphasizing that there is a form of monetary accounting that is peculiar to rational economic profit making, namely “capital accounting”:

Capital accounting is the valuation and verification of opportunities for profit and of the success of profit making activity by means of a valuation of the total assets, goods and money of the enterprise at the beginning of a profit making venture, and a comparison of this with a similar evaluation of the assets still present and newly acquired at the end of the process; in the case of a profit making organization operating continuously, the same is done for an accounting period. In either case a balance is drawn between the initial and final states of the assets. "Capital" is the money value of the means of profit making available to the enterprise at the balancing of the books; "profit" and corresponding "loss", the difference between the initial balance and that drawn at the conclusion of the period.

Of course, the technically most advanced form of capital accounting is that first developed in the Middle Ages and now universally applied known as “double-entry bookkeeping”.

**References**

21 Ibid, p. 86.


23 Ibid, pp. 90-1.

24 Ibid, p. 91.
Weber’s definition of "economic enterprise" is directly connected to the features outlined above for he defines it as autonomous economic action capable of orientation to capital accounting. In effect this is where he provides his most fundamental definition of modern capitalism. The modern capitalist enterprise is an institution that is singularly oriented to profit making utilising the means of capital accounting and estimating its profit and/or loss over given periods of time in terms of capital. Weber's estimate of world-historical significance of this form of capitalism is hard to overemphasize. He says, "The extraordinary importance of the highest possible degree of calculability as the basis for efficient capital accounting will be noted time and again throughout the discussion of the sociological conditions of economic activity. It is far from the case that only economic factors are important to it. On the contrary it will be shown that the most varied sorts of external subjective barriers account for the fact that capital accounting has arisen as a basic form of economic calculation only in the Western World."25 Here Weber is noting not merely that rational capital accounting has reached its zenith with modern capitalism; he is highlighting the fact that such an outcome is not a result of economic factors working alone.

A market economy has numerous special characteristics under conditions of formal rationality. And what Weber says about this again suggests his approach owes much to the notions of a market economy and competitive enterprise as developed by Austrian economics in particular. He says, "In a market economy every form of rational calculation especially of capital accounting is oriented to expectations of prices and their changes as they are determined by the conflicts of interest in bargaining and competition and the resolution of these conflicts. In profitability-accounting this is made particularly clear in that system of bookkeeping which is (up to now) the most highly developed one from a technical point of view, in the so-called double entry bookkeeping."26 Weber explains how the monetarization of the economy facilitates the use of the principle of marginal utility by both producers and consumers. He also emphasizes that the process of exchange involves inherent conflict, for money prices are in effect weapons in a continual and ineluctable struggle for economic success:

In an economy which makes use of capital accounting and which is thus characterised by the appropriation of the means of production by individual units, that is by 'property', profitability depends on the prices which the 'consumers', according to the marginal utility of money in relation to their income, can and will pay. It is possible to produce profitably only for those consumers who, in these terms, have sufficient income. A need may fail to be satisfied not only when an individual's own demand for other goods take precedence, but also when the greater purchasing power of others for all types of goods prevails. Thus the fact that the battle of man against man on the market is an essential condition for the existence of rational-monetary accounting further implies that the outcome of the economic process is decisively influenced by the ability of persons who are more plentifully supplied with money to outbid the others, and if those more favourably situated for production to underbid their rivals on the selling side. The latter are particularly those well supplied with goods essential to production or with money. In particular, rational-money

26 Ibid.
accounting pre-supposes the existence of effective prices and not merely of fictitious prices conventionally employed for technical accounting purposes. This in turn, presupposes money functioning as an effective medium of exchange, which is in demand as such, not mere tokens used as purely technical accounting units.\footnote{Ibid, p. 93.}

In these last remarks on pricing Weber is no doubt alluding to the possibility of a socialist system in which prices are fixed by a central authority. And it is apparent that he is expressing his scepticism that an economy that dispenses with money can achieve a level of economic rationality equivalent to that of a capitalist economic system. “A socialist regime might issue vouchers, in payment for a given quantity of socially useful “labour”, valid for the purchase of certain types of goods. These might be saved or used in exchange, but their behaviour would follow the rules of barter exchange, not of money.”\footnote{Ibid, pp. 79-80.} So consequently actors under these conditions cannot orient themselves to the possibilities of exchange as presented by the market system.\footnote{Of course, since Weber’s time there have been a number of socialist economists, most notably Oskar Lange, who have argued that via the mechanism of “indicative prices” the central authority can achieve a rational allocation of resources.}

Weber wants to explore the inescapable social consequences of an economy based on capital accounting and the orientation of action to money prices and profit making. He alludes to the various critiques of capitalism current in his day and in particular to the fact of economic inequality when he states that orientation of action to money prices has the following consequences:

(1) the differences in the distribution of money or marketable goods between the individual parties in the market is decisive in determining the direction taken by the production of goods, so far as it is carried on by profit-making enterprises, in that it is only demand made effective through the possession of purchasing power which is and can be satisfied. Further, (2) the question, what type of demand is to be satisfied by the production of goods, becomes in turn dependent on the profitability of production itself. Profitability is indeed formally a rational category, but for that very reason it is indifferent with respect to substantive postulates unless these can make themselves felt in the market in the form of sufficient purchasing power.\footnote{Ibid, pp. 93-4.}

Weber does not shy away from drawing the social implications of a fully rational capitalism. Once capitalism becomes the dominant form of economic activity, society as a whole will be governed by the machinations of capital per se. For in a society so driven, substantive values like equality of income or concerns about the “justice” of the labour contract etc. must be, at least partially, sacrificed. Weber explains what he means when he speaks of "the power of capital" as follows: "We mean that the possessors of control over the means of production over economic advantages which can be used as capital goods in a profit-making enterprise enjoy, by virtue of this control and of the orientation of economic action to the principles of capitalistic business calculation, a specific position of power in relation to others."\footnote{Ibid, p. 95.} Hence, he is to an extent in agreement with Marx that capitalism must inevitably lead
to a class situation in which to a degree at least capitalists are at odds with workers. Where he differs is in accepting that this division is all there is to the issue of social stratification and that it is ultimately determinative of the future course of historical development.

Weber distinguishes rational profit-making activity with the use of capital accounting from earlier forms of profit-making such as occurred in antiquity and the Middle Ages in a fashion largely consistent with what he has said in his earlier investigations. He alludes to the commenda-type venture capitalism where investments are made and profits generated in what appears to be an arrangement similar to or equivalent to that of the modern business enterprise. With such arrangements, however, "capital appears though not under that name and is only a sum of money used for accounting purposes. The capital of the commenda was simply the money valuation of the goods which were transported and served merely for the purposes of settling accounts between the parties at the end of the enterprise."32 The modern type of "enterprise" has an entirely different nature. Although he says he uses this term in accord with ordinary usage, he wants to emphasize the fact that the orientation to capital accounting is crucial to the modern form.

Another phenomenon Weber has occasion to define is "capital market". By this concept he means that certain "goods" such as money are in demand in order to be used as capital goods and that there are profit-making enterprises, namely banks, which derive their profit from the business of supplying these goods.33 Here Weber is alluding to the significance of banking and financial institutions and their role in the provision of credit, a point of obvious intersection with the work of Schumpeter. Weber distinguishes the lending of money for purposes of consumption and non-economic uses from the lending of money with the object of profit making. In the latter case the concept of interest on capital becomes relevant:

In a rational profit-making enterprise, the interest, which is charged on books to a capital sum is the minimum of profitability. It is in terms of whether or not this minimum is reached that a judgment of advisability of this particular use of capital goods is arrived at. Advisability in this context is naturally conceived from the point of view of profitability. The rate for this minimum profitability is, it is well known, only approximately that which is possible to obtain giving credit on the capital market at the time. But nevertheless, the existence of the capital market is the reason why calculations are made on this basis, just as the existence of market exchange is the basis for making entries against the different accounts. It is one of the fundamental phenomena of a capitalist economy that entrepreneurs are permanently willing to pay interest for loan capital. This phenomenon can only be explained by understanding how it is that the average entrepreneur may hope in the long run to earn a profit, or that entrepreneurs on the average in fact do earn it, over and above what they have to pay as interest on loan capital. . . 34

These remarks show Weber is fully cognizant of the way in which the financial market intersects with the operation of the industrial system. We shall see below that

32 Ibid.
33 Ibid.
34 Ibid, p. 97.
Schumpeter has a highly developed theory of entrepreneurial profit, but we maintain the two perspectives are largely consistent.

Weber also refers to the typical subjective attitude of the entrepreneur under conditions of competition in a modern market situation. Importantly from our point of view, he refers explicitly to the manner in which economic theory deals with the financial realities of the market: "economic theory approaches this problem in terms of the relative marginal utilities of goods under present and future control." He proceeds to show the distinctiveness of his own approach:

But the sociologist would then like to know in what human actions this supposed relation is reflected in such a manner that the actors can take the consequences of this differential valuation of [present and future goods], in the form of "an interest rate", as a criterion for their own operations. For it is by no means obvious that this should happen at all times and places. It does indeed happen, as we know, in profit-making economic units. But here the primary cause is the economic power distribution between profit-making enterprises and budgetary units (households) . . . Profit-making enterprises will be founded and operated continuously (capitalistically) only if it is expected that the minimum rate of interest on capital can be earned. Economic theory . . . might then very well say that this exploitation of the power distribution (which itself is a consequence of private property in goods and the means of production) permits it only to this particular class of economic actors to conduct the operations in accordance with the “interest” criterion.

In this last sentence Weber highlights the class structure of modern capitalist system and notes the fact that the orientation to profit making presupposes a division between those well endowed with capital and those who are not. The latter operate their households largely on budgetary principles and are obliged to accept whatever remuneration is obtainable from employers by selling their labour on the market—as Weber puts it on one occasion, under the terms “take it or leave it”. The further import of the remarks about interest is to say that only once a certain level of market orientation and a credit system based on banking have been established can a capitalistic economy in the modern sense be said to exist. Again here are obvious points of contact with Schumpeter, as we shall see in more detail below.

35 Ibid.
37 Weber was clearly highly cognizant of the Marxist critique of capitalism and was familiar with the argument that characterized the market situation as one which allows for the “exploitation” of the workers who, having been separated from the means of production, are obliged to sell their “labour power” to the capitalists at under its true value. While he does not endorse the labour theory of value as such, Weber remained highly sympathetic to the underprivileged condition of the working class as a whole. An interesting analysis of Weber’s relation to Marxist class theory and his treatment of class domination, see the essay by Erik Olin Wright, “The Shadow of Exploitation in Weber’s Class Analysis,” in Charles Camic, Philip S. Gorski, and David M. Trubek, Max Weber's Economy and Society: A Critical Companion, Stanford University Press, 2005, pp. 204-36.
On the basis of his description of these basic features and their interconnections, Weber draws further conclusions. He lists the following elements as being decisive for the motivation of economic actors in a market economy:

1. For those without substantial property (a) the fact that they run the risk of going entirely without provisions, both for themselves and for those personal dependants, such as children sometimes parents, who the individual typically maintains on his own account; (b) that, in varying degrees subjectively they value economically productive work as a mode of life.

2. For those who enjoy a privileged position by virtue of wealth or the education which is in turn dependant on wealth: (a) opportunities for large income from profitable undertakings; (b) ambition; (c) the valuation as a "calling of types of work enjoying high prestige, such as intellectual work, artistic performance, and work involving high technical competence.

3. For those sharing in the fortunes of profit making enterprises: (a) the risk to the individual's own capital, and his own opportunities for profit combined with; (b) the valuation of rational "acquisitive activity" as a calling.

In contrast to Marx, Weber points to the diversity of the social class situation of individuals within a capitalist society. He is implicitly criticizing the view that the motivation of individuals can be explained as a mere reflex of the pre-existing socio-economic structure, as is the tendency of Marxism. It is noteworthy that for all three groups distinguished above the motivation of a vocational type and/or the work ethic is cited as typical of the driving incentive, an obvious connection to the ongoing relevance of the Protestant Ethic.

As already noted, Weber is fully aware of the issues raised by the socialist critique of capitalism, and indeed, despite his rejection of socialism, he made significant contributions to the development of the theory of a planned or socialist economy. Highlighting the inevitable negative consequences of a thoroughgoing socialization of the economy, he explains how the socialistic provision of individual needs must inevitably weaken the incentive to labour. For, "it would be impossible to allow workers' dependents to suffer the full consequences of a worker's lack of efficiency in production. Hence it would be impossible to retain capital risk and proof of merit by a formally autonomous achievement. . . . Where a planned economy is carried out, it must further accept the inevitable reduction in formal, calculating rationality which would result from the elimination of money and capital accounting. Substantive and formal (in the sense of exact calculation) rationality are, it should be stated again, after all largely distinct problems." It is simply not possible to optimise want satisfaction on egalitarian or other substantive bases of valuation at the same time as maximising the formal rationality of economic activity. It follows that any enhancement of substantive rationality must come at the cost of formal rationality. As we shall explain in more detail later, Weber does not argue that formal rationality is superior to substantive rationality, and in any event judgements about this are not a matter that can be decided scientifically. Personally, he advocated a compromise between the two forms of rationality—in other words, he saw the necessity of a trade-off between the efficiency gains of formal rationality and the satisfaction of substantive values such as justice, equality, individuality, freedom.

38 Ibid, p. 110.
39 We shall consider these issues further in Chapter 5 below.
and the like. It bears noting that Weber was a passionate advocate of many of the social reforms being fought for in Germany at the time, and he was genuinely concerned for the welfare of the working classes.\textsuperscript{41} Equally, however, he was wary and at times highly critical of attempts to eliminate the market and to overthrow capitalism as a system. If these efforts were finally successful, he feared the effect would be to so reduce the efficiency of the economy as to lead to an unacceptable reduction in the standard of living of the masses along with other social and political consequences that would not be desirable. But importantly, Weber had no illusions that the general significance of a capitalist system of high rationality is the subjection of the workers to the domination of entrepreneurs.\textsuperscript{42} We shall have occasion to return to these issues at some length below.

\textbf{“The Conditions of Maximum Formal Rationality of Capital Accounting”}

In Section 30 of the “Sociological Categories of Economic Action”, where Weber’s discusses what he terms "The Conditions of Maximum Formal Rationality of Capital Accounting”, his analysis reaches a kind of culmination. Here he outlines in ideal typical fashion the principle conditions necessary to raise the essential features of capitalism to a level of development that is the highest conceivable. Like all ideal types this is a “utopia”, not in the sense of being ethically ideal, but because these conditions if institutionalised would create a capitalist system with the greatest formal rationality. The conditions necessary for maximising formal rationality may from time to time be approached or approximated in concrete reality, and Weber implies this has been the case at various points in the recent history of Europe and possibly elsewhere. In the following we list Weber’s principle conditions and comment briefly on them:

1. \textit{Appropriation of the means of production} that is, "complete appropriation of all material means of production by owners and the complete absence of all formal appropriation opportunities for profit in the market, that is, market freedom.” In other words, the distribution of business assets is such that all means of production that are held by discrete entities (companies, partnerships or individuals) and there is an absence of monopoly. These entities are in consequence obliged to compete against each other for their economic survival. This condition would appear to correspond to what in economic theory is usually termed “perfect competition”.

2. \textit{Autonomy in selection of management} that is, "complete autonomy in the selection of management by the owners, thus complete absence of formal appropriation of rights to managerial functions.” Business competence and managerial expertise must alone be the criterion for selecting managers. Managers should be selected for their skill and ability to maximise profitability. This means religious, ethical, or other non-economic criteria are irrelevant for the selection of the personnel of management.

\textsuperscript{41} On Weber’s involvement with the Verein für Sozialpolitik, which was an association of academics that supported various social reforms, see Dieter Krüger, “Max Weber and the Younger Generation in the Verein für Sozialpolitik”.
\textsuperscript{42} ES, p. 138.
3. *Free labour,* that is, "complete absence of appropriation of jobs and opportunities for earning by workers and conversely the absence of appropriation of workers by owners.” By this Weber first means that the workers cannot “own” their job positions. In other words, management must have the freedom to employ whichever workers they deem suitable and conversely have the ability to dismiss those not competent or superfluous. The other feature stated, the absence of appropriation of workers by owners, means the absence of various forms of unfree labour. The reason this is important is that, contrary to what is sometimes thought the tendency of capitalism, it is not in the interests of a rational profit-making enterprise to hold its workers as slaves or to operate other types of indenture and labour. For such ownership places an excessive burden on the enterprise to maintain its workers and their dependents even in situations where they are not fit, proficient or otherwise needed, thus limiting the ability of the organization to minimize its costs. As Marx was keen to emphasize, a capitalist enterprise requires only the workers’ labour power and not their persons.

4. *Freedom of contract* that is, "complete absence of substantive regulation of consumption, production, and prices, or other forms of regulation which limit freedom of contract or specify conditions of exchange. This may be called substantive freedom of contract.” The economic transactions that occur between consumers and producers and between production units in a capitalist economy must be oriented to the prices set exclusively by the market/exchange mechanism. Weber accepts that the theory of marginal utility gives the most adequate account of how those prices are actually formed. This condition implies that the various forms of state intervention in the economy for welfare, environmental and other reasons may limit formal rationality.

5. *Rational technology* implies, "complete calculability of the technical conditions of the production process; that is, a mechanically rational technology". Only where modern science has become established and the application of science to the field of industrial technics is widespread is it possible to maximise the calculability of the economic enterprise. As Swedberg explains, “By ‘rational science’ Weber means natural science with a mathematical foundation, which is developed through experimentation by a specifically trained staff in laboratories. Western science united with capitalism in the eighteenth century . . . and this meant the production of goods could be liberated from economic traditionalism.” Insofar as industrial technique is restricted by tradition, religious taboos or other non-economic restraints it is not possible to maximise productivity. Weber has in mind here the need of the enterprise to estimate the likely returns from investments in alternative configurations of plant and machinery so that the level of potential output and thus returns can be reliably estimated.

6. *Rational law and administration* that is, "complete calculability of the functioning of public administration and of the legal order and a reliable purely formal guarantee of all contracts by the political authority. That is, a formally rational administration in law." Only under the conditions of a relatively stable

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political system and a relatively predictable and rational legal system is it possible for the enterprise to pursue its economic interests in the security that efforts will be rewarded as expected. There should be no interference from sources outside the economic sphere such as may happen if interest groups usurp profits or otherwise determine the operations of a firm from outside. The other aspect referred to is the formal guarantee of all contracts by the political authority. As we shall see subsequently, in Weber's account of the development of freedom of contract it is important first that contract has emerged as the key medium for economic transactions. But secondly, the political authority has the function of guaranteeing those contracts, which effectively creates law. Owing to the legal underpinning of contractual agreements, there is a high likelihood of their being carried out as agreed.

7. *Separation of the household from the enterprise* that is, "the most complete separation possible of the enterprise and its conditions of success and failure from the household or private budgetary unit and its property interests". Here Weber has in mind the historical process by which the economic enterprise has emerged as a distinct entity. We shall argue it has been further transformed with the advent of the corporation. Today the enterprise typically takes the form of the limited liability company wherein the actions of those managing operations are formally separated from the substantively-oriented needs of the household.

8. *A rational monetary system* that is, "a monetary system with the highest possible degree of formal rationality". The condition Weber thinks most supports capitalism is where there is "state money", that is, media of exchange that have been coined or printed by a state authority, are guaranteed by that authority and thus have the least chance of being debased.\(^{44}\)

In what follows we shall from time to time comment on each of these features in some detail and show the extent to which Weber's understanding of the capitalist economy requires a grasp of the full significance of the elements listed. From the point of view of our exploration of the relation between Weber and Schumpeter what is significant in Weber's account of modern capitalism in *Economy and Society* is the extent to which his notion of capitalist enterprise under conditions of formal rationality dovetails with the account of the functioning of an economic system as expounded in the theorists of the market economy of his day.

**The Significance of the Factory**

As we have already seen, in his discussion of the development of capitalism Weber refers extensively to the advent of the factory. He is fully aware that institutions ostensibly similar to factories existed in antiquity and in the Middle Ages. He variously refers to the *ergasterion* that was a common characteristic of Greek and Byzantine economic life, and he also discusses the similar Roman *ergastulum*. But these "workshops" never approached the equivalent of the modern factory. In many such cases, even where the means of production were owned by an individual, labour was not hired but invariably that of slaves or some other form of forced labour was in

\(^{44}\) ES, pp. 161-2.
use. In addition, such pre-modern workshops seldom used any form of machinery or mechanical power, nor did there come into being internal differentiation of labour. Thus, for Weber the development of the market system, mass production and consumption etc. is intimately bound up with the advent of the factory. In this regard I venture to suggest Weber is closer to Marx than he is to Schumpeter for whom the concept of the factory does not loom so large.

In considering the earliest stages of the modern factory Weber refers to workshops such as that of "Jack of Newbury" of the early sixteenth century, which is alleged to have had hundreds of handlooms that were apparently the property of the workers. However, Weber says each worker worked independently as if he was at his own home and there was no internal division of labour and combination of functions. The factory system and the industrial type of production oriented to profit-making presupposes what Weber calls “the expropriation of the workers from the means of production”. In using such phraseology Weber is evidently in agreement with Marx on this aspect. He says the expropriation of the workers in general, including clerical personnel and technically trained persons, from ownership of the means of production has important economic consequences because it enables the achievement of higher levels of economic rationality. This follows from the fact that management thereby has extensive control over the selection of the workers and the modes of use to which their labour is put. In a market economy management is not hampered by traditional claims of workers to their position or by their insisting on working in their own way. Under capitalist management operations are oriented predominantly to the requirements of efficiency and profitability.

Because economic enterprise oriented to the exploitation of market opportunities requires capital accounting, it is necessary to obtain the fullest possible control over

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45 On these issues see the analysis in my *Antiquity and Capitalism*, pp. 110-53.
46 ES, p. 135.
48 It is not clear how far Weber endorses the Marxist account of the expropriation of the workers, in particular as regards Marx’s celebrated account of naked and bloody class struggles classically formulated in the famous Chapter 24 of Marx’s *Capital* Volume 1 wherein the peasants were forcibly expropriated from their lands. But he does concede that elements of these events are valid especially insofar as the enclosure movement was a feature of the English situation in the sixteenth century and after.
49 These are issues made well known by Harry Braverman in his *Labor and Monopoly Capital. The Degradation of Work in the Twentieth Century*. 
capital goods by the entrepreneur. Associated with this is the requirement to focus on purely commercial considerations, which means management must have complete command of the resources necessary to compete effectively. Further, Weber says expropriation in the last analysis was made possible by the sheer bargaining superiority of those well endowed with property over those who merely had their labour to offer on the market. He is under no illusion that the unequal distribution of property is an inescapable feature of modern capitalism, and for that reason one cannot claim capitalism is ethically ideal. "The fact that the maximum of formal rationality in capital accounting is possible only where the workers are subjected to domination by entrepreneurs, is a further specific element of the substantive irrationality of the modern economic order." 50 Nonetheless, as we shall explain more fully below, Weber ultimately supports a capitalist economy on the grounds that, despite the inevitable inequality, it facilitates and promotes numerous other values of significance.

Weber’s account of the way in which labour is organized in the modern factory setting coincides to a certain extent with Frederick Taylor’s idea of “scientific management”. As we have seen already, Weber noted the early forms of discipline in large organizations in slave plantations, ancient ergastula and military barracks and expressly contrasted these with the modern factory. In the latter, organizational discipline has a rational basis:

With the help of suitable methods of measurement, the optimum profitability of the individual worker is calculated like that of any other material means of production. On this basis, the American system of “scientific management” triumphantly proceeds with its rational conditioning and training of work performances, thus drawing the ultimate conclusions from the mechanization and discipline of the plant. The psycho-physical apparatus of man is completely adjusted to the demands of the outer world, the tools, the machines—in short, it is functionalised, and the individual is shorn of his natural rhythm as determined by his organism; in line with the demands of the work procedure, he is attuned to a new rhythm through the functional specialization of muscles and through the creation of an optimal physical effort. 51

The Dependence of Modern Capitalism on the State

As we have already seen, Weber regards the modern state as crucial for the advent of modern capitalism, and sees the state as having achieved a unique degree of rationality compared with non-western states. He contrasts the state in the modern West, for example, with the Chinese state of the old regime, which was based on the rule of a stratum of officials called mandarins. Mandarins were primarily humanistically-educated literati who enjoyed the position of a benefice but were not trained for administration. For administration lay in the hands of chancery officials who also had knowledge of jurisprudence. Everything was based on magical theory, that the virtue of the empress and the merits of the officials would keep society in order. Essentially things are left to take care of themselves. Clearly capitalism cannot flourish under these sorts of conditions. It is only under a rational state that

51 ES, p. 1156.
expert officialdom and rational law come into their own. Weber claims that a fully “rational state” has only existed in the modern West. By “rational” he first means that the basis of the state’s legitimation is grounded in conceptions that are justified through rational discourse, that is, through notions of legitimacy that are amenable to reasoned exegesis: “Rational grounds—resting on a belief in the legality of enacted rules and the right of those elevated to authority under such rules to issue commands (legal authority).” Secondly, rationality means that the state is governed with the means of a rational bureaucratic administration. This entails the following key elements: (a) there is continuous rule-bound conduct of official affairs; (b) there exists the principle of official jurisdictional areas; (c) there is the principle of office hierarchy; (d) the rules that regulate the conduct of the office are either technical rules or rational norms; (e) management of the office is based upon written documents or “files”; (f) officials have specialized training; (f) office work is the primary activity of paid employees who have no ownership of their positions; and (g) management follows general rules which can be learned.

Thirdly, Weber includes in the idea of the rational state “rational law”, a phenomenon to which we shall return in detail below.

The rational state with rationalized rules and norms as the basis upon which the officials make decisions arose at least on the formal side with Roman Law. But Weber is quick to point out that most of the substantive legal requirements of modern capitalism were not Roman in origin. The Roman and the Greek courts administered what Weber terms a “petty justice”: the litigants worked on the judge with pathos, tears and the abuse of their opponents. But in civil trials the praetor appointed a iudex or judge and strict instructions were given requiring a judgement against the accused or acquittal. Eventually, Weber explains, “Under Justinian the Byzantine bureaucracy brought order and system into this rational law, in consequence of the natural interest of the official in a law which would be systematic and fixed and hence easier to learn.” Later, around the twelfth century, Roman Law came into the hands of Italian notaries. These individuals and secondarily the universities are responsible for the revival of Roman Law, which led to the subsequent influence of Roman Law on European Law and the transformation of the latter into Civil Law. Roman Law was progressively reinterpreted according to the needs of the time and the universities developed systematic legal doctrine. An essential feature of all this was the rationalisation of legal procedure. German law picked up on the formalism of Roman Law, which had an affinity with its own primitive trial procedure. The French borrowed the idea of the representative or advocate. The Catholic Church was also attracted to many of these features, and out of its association with Roman institutions it developed Canon Law. The Church utilised strict Roman forms for disciplinary matters in relation to the laity and its own internal order. But the businessman could not permit his claims to be decided by a rigidly formal procedure involving reciting formulas. Weber says that everywhere businessmen sought and were often granted exemption from formalistic legal contests and ordeals. The Church also eventually abandoned its excessively legalistic procedure.

See ES, p. 217.
GEH, p. 340.
Somewhat paradoxically given the rationalism of Roman Law, Weber downplays its significance for the development of modern capitalism because in England, which he designates the birthplace of capitalism, Roman Law was never accepted—though it did have some influence as is known in legal education and legal theory. The reason Roman Law was not taken up in England was because in the Royal Courts there existed a class of advocates who protected the national institutions against corruption and who controlled the development of legal doctrine. From its ranks were chosen, and still are chosen, the judges. The dominance of the Common Law advocates prevented Roman Law from being taught in universities and this meant an academic form of recruitment to the judiciary never developed. The crucial point is that all the characteristic legal institutions of modern capitalism have origins other than in Roman Law. The annuity bond came from medieval law. Similarly, the stock certificate rose out of medieval law. The bill of exchange was developed from Arabic, Italian, German and English influences. The commercial company is also medieval in origin, only the commenda sea loan having an ancient origin. Likewise, the mortgage with security registration and deed of trust, and the power of attorney are all derived from medieval times. Roman Law was mainly relevant for formal juristic thought.

In its structure a legal system is based on either formal (legalistic) or material principles. By material principles Weber means utilitarian and economic considerations such as those to which the Islamic Kadi pays attention in his conduct of a case. This is the case with bureaucracies and absolutist system of justice. According to Weber, Roman law was a way of resisting material or substantive orientation of legal thought in favour of formalisation.\textsuperscript{55} Formalisation is important because it tends to promote a calculable legal order. Weber gives as an example what may happen in China when a man who has sold his house to someone later comes back and asks to be taken in because in the meantime he has become impoverished. If the purchaser refuses to heed the ancient Chinese command to aid a brother, the spirits will be disturbed; hence the impoverished seller ends up in the house as a non-paying renter. Capitalism cannot exist with such a system. It requires a law that can be counted upon like a machine: from particular inputs a definite outcome is highly probable and can be relied upon. As Weber puts it on one occasion: “Industrial capitalism must be able to count on the continuity, trustworthiness and objectivity of the legal order, and on the rational, predictable functioning of legal and administrative agencies.”\textsuperscript{56} Such a body of law was achieved in the West through an alliance between the modern state and the jurists for the making good of the state’s claims to power. But paradoxically, capitalism arose first in England where the rule of officials was minimized.\textsuperscript{57} This could occur in part because of the role of the bourgeoisie whose practical need for a calculable law was decisive in developing the tendency toward formal law. But this did not culminate in a highly formalized gapless system as advanced by the Pandecists in Germany because a formal, empirical case law was more apposite.\textsuperscript{58}

\textsuperscript{55} Ibid, p. 342.
\textsuperscript{56} ES, p. 1095.
\textsuperscript{57} Ibid, p. 1109.
The Legal Bases of Modern Capitalism

Weber’s complete account of the role of law for the development of capitalism is complicated and involved. It is largely to be expounded in Chapter Eight of *Economy and Society*, “The Sociology of Law”, though this chapter treats the field of law broadly and is also an historical inquiry concerning the development of law as an institution. In what follows we shall attempt to limit our discussion to those aspects that are of significance for the theory of capitalism that is our focus.

A first distinction Weber makes is that between public law and private law. Public law is defined as the total body of those norms that regulate state-oriented action, that is those activities that serve the maintenance, development and pursuit of the objectives of the state. By contrast, private law, Weber suggests, should be defined as the totality of those norms, which, while issuing from the state, regulate conduct other than state action. Weber compares this dichotomous with primitive societies where crime and tort are not distinguished; procedure does not vary whether the suit is about a piece of land or a homicide. In these societies there was often no official machinery to enforce judgments, it being sufficient simply that a judgment has been arrived at. The assumption is that magical forces will do whatever is necessary to enforce the judgment. It is only with the advent of the state as a compulsory association with a staff to carry out enforcement that the legal order becomes routine and reliable.

An analysis of the role of law in relation to the advent and advance of capitalist institutions must first consider Weber’s discussion of freedom of contract. He makes a distinction between two fundamental kinds of rights: Rights generally confer upon a person a power to control an object or to act in a particular way unfettered by the state or other individuals. A right effectively gives rise to a legally guaranteed expectation that is equivalent to a kind of privilege. There are two kinds of privileges. The first kind is constituted by the so-called “freedoms”, that is, such privileges as freedom of movement, freedom of conscience, freedom to dispose of or deal with property as one chooses. The second type of privilege is that which grants an individual autonomy to regulate his relations with others by his own transactions. Such “freedom of contract” exists exactly to the extent to which this autonomy is recognized by the legal order.

Weber argues that it is an essential feature of modern private law that contracts have become characteristic. Today, even in public law contractual transactions have become very important, but that is not our present concern. Weber’s point is that contracts in a general sense, meaning voluntary agreements constituting the basis for claims and obligations, have become very widely diffused. He further insists that the extensive development of freedom of contract has been a crucial causal prerequisite for the advance of capitalist institutions of the modern kind, but this outcome cannot be reduced to a reflex of economic factors, as in Marxist theory. Nonetheless, the development of the market and capitalist economic arrangements generally has greatly facilitated expansion of the scope of contractual relations. Hence, in business transactions exchange is typically construed as a legal transaction, namely, the acquisition, transfer, relinquishment or fulfilment of a legal claim. With every extension of the market legal transactions become more numerous and intricate.
However, Weber points out, in no legal order is freedom of contract unlimited in the sense that the law would place its guarantee of coercion at the disposal of every agreement regardless of its terms.

Weber’s Sociology of Law makes a further distinction between what he terms “status contracts” and “purposive contracts”. In early times all contracts were status contracts and contracts were of little or no significance in economic affairs. The distinction between status contracts and purposive contracts is based on the fact that primitive contracts by which political or other personal associations are created involve a change in what Weber calls the total legal situation and social status of the persons involved. He says, such status contracts mean “that the person would become something different in quality (or status) from the quality he possessed before. For unless a person voluntarily assumed that new quality, his future conduct in his new role would hardly believed to be possible at all. Each party must make thus a new “soul” enter his body.”59 These primitive contracts are secured by the threat of the imposition of magical sanctions, but, as the notion of the divinity replaces animism, the oath appears as a person’s conditional self-surrender to evil magical forces. The oath was subsequently transformed from a conditional self-surrender to evil forces to the conditional self-curse calling for divine wrath to strike.

Despite its origins the oath has been important for the rise of purposive contracts. This is because the oath was technically suited as a guarantee that the obligations entered into would be honoured. One of the earliest forms of purposive contract is associated with the phenomenon of barter, though barter was initially focused merely on instrumental contracts often of no economic significance, such as the exchange of women between exogamous sibs. Insofar as economic barter existed, this was usually confined to transactions with persons who were not members of one’s own household or were outsiders. Weber claims that a formal legal construction of barter did not begin to occur until goods such as metals took on a monetary function. Prior to this stage, the various forms of contract were all orientated toward the total social status of the individual and his integration within an association. Such contracts with their all-inclusive rights and duties and special attitudinal qualities are in marked contrast to the money contract that, Weber says, is quantitatively delimited and is qualityless. Weber tells us that the concept of obligation was not entirely absent from primitive law, but it knew only one form, namely, that arising ex delicto or from fault.

Weber says that primitive contracts were gradually transformed from obligations of a delictual nature as disputes over land became more common. Initially, in the early military associations like the ancient polis, disputes about ownership of a farm (fundus or kleros) assumed the form of a bilateral dispute. Typically such disputes turned upon the rights of an individual by virtue of their membership of a group. Nobody could steal a farm because nobody could steal from a person his status as a member of the group. Hence, disputes about land and disputes about status emerged alongside unilateral tort action, such as the Roman vindicatio, which was an action concerned to establish one’s legitimate claim over a parcel of land against a competing claim. Gradually, out of such disputes the concept of contractual obligation emerged. One of the earliest forms in which an obligation was

59 Ibid, p. 672.
acknowledged as arising from a purposive contract was the obligation to pay a debt arising from a loan. The loan was originally an interest-free form of emergency aid among brothers. At first there was no way of enforcing a loan other than by magical means or by shaming or by other forms of social pressure such as the boycott. But gradually a unified law of obligations arose from the action of tort. The delictual liability of the entire kinship group was often the source of a joint liability of all kin to the performance of a contract made by one member. Weber says the entry of money into economic life was decisive for contractual development. Both primitive forms of contract in Roman law, the debt contract \textit{per aes et libram} and the debt contract by symbolic pledge \textit{stipulatio}, were money contracts. These were rigorously formal though oral transactions and required the necessary acts to be performed by the parties in person.

As trial procedure became more and more formal and fixed, the occasions on which incidental transactions could create contractual obligations increased. Even though the legal system had introduced procedures to eliminate self-help, the plaintiff could drag the defendant into court and not release him until he received a security that if found guilty he would pay up. The security the defendant had to give in order to remain unmolested till the time of judgement was provided by way of the pledge. The legal view was that the defendant was his own surety. In Germanic Law the giving of a pledge or a hostage was the ancient means of contracting debts. The giving of a pledge constituted a kind of transfer of the possession of goods for as long as the debt remained unpaid and therefore they were to be regarded as in the creditor’s possession lawfully. Originally, the liability for a contracted debt was not a personal liability of one’s assets but a liability of the debtor’s physical body and it alone. There was no execution upon the debtor’s assets, but execution could be had upon the person, who could even be killed or imprisoned as a hostage or held as a bond-servant or slave. Economic contracts at first related only to changes in the possession of goods. Hence, all legal transactions were connected to legal forms of a transfer of possession, often resting upon magical conceptions. Legal thought did not recognise intangible phenomena such as promises but was interested only the wrong, that is, a misdeed against the gods or a person’s life and wellbeing. The contract to be legally relevant had to involve tangible goods. Only transactions which could be formulated to show connection with such contents could be accepted as legally effective. Thus arose the principal that only purposive contracts involving payments could be binding, and this remains to this day the basis for the English doctrine of consideration as being an essential element of all contracts.

Weber refers to various patterns by which contracts in the modern form began to emerge. We have just referred to the formalistic monetary transaction and the procedural suretyship that was part of procedure. A third way in which new contractual actions arose was out of actions \textit{ex delicto}. By this a non-performance of a promise was characterised as a harm requiring compensation. Thus, in England the Royal Courts increasingly construed non-performance as a trespass to be dealt by the writ of assumpsit. As to the specific prerequisites for the development of the modern capitalistic legal forms, Weber points out that, “Every rational business organization needs the possibility of acquiring contractual rights and of assuming obligations through temporary or permanent agents. Advanced trade moreover needs not only the possibility of transferring legal claims but also and quite particularly a method by which such transfers can be made legally secure and which eliminates the need of
constantly testing the title of the transferor.”\textsuperscript{60} One step on the way to achieving the necessary legal forms was the development of the concept of agency. Weber says this was virtually unknown in Roman Law, a consequence of the fact that direct representation was virtually impossible, probably owing to the widespread use of slaves. Similarly, choses in action could not be assigned in ancient Roman Law and Germanic Law owing to the highly personal character of the debt relationship. He claims that up to the beginning of modern times no practical demand existed for the assignability of choses in action. To meet the needs of commercialisation the device of an instrument made to the order of the payee or to the bearer came into being. The development of the various types of commercial paper indicative of modern commerce first arose in the Middle Ages largely under the influence of the Arabs and were not derived directly from Roman antiquity.\textsuperscript{61}

Modern contract law is the most perfect realisation of the purposive contract in Weber’s sense. Further, “Today it is fundamentally established that any content whatsoever of a contract in so far as it is not excluded by limitations on the freedom of contract creates law among the parties, and that particular forms are necessary only to the extent that they are prescribed for reasons of expediency, especially for the sake of the unambiguous demonstrability of rights, and thus of legal security.”\textsuperscript{62} The purposive contract first arose in Rome gradually by virtue of the internationalisation of law, and in modern times it was reinvigorated under the influence of Civil Law doctrine. But modern law does not allow that the parties can agree to whatever contents they wish; rather contracts are regulated by very various special rules and these rules apply unless the parties have specifically agreed otherwise. As a general rule, permitted legal transactions involving contracts include a power of the parties to enter transactions to effect even third parties. Almost every legal transaction affects persons who are not the immediate parties to a contract. For example, the interests of every creditor of a person attracting a debt are affected by the debtor’s increased liabilities, or the interests of neighbours are affected by land transfers from one person to another.

Weber is especially interested in a second group of cases where third parties are affected. He considers the case of the corporation with its unique structure and its legal status with so-called “legal personality”. Contracts in these settings affect the interests of third persons in a way that is qualitatively different to the other cases mentioned. In these situations there is created for the benefit of the contracting parties entirely new special law which binds every third person’s claims and expectations to the extent to which legal validity and coercive guaranty apply. This new special law has far-reaching implications because it can affect third party rights even before a person has entered the contract in question. Third parties who are not members of a corporation, for instance creditors or later purchasers of shares, may be seriously disadvantaged by decisions of a corporation to distribute the profits or otherwise conduct the affairs of the corporation regardless of impacts on outsiders. As Weber puts it,

This modern technique of leaving it to the interested parties to create not only law for themselves but also with operative effects as regards third parties gives

\textsuperscript{60} Ibid., pp. 681-2.
\textsuperscript{61} Ibid., p. 683.
\textsuperscript{62} Ibid.
those interested parties the advantages of a legal institution of special law, provided they comply with the substantive requirements as expressed in those terms which they have to incorporate in their arrangement. This modern type of special law differs from that type of special law which was allowed to develop in the past. The modern technique is a product of the unification and rationalization of law; it is based on the official monopoly of law creation by, and the compulsion of membership in, the modern political organization.  

Weber explains that before the emergence of the purposive contract and the advent of the doctrine of freedom of contract prior to the rise of the modern state, every rational association was constituted in its membership by characteristics such as birth, political affiliation, ethnic origin, religious denomination, mode of life or occupation or through some process of fraternisation. Any action which represented something akin to a lawsuit would take place only in the form of composition proceedings between different groups. Within the group patriarchal arbitration prevailed. Subjection to special law was in these circumstances a strictly personal quality, a ‘privilege’ acquired by usurpation or grant. Roman Law was at first the law for Roman citizens only (ius civile). Only later did it develop ius gentium owing to the need for common legal principles in the relations between Roman citizens and their neighbours. Law was not truly lex terrae until after the Norman Conquest when English law became the law of the King’s Court and Common Law came into being. The situation changed with the development of the modern state that rests upon formal legal equality. The change was fostered by two great rationalizing forces: the extension of the market economy and the bureaucratisation of the various institutions created by consensual groups.

Weber argues that, as the internal relations between group members and the power of officials became more fixed and rule-governed, purposive contracts became more frequent. It became necessary to establish unambiguously the significance of every action of the members and of every official to legitimise them. The technical solution found to this problem was the concept of the “juristic person”:

The most rational actualisation of the idea of the legal personality of organizations consists in the complete separation of the legal spheres of the members from the separately constituted legal sphere of the organization; while certain persons are designated as alone authorized to assume obligations and acquire rights for the organization, the legal relations thus created do not at all affect the individual members and their property and are not regarded as their contracts, but all these relations are imputed to a separate and distinct body of assets. . . . The concept of juristic personality can be extended even further to contain the control over economic goods the benefit of which is to accrue to a plurality of persons who, while they are determined in accordance with rules, are not to be associationally organized. . . . [A consociation of persons] can be organized as a corporation. . . . the body of members is constituted as a fixed group of persons.

63 Ibid, pp. 694-5.
64 Ibid, p. 696.
65 Ibid, p. 698.
The evolution of law to a stage where it can facilitate the institution of the corporation has of course enormous relevance for the emergence of modern capitalism. Weber explains the nature of early corporate structures and their significance for capitalism in this passage:

In an organization aiming at capitalistic profit, such as a business corporation, a mining or a shipowners’ company, or a company for financing state needs or colonial enterprise, capital is of predominant significance for the efficiency of the whole, and the prospect of a share in the profits for the interests of the members. Such an organization thus requires that, at least as a general rule, that membership be closed and that the purposes be fixed in a relatively stable way; also that the membership rights be formally inviolable and transferable upon death and, at least usually inter vivos; that the management be carried on bureaucratically; that the members participate either themselves or through proxies in an assembly that is de iure organized democratically but in fact plutocratically, and that adopts its resolutions, after discussion, by a vote proportionate to capital shares. The special aim of such organizations, furthermore, does not require personal liability of the members externally, since it is irrelevant to the credit standing of the enterprise.  

Clearly, this is the legal framework that came to underpin the modern business corporation, typically today structured as a joint stock company with limited liability. Such legal arrangements are not found in ancient western society or elsewhere. Their emergence is a key element in the causal matrix giving rise to modern capitalism and we shall explore these historical developments further in what follows.

Weber’s view of the crucial role of law and the modern legal order for the development of capitalism of the modern type can hardly be over emphasized. The following paragraph summarizes his view:

But an economic system, especially of the modern type, could certainly not exist without a legal order with very special features which could not develop accept in the frame of a public legal order. Present-day economic life rests on opportunities acquired through contracts. It is true, that private interests in the obligations of contract, and the common interest of all property holders in the mutual protection of property are still considerable, and individuals are still markedly influenced by convention and custom even today. Yet the influence of these factors has declined due to the disintegration of tradition, that is of the tradition-determined relationships as well as of belief in their sacredness. Furthermore, class interests have come to diverge more sharply from one another than ever before. The tempo of modern business communication requires a promptly and predictably functioning legal system, that is, one which is guaranteed by the strongest coercive power. Finally, modern economic life by its very nature has destroyed those other associations which used to be the bearers of law and thus of legal guarantees. This has been the result of the development of the market. The universal predominance of the market consociation requires on the one hand a legal system the functioning of which is calculable in accordance with rational rules. On the other hand, the constant expansion of the market which we shall get to know as an inherent tendency of the market consociation, has favoured the monopolisation and regulation of all

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(legitimate) coercive power by one *universalist* coercive institution through the disintegration of all particularist status-determined and other coercive structures which have been resting mainly on economic monopolies.\(^{68}\)

Here Weber is not merely alluding to the dependence of the capitalist system on the legal and political structures of a modern society, he is suggesting a mutually reinforcing relationship: not only is the capitalist economic order dependent upon a legal system and legal order with specific characteristics, the capitalist order itself partly determines the nature of the legal order. The market system tends to undermine independent sources of economic power based on status, thus opening the way for modern type states where a single institution has a monopoly of the legitimate means of coercion.

**Excursus: The Development of the Business Corporation in England**

Owing to the centrality of the corporation in modern capitalism, and the fact that both Weber and Schumpeter had a deep appreciation of its unique role, in what follows we shall briefly review the account of its history in England, relying largely on the work of Bishop C. Hunt. Whilst Hunt’s work post-dated Weber’s time, it is worth noting that Schumpeter relied on it to a certain extent in his *Business Cycles*.

According to Hunt, historically in England corporations could only be created by one of four means: by Common Law, by the authority of Parliament, by the King’s Charter or by prescription. At first, the power to create corporations or to endow commercial societies with the incidence of a corporation, was exercised by the King alone. In fact, Royal Charter created most of those formed between 1485 and 1700, and more often than not some element of monopoly was associated. Thus the Russia Company of 1555, the East India Company of 1600 and the Hudson’s Bay Company of 1670 were chartered directly by the Crown, although they were later regulated by statute. Charters or the equivalent Letters of Patent were also granted by the Crown in respect to special statutory authorities, as, for instance, was the case with the Bank of England (in 1694) and London Assurance in (1720). At this time promoters could seek privileges to pursue their commercial interests directly from Parliament. Incorporation by a special act became common in the eighteenth century, especially with the establishment of various canal and water companies. This was a practice continued thereafter with various public utilities. But at this early stage, the joint stock company with limited liability and the typical process of registration under general statutes had not become a general right. Such developments did not arise until the middle of the nineteenth century. Before that, there was no general right or freedom of incorporation; this was only achieved after a protracted and bitter struggle throughout the eighteenth and early nineteenth centuries.

Hunt tells us that for a long time the idea of the joint stock company was subject to severe misgivings by Parliament, especially after the South Sea Bubble Crash of 1720. It had been recognised that the joint stock company was a valuable means for the promotion and working up of new industries and the mobilisation of national credit, but it was also very apparent that it could be used to perpetrate large-scale

frauds on the public and encouraged wild speculation in stocks and shares. In 1720 the House of Commons resolved,

That for some time past several large subscriptions having been made by great numbers of persons in the City of London to carry on public undertakings upon which the subscribers have paid in small proportions of their respective subscriptions, though amounting on the whole to great sums of money. The subscribers having acted as corporate bodies without any legal authority for their so doing and thereby drawing several unwary persons with unwarrantable undertakings, the said practices manifestly tend to the prejudices of the public trade and commerce of the Kingdom.\footnote{Hunt, p. 7.}

This resolution was followed by the so called Bubble Act which, as Hunt explains, . . . complained of persons ‘who contrived dangerous and mischievous undertakings or projects under false pretence of the public good;’ who had ‘presumed to open books for public subscription and drawn in unwary persons to subscribe,’ and ‘to act as if they were corporate bodies,’ who had ‘pretended to make their shares transferable,’ without legal authority; who had ‘acted or pretended to act under some formal charter granted by the Crown’ for other purposes and had ‘acted under obsolete charters.’\footnote{Ibid.}

Hunt says the passage of the Act was in part inspired by the directors of the South Sea Company, jealous of rival manufacturers and other exploiting various instruments of speculation.

The Bubble Act of 1720 and the ensuing crash of the great speculative enterprise of the South Sea Company had the effect of arresting the spread of the joint stock economic structure for some time to come. Despite the deterrent effect upon company promotion, however, the advantages of corporate organization in raising and applying large volumes of money for commercial enterprise had nonetheless been well demonstrated. There were various survivors of the South Sea period, in particular of note was the success of Brindley and the Duke of Bridgewater, who were the beneficiaries of the more than 100 canal acts given assent by 1800. The largest part of the great bulk of the canal system, which had been completed by 1800, was largely constructed by such private enterprise. Through these examples the corporation gradually became the preferred method of obtaining large loans. Subsequently, new corporations emerged in manufacturing, such as in brass and copper. The British Plate Glass Company was incorporated in 1773, though an early attempt to establish a cotton and linen cloth manufacturing company in 1779 was not successful. But even with these successes the Government was still very cautious about the idea of allowing widespread freedom of incorporation. A report to the Privy Council in 1761 states,

The Crown has very wisely been always cautious of incorporating traders, because such bodies will either grow too great, or by overwhelming individuals become monopolies, or else by failing, will involve thousands in the ruin attendant upon corporate bankruptcy. As trade seldom requires the aid of such combinations, but thrives better when left open to the free speculations of private men; such measures are only expedient where trade is impracticable upon any
other than a joint stock, as was thought to be the case in the East Indies, South Sea, Hudson’s Bay and some other companies erected upon that principle . . . \(^71\)

Despite the resistance of the Parliament, Hunt says the early nineteenth century saw a renewed interest, indeed, almost universal excitement in promotions of all sorts. The success of corporate enterprise in banking, insurance and especially in canals, had given rise to the idea that companies might be extended to the field of trade and manufacture generally.

Hunt claims there is evidence of an expanding securities market in the early 1900s. This is when the *Course of Exchange* (the official price list) was first published under the authority of the Stock Exchange and the number of securities quoted more than doubled. However, concern remained about the possible abuse of the numerous joint stock companies that were rising up every day. It was apparently possible to elicit subscriptions merely by inserting advertisements in a newspaper. Many of these promotions were stillborn or were abandoned for various reasons, but there were some important survivors, such as the Gas Light & Coke Company. At this early stage, according to Hunt, the joint stock type of enterprise was of little significance in the fields of industry that were later to become significant, that is, in the making of cloth, metal working and mining. Public opinion was generally hostile to the idea of the joint stock company because it had been historically associated with monopoly, which was considered a dangerous and potentially vicious phenomenon. It was generally felt that the fields of industry ought to be conducted by individuals, and that monopolies would compete unfairly against individual enterprise and ruin many of the ordinary tradespeople and the merchant classes.

Although incorporation remained restricted, Hunt explains that a compromise was eventually reached that allowed its expansion. To overcome one of the most serious difficulties inherent in partnership where there might be hundreds of shareholders, several companies applied to Parliament for permission to allow them to sue or be sued in the name of a principal officer, typically the secretary. Around 1815, this right was extended to twenty or so insurance companies as well as a copper mining company. Vested interests, such as existing companies, like Lloyds, vigorously opposed the extension of insurance into the marine insurance area. Their spokesmen argued that companies should not be permitted to do what was already being done by individuals—Britain’s prosperity was due to the competition of individual exertions and the spread of companies would effectively destroy individual enterprise. On the other hand, it was gradually becoming recognised that it was socially expedient to form companies “to carry on great undertakings requiring large capital and a steady perseverance, not dependent on the exertions or life of an individual.”\(^72\) Unless subscribers were exempted from the effects of the bankruptcy laws, large undertakings such as those being proposed by the Gas Light & Coke Company would simply not take place.

Hunt tells us that in the Parliamentary debates of the time there was genuine concern over the difficulty of establishing how the responsibility of shareholders in an unincorporated company could be held to their obligations in the event of financial catastrophe. The principle of personal responsibility was well adapted to

\(^71\) *Ibid*, p. 11.

\(^72\) Lord Sheffield quoted in *ibid*, p.26.
this situation because the individual could be pursued for every cent they were worth, but in the case of corporations it was not clear how debts could be satisfied in the event of a corporation suffering financial embarrassment. In spite of these reservations, the argument was put that the joint stock fund, owing to its ability to be subject to regulation, could have the corporation’s assets periodically ascertained and made known, and by this means creditors could be satisfied that they were not being duped. Also the joint stock fund would be answerable to its contracts, because its assets are exclusively appropriated to the use of the company and cannot be used for the private dealings of individuals. Thus the corporate structure became established finally in the form of the limited liability company.

Weber points out that capitalist interests tend to favour the continuous extension of the free market, though only up to the point where some players succeed. The effect of protracted business enterprise, however, is to break up status-based monopolies that constitute an impediment to the unlimited pursuit of profit. Hence, the early monopolies based on a grant of rights from the state were challenged by the rising bourgeoisie who fought against such privileges based on claims of status. But free competition, which ensues when the older monopoly situation is undermined, persists only so long as new monopolies are not created based on the machinations economic forces per se. Those monopolies, on the other hand, which are based solely upon the power of property, rest, on the contrary, upon an entirely rationally calculated mastery of market conditions which may, however, remain formally as free as ever. The sacred, status, and merely traditional bonds, which have gradually come to be eliminated, constituted restrictions on the formation of rational market prices; the purely economically conditioned monopolies are, on the other hand, their ultimate consequence... the rational-economic monopolist rules through the market.”

We shall have occasion to return to this issue of monopoly at length in relation to Schumpeter, for whom monopoly is a natural occurrence of the a free market economy and not necessarily negative from a purely economic standpoint.

The Ethical Character of the Market under Capitalism

According to Weber, the advent of the modern corporation has specific implications for the possibility of the regulation of business activity in accordance with substantive ethical norms of the kind that have been typically advanced by the world religions. He explains that the separation in West of the hierocratic power of the Church from the state and its accompanying legal system has allowed the realm of profit marking enterprise to remain relatively immune from interference by forces that were usually antipathetic to it. The reasons underlying this he locates in the extreme impersonality of capitalist relationships under modern market conditions:

It is possible to advance ethical postulates and to attempt the imposition of substantive norms with regard to household head and servant, master and slave, or patriarchal ruler and subject, since their relationship is personal and since the expected services result therefrom. Within wide limits, personal, flexible interests are operative here, and purely personal intent and action can decisively

73 Ibid., p. 639.
change the relationship and the condition of the person involved. But for the
director of the joint-stock company, who is obliged to represent the interests of
the stockholders as the masters proper, it is difficult to relate in this manner to
the factory workers; it is even more difficult for the director of the bank that
finances the joint-stock company, or for the mortgage holder in relation to the
owner of property on which the bank granted the loan. Decisive are the need for
competitive survival and the conditions of labour, money and the commodity
markets; hence matter-or-fact considerations that are simply non-ethical
determine individual behaviour and interpose forces between the persons
involved. From an ethical viewpoint, this “masterless slavery” to which
capitalism subjects the worker or the mortgagee is questionable only as an
institution. However, in principle, the behaviour of any individual cannot be so
questioned, since it is prescribed in all relevant respects by objective situations.
The penalty for non-compliance is extinction . . . such economic behaviour has
the quality of service toward an impersonal purpose.⁷⁴

By these remarks Weber is not saying that capitalism ought not to be criticized from an
ethical point view, and indeed, as we have noted above and will comment further
below, he was intimately involved in various reform movements of his day with a
view to ameliorating the undesirable effects of full-fledged market capitalism. It is
not a simple matter to achieve an ethically satisfactory regulation of capitalism
without effectively undermining the very rationality of the economic system upon
which society is totally dependent.

At this point it is well for us to consider a brief section of *Economy and Society*
in which Weber specifically addresses the nature of the market and its ethical
meaning. This section is described as a “fragment” and was included in the final
published version of the work even though it was evidently uncompleted. Weber
begins his discussion with a statement of the nature of the market from a purely
sociological point of view. He specifically eschews the task of discussing the market
from an economic point of view because this constitutes the task of economics and
he is approaching the phenomenon sociologically. He explains that,
the market represents a coexistence and sequence of rational consociations, each
of which is specifically ephemeral in so far as it ceases to exist with the act of
exchanging the goods, unless a norm has been promulgated which imposes upon
the transferors of the exchangeable goods the guaranty of their lawful acquisition
of warranty of title or of quiet enjoyment. The completed barter constitutes a
consociation only with the immediate partner. The preparatory dickering,
however, is always a social action (*Gemeinschaftshandeln*) insofar as the
potential partners are guided in their
efforts by the potential action of an
indeterminately large group of real or imaginary competitors rather than by their
own actions alone. The more this is true, the more does the market constitute
social action. Furthermore, any active exchange involving the use of money
(sale) is a social action simply because the money used derives its value from its
relation to the potential action of others.⁷⁵

Weber goes on to argue how the use of money necessarily implies not only
social action but group formation as well, because its use requires a community of

interest between the potential participants in the market in the reliability of payments with money. He explains the market community is the result of a peculiar set of orientations by social actors to the potential action of others, even though those others may not be physically present and even though a particular act such as the purchase or sale of a good may bring them into association with the others only momentarily:

Within the market community every act of exchange, especially monetary exchange, is not directed, in isolation, by the action of the individual partner to the particular transaction, but the more rationally it is considered, the more it is directed by the action of all other parties potentially interested in the exchange. The market community as such is the most impersonal relationship of practical life into which humans can enter with one another. The reason for the impersonality of the market is its matter-of-factness, its orientation to the commodity and only to that. Where the market is allowed to follow its own autonomous tendencies, its participants do not look towards the persons of each other but only towards the commodity; there are no obligations of brotherliness or reverence, and none of those spontaneous human relations that are sustained by personal unions. Market behaviour is influenced by rational, purposeful pursuit of interests.76

In this description of the market community we believe Weber in effect has provided a sociological complement to the capitalist mechanism as described in the Schumpeter’s equilibrium theory. In both cases it is assumed the behaviour of the individual is oriented to the exchange of goods in terms of the estimated values in monetary terms or prices. Prices of goods are not determined by single exchanges but ultimately by the behaviour of all those pursuing their interests in the market place, more or less rationally, in accordance with the principle of marginal utility. As Weber puts it, “... any active exchange involving the use of money (sale) is a social action simply because the money used derives its value from its relation to the potential action of others. Its acceptability works exclusively on the expectation it will continue to be desirable and can be further used as a means of payment.”77 Later we shall see in detail how this aspect is crucial to the idea of equilibrium, because the interplay of individuals in the course of exchange activities generates the price mechanism and this in turn causes markets to balance supply and demand.

Weber is particularly focused on the possibility of a normative grounding of market behaviour and paradoxically posits a “minimal ethic” which can be said to constitute a form of morality. He explains that,

The partner to a transaction is expected to behave according to rational legality and, quite particularly, to respect the formal inviolability of a promise once given. These are the qualities which form the content of market ethics. Violations of agreements, even though they may be concluded by mere signs entirely unrecorded, and devoid of evidence, are almost unheard of in the annals of the stock exchange. Such absolute depersonalisation is contrary to all the elementary forms of human relationship. It is normally assumed by both partners to an exchange that each will be interested in the future continuation of the exchange relationship, be it with this particular partner or some other, and

76 Ibid, p. 636.
77 Ibid.
that he will adhere to his promises for this reason and avoid at least striking infringements of the rules of good faith and fair dealing. It is only this assumption which guarantees the law-abidingness of the exchange partners. In so far as that interest exists, ‘honesty is the best policy.’

Weber is in no doubt that this minimal ethic of the market falls far short of any ethic that would be defensible on typical religious grounds: “The ‘free’ market, that is, the market which is not bound by ethical norms, with its exploitation of constellations of interest and monopoly positions and its dickering, is an abomination to every system of fraternal ethics.”

Weber goes on to describe how in the early period of the development of rational capitalism there develops a kind of stability in market relationships in which trading activity frees itself from unlimited dickering and the exploitation of momentary interest situations. This has the effect of limiting fluctuation in prices and brings about greater stability and predictability of the general market situation. He suggests that the fixed price without any preference for a particular buyer and business honesty are unique to the regulated local markets of the medieval Occident, but this situation no longer exists. Weber has in mind the kind of market communities set up within Protestant sects and elsewhere in the early era of market capitalism.

Conclusion

In this chapter we have outlined the complex structural analysis of modern capitalism that Weber provided, especially in *Economy and Society*. In the section on the “Sociological Categories of Economic Action” Weber introduced a number of theses as to the role of calculation and rationality in economic life generally and in capitalist profit-making in particular. We have sought to show how these ideas were significantly influenced by strands of thought derived from economic theory, in particular those advanced by the Austrian Marginalist School. We have argued that Weber not only recognized the significance of marginal utility as a dominant strand of contemporary economic theory, but he allowed for it in his own sociological theorising. He reasoned that the more economic action becomes rational the more it is ordered by considerations of marginal utility. While not endorsing the economic theory of marginal utility as such, we suggest Weber’s familiarity with and even admiration of the Austrian Marginalist School led him to construct his economic sociology so as to complement of that theory.

Weber went on in his economic sociology to develop a full-blown model of a highly rational capitalistic system as an ideal type, which nonetheless corresponds in no small measure with the existing reality of Western Europe and America. In developing this model he highlighted a number of institutional features of the

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79 *Ibid.*, p. 367. Perhaps Weber is here echoing aspects of the Marxian critique of capitalism, as expressed classically in *The Communist Manifesto* where capitalism is derided for reducing all human relationships to nothing other than “the cash nexus”.

80 The role of the early Protestant sects and in particular their effects on promoting ethical business dealings is discussed at length in Weber’s essay “The Protestant Sects and the Spirit of Capitalism” in FMW, pp. 302-22.
capitalist system that were essential to its ongoing existence. These included the business enterprise, which coincides to the idea of the corporation. Weber developed an elaborate theory of the modern state in which he highlighted its rational constitutional form as well as the role of bureaucracy. In so doing he was able to show that the advent of modern capitalism was intimately associated with the rise of the bourgeois political classes to dominance in the eighteenth and nineteenth centuries. In order to address the issue of the corporation more adequately, we have included an excursus on this topic based largely on B. C. Hunt’s contribution it history. We have also discussed Weber’s Sociology of Law in which he was able to show how contract law emerged from earlier forms. He argues that this transition occurred partly under the influence of economics as such, but law was just as much an independent factor that is part of the matrix of causes giving rise to modern capitalism.
CHAPTER THREE

The Work of Schumpeter:
Part One

Introduction to the Work of Schumpeter

Schumpeter is best known for his work *Capitalism, Socialism and Democracy*, a book he produced as a “popular” exposition of his theory of capitalism, whereas his larger writings such as *Business Cycles: A Theoretical, Historical and Statistical Analysis of the Capitalist Process* and the *History of Economic Analysis* are not well known outside a limited circle of followers. This is partly parallel to the reception of Weber whose *The Protestant Ethic and the Spirit of Capitalism* became his best-known work at the expense of an appreciation of his other writings. But whereas Weber became the most cited and probably the most lauded of all scholars in the social field in the twentieth century, Schumpeter did not achieve the same measure of celebrity. This in not to say Schumpeter has not been well recognized; some commentators have noted the large number of citations of Schumpeter in the literature of economics even suggesting he tops the list.¹

The comparative lack of appreciation of Schumpeter’s work can perhaps be attributed to the timing of the writings, for his early works were published in German just prior to the First World War. This meant they did not receive an “airing” in the English-speaking world until many years later—*The Theory of Economic Development* originally published in 1911 was not published in an English version until 1934. Another reason is that in the period prior to this point in time the Western economies were in the grip of the Great Depression and as a consequence socialist ideas had become highly influential, so much of the political commentariat was unreceptive to a thinker as apparently sympathetic to capitalism as was Schumpeter. By the time Schumpeter produced his most mature writings, in particular *Business Cycles* in 1939, the Keynesian perspective on the woes of capitalism as set out in *The General Theory of Employment, Interest and Money* of 1936, had come to dominate economics. A further factor is that much of Schumpeter’s work is written as a contribution to economic science viewed at the highest level of theoretical sophistication. That is, many of his writings are directed exclusively to the professional economic theorist and are rather inaccessible to the general reader. This is true in particular of his two great master works, *Business Cycles* of 1939 and the *History of Economic Analysis*, the latter published posthumously in 1954. Both are large, extremely complex and difficult to master—though it has to be said they are probably no more demanding than many of Weber’s works. The subsequent history of the reception of the works of our two thinkers is clearly relevant to the fate of their reputations and the transmission of their influence—for, as we have noted, Weber gradually came to be recognized as the seminal sociologist of his day and a founding father of modern sociology, largely through his incorporation into American academic sociology (Parsons and Mills),

¹ For example, see Peter Senn, “The Influence of Schumpeter’s German Writings on Mainstream Economic Literature in English”, *Joseph Schumpeter: Entrepreneurship, Style and Vision*, Kluwer, 2003, pp. 142-9.
whereas Schumpeter’s star was somewhat eclipsed by the success of Keynes and this remained the case for some time thereafter and even up to the present.

As has been noted by various commentators, Schumpeter is a unique kind of eclectic thinker whose special talent lay in his ability to take up, digest and synthesize ideas from all manner of sources. For example, he is eager to incorporate the best elements of the theories of classical economic thought as it had been developed by major innovators like Alfred Marshall, Léon Walras and Carl Menger. But as well as these thinkers, Schumpeter was open to the influence of a diverse range of others, including Karl Marx, Wilfredo Pareto, Wesley Mitchell, Irving Fisher and Frank Taussig. Whilst Schumpeter’s approach owes a great deal to the influence of Walras and the Austrian School, it is also the case that he sought to introduce a new paradigm influenced by Marx that he contrasted explicitly with the perspectives of the Austrian School. The impact that Marx’s approach had on Schumpeter is especially apparent in the latter’s concept of “development” and his idea of the role of “vision” in theoretical work. We shall see how Schumpeter’s idea of development is unpacked in what follows below.

Though recognizing and accepting many of their achievements, Schumpeter had a somewhat equivocal relation to the Austrian School, as is clearly reflected in an article on Menger of 1921. There he writes that, on the one hand, “Menger’s theory of value, price and distribution is the best we have up till now.” Yet he also says, “No economic sociology or sociology of economic development can be derived from Menger’s work. It makes only a small contribution to the picture of economic history and the struggle of social classes . . .” This ambivalence is reflected throughout Schumpeter’s work where he, on the one hand, assumes and builds on equilibrium analysis but, on the other hand, emphasizes how economic life experiences instability and deep changes, sometimes with far-reaching implications.

In what follows we shall not explore in any detail Schumpeter’s early writings such as The Nature and Essence of Economic Theory or Economic Doctrine and Method. This is not because they are unimportant but because many of their themes are repeated in his later work and it is not our purpose here to provide a complete intellectual biography. Nonetheless, it will be useful to refer briefly to Economic Doctrine and Method owing to its connection with Weber’s Grundriss as pointed out above. In Economic Doctrine and Method we find a survey of economic theory that is in many ways a curtain-raiser to the History of Economic Analysis. It is worth noting that toward the end of the book Schumpeter discusses the rise of marginal utility theory and it is clear that he takes this as being a theoretical achievement of the utmost significance. He writes that, “. . . marginal utility was the ferment which has changed the inner structure of modern theory into something quite different from that of the classical economists.”

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2 For a full understanding of Schumpeter’s appreciation of Marx, attention should be drawn to the extensive discussions in Capitalism, Socialism and Democracy, Harper, 1950 (CSD), Part 1 and in History of Economic Analysis (HEA), Oxford University Press, 1954 especially at pp.383-92.
3 “Carl Menger,” in Ten Great Economists: From Marx to Keynes, Oxford University Press (TGE), 1951, p. 86.
He goes on describe the general features of marginal utility theory and explains how it differed from what went before:

The theory of marginal utility . . . places the main emphasis on the complex of problems which the classical economists passed over too lightly, namely, the foundations for the determination of value and price. . . . It placed the explanation of the nature of price determination and of the various forms of income into the forefront . . . Thus a different and much ‘purer’ economics originated which contains much less concrete and factual material . . . but is immeasurably more firmly founded.\(^5\)

Now even though Schumpeter is fully aware of the fact that marginal utility was developed independently by the Austrians and Jevons in England, he regards Léon Walras as having brought the notion to its highest level of theoretical sophistication. And despite his concern to address the issue of the irregular character of capitalist progress and his scepticism as to it long-term prospects, he accepts the general approach of the great equilibrium economist. Indeed, there is hardly a figure in the history of thought that Schumpeter admires more. For not only does he attribute to Walras a profound achievement in his account of the mechanism of general equilibrium, he also credits Walras as having placed economics as a whole on a secure scientific footing for the first time. For a long time, Walras’s work was not well known in the English-speaking world, owing of course to its availability only in French and in part to the complex mathematics that underlay its theorems. This situation was decisively changed by the 1950s when William Jaffé began to champion his works in the English speaking world, and figures such as Kenneth Arrow developed so-called “general equilibrium theory”\(^6\). In what follows we must first briefly discuss Schumpeter’s relation to Walras.

The Significance of Walras

In Schumpeter’s oeuvre there are several detailed accounts of Walras and he refers to him frequently throughout. He gives his most detailed appraisal of Walras’s theories in the History of Economic Analysis. There he is concerned to explain the nature of Walras’s system of equations and why it was such a path-breaking achievement. In essence Walras’s achievement lies in his ability, at least in theory, to explain the equilibrium values of all economic variables: that is, “the prices of all products and factors and the quantities of these products and factors that would be bought in perfect equilibrium and pure competition, by all households and firms.”\(^7\) Walras conceived equilibrium prices to be the level around which actual prices oscillate in the real economy, though he was aware that this was to some degree an approximation because there are always disturbing factors of a non-economic nature in the real world.\(^8\)

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\(^5\) *Ibid*, p. 188.


\(^7\) HEA, p. 999.

\(^8\) Walras’s key description of the economic pattern that is expressed by his equations is set out in Lessons 17-19 of his *Éléments d'économie politique pure, ou théorie de la richesse sociale.*
According to Schumpeter, the Walrasian entrepreneur operates as follows: he buys raw materials from other entrepreneurs, hires land from landowners, acquires the personal aptitudes of workers, buys capital goods from capitalists, and sells the products that result from a creative combination of these factors for his own benefit. Walras set out to construct a theory of the various markets through which all this economic activity must function, the interaction of which comprises the economic system. A key notion in the theory is the concept of *tâtonnement* which he introduced in the following terms: “What must we do in order to prove that theoretical [that is, mathematical] solution [of the problem of the determination of the equilibrium prices in a multi-commodity universe] is identically the solution worked out by the market? Our task is very simple: we need to show [in the case of pure exchange] that upward and downward movement of prices solve the system of equations on offer and demand by a process of groping [par *tâtonnement*].”9 Schumpeter is especially concerned to note precisely how Walras identifies the various markets through which the economic mechanism operates, the interaction of which make up the object of analysis. Walras distinguishes two fundamental markets—those for products and those for productive services, but in addition he points to the existence of markets that determine the prices of capital goods and other elements of the system. He places considerable emphasis upon the inventories that economic agents have at their disposal. He explains that, there are inventories of new capital goods, consumers goods inventories held by households and by firms, raw material inventories held by both their producers and their users, and also as we have seen stocks of money (cash holdings of various types). Since the existence of these inventories presuppose a certain past behaviour of the people concerned and since their current reproduction presupposes certain expectations, the system—even if perfectly stationary—still depicts a process in time and might therefore be called “implicitly dynamic.”10 However, in the Walrasian system households do not purchase consumer goods or sell their services as such. Nor do entrepreneurs purchase productive services and offer their products outright:

They all merely declare what they would respectively buy and sell (produce) at prices *cries au hazard*, that is, announced experimentally by some agent in the market, and are free to change their minds if these prices do not turn out to be the equilibrium prices: other prices are thereupon announced, other declarations of willingness to buy or sell (and to produce) are written down on *bons* [tickets]—pieces of paper that do not carry any obligation—until equilibrium values emerge, namely prices such that no demand willing to pay them and no supply willing to accept them remain unsatisfied. And the only mechanism of reaction to these variations of experimental prices that Walras recognises is to raise the prices of

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9 Quoted in W. Jaffé, *Essays on Walras*, p. 222. Jaffé explains that by “groping” Walras means a process of “blindly feeling its way, since no one in the actual world is presumed to know in advance the parameters or the solution of the equations.” However, Jaffé argues that Walras actually failed in his attempt to prove his thesis, because, “Though he allowed for trading at ‘false prices’ in his preliminary description of the operation of the mechanism of competition in the real market, he overlooked it completely in his analytical discussion of *tâtonnement*.” (pp. 222-3). The question of whether Walras “solved” his fundamental theoretical problem is complicated and remains controversial to this day. See Jaffé’s further discussion of the issues involved at pp. 223-42.

10 HEA, p. 1002.
commodities of services, the demand for which at these prices is greater than the supply, and to reduce the price of commodities or services, the supply of which at these prices is greater than the demand.\[^{11}\]

Importantly, Walras advanced a “system of exchange relations”, rather than a theory of competitive exchange of two commodities, for his theory of equilibrium requires the existence of a number of commodities in order for unique prices to emerge. According to Schumpeter, Walras assumes that a certain number of players endowed with definite tastes and possessing at the start arbitrary quantities of a range of commodities enter the market in order to see what advantages trade will bring.\[^{12}\] He takes for granted that there is a tendency for all participants to maximise their satisfaction. If the number of people is \(n\) and the number of commodities is \(m\) then there must be \(m(n-1)\) behaviour equations expressing for all \(n\) participants the quantities they will give away or acquire in any given system of exchange relations. They will go on trading at prices in terms of a standard commodity or \((\text{numéraire})\) until no further exchange will increase their level of satisfaction. Further, there must be \(m\) equations for every commodity. The total amount of a commodity given away must equal the total amount of the commodity acquired for the market as a whole. There are therefore \(m(n+1)\) conditions or equations. Without going into the further technical/mathematical aspects of Walras’s system, the thrust of his argument is that the system of equations is able to produce a solution that is an approximation of the actual price level.

The key problem which arises from all this is: given the possibility that there can be a unique solution, is there in fact a tendency in the economic system to actually produce this solution? In other words, what is the relationship between the strict logic of the theory wherein a mathematical solution to the equations is available and the process of price formation in the actual market place? Walras solved this problem, according to Schumpeter, by arguing that, “the people in the market, though evidently not solving any equations, do by a different method the same thing that the theorist does by solving equations; or, to put it differently, that the ‘empirical’ method used in perfectly competitive markets and the ‘theoretical’ or ‘scientific’ method of the observer tend to produce the same equilibrium configuration.”\[^{13}\] In the Walrasian system, as we have said, people appear in the market with the commodities they possess and with definite marginal utility schedules, and are confronted with the prices as \(\text{criés au hazard}\) (random price calls). They offer to give away certain commodities to acquire certain others at the prices called. But actually they do not complete the transactions, because they only note on \(\text{bons}\) (tickets) what they would buy and sell at those prices should they persist. If, however, no recontract proves necessary and the \(\text{bons}\) are redeemed, then the conditions of the equations are in fact fulfilled. If they are not able to agree to the prices and recontract at different prices which are higher or lower than those initially offered, then, accordingly as they experience a positive or negative excess demand, the

\[^{11}\] Ibid.
\[^{12}\] The following account of Walras relies on Schumpeter’s exegesis in HEA at pp. 998–1026.
\[^{13}\] Ibid., p. 1008. This problem of whether Walras actually solved the problem of how an economy arrives at equilibrium prices is discussed at length by William. Jaffe in his essay “Walras’s Theory of Tâtonnement: A Critique of Recent Interpretations”, *Journal of Political Economy*, 75 (1967).
prices offered will be adjusted until they are equated in all cases. Schumpeter says, “whatever we might have to say about this on the score of realism, it seems at first sight to be intuitively clear that, so long as no other mechanism of reaction is admitted than the one exclusively considered by Walras, equilibrium will be attained under these assumptions: that, in general, this equilibrium will be unique and stable; and that the prices and quantities in this configuration will be those we get from our theoretical solution.”

Walras’s theory of production has direct parallels with his theory of consumption. It is a theory of the way in which the mechanism of pure competition allocates the services of the different types of natural agents, labour and produced means of production. The theory of allocation effectively amounts to the same as a theory of the pricing of those services because the price mechanism brings the services into the arena of the marketplace in just the quantities necessary to satisfy demand. The question that must now be raised is whether or not there exists a unique set of solutions for a system of equations that covers both consumers’ and producers’ behaviour. Schumpeter concludes that,

Intuitively we realise that, with the same qualifications we had to make in the general case of multi-commodity exchange and with the further qualifications that were imposed upon us by the additional assumptions by Walras in order to reduce the problem of production to manageability, the answer will be affirmative. . . . [Walras’s solution] comes to this; the households that furnish the services has in Walras’ set up definite and single valued schedules of willingness to part with these services. These schedules are determined, on the one hand by their appreciation of the satisfaction to be derived from consuming their services directly and, on the other hand by their knowledge of the satisfaction they might derive from the incomes in terms of numéraire that they are able to earn at any set of consumers’ goods and service ‘prices’. For the ‘prices’ of consumers’ goods are determined simultaneously with the ‘prices’ of the services and with reference to one another: every workman, for an instance, decides how many hours of work per day or week he is going to offer in response to a wage in terms of numéraire that is associated with definite prices, in terms of numéraire, of all the consumers’ goods that would be produced with the total amount of work being offered at that wage rate. Mathematically, we express this by making everybody’s offer of every service he ‘owns’ a function of all prices (both of consumers’ goods and the services) and, for the same reason, everybody’s demand for every commodity another function of all prices (both of services and the consumers’ goods). Everybody’s demand for the numéraire commodity follows simply from everybody’s balance equation . . .

Schumpeter points out that for a mathematical solution the number of variables to be determined must be equal to the number of equations and, though Walras did not reach the standards of modern mathematics in arriving at his view that a solution is obtainable, he was not far from that level: “It may be averred that, so far as this part of the Walrasian analysis is concerned, our result is, or it comes near to being the common opinion of theorists.”

14 HEA, p. 1008.
15 Ibid, p. 1012.
16 Ibid, p. 1014.
But Schumpeter goes on to point to a fundamental difficulty in the Walrasian system as regards the tendency of the economic system to move toward the establishment of equilibrium prices. This arises because of the way Walras sets up the process of tâtonnement with the requirement that there be experimentally fixed crièś to be followed by rearrangements when parties do not accept those prices. The problem is that such arrangements must occur amongst all the participants in the market instantaneously, which cannot be the case in actual reality. “Even if all firms and all owners of productive services did succeed in this task, they would still have to carry out this production program which takes time, during which nothing must be allowed to change.”17 The issue of time is thus critical and the question of how equilibrium can be a product of a dynamic system becomes all the more pressing. It is not difficult to see that Schumpeter saw the task of dealing with this problem, which of course leads to the problem of cycles and crises, as his own special task. So one could say that the essence of Schumpeter’s approach is to critically engage with the Walrasian system and to overcome it in a positive way, to resolve its underlying weaknesses without displacing its fundamental insights.

Just as Marx saw the essence of the capitalist system as leading inevitably to system-wide crises, Schumpeter also sees that there are inherent tendencies in the system toward instability because of the working out of elementary forces. As with Marx, grasping this requires not merely an economic analysis but also a sociological analysis of the capitalist mechanism. Innovations, the credit mechanism and the process of carrying out new combinations in the form of enterprise not only create cyclical effects (to be described in detail later in Business Cycles), they also eventually lead to outcomes that may even change capitalism as such into something fundamentally different. Schumpeter at times even tends to agree with Marx about the fundamental limit of the capitalist dynamic, which arises with the circumstance that cuts short the profit bonanza resulting from the upswing in economic activity: that is, both suggest it is the over-production of capital goods that leads to the busting of the boom. But whereas Marx saw the tendency for over-production to culminate inevitably, and not long into the future, in the collapse of the capitalist system as a whole, Schumpeter generally sees such things as being accommodated and managed short of total system failure—at least for the time being and probably well into the future. But ultimately Schumpeter regards socialism as a distant prospect and more than a remote possibility, as we shall see.

Schumpeter’s theory of the wave-like fluctuations of business activity and his account of the tendency of the system toward crises in part derive from his view that entrepreneurial activity will manifest in the form of “clusters”. An economic boom will start when one or a few branches of industry are witness to the activity of an entrepreneur, but the success of his actions will attract other innovators to the same area. The initial actors may simply remove obstacles that allow others to take up the opportunities unleashed by the first wave, and this creates a swarm-like effect or rush. A starting point for understanding Schumpeter’s work in this regard must be his early study the Theory of Economic Development published in 1911. This is one of the works that gave him his early standing as a major thinker in the field of economics, and it contains many of his essential ideas in basic form. Unfortunately, it is not possible to gauge the precise extent of Weber’s appreciation of this work, though the timing of

17 Ibid.
Schumpeter’s appointment to write the section on the history of economics for the Grundriss in our view shows he was quite familiar with it. ¹⁸

The “Circular Flow” and the Basic Elements of Economic Activity

In a nutshell, in The Theory of Economic Development Schumpeter sets out to build a framework for grasping the entire capitalist system and its dynamics on the basis of the insights derived from the Marxian vision of the capitalist system and the marginal utility school of economic theory. That is, he wants to combine the marginalist account of how an economy typically sets prices and operates under competitive conditions with an evolutionary perspective where change is seen as endemic, involving continual innovation and disruptive adjustments. It is of considerable interest that Schumpeter takes up perspectives of Marx, especially certain aspects of his Capital, as being fruitful for the understanding of capitalism as an evolutionary system—though his overall approach, as already noted, is somewhat at odds with the underlying thrust of Marx’s thought as a whole.

Schumpeter begins his account of the capitalist economy by proposing a conceptual simplification along the lines of a theoretical device also employed by numerous others. ¹⁹ Such an approach, Schumpeter believes, is the only way the theorist can build a theory that is capable of grasping the full complexity of the reality that is modern capitalism. Schumpeter starts out with a model of his simplified economy in pure form. The model has only some of the basic features of an exchange economy, and it lacks important dynamic phenomena that are associated with the full development of modern capitalism. He adopts this approach in order to later show how such dynamic elements are crucial to and constitutive of actually existing capitalism. As he puts it later in Business Cycles, “Obviously, such a model will present the fundamental facts and relations of economic life in their simplest form, and it is hardly possible to bring them out satisfactorily without it. Implicitly and in a rudimentary form it has, therefore, always been present in the minds of absolutely all economists of all schools at all times, although most of them were not aware of it.” ²⁰

Schumpeter posits the idea of an unchanging economic process that flows in a regular fashion without growing. He does this to establish a kind of foundational


¹⁹ For example, just as Marx begins his exegesis of the capitalist mode of production with a preliminary account of a simplified economic system based on the extraction of what he calls “absolute surplus value” and then proceeds to explain the more complex situation of the actual capitalist manufacture with its labour-replacing machinery allowing the extraction “relative surplus value”, so Schumpeter begins by outlining a simplified model of an economy that does not correspond to the realities of the actual capitalist economy and then adds in the crucial real-world elements.

structure upon which he can subsequently build-in the complications of an economy that continually expands in the fashion of modern capitalism. In this model of an unchanging economy there are no technological innovations, no surplus or profits, no growth in output—therefore, there are none of the typical features of mature capitalism such as capitalists, banks, inflation, unemployment, the stock market, or business fluctuations. But, in doing this he conceptualizes an economic system that is otherwise akin to capitalism insofar as it has certain systemic features in common with actually-existing capitalism—such as market exchange, money, production and consumption adapted to market prices and so on. “To that end.” he says, “we shall primarily think of a commercially organised state, one in which private property, division of labour, and free competition prevail.” From these assumptions Schumpeter proceeds to build an elaborate model of this basic economy in which all factors promoting fundamental change are absent. In effect he is conducting a protracted thought experiment to bring out as graphically as he can the nature of a perfectly static market economy. In all this we suggest Schumpeter is employing the method of ideal types similarly to Menger and consistently with Weber’s approach. Just as Weber explains that the theoretical schemas of the historian or economist do not exist in reality, so Schumpeter knows his unchanging exchange economy has never actually existed nor could it—but it has features that actually do appear in reality, as we shall see.

Schumpeter wants to analyse an aspect of his static economy that he terms the “circular flow of economic life” (He later calls this, somewhat paradoxically, the “stationary flow”). He goes to considerable length to describe its detailed characteristics. And, along the way he feels obliged to provide a commentary on a series of theoretical problems that are current in economic science, some of which have been issues since at least the time of Adam Smith. He refers to issues such as what is the ultimate source of wealth creation, the difference between various types of labour, the distinction between consumer goods and producer goods, the role of money in exchange, and so on. We will not be surprised to find as a backdrop to much of what he says an endorsement of the “theory of marginal utility” and use of the concept of “equilibrium”. Indeed, much of what Schumpeter says is not particularly novel and might even be considered the conventional view. But, typically, he always gives things his own unique twist, and later we shall see he departs markedly from classical conceptions at various points.

Schumpeter asks the reader to consider the following hypothetical situation: If someone who has never seen or heard of such a state were to observe that a farmer produces corn to be consumed as bread in a distant city, he would be impelled to ask how the farmer knew that this consumer wanted bread and just so much. He would assuredly be astonished to learn that the farmer did not know at all where or by whom it would be consumed. Furthermore, he could observe that all the people through whose hands the corn must go on its way to the final

21 TED, p. 5.
22 The term “circular flow” in English is a rendering by the 1934 translator of Schumpeter’s German term “Kreislauf”. We do not know if Schumpeter agreed with this translation. The later term “stationary flow” referring to the same phenomenon is Schumpeter’s own term as employed in Business Cycles, which he wrote in English.
23 BC, p. 35.
consumer knew nothing of the latter, with the possible exception of the ultimate
sellers of bread; and even they must in general produce or buy before they know
that this particular consumer will acquire it. The farmer could easily answer the
question put to him: long experience, in part inherited, has taught him how much to
produce for his greatest advantage; experience has taught him to know the extent
and intensity of the demand to be reckoned with. To this quantity he adheres, as
well as he can, and only gradually alters it under the pressure of circumstances.24
Schumpeter says the same holds good for other items in the farmer’s calculations. He
ordinarily knows the prices of the things he must pay when he buys inputs, how much
of his own labour will be needed and the method of cultivation this is best—all from
years of experience. Also from experience all those from whom he buys will be
familiar with the extent and intensity of his demand. In every economic period more or
less the same thing occurs. The experience of previous economic periods governs the
activity of the individual. This is the case not only because experience has taught him
what he has to do, but also because during every period the farmer must live either
directly upon the physical product of the preceding period or upon what he can obtain
with the proceeds of this product. All the preceding periods have, furthermore,
entangled him in a web of social and economic relations that have bequeathed him
definite means and methods of production.

Schumpeter then says the case of the farmer can be generalized. He supposes that
everyone sells all their own products and, insofar as they themselves consume, are their
own customer, since such consumption is determined by the market price, that is,
indirectly by the quantity of other goods obtainable by ceasing consumption of one’s
own products. Everyone is, therefore, in the position of the farmer. They are all
simultaneously buyers—for the purposes of their production and consumption—as well
as sellers. The workers can be similarly conceived, that is, their services may be
included in the same category with other marketable items. Now since every one of
these businessmen produces their product and finds their buyers on the basis of their
experience, just like the farmer, the same must be true for all taken together. In general,
all products must be disposed of, for they will only be produced with reference to
known market possibilities. Thus, how much meat the butcher sells depends upon how
much his customer the tailor buys and at what price. That depends, however, upon the
sales from the latter’s business, these proceeds again upon the needs and the purchasing
power of the shoemaker, whose purchasing power again depends upon the needs and
purchasing power of those for whom he produces, and so on. This concatenation and
mutual dependence of the quantities of which the economic system consists are always
transparent, in whichever of the possible directions one may choose to move. Analysis
never discovers an element that does more to determine other elements than it is by
them determined.25

Schumpeter wants to press his ideal-typical conception of the stationary flow to its
logical conclusion. He says we can imagine that, year in and year out, there is an ever-
recurring employment of productive powers designed to reach the same set of
consumers, the result of which is similar in each case. Hence, somewhere in the
economy every demand is matched by a corresponding supply, and nowhere are there
commodities in the hands of people who will not exchange them given the right

24 TED, pp. 5-6.
conditions. It follows that the circular flow of economic life is a closed system in that the sellers of commodities are also buyers in sufficient measure to acquire those goods that will maintain their present level of consumption as well as their productive equipment into the next period, and vice versa. Schumpeter explains that, obviously this does not mean that no changes can take place in their economic activity. The data may change, and everyone will act accordingly as soon as it is noticed. But everyone will cling as tightly as possible to habitual economic methods and only submit to the pressure of circumstances as it becomes necessary. Thus the economic system will not change capriciously on its own initiative but will be at all times connected with the preceding state of affairs. This may be called Wieser’s principle of continuity.  

Schumpeter points out that economic activity may have numerous possible motives, even spiritual ones, but its ultimate meaning is always the satisfaction of wants. Hence, the fundamental importance of concepts that are derived from the fact of wants, foremost of which is the concept of utility and its derivative marginal utility. From this he argues that certain theorems follow about the distribution of resources to possible uses, about complementariness and rivalry among goods, and about ratios of exchange, prices, and the “law of supply and demand.” Finally one reaches a system of values and the conditions of the system’s equilibrium. 

But Schumpeter then asks: what is the underlying purpose of production? The goal that economic man pursues in producing goods, and which explains why there is any production at all, he say, puts its mark on the method and volume of production. This end determines the “what” and the “for why” of production within the framework of given means and objective necessities. The end can only be the making of useful things, of objects of consumption. Therefore, production follows needs; it is pulled after them. But this characteristic of production creates a problem that is essentially economic in nature. It must be distinguished from a purely technological question. For there are changes in the productive process recommended by the technician that are rejected by management; for example, the engineer may recommend a process which is rejected with the argument that it will not pay. The difference in judgment derives from the fact that each has a different view of what is appropriate. What concerns the businessman is commercial advantage, for he may well say that the resources that the provision of a machine requires can be employed otherwise to better effect. If the economical satisfaction of wants is the end of production, then there is no economic sense in recourse to measures that detract from this. The business leader is correct in not following the engineer’s recommendations. These views clearly coincide with Weber’s on the same topic—as we have seen, in Economy and Society Weber also sees a fundamental contrast between the technical and the economic point of view.

Schumpeter points out that technologically, as well as economically considered, production “creates” nothing physically. Production can only control things and processes. It is always a question of changing the existing state of the satisfaction of our wants or of changing the relations of things. To produce means to combine things and forces. Different methods of production can only be distinguished by the objects combined or by the relation between their quantities. Schumpeter emphasizes this feature and analyses the enterprise and the productive set up of the whole economic

\[26\text{Ibid, pp. 8-9.}\]
system as being bound up with such “combinations”. He argues that “production coefficients” represent the quantitative relation of production goods contained in a unit of product, and they are therefore specified for any combination. The economic point of view does not only decide between different methods of production but it also determines the coefficients, since the individual means of production can to a certain extent be substituted for one another. That is, deficiencies in one means can be compensated for by increases in another without altering the method of production: for example, a decrease in steam power by an increase in hand labour. Schumpeter’s concept of combination is very important to his subsequent theory of development, as we shall see. Under the conditions of developed capitalism, “new combinations” are the driving force of technological innovation. But in the stationary state new combinations are in principle not present.

According to Schumpeter, the basic ingredients that are required in the production of all goods are land and labour. Much of what he says here is linked to debates that have engaged economists over the years concerning the ultimate source of wealth creation. Like Marx, Schumpeter agrees that labour is a fundamental source, but contrary to Marx, he says nature/land is also such a source and entrepreneurial and managerial work must equally be counted as a type of labour. He says, “It is usual to classify goods into “orders” according to their distance from the final act of consumption. Consumption goods are of the first order, goods from combinations of which consumption goods immediately originate are of the second order, and so on, in continually higher or more remote orders.” It follows from this that labour is a good of the highest order because it enters at the very beginning of production. In successive stages each good matures into a “consumption good” through the addition of other goods belonging to the various orders. Schumpeter imagines a hierarchy of orders such that at the lowest level are specialized consumption goods and the highest goods that are increasingly amorphous and lack any precise qualities that predestine them for particular uses. The higher up in the orders of goods, the more they lose their specialized character. As we ascend in the hierarchy of goods, we eventually come to the ultimate elements, namely labour and the gifts of nature or “land”. For Schumpeter all other goods are in effect made up of at least one and mostly of both of these. All goods are “labour and land” in the sense that all goods are ultimately bundles of the services of labour and land.

Having broached the issue as to the essential role of labour, Schumpeter feels obliged to comment upon the question as to the role of managerial activities in the economic setting. This means he must clarify the distinctions between so-called directing and directed labour and between independent and wage labour. Importantly, he proposes definitions that are clearly at odds with the Marxist approach in particular. What distinguishes directing and directed labour is fundamental. Directing labour stands higher in the hierarchy of the productive organism. Supervision of the “executing” labour places directing labour in a different order to ordinary labour. While executing labour is similar to the uses of land and from the economic standpoint has the same function as these, directing labour occupies a governing position. Schumpeter

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28 TED, p. 17.
thereby suggests that it forms a third productive factor. And another characteristic separating it from directed labour is that it has something creative about it in that it sets its own ends. The important fact about supervising labour is that it directs the method and quantity of production.

Under the assumptions Schumpeter has set down as basic constituents of the circular flow there is no leader of the productive process in general—or rather, the real leader is the consumer. The people who direct business activity only execute what is required of them by the expressed wants and by the available means of production. Every individual takes part in the direction of production, not only the director of the business firm, but everyone including the workers. The data that have governed the economic system till then remain unchanged and the system will continue in the same way into the future. To anticipate a little, Schumpeter wants to emphasize the importance of consumer sovereignty and the lack of leadership in the state of the circular flow because in the real world of dynamic capitalism these features are paradoxically reversed.

Schumpeter says that in his imagined stationary economy the quantity of labour is set by the given circumstances. Assuming that the best possibilities of employing the labour of all individuals are known, then the anticipated utility of every concrete employment of labour is compared with the disutility accompanying that employment. The burden of work ensures that no labour is undertaken which is not required out of necessity. These considerations determine the amount of work that each worker performs. At the beginning of each working day, it is clear what work is to be undertaken. But the more one achieves in the satisfaction of wants, the more the impulse to work declines and at the same time the more the disutility of work, increases; so that eventually the moment comes when increasing utility and increasing disutility of work balance each other.\footnote{Ibid, pp. 22-23.}

**Imputation and the Theory of Value**

As the services of labour and of land are the only productive powers, the issue arises as to how the system is stabilized. The measurement of the quantity of labour and the measure of the services of land, however complicated in practice, are not in principle insoluble. This leads to the problem of values. Schumpeter wants to explain how the economic system generates the price mechanism from the valuations that must be placed on the ingredients that go into production. He relies here on the ground-breaking work of his fellow Austrians and especially the work of Wieser\footnote{On Wieser’s contribution see his seminal essays “On the Relationship of Costs to Value” Chapter 8 and “The Austrian School and the Theory of Value” Chapter 9 in Israel Kirzner (ed.), *Classics in Austrian Economics*, Vol 1, Pickering, 1994.} and the notion of “imputation”:

What the individual wishes to measure is the relative significance of quantities of his means of production. He needs a standard with the help of which to regulate his economic conduct; he needs indexes to which he can conform. In short, he requires a standard of value. But he has such a thing directly only for his consumption goods; for only these immediately satisfy his wants, the intensity of which is the
basis of the meaning of his goods to him. For his stock of services of labour and land there is in the first instance no such standard, and likewise none, we may now add, for his produced means of production.\textsuperscript{31}

But how do means of production or producer goods acquire value and how are they costed in accordance with the theory of imputation? It is clear that these goods also owe their importance to the fact that they likewise satisfy wants, because they contribute to the realisation of consumption goods. The value of the consumption goods, as it were, radiates back to them and is “imputed” to them. Schumpeter explains his view as follows:

In contrast to use value of consumption goods this value of production goods is “return value” (Ertragswert), or as one might also say, productivity value (Produktivitätswert). To the marginal utility of the former corresponds the marginal productive use (Produktivitätsgrenznutzen) of the latter, or, following the usual term, the marginal productivity; the significance of an individual unit of the services of labor or land is given by the marginal productivity of labor or land, which is therefore to be defined as the value of the least important unit of product so far produced with the help of a unit of a given stock of the services of labor or land. This value indicates the share of every individual service of labor or land in the value of the total social product, and can hence be called in a definite sense the “product” of a service of labor or land. . . . In this sense also we say that the prices of the services of land and labor in an exchange economy, that is rent and wages, are determined by the marginal productivity of land and labor, and therefore that under free competition landlord and laborer receive the product of their means of production.\textsuperscript{32}

But how does knowledge of the correct values arise in practice? Schumpeter says that, although once in operation the individual relies on previous experience, we must disregard the existence of this given experience and start from the point where the individual is not yet clear about the existing possibilities of employment. He says the individual will first employ his means of production in the production of those goods that satisfy his most urgent needs, and thereafter pursue less pressing needs. And at each step he will consider what other wants must go unsatisfied in consequence of the decisions he makes. Each step is only economical provided that the satisfaction of more intensive wants is not rendered impossible. To each contemplated option of employment of resources there corresponds a particular value of every increment. If no choice is made, the means of production will have no definite value. Schumpeter assumes that, if no given want is satisfied before more intensive wants have been satisfied, then the result must be that all goods will be so divided amongst their different possible uses that the marginal utility of each good is equal in all its uses. In this arrangement the individual has found the circumstance that is the best possible. He will strive after this state of want satisfaction until it is achieved. If necessary, he must feel his way to the optimum step by step. If previous experience is already available, he will use this to avoid having to employ trial and error. And if the conditions change, he will submit to the new conditions and adapt his conduct accordingly. In all cases, according to Schumpeter, there is a definite way of employing every good, hence a definite satisfaction of wants. As a result, one can arrive at a utility index for the individual increments of the goods involved. If a new possibility of employment of a

\textsuperscript{31} TED, p. 24. German translations in original.

\textsuperscript{32} Ibid, p. 25.
good occurs, it must be considered in the light of this value. There finally emerges a
definite utility-scale for every good, and this reflects the utilities of all its possible uses
and gives rise to a definite marginal utility. With means of production the same applies
through their “productive contribution.”

Schumpeter now comes to the crucial issue of “costs”. As all production involves a
choice between various possibilities and always entails the renunciation of producing
other goods, the total value of the product will not be a net gain. This is where the
element of costs arises. For as Schumpeter explains,
In the final analysis what the production of a good costs the producer is those
consumption goods which could otherwise be acquired with the same means of
production, and which in consequence of the choice of production cannot now be
produced. Therefore the outlay of means of production involves a sacrifice, in the
case of labor just as in the case of other means of production. To be sure, in the case
of labor there is also another condition which must be fulfilled, viz., that every
expenditure of labor must result in a utility which at least compensates for the
disutility attaching to that expenditure of labor. This, however, in no way alters the
fact that within the limits of this condition the individual behaves towards the
expenditure of labor exactly as towards the expenditure of other productive
resources.\footnote{Ibid, p. 28}

Schumpeter points out that unsatisfied wants are by no means without significance,
for every productive decision must contend with them. The further the producer goes in
a given direction, the harder this battle with unsatisfied wants becomes: “that is the
more a particular want is satisfied, the less the intensity of the desire for more in the
same line, hence the less the increase in satisfaction to be achieved through further
production.”\footnote{Ibid.} Further, the sacrifice associated with production in this direction also
increases at the same time. For the means of production for this product must be taken
away from ever more pressing wants. The key theorem of the theory of marginal utility
is thus stated as follows: “The gain in value from the production in one direction
becomes therefore continually smaller, and finally it vanishes. When that happens, this
particular production comes to an end. Thus we can speak here of a law of decreasing
returns in production.”\footnote{Ibid, p. 28}

Schumpeter takes up the further implications of the classical theory of marginal
utility with a discussion of the related notion of equilibrium that he takes largely from
Walras. He maintains that the system of the circular flow tends to always be in
equilibrium. This is a necessary consequence of the way he has created his model. He
has built it this way precisely to show the conditions under which equilibrium would in
theory be the normal and constant result of economic activity. But of course he does
not accept that equilibrium is the usual state of a really existing capitalist economy—
though he maintains there is a tendency toward equilibrium, as we shall see. The state
of equilibrium in the circular flow arises essentially because of the nature of costs.
Costs are an expression of the value of other potential employments of means of
production and, as we saw, this is the deepest significance of the cost phenomenon:

33 Ibid, p. 28
34 Ibid.
It follows from [economic equilibrium], first of all, that the last increment of every product will be produced without a gain in utility above costs. . . . But further, it follows that in production generally no surplus value above the value of producers’ goods can be attained. Production realises only the values foreseen in the economic plan, which previously exist potentially in the values of means of production. Also in this sense . . . production “creates” no values, that is in the course of the productive process no increase in value occurs.36

Following the Austrian School’s approach to the problem of value, Schumpeter argues that the imputation process refers us back to the ultimate elements of production, namely, the services of labour and land. It cannot stop at any particular produced means of production, for these can be reduced to more basic elements themselves. Hence, no product can show a surplus of value over the value of the services of labour and land embodied in it. In an exchange economy in the circular flow the prices of all products will, where there is free competition, be equal to the prices of the services of labour and land embodied therein. For the price obtainable for the product after production has occurred must have been obtainable at the outset for the complete set of required means of production. Each producer must give up his total receipts to all those who supplied him with means of production, and in so far as they are also producers of some product or other, they must in their turn pass on their receipts until the whole original price falls to the providers of the services of labour and of nature. 37

Now the question arises as to whether profit can exist under these conditions. This is a crucial issue because profit appears to be an essential element of the capitalist system. So if it does not exist in the circular flow, how does it come about? Schumpeter argues that, if the businessman takes into consideration the costs he must pay for his inputs in order to produce goods for sale, and if he adds in a sum equivalent to the money value of his own efforts, this total must equal the total price for the services of labour and nature and, insofar as this is the case, there can be no profit. As he explains:

That the economic system in its most perfect condition should operate without profit is a paradox. If we remember the meaning of our statements, the paradox vanishes, at least in part. Of course our assertion does not mean that if it is perfectly balanced the economic system produces without result, but only that the results flow entirely to the original productive factors. . . . But let it be assumed that producers make such a profit. Then they must value correspondingly the means of production to which they owe it. Now these are either original means of production, viz. personal efforts or natural agents, in which case we are where we were before; or else they are produced means of production, in which case these must be correspondingly more highly prized, that is the services of labour and land embodied in them must be more highly prized than other such services. . . . Consequently, net profit cannot exist, because the value and price of the original productive services will always absorb the value and price of the product, even if the productive process is parcelled out among ever so many independent firms. 38

38 Ibid, p. 31.
In Schumpeter’s schema the value system set up in the circular flow exhibits a unique kind of stability. For in every economic period there is a tendency to follow well-worn tracks and thereby to realise the same values. Even when this constancy is disrupted, some continuity always remains; it is never a question of doing something completely new, but only of adapting the previous approach to new conditions. The established value system and the combinations once given are always the basis of the values of a new period. Such stability is crucial for the economic life of individuals who could not readily do the mental labour necessary to create their economic world anew each day. And in any event, experience teaches that the rules of behaviour previously followed have stood the test of time and that one will not do better than go on acting by following them. According to Schumpeter, there must be one unique set of economic behaviours which, under given conditions, establishes the equilibrium between the means available and the wants to be satisfied in the optimum way. The value system outlined corresponds to a state of economic equilibrium whose constituent parts cannot be changed without the individual believing he is worse off than before.

In every period of economic activity operates with goods that were produced at an earlier time, and in every period goods are produced for use in a later one. Schumpeter assumes for simplicity that in each period only goods that were made in the previous one are consumed, and that only goods to be consumed in the following period are produced. Such dovetailing of the economic periods does not alter anything essential. Schumpeter then proceeds to classify the exchanges that are necessary to carry out the basic economic process in each period. Most important is the exchange of the services of labour and land against consumption goods. But labourers and landlords also sell their productive services for the production of producers’ goods and this complicates the matter somewhat. Schumpeter wants to show is that, contrary to the situation of capitalism proper, in the situation of the circular flow there is no need for credit. For in every period the services of labour and land that are not already part of the means of production to be used in the period under consideration are exchanged for consumption goods that were made in the preceding period. In effect those individuals who produced consumption goods in the preceding period give up a portion of them in the present period to workers and landlords whose services they need for the production of new consumption goods for the next period. The individuals who made production goods in the earlier period and who want to continue doing this will give up these production goods to the producers of consumption goods in return for consumption goods which they require in order to obtain new productive services. Hence, workers and landlords only exchange their productive services for present consumption goods, whether the former are employed directly or indirectly in the production of consumption goods. They do not need to exchange the services of labour and land for future goods or for promises of these or to apply for any “advances”. It is simply a matter of exchange, and no credit transactions are involved. The element of time plays no role. All products are nothing more that what they are as such. For the individual firm it does not matter whether it produces means of production or consumption goods. In either case the product is paid for immediately and at its full value. And the individual does not look beyond the present period, even though he works for the results of the next. He simply responds to the given state of demand, and the economic process ensures that he simultaneously caters for the future.39

According to Schumpeter, in the organization of an exchange economy individual businesses appear as sites of production for the requirements of people other than the owners, and the output of the whole nation is in the first place “distributed” among these units. These units have no other functions than that of combining the two basic factors of production, and this function is performed in every period mechanically, as it were of its own accord, without requiring a personal element distinguishable from superintendence. Thus, if one supposes that the services of land are in private hands, then there are no persons with any claims upon the product except those who do some kind of labour or put land at the disposal of production. That is, there is no other class of people in the economic system, for example a class whose special characteristic is that they are the owners of produced means of production or consumption goods. Schumpeter then comes to a key point of differentiation with the real world of a capitalistic economy. He says, if we choose to call the manager or owner of a business ‘entrepreneur’, then he would be an entrepreneur faisant ni bénéfice ni perte, without special function and without income of a special kind. If the possessors of produced means of production were called ‘capitalists’, then they could only be producers, differing in nothing from other producers, and could no more than the others sell their products above the costs given by the total of wages and rents.  

In the theory of the circular flow, therefore, Schumpeter sees a stream of goods being produced continually in a repetitive sequence of productive efforts. Only for an instant is there anything like a stock of goods. In one sense the circular flow ends here. In another sense, however, it does not cease, for consumption generates the desire to repeat it and this fosters renewed economic activity. But Schumpeter must explain how transactions take place in a system where many exchanges of different commodities occur on a regular basis, and for this purpose he introduces the concept of “exchange value”. He says the exchange value of a commodity depends upon the value of the goods the individual can procure and in fact intends to procure with that outlay. When the best employment for a good is found, the exchange value remains at one and only one definite level, given that conditions remain unchanged. The exchange value of any unit of one and the same commodity varies for different individuals in part because of the differences of their tastes and their differing economic situations as a whole, but also, quite independently of these aspects, because of differences in the goods which the individual exchanges. But he argues that the relation of the quantities in which any two goods are exchanged in the market, that is, the “price” of each good, is the same for all individuals. For the price of every good is connected with the prices of all other goods. 

At this point Schumpeter introduces his account of the role of money. He explains this role as follows: At first sight money appears as a general order upon different quantities of goods or as we may say as “general purchasing power.” Every individual regards money first of all as a means of obtaining goods in general; if he sells his services of labor or land, he sells them not for definite goods but, as it were, for goods in general. If one looks more closely, however, things take on a different aspect. For every individual values his money income really according to the goods which he actually obtains with it and not according to goods in general. When he speaks of the value of money, the range of goods he customarily purchases floats more or less plainly

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Thus far Schumpeter has not had to refer to any employment of money that would necessitate an accumulation beyond the amount sufficient for the individual to pay for his current purchases. And for similar reasons he has not had to speak of credit instruments. Clearly, when he later comes to explore the reality of an actually existing capitalist economy, money and credit become absolutely central. But in the circular flow they are not essential. For the exchange process could in theory do without money altogether and rely on something like the bill of exchange. All that is necessary to put money in a fixed relation to the values of other goods is that it should have a connection with something of definite value, thus there is no inherent need for metal money. Schumpeter’s argument also entails that no interest would appear in the economic system under the assumptions of the circular flow. In summing up, he says, “Thus, corresponding to the stream of goods there is a stream of money, the direction of which is opposite to that of the stream of goods, and the movements of which, upon the assumption that no increase of gold or any other one-sided change occurs, are only reflexes of the movement of goods. With this we have closed the description of the circular flow.”

The Causes of “Development”

In the present writer’s view, Schumpeter’s unique and truly original contribution to economic theory really begins with his concept of “development”. By this term he means something special that causes progressive change but that, importantly, is intrinsic to the economy as such. An account of economic development cannot be merely a description of historical events as they have unfolded and contributed to the shaping of the modern economy. Schumpeter may well have Weber in mind when he sets out to distinguish his approach from that of economic history or economic sociology. That is, he wants to focus exclusively on the nature of the economic process in pure form, no matter how much this may be influenced by non-economic factors from time to time, concerns that are abiding preoccupations of Weber. As Schumpeter puts it: “No historical evolutionary factors will be indicated, whether individual events like the appearance of American gold production in Europe in the sixteenth century, or ‘more general’ circumstances like changes in the mentality of economic men, in the area of the civilized world, in social organization, in political constellations, in productive technique, and so forth—nor will their effects be described for individual cases or for

\[41\] Ibid, pp. 51-2.
\[42\] Ibid, p. 55.
groups of cases.” Rather, Schumpeter intends to build on his account of the “circular flow” as expounded above and to demarcate a field of enquiry that is purely “economic”.

As we have seen, the theory of economic life from the standpoint of the circular flow shows economic activity running on in channels essentially the same year after year. Now, by contrast, Schumpeter wants to emphasize that it is essential to the reality of modern capitalism that certain events occur that do not appear as a result of the routine and regular working of the economy, as do normal adaptive changes in the ordinary functioning of the circular flow. For some occurrences alter the basic framework of the economy as such. Such changes, he says,

... cannot be understood by means of any analysis of the circular flow, although they are purely economic and although their explanation is obviously among the tasks of pure theory. Now such changes and the phenomena which appear in their train are the object of our investigation. But we do not ask: what changes of this sort have actually made the modern economic system what it is? nor: what are the conditions of such changes? We only ask, and indeed in the same sense as theory always asks: how do such changes take place, and to what economic phenomena do they give rise?44

It is crucial to Schumpeter’s approach to rigorously exclude from the problem of explaining change the impact of non-economic factors—which he does not deny or ignore but which he claims constitute a fundamentally different category of causation. He seeks a source of change that is endogenous to the working of the economic system itself. As we shall see, his approach has numerous parallels with that of Darwin in developing his theory of the origin of species. Just as Darwin sought to find within the very processes of living nature itself factors that explain the creation of new species, a principle encapsulated in the notion of “natural selection,” in a like manner Schumpeter wants to claim that the capitalist economy “evolves” as a result of forces at work within the structures of the system as such. “If the change occurs in the non-social data (natural conditions) or in non-economic social data (here belong the effects of war, changes in commercial, social, or economic ‘policy), or in consumers’ tastes, then to this extent no fundamental overhaul of the theoretical tools seems to be required. These tools only fail—and here this argument joins the preceding, where economic life itself changes its own data by fits and starts.”45 Schumpeter gives as a classic illustration of “pure” economic change the case of the building of a railway and all that flows from this. But he also he mentions the situation where many small, continuous changes, which though small steps, can for example create a great department store out of a small retail business. Crucially for Schumpeter the ‘static’ analysis of the circular flow is not only unable to deal with discontinuous change in the accepted way of doing things. It cannot account the occurrence of such productive revolutions as are caused by “railroadization” or the phenomena that are associated with them. It can only describe the equilibrium position after the changes have taken place. Thus he says, “It is just this occurrence of the ‘revolutionary’ change that is our problem, the problem of economic development in a very narrow and formal sense. ... By ‘development,’ therefore, we

43 Ibid, p. 61.
44 Ibid, pp. 61-2.
shall understand only such changes in economic life as are not forced upon it from without but arise by its own initiative, from within.\textsuperscript{46}

In summary, Schumpeter’s main focus is the process of change that arises from \textit{within} the economy. If major changes in the economy were only the result of exogenous factors affecting it from the outside, there would be no “economic” development as such and thus no need for economic theory to explain the changes. Hence, the mere growth of the economy, as occurs due to the increase of population, is not part of the process of development in Schumpeter’s sense: “For it calls forth no qualitatively new phenomena, but only processes of adaptation of the same kind as the changes in the natural data.”\textsuperscript{47} As he adds in a footnote: Development in our sense is a distinct phenomenon, entirely foreign to what may be observed in the circular flow or in the tendency towards equilibrium. It is spontaneous and discontinuous change in the channels of the flow, disturbance of equilibrium, which forever alters and displaces the equilibrium state previously existing. Our theory of development is nothing but a treatment of this phenomenon and ‘the processes incident to it.’\textsuperscript{48}

And he goes on to explain: “what we are about to consider is that kind of change arising from within the system which so displaces its equilibrium point that the new one cannot be reached from the old one by infinitesimal steps. Add successively as many mail coaches as you please, you will never get a railway thereby.”\textsuperscript{49}

But precisely how do endogenous changes in the economy arise? For Schumpeter it is a fundamental assumption that, contrary to what may be intuitively thought, major economic changes manifest themselves first in the sphere of industrial and commercial life and not in the wants of the consumers: Where spontaneous and discontinuous changes in consumers’ tastes appear, it is a question of a sudden change in data with which the businessman must cope, hence possibly a question of a motive or an opportunity for other than gradual adaptations of his conduct, but not of such other conduct itself. . . . Yet innovations in the economic system do not as a rule take place in such a way that first new wants arise spontaneously in consumers and then the productive apparatus swings round through their pressure. We do not deny the presence of this nexus. It is, however, the producer who as a rule initiates economic change, and consumers are educated by him if necessary; they are, as it were, taught to want new things, or things which differ in some respect or other from those which they have been in the habit of using.\textsuperscript{50}

Schumpeter argues that producing means combining materials and forces within the power of the individual actor. Insofar as a “new combination” may over time grow out of the old by incremental steps of adjustment there is certainly change, and possibly growth, but not a new phenomenon. But, if the new combinations appear

\textsuperscript{46} \textit{Ibid.}
\textsuperscript{47} \textit{Ibid}, p. 63.
\textsuperscript{48} \textit{Ibid}, p. 64.
\textsuperscript{49} \textit{Ibid}, footnote 1, p. 64.
\textsuperscript{50} \textit{Ibid}, p. 65.
discontinuously, then “development” in Schumpeter’s sense can be said to have occurred.\textsuperscript{51} The concept of development may involve any of the following:

(1) The introduction of a new good—that is one with which consumers are not yet familiar—or of a new quality of a good. (2) The introduction of a new method of production, that is one not yet tested by experience in the branch of manufacture concerned, which need by no means be founded upon a discovery scientifically new, and can also exist in a new way of handling a commodity commercially. (3) The opening of a new market, that is a market into which the particular branch of manufacture of the country in question has not previously entered, whether or not this market has existed before. (4) The conquest of a new source of supply of raw materials or half-manufactured goods, again irrespective of whether this source already exists or whether it has first to be created. (5) The carrying out of the new organization of any industry, like the creation of a monopoly position (for example through trustification) or the breaking up of a monopoly position.\textsuperscript{52}

Having defined his notion of development and explained how it is crucial to what is essential to the capitalist economy, Schumpeter proceeds to unpack the further implications of his approach. He starts to explore various themes that are to become significant in his later work. In the first place, he says, it is not necessary for new combinations to be carried out by the same people who control the existing productive or commercial processes. On the contrary, new combinations are typically to be found in new firms and do not arise out of established ones—it is not the owner of stage-coaches who builds railways. Schumpeter points to how this is confirmed by the fact that in a capitalist society it is a normal feature that individuals and families rise and fall economically and socially—that is, there is high volatility in the fortunes of businesses as well as high socio-economic mobility. A further aspect of development, he insists, is that the carrying out of new combinations does not take place by employing means of production that happen to be unused. Rather, the new combinations must draw the necessary means of production from existing combinations. The carrying out of new combinations means, therefore, a different employment of the system’s existing productive means.

**Capitalists, Banks and the Creation of Credit**

The next stage in Schumpeter’s argument is to show how command over means of production is necessary to the carrying out of new combinations. Procuring the means of production is not a problem for the established firms operating within the circular flow. For they have already procured them or else can procure them with the proceeds of previous production; there is no fundamental gap between receipts and disbursements, which necessarily correspond to one another. The problem of procuring the means of production does not exist in a competitive economy if those who wish to develop new combinations can get them in exchange for others that they have. But do those who wish to establish new combinations already possess the ware withal to purchase the means of production they require? The instructive case that interests Schumpeter is that where an individual must resort to credit if he wishes to carry out a

\textsuperscript{51} *Ibid*, pp. 65-6.

\textsuperscript{52} *Ibid*, p. 66.
new combination, because he does not control an established business that could finance its new operations by returns from previous production.

To provide this credit is clearly the function of that category of individuals which we call ‘capitalists’. It is obvious that this is the characteristic method of the capitalist type of society—and important enough to serve as its differentia specifica—for forcing the economic system into new channels, for putting its means at the service of new ends, in contrast to the method of a non-exchange economy of the kind which simply consists in exercising the directing organ’s power to command.\(^{53}\)

While the process of production within the circular flow does not require borrowing as a necessary ingredient, this is crucial in the creation of new combinations: ‘financing’ as a special act is fundamentally necessary, in practice as in theory.\(^{54}\)

A key requisite for the establishing of new combinations is a mechanism whereby existing means of production can be detached from their previous uses in the circular flow so as to be available for novel productive purposes. For Schumpeter this is effected by the means of credit. More specifically, it is achieved by the individual who wishes to carry out new combinations outbidding the producers remaining in the circular flow in the market for the desired means of production. But from where do the sums needed to purchase the means of production necessary for the new combinations come if the individuals concerned do not happen to possess them already? For in the circular flow there is no source out of which sufficient funds can be saved to finance new combinations, and in any event there would be essentially little, if any, incentive to save. The only big incomes would be monopoly revenues and the rents of large landowners. The most important incentive, the chance of participating in the profits of development, is totally absent. Hence, in such an economic system like that of the circular flow there are no great reservoirs of free purchasing power to which one who wished to form a new combination could turn for finance.

At this point in his argument Schumpeter introduces his unique account of how the financing of new combinations is achieved under the conditions of modern capitalism. The key method of obtaining money for the purpose of development is the creation of purchasing power by banks:

The issue of bank-notes not fully covered by specie withdrawn from circulation is an obvious instance, but methods of deposit banking render the same service, where they increase the sum total of possible expenditure. Or we may think of bank acceptances in so far as they serve as money to make payments in wholesale trade. It is always a question, not of transforming purchasing power which already exists in someone’s possession, but of the creation of new purchasing power out of nothing—out of nothing even if the credit contract by which the new purchasing power is created is supported by securities which are not themselves circulating media—which is added to the existing circulation. And this is the source from which new combinations are often financed, and from which they would have to be financed always, if results of previous development did not actually exist at any moment.\(^{55}\)

\(^{53}\) Ibid, pp. 69-70.

\(^{54}\) Ibid, p. 70.

\(^{55}\) Ibid, p. 73.
Schumpeter further explains how these credit means of payment serve as ready money because they can be converted immediately into payments to individuals such as wage-earners and for payments to purchase existing stocks of productive means. In this way he gives special emphasis to the role of the financier of new combinations, because without the credit-creating function development in the operative sense would simply not occur.

The banker, therefore, is not so much primarily a middleman in the commodity “purchasing power” as a producer of this commodity. However, since all reserve funds and savings to-day usually flow to him, and the total demand for free purchasing power, whether existing or to be created, concentrates on him, he has either replaced private capitalists or become their agent; he has himself become the capitalist par excellence. He stands between those who wish to form new combinations and the possessors of productive means. He is essentially a phenomenon of development, though only when no central authority directs the social process. He makes possible the carrying out of new combinations, authorizes people, in the name of society as it were, to form them. He is the ephor of the exchange economy.  

The Function of the Entrepreneur

Thus far Schumpeter has analysed two of three essential elements of development: the new combinations of means of production and credit. But a third ingredient is possibly the most important of all, and this is the “entrepreneur” and his “enterprise”, which bring the first two elements together in such a way as to transform the circular flow into modern capitalism proper. He explains,

The carrying out of new combinations we call ‘enterprise’; the individuals whose function it is to carry them out we call ‘entrepreneurs.’ These concepts are at once broader and narrower than the usual. Broader, because in the first place we call entrepreneurs not only those ‘independent’ businessmen in an exchange economy who are usually so designated, but all who actually fulfil the function by which we define the concept, even if they are, as is becoming the rule, ‘dependent’ employees of a company, like managers, members of boards of directors, and so forth, or even if their actual power to perform the entrepreneurial function has any other foundations, such as the control of a majority of shares. As it is the carrying out of new combinations that constitutes the entrepreneur, it is not necessary that he should be permanently connected with an individual firm; many “financiers,” “promoters,” and so forth are not, and still they may be entrepreneurs in our sense.  

Schumpeter says that the modern idea of the “captain of industry” corresponds fairly closely to what he means. But whatever the type, anyone is an entrepreneur only when he actually carries out new combinations, and he loses that character as soon as he has built up his enterprise and settles down to running it along conventional lines.

Schumpeter does not appear to acknowledge that entrepreneurs form a class as such. His view as to whether entrepreneurs constitute a class makes an interesting contrast with the approach of Weber who is quite explicit that entrepreneurs do occupy

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56 Ibid, p. 74.
57 Ibid, pp. 74-5.
a distinct class position. Schumpeter may be thinking primarily of the concept "social class", in which case he is not necessarily at odds with Weber. Weber defines a social class as "the totality of those class situations in which individual and generational mobility is easy and typical", and accordingly he does not include entrepreneurs in his listing of major social classes.\footnote{ES, pp. 302-5.} Schumpeter explains that,

Because being an entrepreneur is not a profession and as a rule not a lasting condition, entrepreneurs do not form a social class in the technical sense, as, for example, landowners or capitalists or workmen do. Of course the entrepreneurial function will lead to certain class positions for the successful entrepreneur and his family. It can also put its stamp on an epoch of social history, can form a style of life, or systems of moral and aesthetic values; but in itself it signifies a class position no more than it presupposes one. And the class position which may be attained is not as such an entrepreneurial position, but is characterized as landowning or capitalist, according to how the proceeds of the enterprise are used.\footnote{TED, pp. 78-9.}

Weber’s analysis on these issues is somewhat cryptic and underdeveloped. In a brief section of \textit{Economy and Society} he sets up a dichotomy between positively-privileged and negatively-privileged classes. He explains that the general advantage enjoyed by a “positively privileged commercial class” is their “the monopolization of entrepreneurial management for the sake of its members and their business interests” and the safeguarding of those interests through influence on the economic policy of political and other organizations. That entrepreneurs as a group have these interests would seem to be a definite feature of modern capitalism. Class position in general for Weber means any situation which allows for increased opportunities of procuring goods, obtaining a position in life and finding inner satisfactions, and on these assumptions it could hardly be denied that entrepreneurs occupy a distinct class position.

But regardless of whether the two approaches to class of commensurable, what especially concerns Schumpeter is to bring out the significance of the entrepreneur for development. He raises the question of whether the carrying out of new combinations is a special process and the object of a special kind of “function”. He points out that economic actors in general are obviously eager to do the best they can and are prepared to adopt new methods or change their type of business if they can see advantages in doing so. But while the individual in the circular flow will act rationally and expediently given his usual circumstances, he cannot do this easily when confronted with the prospect of a completely new task.

While he swims with the stream in the circular flow which is familiar to him, he swims against the stream if he wishes to change its channel. What was formerly a help becomes a hindrance. What was a familiar datum becomes an unknown. Where the boundaries of routine stop, many people can go no further, and the rest can only do so in a highly variable manner. . . . Therefore, too, the carrying out of new combinations is a special function, and the privilege of a type of people who are much less numerous than all those who have the “objective” possibility of doing it. Therefore, finally, entrepreneurs are a special type . . .\footnote{\textit{Ibid}, pp. 79-81.}
Having sketched his concept of the entrepreneur, Schumpeter proceeds to characterize this individual in some detail. Firstly, he wants to insist that the entrepreneur should not be confused with a manager, for the two roles are significantly different. Whereas the manager remains wedded to the situation of the circular flow and is oriented to maintaining the existing mode of operation of his business, the entrepreneur is focused on a non-existent reality that has to be imagined and created sometime in the future. This latter aspect requires uncommon qualities that amount to special psychological propensities. To a degree the entrepreneur also has the qualities of a manager, for he must set people their tasks, keep up discipline, and so forth; but these qualities are relatively easy to find and comprise skills any normal person can learn to fulfil. Even the directing of other people, though essential, is mere “work” like any other, comparable to the labour of tending a machine. In any production process everyone learns their daily tasks and carries them out more or less well, including the manager. The knowledge to perform such tasks does not need to be continually renewed and consciously reproduced, for it is transmitted almost unconsciously by inheritance, teaching, upbringing and the pressure of the environment. Even so, the demands on the individual remain considerable because the burden of work is never slight and most manage to just cope. To go beyond the level of work competence required in the ordinary circumstances of the circular flow, a person needs something extra and rare, and this is what Schumpeter terms “leadership.”

At this point it is worth noting some possible parallels and synergies with the thought of Weber on leadership, especially political leadership as he expounds its nature in his celebrated essay “Politics as a Vocation.” There Weber sought to characterize the nature of genuine political leadership and distinguished it in particular from mere administration of the bureaucratic official. Weber’s ideal politician requires a genuine calling for politics, possesses moral qualities and, perhaps, charisma, an aspect which may not be as relevant to the economic enterprise. But there are definite affinities between the two types of leadership insofar as they both involve the capacity for vision and require an ability to break new ground. For Schumpeter leadership requires several important capacities: First, outside accustomed channels the individual is without data for his decisions and lacks rules of conduct that are tried and tested. Many things are uncertain, and others can only be guessed at. Schumpeter also makes a very interesting comment that bears comparison with Weber on the same issue. He says, “There will be much more conscious rationality in this than in customary action, which as such does not need to be reflected upon at all; but this plan must necessarily be open not only to errors greater in degree, but also to other kinds of errors than those occurring in customary action.” Here is a possible correlation with Weber’s account of the increasing prevalence of “instrumentally-rational action” and the dominance of formal rationality under the conditions of modern capitalism.

Schumpeter’s entrepreneur is a highly rational individual, because he must calculate and estimate as best he can all the elements of a proposed course of action in advance without being able to rely on customary arrangements. Even so, it is impossible to survey exhaustively all the effects and counter-effects of a projected venture. In economic life decisions must be taken without having at hand all the details of what is to be done; that is, one must proceed with so-called “imperfect knowledge”. Much depends upon intuition, the capacity of seeing things in a way which afterwards

proves to be true, and discarding the non-essential. The temptation always remains to revert to habits of thought and traditional ways of doing things. An effort of will is therefore necessary, Schumpeter says, “in order to wrest, amidst the work and care of the daily round, scope and time for conceiving and working out the new combination and to bring oneself to look upon it as a real possibility and not merely as a day-dream. This mental freedom presupposes a great surplus force over the everyday demand and is something peculiar and by nature rare.”62 To be able to make the kind of effort Schumpeter says is needed the entrepreneur must also possess a special kind of psyche. The habits of the mind are very fixed and have an energy-saving function, and as such become drag-chains when no longer useful. The entrepreneur must somehow break free from the accustomed tracks of thought if he is to bring on his novel enterprise. He must also resist the negative reaction of the social environment, and if necessary conquer any political or legal impediments:

Surmounting this opposition is always a special kind of task which does not exist in the customary course of life, a task which also requires a special kind of conduct. In matters economic this resistance manifests itself first of all in the groups threatened by the innovation, then in the difficulty in finding the necessary cooperation, finally in the difficulty in winning over consumers. Even though these elements are still effective to-day, despite the fact that a period of turbulent development has accustomed us to the appearance and the carrying out of innovations, they can be best studied in the beginnings of capitalism.63

For the purposes of clarification Schumpeter refers to the relation of entrepreneurship or innovation to “invention.” Economic leadership he insists must be distinguished from invention. If inventions are not developed into products then they are economically of no consequence. The crucial point is that the task of bringing an invention to fruition in the form of a saleable product is an entirely different task to that of invention per se. Of course, some entrepreneurs are also inventors just as they may also be capitalists, but their role as entrepreneur has no necessary connection with that of the inventor. Besides, as Schumpeter points out, many innovations do not depend on inventions at all.

Schumpeter makes reference to the wider significance and the status situation of the entrepreneur. He suggests the entrepreneur in effect “leads” the means of production into new channels. He leads by drawing other producers in his branch after him, even though they are his competitors who at first set out to reduce and then annihilate him. This means that the entrepreneur is a crucial driving force of the constant progress that capitalist societies experience. For all this the entrepreneur is not generally revered by his society, as are leaders in other fields like politics or war. Further, the precariousness of the economic position of the entrepreneur, and the fact that despite his economic success he has no cultural tradition or social standing to fall back upon, means that he appears in society as an upstart and gains relatively little status for all his efforts. Schumpeter reflects upon the meaning of the entrepreneur’s life orientation in the following:

In one sense, [the entrepreneur] may indeed be called the most rational and the most egotistical of all. For, as we have seen, conscious rationality enters much more into the carrying out of new plans, which themselves have to be worked out

62 Ibid, p. 86.
63 Ibid, p. 87.
before they can be acted upon, than into the mere running of an established business, which is largely a matter of routine. And the typical entrepreneur is more self-centred than other types, because he relies less than they do on tradition and connection and because his characteristic task— theoretically as well as historically—consists precisely in breaking up old, and creating new, tradition. Although this applies primarily to his economic action, it also extends to the moral, cultural, and social consequences of it. It is, of course, no mere coincidence that the period of the rise of the entrepreneur type also gave birth to Utilitarianism.\textsuperscript{64}

There are aspects in this discussion that warrant further comparison with Weber. Schumpeter remarks on the fact that the rationality of the entrepreneur is antithetical to motivation of the hedonistic kind. For the specific motivation of the entrepreneur has no connection, in Schumpeter’s view, with a desire to increase the level of his own want satisfaction: “Experience teaches, however, that typical entrepreneurs retire from the arena only when and because their strength is spent and they feel no longer equal to their task. And activity of the entrepreneurial type is obviously an obstacle to hedonist enjoyment of those kinds of commodity which are usually acquired by incomes beyond a certain size, because their “consumption” presupposes leisure.” \textsuperscript{65} These remarks have obvious resonances with the ideas of Weber regarding the ascetic disposition of the early modern capitalists. Not only do they suggest the entrepreneur is subject to ascetic impulses and that he rationally tempers his enjoyment of wealth, they also imply something along the lines of a work ethic.

A further issue that is touched upon at this point in Schumpeter’s work is the question of whether the dynamism that flows from the innovative activity of the entrepreneur can be provided in some other way than through the drive of individuals. Of course, this issue is connected with the question of the impact of a possible socialization of the economy and the elimination of private enterprise. Weber was highly concerned at this prospect and, as we shall see, argued passionately against such a radical transformation of the capitalist system. Schumpeter, curiously given how much he appears to celebrate the role of the entrepreneur, was much more open to the idea that a social institution of some kind could under the right circumstances provide the environment for innovation to flourish even in the absence of the private entrepreneur. The extent to which we can say Schumpeter’s approach here is at odds with Weber’s approach must await our more extensive discussion in a later chapter.\textsuperscript{66}

\textbf{Conclusion}

\textsuperscript{64} Ibid, pp. 91-2.
\textsuperscript{65} Ibid.
\textsuperscript{66} As a final comment on \textit{The Theory of Economic Development} and for completeness mention must be made of the fact that in the English edition of the work and the subsequent German editions an important section, namely Chapter Seven, was omitted. The reasons for this need not concern us here, but the Chapter is now available in German and English with a full bibliographical account and commentaries in the collection edited by Jürgen Backhaus entitled \textit{Joseph Alois Schumpeter: Entrepreneurship, Style and Vision}, Kluwer, 2003.
In this chapter we have presented the basic theory of capitalist development as advanced by Schumpeter in the first instance in his early work *The Theory of Capitalist Development*. We have shown how Schumpeter advanced his theory by first presenting an ideal type of an economy which does not advance or progress, what he calls the situation of the stationary flow or the circular flow. This is a term that implies exchanges occur within an economy in a circular process and reproduce the production system repeatedly without any fundamental change. This economy is based on the exchange of goods and services and their payment in a manner not unlike that which actually occurs in a capitalist economy, but all this takes place in circumstances in which there are pre-existing needs, known technologies and recognised standards of performance which are largely unchanging. In some ways it could be said to be a traditional economy, however, Schumpeter does not wish to say that individuals in such an arrangement do not act rationally on the basis of price signals and would not optimise their interests or maximise their satisfaction. So to this extent his stationary economic system has some of the features of an existing capitalist economy even though it lacks key elements such as new technology, the entrepreneur, the phenomenon of profit, and cyclical phenomena of the type associated with depressions and stock market crises.

Schumpeter developed his model of a static economy as an heuristic device for grasping the actual operation of capitalism in which change and development take place. He argues that only with innovation does progress of a capitalistic kind occur, and only under these circumstances are all the other elements of the typical modern economy present, such as the role of the entrepreneur, the existence of profit, the capitalist, credit, the banks, stock markets and cyclical phenomena. In developing his theory Schumpeter, it has to be said, relies heavily on the pre-existing economic theory. He is clearly under the influence of his fellow Austrians, in particular Menger but also others such as Wieser and Böhm Bawerk. But equally, he takes up the celebrated contributions of Walras and Marx and integrates them into his own grand vision. The extent to which Schumpeter’s theory is entirely original is a question we need not attempt to definitively answer. Clearly his skill lay to a degree in his ability to synthesise a range of perspectives deriving from various quarters. But he was also more than prepared to endorse elements that were already current in existing economic theory, such as the principle of marginal utility. Added to these skills was Schumpeter’s ability to express his ideas in a coherent and forceful fashion, and this gave his work its considerable impact in both the academy and even to a degree in the real world of economic affairs. Especially influential have been Schumpeter’s ideas about innovation and the entrepreneur, as these lie at the heart of the phenomenon of the capitalist development. Furthermore, these ideas remain of lasting significance because they explain how it can be that capitalism is able to advance the economic well being of society so markedly and why there has been such tremendous and far-reaching change in the modern era.
CHAPTER FOUR

The Work of Schumpeter:
Part Two

Introduction to the Theory of Business Cycles

Schumpeter first addressed the phenomenon of the business cycle in Chapter VI of *The Theory of Economic Development*. But at this early stage he did not advance a fully worked-out theory, contenting himself with some comments on the relation of business fluctuations and economic crises to the typical conduct of the entrepreneur and to the effects of development. However, he did outline ideas that were subsequently the basis of his great work *Business Cycles: A Theoretical, Historical and Statistical Analysis of the Capitalist Process*. In what follows we shall first offer a brief introduction and summary to the latter work, and thereafter we shall provide a more extensive discussion of the theory in all its facets. It will become apparent that much of the framework that Schumpeter utilizes in *Business Cycles* is already present in *The Theory of Economic Development*, so that a good deal of the opening theoretical section of *Business Cycles* is a restatement but refinement of the approach first advanced in the earlier work. Consequently, in what follows there will necessarily be some repetition of the themes discussed in the previous chapter.

A fundamental issue for a theory of business cycles is the problem of causation, for fluctuations in economic activity can be attributed to a large variety of causes, both economic and otherwise. Essentially, what Schumpeter’s theory of business cycles is attempting to establish is that there is a set of conditions internal to the economy that is essential to the generation of cyclical phenomena. But the difficulty with any such theory is that economic phenomena are never present by themselves without the influence of other factors that are fundamentally non-economic. Schumpeter at the outset fully recognised the problematic nature of his approach in dealing with the effects of what he calls “external factors”. External factors include phenomena such wars, social upheavals, geographic factors, climatic factors and other influences of a religious or political nature. Clearly, in the course of economic development these non-economic phenomena frequently, in fact regularly, interfere with the conduct of economic affairs. Nonetheless, the point of Schumpeter’s approach is to show that, despite the undoubted impact of external factors, it is possible to divine the workings of a cyclical process determined by purely economic phenomena.

In order to achieve his goal, Schumpeter says he will construct a model of the entire economic process as it functions over time and, just as with any other science, will attempt to compare this with concrete reality to see whether in fact the model is confirmed by the observable facts. In contrast with his theory of the circular flow with its focus on the static state of affairs, this model will be essentially dynamic in character. In what follows we shall give a brief summary of Schumpeter’s overall theory of innovation and business cycles before exploring its contours in detail later in this chapter.
A key role in Schumpeter’s theory, as we have seen, is played by entrepreneurship, because it is the entrepreneur through his innovation, or his exploitation of other’s innovations, that gives rise to new “production functions.”¹ The advent of a new production function refers not only to the case of the creation of a novel commodity but also to novel forms of organization or novel ways of marketing existing goods. As already noted, innovation is not the same as invention, though the two phenomena are clearly inter-related and at times an invention is the basis upon which a new innovation takes place. But innovation refers to the economic exploitation of new ways of doing things, and these may or may not involve inventions in the strict technical sense of the term. The individuals who create new production functions, as distinct from those who simply carry on the business of exploiting old ones, Schumpeter calls “entrepreneurs”. Innovation is more difficult and potentially more risky than the mere management of an existing business operation because it involves a step beyond the existing ways of producing goods and requires making choices between untried and untested ways of doing things. There are various ways in which an entrepreneur’s approach may differ from the ordinary running of a business. It can involve, of course, a radical departure from an existing process of production, and this occurs where there is an entirely new commodity or an entirely new process of producing goods. But equally important and perhaps more common and more significant overall are developments in which existing techniques are simply improved, developed or further advanced, sometimes with small steps and sometimes with a sequence of steps. The other way in which innovation can occur, which is also quite common, is where techniques that have been in place or used in one area are applied in another, perhaps using an existing technology but applying it in a new setting. This is what Schumpeter calls “induced innovation”.

Induced innovation is important because it contributes to the outcome that innovations do not occur in a uniform way but happen in “clusters”. These clusters are crucial in accounting for the prosperity phase of the business cycle because, when there is a spate of innovations, there occurs a burst in the intensity of economic activity. It is because of the effect of these “clusterings” that we see the wave-like pattern of economic evolution and thus the phenomena of the business cycle. But innovations are only part of the cause of business cycles because their impact is momentary. For in a market system competition eventually leads to copying and absorption of the new innovations, so that the persons, firms or companies that first develop them eventually find their advantage over rivals lost as the economy as a whole takes up the advances they were first to use. For a time, the businesses that introduce a new innovation make good profits and the individuals who own or command these companies may become rich. But inevitably, owing to competition, their superiority over their rivals disappears and a once successful business may then even go into decline.

Innovations usually require the creation of new plant and machinery and their exploitation takes time and money. Schumpeter insists that the money to finance innovations must come from a source other than the existing profits of pre-existing

¹ In orthodox economics, the concept of the “production function” relates physical output of a production process to physical inputs and is used to define the “marginal product” and to distinguish what is termed “allocative efficiency”.

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firms made using old technology. This is because entrepreneurs cannot rely on routine sources of finance that have been set in place by the previous production function for these funds are already allocated. Funds must be obtained from another source and for Schumpeter this means credit must be somehow found. Herein lays the crucial and unique role of banks. The banks distribute funds that are in part acquired by saving and saving comes in turn from profits, which means ultimately from innovation. He defines saving as the earmarking of an element of a business’s current receipts for the acquisition of titles to income in the future. As such it is fundamentally different from non-spending or hoarding. The carrying into effect of decisions to acquire titles to income is what makes for “investment,” so that for businesses this means spending on any kind of producer goods beyond replacement. While saving and investment are not necessarily equal they are connected with each other by an equilibrating mechanism in which the rate of interest plays a key role.

Now it is clear from Schumpeter’s numerous discussions on the topic that the concept of equilibrium is absolutely crucial. He clearly adopts the concept in the Walrasian sense, which implies that there is inherent tendency for an economy to move towards a state of equilibrium over the long term (in this connection he often employs the phrase “neighbourhood of equilibrium”). This is not to say that the economy ever actually is in perfect equilibrium, or that the state of equilibrium is somehow more desirable or to be preferred. Nonetheless, the nature of economic life under conditions of competitive capitalism must involve a tendency towards equilibrium due to the operation of the price mechanism and the market process. Schumpeter knows that capitalism is actually a system of “imperfect competition” and that there are various phenomena that tend to have an effect of preventing the state of equilibrium from being consistently achieved. But for exegetical purposes he believes it is necessary for theory to begin with the positing of a system in which there is perfect competition and perfect equilibrium, and as we have seen, this is the state he calls the circular flow. Schumpeter is fully aware that the situation described in his model is unrealistic and does not correspond directly with historical fact. He argues, though, that in some respects it corresponds to a theoretical possibility of the historical reality of capitalism. The theory of the circular flow is a simplified model that attempts to set out key relations that are nonetheless actually operative in any exchange economy. Only by being understood in this simplified form is it possible to eventually grasp the complex reality of actually existing capitalism.

As we have seen, in the circular flow there is no innovation and no profit; there is simply the production of goods using the existing technology and the employment of all the resources of the economy to the point where no surpluses exist and no needs remain unmet. Into this system Schumpeter introduces the entrepreneur and the phenomenon of innovation. The entrepreneur borrows money to build new plant and equipment. If his innovations are successful, others follow and after them still further players enter the field and adapt and smooth out the changes introduced with the original innovation. At first, no increase in output is possible because the original entrepreneurs are still creating their plant and equipment and have not been able to produce any returns. In fact, initially the output of consumer goods declines because the entrepreneurs have to obtain factors of production from the marketplace that would otherwise go to the older systems of production, so there is thereby a temporary decline in overall output while the new production function is being set up. But when the new products that are created by the entrepreneurs are eventually
sold on the market, the output of the economy is substantially increased and, importantly, this expansion more than compensates for the former reduction in output. This is because the new goods embody the superior technology and usefulness wrought by the innovations that have been developed. Pre-existing firms now face particularly difficult issues of adaptation owing to their lack of competitiveness. Some may, by sheer chance, find themselves well placed because the products that they produced with existing technology are still well in demand. But others will find their products no longer competitive at all and will have to undergo contraction and may even cease production altogether. The question arises as to whether innovation and entrepreneurial activity will eventually slacken and possibly cease for a period. Schumpeter argues that an indefinite and steady process of advancement does not occur because the possibilities of development are inherently limited, and eventually the profits being generated are brought back to equilibrium levels because of competition. The temporary cessation of entrepreneurial activity causes new credit creation to come to an end. This has the effect of depressing the price level, and this in turn creates difficulties for various firms owing to the need to repay bank debts, which may destroy the surpluses they created in the upswing. What then occurs is explained by Schumpeter as follows: adaptation to the new things created, including the elimination of what is incapable of adaptation, reabsorption of the results of innovation into the system, reorganisation of economic life so as to make it conform to the data as altered by enterprise, remodelling of the system of value, liquidation of indebtedness. It is readily seen that, under our assumptions and with but minor qualifications, that sequence of phenomena leads up to a new neighbourhood of equilibrium, in which enterprise will start again. This new neighbourhood of equilibrium is characterized, as compared to the one that preceded it, by a “greater” social product of a different pattern, new production functions, equal sum total of money incomes, a minimum (strictly zero) rate of interest, zero profits, zero loans, a different system of prices, and a lower level of prices, the fundamental expression of the fact that all the lasting achievements of the particular spurt of innovation have been handed to consumers in the shape of increased real incomes.2

Whilst output may decrease in the initial stages of the innovating period, consumption may in fact increase as innovators pay higher wages to attract workers to new modes of production. This may give rise to an inflationary period and may also lead to a tendency for all manner of economic actors to speculate on prospects for the intensification of economic activity to continue into the future. Further borrowing takes place as wholesalers anticipating increased sales and in order to finance larger orders take out bigger loans. This phase of economic activity Schumpeter refers to as the “secondary wave.” It means that there is a cumulative process of additional economic activity that is dependent upon the “igniting mechanism” of the initial entrepreneurial phase. In this secondary wave, however, entrepreneurs may overshoot and take on more debt than they can effectively repay. There may be a series of liquidations, as a result of reckless and speculative ventures that fail, and these may be greater in number than those of the primary wave. In this stage there may even occur a kind of panic culminating in a crisis, though this is not inevitable. Nonetheless, every liquidation contributes to a fall in values, which

2 BC, p. 137.
further undermines confidence, and a pessimistic attitude may gradually engulf the
economic environment as a whole. As a consequence, the process of adjustment just
described may overrun the point of equilibrium towards which it was tending and
enter a state of depression that Schumpeter describes as “abnormal liquidation”—
this is where a downward revision of values occurs and a reduction of operations
causes the economy to operate at below equilibrium levels. Whereas a recession
involves a mechanism drawing the system towards equilibrium, if the crisis develops
to a point where a new disequilibrium is developing, there is the possibility of
“depression”.

But if a depression has developed, eventually a new mechanism comes into play
wherein the depressive phase runs its course. For the system inevitably tracks back
toward the point of equilibrium again; this is the phase of recovery or revival.
Whereas recession, accordingly to Schumpeter, is an inevitable part of the cyclical
process of business evolution, depression is not, and whether it occurs depends on
accidental circumstances such as the mentality of businessmen, the moral character
of the community and the individuals that make it up along with other circumstances
of the day. The spiral into depression, if it occurs, may be accentuated by the
influence of external factors such as warfare or natural disasters. But when the
depression phase eventually ends, reversion towards the neighbourhood of
equilibrium occurs leading sooner or later to a further phase of innovation—and thus
the cycle continues again repeating the stages as before.

Thus far Schumpeter has built his model of the cyclical process on the
assumption of perfect competition, but as noted above he is aware that perfect
competition does not correspond to the reality of modern capitalism and he largely
accepts the analyses of E. H. Chamberlain, Alfred Marshall and Joan Robinson
among others that the reality of capitalism is that competition is always “imperfect”.
Indeed, he argues that evolution in his sense is one of the most powerful forces
creating such imperfection. The imperfect character of competition, of course,
creates a number of complications that require examination, including the effect that
some level unemployment will almost always be present to differing degrees because
full employment is not an automatic result of equilibrium. Further difficulties arise
because economic actors become conscious of the fact that there is a cyclical
process. Accordingly, they make adaptations in such a way as to anticipate the
possibility of expanding output at later stages when good economic times return.
Another complication arises because in each phase there may be undigested elements
of previous prosperities and depressions, because innovations will never be perfectly
worked out in all their implications and adaptations will never be perfectly adjusted
to pre-existing innovations. Further, not all innovations will have the same time
span, as some will have their impact in a relatively short time-frame whereas others
will be taken up over a much longer span. The impact of innovations is also variable
because their effects may be rapid in one field but very slow in others. As
Schumpeter explains,

One railroad or a few lines may be all, and more than all, that can be
successfully built in a given environment at a given time. Reaction and
absorption may have to follow before a new wave of railroad construction
becomes possible. . . . . In such cases, innovation is carried out in steps each of
which constitutes a cycle. But these cycles may display a family likeness, and a
relation to one another which is easy to understand and which tends to weld
them into a higher unit that will stand out as a historical individual.\(^3\)
There may also be cumulative effects from the commercial and industrial
implications of innovations over a long period. For example, in the case of
railroadization,

Expenditure on, and the opening of, a new line has some immediate effects on
business in general, on competing means of transport, and on the relative
position of centres of production. It requires more time to bring into use the
opportunities of production merely created by the railroad and to annihilate
others. And it takes still longer for population to shift, new cities to develop,
other cities to decay, and, generally, the new face of the country to take shape
that is adapted to the environment as altered by the railroadization.\(^4\)

These complications suggest there are many and perhaps an indefinite number of
separate cycles for each innovation and its related adaptations. However,
Schumpeter argues that the business cycle can be fully understood on the basis of a
three-cycle schema. The shortest cycle he says is the forty-month or Kitchin cycle,
the next cycle of a ten-year duration he terms the Juglar cycle, and the final and
longest span is the Kondratieff cycle with a time span of sixty years. Schumpeter
claims that within each Kondratieff cycle there are a set number of Juglars and
within each Juglar a set number of Kitchins. He claims there is nothing inherent in
reality that causes these specific periods to be the case, but nonetheless they provide
the most adequate theoretical schema available with which to analyse the cyclical
processes of the capitalist system. In his analyses of time series Schumpeter found
that as a matter of fact there were three Kitchins to each Juglar and six juglars to
each Kondratieff. We shall now turn to a detailed exegesis of Schumpeter’s
theoretical schema as developed in *Business Cycles*.

**“Equilibrium and the Theoretical Norm”**

Schumpeter sets out his fundamental question as follows: “When we behold one of
the familiar graphs of economic time series—such as the graphs of the US Bureau of
Labour Price Index, the commercial paper rate, bank clearings or debits, numbers of
unemployed—or one of the business barometers, for example, that of the American
Telephone and Telegraph Company, we undoubtedly have, as our business man had,
the impression of an ‘irregular regularity’ of fluctuations. Our first and foremost task
is to measure them and describe their mechanism.”\(^5\) But more than this, Schumpeter
wants to explain the underlying causes. Of course, he is aware that there will never
be a single factor or prime mover that accounts for all of the phenomena of crises,
booms and depressions that are observed. To get at the primary causes of the
individual phenomenon, the facts of each case and their background must be
explored in detail. But a further question arises, in Schumpeter’s view, which is that,
even if we can succeed in describing the economic system by means of a general
schema, does the system by its own working produce the various crises and
depressions and if so under what circumstances? Schumpeter uses the analogy of the

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\(^3\) Ibid, p. 167.
\(^4\) Ibid, p. 168.
\(^5\) Ibid, p. 33.
human body and says that, while it may not be of interest scientifically to explore why a particular man dies, there is a very great scientific interest in explaining why human beings die just because of the working of the human organism or the cells in which it consists.

Schumpeter’s starting point is again his analysis of the circular flow or what he now terms the “stationary flow”. His approach here repeats and develops the ideas originally set out in *The Theory of Economic Development*. He says “the analytic treatment of the facts of autonomous change in a closed domain of which it is our task to give account, begins conveniently with the construction of the model of an unchanging economic process which flows on at constant rates in time and merely reproduces itself.” Such a model will present the fundamental facts and relations of economic life in simplified form, but Schumpeter says there is no other way to proceed. He of course comes very close here to consciously adopting Weber’s methodological device of the “ideal type model” where there is a necessary simplification and idealization of the facts for heuristic purposes. The most fruitful example of a model of such closed economy was first created, in Schumpeter’s view, by the physiocrats, but it was then definitively elaborated by Léon Walras. Following Walras, Marshall built his theory on the basis of the same idea, and economists ever since have used similar devices of one kind or another.

In developing his account of the stationary flow, Schumpeter unpacks his notion in the following way. He says one can visualise an economic process in which the system merely reproduces itself at constant rates. There is a given population that is static and organised for the purposes of consumption in households and for the purposes of production in firms. The population lives and works in a static physical and social environment. The wants and needs of households are given and do not alter over time, and the ways of producing things and the means of commerce are already at maximum efficiency and cannot be further improved. The ways in which the quantities of the factors of production are linked together, such as the labour, the services of natural agents and the means of production, constitute a “production function”.

In the stationary economy of the kind Schumpeter is postulating the production function itself is a datum given and is invariant in form. The co-efficients of production are therefore all fixed so that, if it is necessary to produce a bushel of

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6 *Ibid*, p. 35.
7 In anticipation of the objection that building a model of a static exchange economy has fundamental limitations, Schumpeter elsewhere responds to just such a criticism by Marshall directed at John B. Clark in a footnote in an essay of 1928. Schumpeter gives the following riposte: “Now if it were true that reasoning by means of [the static apparatus] is ‘too removed from life to be useful,’ then the greater part of the analysis of the *Principles* would be useless—as would be the greater part of any exact science: For Marshallian analysis rests just as much on static assumptions as Prof. Clark’s structure. But it is not true. There is nothing unduly abstract in considering the phenomena incident to the running of economic life under given conditions taken by themselves.” “The Instability of Capitalism,” in Richard Clemence (ed.), *Essays of J. A. Schumpeter*, Addison-Wesley Press, 1951 (EJAS), footnote 2, p. 54.
wheat, it is necessary to combine land, labour, seed, fertilisers and so on in given and unalterable proportions. In this system no other than ordinary work by managers and workers is required. It is not necessary to pursue efforts in the area of production other than the repetition of orders and operations based on previous experience. “The production process is entirely ‘synchronised’, which means there is no waiting for the results of production, all of which represent and replace themselves at the moment they are wanted according to a plan to which everything is perfectly adapted. Everything is financed by current receipts.” In the pure version of his system Schumpeter says it is convenient to exclude savings, since anyone who saves does something with a view to changing his economic situation into the future. The income stream consists of wages, which are payments for productive and consumptive services rendered by people, and rents which are payments for natural agents. In such a system year after year the same kinds of goods and the same quantities of consumers and producers goods would be produced. Every business would employ the same quantities of inputs every year, and finally all these goods would be bought and sold at the same prices every year. The question of what prices would be, of course, necessarily depends upon the relations between prices and quantities. This relationship is one of interdependence and forms a system.

A first task for Schumpeter is to explore more fully the workings of this system. The initial problem is to establish the relations between various elements of the system such that prices and quantities are determined uniquely.

For our system is logically self contained only if this is the case: we can be sure that we understand the nature of economic phenomena only if it is possible to deduce prices and quantities from the data by means of those relations and to prove that no other set of prices and physical quantities is compatible with both the data and the relations. The proof that this is so is the magna charta of economic theory as an autonomous science, assuring us that its subject matter is a cosmos and not a chaos. . . . The values of prices and quantities which are the only ones, that data being what they are in each case, to satisfy those relations, we call equilibrium values. The state of the system which obtains if all prices and quantities take their equilibrium values we call the state of equilibrium. . . . Equilibrium that is unique and stable is, of course, the only perfectly satisfactory case.”

Schumpeter is referring to the concept of “general” or Walrasian equilibrium. It means that every household and every firm is in itself in equilibrium. For households this means that no unit feels itself able to improve its present situation by transferring any of its income from the commodities which it has actually purchased to other commodities. For firms it means that under the existing circumstances no firm believes it is able to increase its returns by deploying its capital resources from one factor it has actually acquired to any other. Generally, it assumes that all households and firms consider that they cannot improve their situation by altering what they are doing. For Walrasian equilibrium to exist prices and quantities must be adjusted accordingly. Every household and every firm must have its budget perfectly balanced. This entails that all the quantities of goods produced by firms must be purchased by the households or by other firms. All existing factors must be employed as far as their owners wish them to be and at the prices they can obtain.

8 BC, p. 40.
9 Ibid, pp. 41-2.
and no demand effective at the given prices must go unfulfilled. It follows also that there can be no effective unemployment. A further presupposition is that there is perfect competition between the various economic entities and agents and of course no monopoly.  

The proof that there is one and only one set of values of the variables that satisfies the given data and relations where there is perfect equilibrium does not mean that firms and households will consciously behave so as to arrive at that set of values or return to them if there is some disturbance. The real question, Schumpeter explains, is whether there is a tendency of the system to move towards the state of equilibrium. If in fact there is such a tendency, it would obviously be of enormous value as a means of analysis of cyclical business behaviour. Schumpeter credits Walras with having first recognised this problem: His solution starts from the observation that disequilibrium, which means deviation of at least one price or quantity from its equilibrium value, necessarily spells profits or losses to somebody at the spot or spots in which it occurs. And the argument is that this somebody can, under conditions of perfect competition get out of that loss or fully reap that profit in no other way than decreasing or increasing the quantity of his commodity. This will drive him toward equilibrium, and if all firms and households simultaneously react in the same manner, it will eventually bring the whole system to equilibrium, provided that all actions and reactions are performed within the bounds of familiar practice that has evolved from long experience and frequent repetition.  

In a subsequent discussion Schumpeter goes on to point to the fact that there is an inevitable lag in the system adapting to any disturbance because there are always elements in the set up of a firm or in the structure of an economic system that prevent immediate and complete adaptation to bring the system into perfect equilibrium. The importance of this for Schumpeter’s purpose lies in the fact that perfect equilibrium, since it takes time to occur, may fail to come about at all and that therefore new disturbances may impinge on an already imperfectly equilibrated system. Schumpeter emphasizes, however, that the lags that occur because of “friction” in the system and which make it not always possible for equilibrium to be reached do not mean that there is no tendency towards perfect equilibrium. He gives as an example of the problem the case where producers’ reactions to changes in price do not take effect immediately. In such cases supply does not work up to equilibrium in small gradual steps and having reached equilibrium stops. The change in supply may outrun equilibrium in one jerk, and then the price reacts with a corresponding jerk back in the opposite direction. In fact it is quite conceivable that adaptation will never stop at any given point and that under conditions of perfect competition prices will...

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10 Schumpeter describes the situation of perfect competition as having the following conditions: “(a) that no seller or buyer is able to influence the price of any commodity or factor by his own action and that there is no concerted action; and (b) that there is perfect mobility of commodities and factors all over the economic field (ie, among all possible uses). Léon Walras has built the relations existing between the elements of the economic system into equations, and has shown that they suffice to determine unique values of variables. His proof left much to be desired in technique and details, but later analysis still retains the principle.” *Ibid*, p. 46.

and quantities will fluctuate indefinitely around equilibrium values without ever coinciding with them exactly. As we have already seen, Walras arrived at a unique approach to the notion of equilibrium by claiming that people effectively say what quantities they would be willing to demand and to supply at the given prices without actually buying and selling, and then adjust the initial price offered so as to equate supply and demand by the mechanism he called \textit{tatonnement}. It follows from the Walrasian theory that, where there is perfect competition under the conditions of a pure capitalist economy, there must be a real tendency necessarily towards equilibrium states.

A further problem Schumpeter says must be addressed is the case of equilibrium under conditions of monopoly. A monopolist may charge a higher price than might otherwise be the case where there are competitors who can produce at lower prices. But this does not necessarily change the general situation wherein there is a tendency to equilibrium. This is because, as long as the monopoly position is surrounded by sufficiently competitive conditions at large, there is no lack of determinateness of prices and quantities and the tendency to equilibrium remains real. A related issue that Schumpeter addresses is the set of problems that are encompassed by the concept of “monopolistic competition”, which as we have said was first advanced by E. H. Chamberlin and later elaborated by Joan Robinson and others. As we shall see, in some ways monopolistic competition has become the norm in an actually existing capitalist economy, not because giant monopolies have taken over many business operations as was anticipated by Marx, but because every firm aims to become a monopolist in its own way. That is, even where there are numerous firms ostensibly in direct competition with each other, they each offer products that differ in some way from the products of every other firm in the sector, and thus it can be said that such firms are in reality supplying a special market of their own. The rationale of this “product differentiation” is, of course, the creation of just such a special market. Product differentiation comprises not only ‘real’ but also ‘putative’ differences, and not just differences in a product as such but also differences in the services associated with supplying it, as well as every other device that enables a purchaser to associate the product with a particular firm (for example, advertising, branding etc.). Creation of a special market in some ways can be said to increase the friction that prevents buyers transferring their allegiance from one firm to another. If this friction is sufficiently strong it may appear to curtail the tendency towards equilibrium. However, Schumpeter says this result does not as a rule occur. He says, the very essence of monopolistic competition is in the fact that the price at which a quantity can be sold at any time is a function of the behaviour both of the firm itself (not independent of costs of the firm) and of all other firms in the field. This might of course be still described as a monopoly with a shifting demand curve. But when these shifts are no longer external to the behaviour of the individual firm but part of its very mechanism and, moreover, so important as to completely overshadow any movements along such a curve, that way of accommodating the case ceases to be useful . . .

Thus the phenomenon of monopoly does not necessarily militate against the tendency towards equilibrium. In practice every firm either produces or at short notice is able to produce a range of commodities or qualities which are in many cases more or less complete substitutes for the products of its competitors, and thus price

\footnote{\textit{Ibid}, pp. 64-5.}
and quantity adjustments will not in general differ fundamentally from those that
would have to be made under conditions of perfect competition. Schumpeter claims, "... if we do insist on using the language of the theory of monopolistic competition,
the demand curves for the individual firms will, in general and in the long run,
display a high elasticity, though not the infinite one of the pure logic of competition.
And this, in turn will enforce approximate realisation of the results of perfect
competition that follow from it."\(^{13}\) He qualifies this by saying that, strictly speaking,
his argument only applies to cases that differ from perfect competition in nothing
else but product differentiation. The general effect of monopolistic competition
however will be simply to increase the amount of friction as referred to previously as
well as what Schumpeter calls “sloppiness” and “rigidity” in the adjustment process.
Traditionalistic and co-operative forms of behaviour may also be reinforced by these
tendencies. In other words, an immediate reaction in the conduct of firms will be
less likely in the case of monopolistic competition than it would be in the case of
perfect competition.

In summing up the argument thus far we can say that the purpose of the theory
of economic equilibrium is to provide the bare bones or underlying logic of the
capitalist system. The necessity of relying upon such a basic theory is made
apparent, Schumpeter says, as soon as we try to define such phenomena as over-
production, excess capacity, unemployment and maladjustment. As soon as theory
tries to find a more precise meaning for these terms, the necessity of relying on
equilibrium relations becomes apparent. Even though the economic order is
regularly disturbed and almost always in a state of disequilibrium, he insists our
understanding of the way the economic organism reacts to any intervening event
must be understood on the basis of equilibrium relations.

Now for Schumpeter what causes the fluctuations to occur must either be
individual shocks which impact on the economy from outside or a distinct process of
change that is generated by the system itself. In either situation it is the theory of
equilibrium that supplies the most effective explanation of how the system will react,
for it is “a description of an apparatus of response.”\(^{14}\) A further feature of the
concept of equilibrium is that, although no such state is ever found to have been
perfectly achieved, use of the notion is indispensable as a means to measure of the
actual states of the economy, for these can be defined by their distances from it.
Economic fluctuations must be movements around something and that something
must be the equilibrium state. But the most important feature that theory has for
Schumpeter concerns the fact that movement toward or away from equilibrium is
always to be understood as a tendency to be considered the result of an actual force;
the concept of equilibrium is not just an ideal state or a mere point of reference. He
explains this as follows:

We take our stand on the fact that the values of economic variables fluctuate in
the course of business cycles between figures which roughest practical common
sense recognises as abnormally high and figures which it recognises as
abnormally low and that somewhere between these two lie values or ranges of
values which that same commonsense would recognise as normal. We wish to
distinguish definite periods in which the system embarks upon an excursion

\(^{13}\) Ibid, p. 65.

\(^{14}\) Ibid, p. 68.
away from equilibrium and equally definite periods on which it draws towards equilibrium. In order to harness our equilibrium concept to this service, which is fundamental for our analytic technique, we will not postulate the existence of states of equilibrium where none exist, but only where the system is actually moving towards one. . . . Hence, we will, for our purpose, recognise existence of equilibria only at those discrete points on the time scale at which the system approaches a state which would, if reached, fulfil equilibrium conditions and since the system in practice never actually reaches such a state, we shall consider instead of equilibrium points, ranges within which the system as a whole is more nearly an equilibrium that it is outside them.15

How the Economic System Generates “Evolution”

A fundamental feature of the modern capitalist system appears to be its propensity to institutionalise material progress, that is, to continually improve the living standards of the general population by constantly enhancing the quality of the goods and services that are produced. In Schumpeter’s approach this correlates with the phenomenon of “economic evolution”. In a way this is the antithesis of his starting point, namely, the stationary flow of a hypothetical economy in a state of perfect equilibrium—which he describes as the “theoretical norm” of the economy. Contrary to the situation of the stationary flow, an actually existing economic system appears to be always in motion, moving from or towards an equilibrium state. There are two obvious possibilities why this is so. One is that external factors impinge upon the economy, but Schumpeter wants to put these to one side for the purposes of his ensuing analysis. What interests Schumpeter most are factors of change that are internal to the economic system as such, that is changes in the quantity or quality of factors of production or changes in methods of supplying commodities. Importantly, he maintains that consumers’ initiative in changing tastes are of little consequence and instead changes in consumer tastes are incident to and brought about by the action of producers. In other words, it is the producer or entrepreneur that elicits the change in taste of the consumer and not the consumer’s changing his needs and creating new demand. This assumption is consistent with the fact that in consumer society the role of product promotion and brand advertising plays a key role in creating and maintaining the demand for the array of consumer goods that are produced. Schumpeter gives as an example the advent of railroads and tells us they have not come into being because consumers took an initiative and demanded the service railroads provide in preference to that of coaches. Nor do consumers demand that electric lamps, rayon stockings, motorcars, aeroplanes, radios or chewing gum be created and produced cheaply because they suddenly have need for such things. So, precisely how does internal economic development generate fundamental change in the system?

One possibility that Schumpeter considers is that there is an increase in productive resources. Given that the physical environment is constant, an increase in productive resources boils down to either an increase in population or an increase in the stock of producers’ goods, but these are not independent variables. In any event, increase in population does not by itself cause a change in the economic system as

15 Ibid, pp. 70-1.
such, for population increases can be absorbed without any variation in the economic system. Similar considerations apply, according to Schumpeter, to increases in the stock of goods. This could mean saving, but “saving” in the requisite sense does not mean the assembling of a sum of goods for the purpose of buying durable consumer goods. Saving in order to buy a motorcar for non-business use or a house to live in is not saving but merely rearranging consumption expenditure. What is crucial is the carrying into effect of a decision to acquire titles to income in the future. In the case of households this often involves the acquisition of shares and bonds, or land or buildings intended for business purposes. In the case of firms it will mean spending on all kinds of producers’ goods beyond replacement, and this is what is designated by the term “real investment.” In any event, in the stationary flow the level of saving is very small if it exists at all, so that it cannot give rise to fundamental change. This is why third world economies find it so difficult to finance a “take-off” to capitalist industry from their own resources. Thus, saving cannot be a major factor giving rise to economic change, as this would include in the premises a part of what has to be explained.

Schumpeter now turns his attention to changes in the methods of supply and production of commodities. He focuses on a range of events wider than what this might at first imply. He includes, as the standard illustration, the introduction of new commodities. But there are numerous other ways in which changes may arise:

- Technological change in the production of commodities already in use, the opening up of new markets or of new sources of supply, Taylorization of work, improved handling of material, the setting up of new business organisations such as department stores—in short, any ‘doing things differently’ in the realm of economic life—all these are instances of what we shall refer to by the term innovation. It should be noted at once that the concept is not synonymous with the term ‘invention.’

We have already referred to Schumpeter’s view of the relationship of innovation to invention. In Business Cycles he again emphasizes that innovation does not necessarily require a scientific novelty, as the concept of invention implies. Of course, many innovations will depend on inventions, but new ways of doing things may simply mean new methods of organising existing techniques and involve no new invention as such. An invention by itself does not necessarily lead to any economically relevant effects at all. Even where an invention does give rise to an economic innovation, the making of the invention and the carrying out of the corresponding innovation logically are two entirely separate things. It is to innovation proper that Schumpeter wants to devote his attention, because when distinguished from invention it shows itself as an entirely internal factor:

. . . we immediately realise that innovation is the outstanding fact in the economic history of capitalist society or in what is purely economic in that history, and also that it is largely responsible for most of what we would at first site attribute to other factors. To illustrate this by an example; modern economic processes are to a great extent contingent upon agglomeration of population in cities and upon facilities put at the disposal of the business community by public action but these conditions of further innovations themselves are, not indeed always, but in most cases the results of industrial processes which come within the concept of innovation, and either directly produced or made possible by

16 Ibid, p. 84.
them. The changes in the economic process brought about by innovation, together with all their effects, and the response to them by the economic system, we shall designate by the term Economic Evolution.\(^{17}\)

**The Theory of Innovation**

Schumpeter begins his detailed analysis of innovation by referring to his definition of the “production function.” He defines this as the way in which the quantity of product varies if quantities of factors vary. If, instead of variation in the quantities of factors, it is the form of those factors that vary, according to Schumpeter, we have innovation. In a nutshell, innovation is the setting up of a new production function. As we have seen, this covers both the situation of a new kind of commodity as well as a new form of organization or way of producing commodities or the opening up of new markets. Innovation means combining factors in novel ways or carrying out “new combinations”. Innovations break the trajectory of the normal curve of productivity. There is a transition from an old to a new curve or, to refer to the Ricardian law of decreasing returns, innovation interrupts the action of this curve, which means that it replaces the law that has so far described the effects of additional doses of resources by another one. The old total or marginal costs curve is destroyed and a new one takes its place. Schumpeter says, “...what dominates the picture of capitalistic life and is more than anything else responsible for our impression of a prevalence of decreasing cost, causing disequilibria, cut throat competition and so on, is innovation, the intrusion into the system of new production functions which incessantly shift existing cost curves.”\(^{18}\) He notes that major innovations, and also minor ones, invariably involve the construction of new plant and equipment or the rebuilding of old plant. The carrying out of innovations always means time lags and requires significant outlays of resources. This feature has manifold implications for the modern economy where the vast bulk of new plant beyond mere replacement either embodies some innovation or is in response to situations connected with innovations of some sort. Every innovation is potentially embodied in a new firm founded for this purpose only, for most new firms are founded on the basis of a new idea of some kind and for a definite purpose. Life goes out of these firms when their purpose has been fulfilled and they become obsolete. Of course, many new firms are failures from the start, whereas others fall by the wayside for various accidental reasons. But importantly, no firm that merely runs along established lines however well managed can remain as a source of profit in a capitalist society indefinitely.

Schumpeter insists there is a critical relation between the novel production function that arises through the action of new firms founded for the purpose of exploiting innovations and the hitherto existing production function. As a result of the clash between these two, the new firms, if successful, prosper and for a time outdo their rivals and are very profitable. On the other hand, the older firms continue on for a time and then react in various ways adapting as best they can to the new state of affairs brought on by the pressure of competition. They either absorb the new ways of doing things by adapting effectively to the competitive environment or they lose profitability and disappear as viable entities. These general features

\(^{17}\) *Ibid*, p. 86.

\(^{18}\) *Ibid*, p. 91.
correspond, in Schumpeter’s view, to what we observe empirically and in particular in the various disequilibria and fluctuations. It also explains the incessant rise and fall of firms, whole industries, and even national economies, all of which are a hallmark of the capitalist system.

A further feature Schumpeter highlights is that innovations are always associated with the rise to leadership of “new men.” New men are required because new production functions typically do not grow out of old businesses, and it takes new men to act creatively in bringing about the new firms through which innovations thrive. Schumpeter notes that where large companies are involved innovations may arise within an existing firm such as when a new leader takes hold. He is aware of course that some firms today are of massive size, so he introduces the concept of “trustified capitalism” to cope with this. But he maintains that the growth of company size does not fundamentally alter his theoretical assumptions because even giant concerns still have to react to others’ innovations and so forth: “even in the world of giant firms, new ones rise and others fall into the background. Innovations still emerge primarily with the ‘young’ ones and the ‘old’ ones display as a rule symptoms of what is euphemistically called conservatism.” This perspective about the role of leadership is critical to Schumpeter’s theory for it explains why innovations are not carried into effect simultaneously and automatically in all firms and in the same manner everywhere. It also accounts for the ‘lumpiness’ of the various economic data that show uneven development and fits and starts of progress. The nature of innovations is such that they inherently cause disequilibria that cannot be absorbed easily and smoothly but only as a result of awkward and painful processes: “only some firms carry out innovations and then act along new cost curves, while others cannot and have merely to adapt themselves, in many cases by dying.” This aspect is what Schumpeter elsewhere describes with the dramatic turn of phrase “creative destruction.”

At this point we shall comment briefly in relation to Schumpeter’s reference to “trustified capitalism,” because this concept suggests a fundamental alteration in the nature of the capitalist system. In an essay of 1928, for example, Schumpeter reflected at length on the issue of whether capitalism is a stable system and can go on indefinitely—especially in the light of the fact that many large corporations have come into being and now dominate the economic landscape as in America. The key issue for Schumpeter is: what becomes of the role of the entrepreneur in such circumstances? He answers:

. . . [Things are] different in “trustified” capitalism. Innovation is, in this case, not any more embodied typically in new firms, but goes on, within the big units now existing, largely independently of individual persons. It meets with much less friction, as failure in any particular case loses its dangers, and tends to be carried out as a matter of course on the advice of specialists. Conscious policy toward demand and taking a long-term view toward investment becomes possible. . . . Progress becomes “automatised,” increasingly impersonal and decreasingly a matter of leadership and individual initiative. This amounts to a

19 Ibid, p. 97.
20 Ibid, p. 98.
fundamental change in many respects. . . It means the passing out of existence of a system of selection of leaders which had the unique characteristic that success in rising to a position and success in filling it were essentially the same thing. . .  

Surprisingly, these remarks suggest that the entrepreneur may indeed be made obsolete and if there were the case, much of what Schumpeter says elsewhere about the character of capitalism may be rendered redundant. Be that as it may, we shall not for the moment pursue the further implications of the above remarks, save to say Schumpeter appears to have adopted them in his later reflections on the prospect of a socialist transformation of late capitalism, a topic to which shall return below.

Relevant to the idea of innovation is the concept of novelty. Schumpeter points out that the ability to favour untried possibilities or to choose between tried and untried options is a quality that, whilst not exceptional, is not universally distributed. It is common sense to say that it is much more difficult to do something that is not part of everyday routine, and Schumpeter mentions three reasons why choosing to do novel things is difficult. In the first place he says doing something novel comes up against the fact that the environment resists it. For example, resistance may consist in disapproval of old machine-made products, or in prohibitions on the use of certain types of new machinery or even their smashing (“luddites”). Secondly, acts of a routine nature are often supported by the environment in special ways; for example, lenders readily loan for established purposes, or labour of the required kind is plentiful, or customers will prefer what they are used to consuming. Thirdly, new arrangements for the operation of a business confront the individual manager with the difficulties of conducting their affairs in an entirely new fashion compared to familiar ways. In the new frame the task itself may change its character. Major elements in a new undertaking simply cannot be known and irrational inhibitions enter. These types of considerations mean that, whenever a new production function has been finally adopted, it then becomes easier for other people to do the same thing and even to improve upon it. In fact there is often a tendency for copying or imitating. It is obviously easier not only to do the same thing but also to do similar things in similar ways. Thus Schumpeter maintains that innovations seldom remain isolated events and, as we have already noted, they are not evenly distributed in time but on the contrary tend to appear in “clusters”. He argues this is because first a few and then most firms follow in the lead of a successful innovation:

Industrial change is never harmonious advance with all elements of the system actually moving, or tending to move in step. At any given time, some industries move on, others stay behind; and the discrepancies arising from this are an essential element in the situations that develop. Progress—in the industrial as well as in any other sector of social or cultural life—not only proceeds by jerks and rushes but also by one sided rushes productive of consequences other than those that would ensue in the case of co-ordinated rushes. In every span in historic time it is easy to locate the ignition of the process and to associate it with certain industries and, within these industries with certain firms, from which the disturbances then spread over the system.  

All this leads Schumpeter to conclude that economic evolution is necessarily “lopsided, discontinuous, disharmonious by nature”, and of course he makes many

22 “The Instability of Capitalism,” EJAS, pp. 70-1.
references to the history of capitalism which is replete with examples of both bursts of progress and crises; hence the need to explain these phenomena and to enquire as to whether they have a cyclical dimension.

The Entrepreneur and Entrepreneurial Profit

The person who Schumpeter believes is responsible for the introduction of innovations and is an economic leader who develops and exploits innovations is as we have seen the entrepreneur. The entrepreneur is more than the mere head or manager of a business that is run along conventional lines, though of course many entrepreneurs will also carry out the mundane tasks of management day-in day-out. Schumpeter points out that nobody is ever an entrepreneur all the time. This is because a person who introduces a new combination invariably also carries out non-entrepreneurial tasks in the course their work. And many innovations once they are established are then exploited in a routine fashion with no other logic to their operations than those typical of the management of an existing firm. But in periods of high intensity in competitive capitalism, the entrepreneur will be found amongst the heads of firms and will often be an owner as well. Typically he will be the founder of a firm and possibly also of an industrial family. Sometimes, the entrepreneur is the controlling owner of the shares of a company, though company promoters are not generally entrepreneurs in Schumpeter’s sense.

The entrepreneur need not necessarily be either the person who provides the capital nor of course the person who is the inventor of the good or process that is being introduced. Often an entrepreneur will have very little of the necessary means at his disposal to begin with. In this respect Schumpeter criticizes figures like Marx who made ownership of capital the decisive quality driving the individuals that make up the dominant class in capitalism. Of course, ownership of goods and assets which may serve as collateral or of money that can be expended in setting up a new production system make it easier for capitalists to become entrepreneurs but this is not an inevitable transition. One consequence of this separation of ownership from the entrepreneurial function is that the entrepreneur strictly speaking does not bear the risks of investment and in fact typically uses other people’s money. What follows from this is the fact that entrepreneurs as such do not form a social class. Nonetheless, according to Schumpeter, if they are very successful, they may rise into the capitalist class.

Schumpeter is especially concerned to account for the nature of entrepreneurial profit, an issue that has famously been a focus of Marx, Böhm-Bawerk and others. He first considers the situation in which an entrepreneur operating in a perfectly competitive economy carries out innovations that consist of producing commodities already in circulation at a total cost per unit that is lower than that of existing businesses. In this case the entrepreneur will buy the producer goods he needs at existing prices based upon the conditions under which the pre-existing firms are operating. And he will sell his product also at the prevailing prices, which are adjusted to the costs of the old firms. As a result, his receipts will be greater than his costs. This difference Schumpeter calls entrepreneur’s profit or simply “profit.” This profit is the premium that capitalist society places upon successful innovation, though it is inherently temporary and disappears as soon as subsequent competition
and adaptation produce the tendency towards equalisation of the premium referred to.

In a stationary economy both the entrepreneurial function and profit are totally absent, for in that situation although there are rents and quasi-rents of factors owned by firms, the manager’s earnings or his wages are merely a return paid for his managerial services. Thus, in a real capitalist society, in order for private fortunes to be amassed, they must result from the process of innovation and not merely from the return of earnings of management. Profit thus understood is a functional return in the sense that it does not necessarily return to the entrepreneur as such. Whether it does accrue to the entrepreneur or to the firm is a matter merely of the institutional structure involved. In corporations profits accrue to the firm as such and their distribution ceases to be automatic but is a matter of policy—shareholders, executives and employees receive dividends, bonuses and other benefits in accordance with contractual and other arrangements. Struggles over the share of profits are simply one feature of the social arrangements of capitalism. More important from the economic point of view, however, is the effort to conserve the stream of profit as such. Schumpeter refers to secrecy regarding processes, patents, judicious differentiation of products, advertising and aggression directed against competitors as illustrative of familiar strategies designed to preserve the profit advantage of one firm vis à vis others. He even considers the possibility that at times the mere prospect of competition from innovations produces efforts of sabotage on the part of the old industries aimed at undermining the success of the new.

Schumpeter explains,

Taking industry as a whole, there is always an innovating sphere warring with an ‘old’ sphere, which sometimes tries to secure prohibition of the new ways of doing things—as the artisans congresses did in Europe as late as the eighteenth and nineteenth century—or to discredit them—the ‘machine-made product’, for instance—or to buy them off—which is sometimes the real rationale of cartelisation—or to penalise them, by fiscal legislation or in other ways, including public planning of the type sometimes resorted to in depressions.  

The Function of Credit and Banking

Schumpeter points out that the idea of credit creation is often difficult to understand because many think that bankers can only lend what is entrusted to them by depositors. This view, however, rests on a misconception. In considering the role of money in the setting up of new businesses under the direction of entrepreneurs, Schumpeter notes that would-be entrepreneurs do not generally already happen to own part or all of the assemblage of goods which they need to carry out their project, nor do they have assets which they can readily exchange for such goods. Existing firms by contrast have the option of financing their plant and equipment from current receipts. Assuming that old firms are so financed, Schumpeter says that it follows that the entrepreneur creating a new combination must borrow all the funds they need both for starting up and operating a new venture, namely their fixed and working capital. Those funds are made up of means of payment created ad hoc by the banks.

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Schumpeter further clarifies what he means by credit creation and how this complements his concept of innovation. To explain the role of credit creation he makes a comparison with a hypothetical socialist economy and points out how in such an economy, in order for new production functions to be set up, it would be necessary to issue orders to those in charge of productive resources to withdraw part of them from the employments in which they have hitherto been engaged and apply them to new purposes. This is also a problem for a capitalist society; the issue to the entrepreneur of new means of payment created *ad hoc*, that is out of nowhere, corresponds to the order issued by the central bureau in socialist society. In both cases, innovation involves the shifting of existing factors from old deployments to new ones, but there is one crucial difference. In the case of the socialist system the new order involves cancelling old uses. But innovation in capitalist society is financed by credit creation, so the shifting of the factors is not affected by the withdrawal of funds cancelling the old orders from old firms. Rather, the old firms suffer a reduction in the purchasing power of their existing funds because newly created funds are placed in the hands of entrepreneurs who bid for existing factors with new means of payment. The new orders for factors come on top of the old ones that are not cancelled as in socialism. This is an crucial feature of the capitalist system. In the socialist system the decision as to which innovations to carry out is made by the central bureau. However, under capitalism this function is effectively fulfilled by the banks, which provide the entrepreneurs with the means to buy the factors of production that they need. The banks thereby constitute a new type of firm whose function it is to produce means of payment.  

Schumpeter is fully aware that this is not the only way which credit can be created. Firms themselves may issue of bills of exchange that circulate, and of course central banks create money in other ways too, but these are secondary from the point of view of the creation of credit on the scale needed to finance the capitalist engine. Anticipating his further discussion, Schumpeter notes that loans to entrepreneurs need not necessarily be repaid in full, and in fact they are often renewed and cause a corresponding amount of means of payment to be permanently part of the circulating medium. At any given time the bulk of bank credit outstanding will be what has become current business and has lost its original connection with innovation or its adaptations, although the history of each loan must lead back to one or the other.

The function of the banks is more than simply to provide the funds in question. Commercial banking means that the banker should know and be able to judge what his credit is going to be used for. The banker must not only be familiar with what the transaction is that he is asked to finance and be mindful of how it will turn out. He must also know the customer, his business and even his personal dispositions in order to be certain of the nature of the risk he is undertaking. Of course, to fulfil this function the banks must be completely independent agents. They cannot act like the equivalent agency in a socialist economy, where they may share all sorts of concerns.

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25 Schumpeter distinguishes *member banks* from *bankers’ banks* or *central banks*. *Member banks* are those which keep the accounts of and manufacture balances for firms and the households of entrepreneurs, whereas *bankers’ banks* keep accounts of, and manufacture balances for, *member banks*. See *ibid*, p. 112.
as to the social policy implications of the financing of a new enterprise. This independence means that banks and their officers must not have a stake in the gains of the entrepreneur’s project beyond what is entailed in the loan contract itself. Banks must also be independent of politics. That is, they cannot be subservient to a government’s public policy objectives such as might jeopardise the rationality of their lending program.

We need not for our present purposes explore in detail Schumpeter’s theory of money, though he did make some important contributions in developing a theory consistent with his general account of the capitalist mechanism. These efforts issued first in an essay published in German around 1918 called in English “Money and the Social Product”. Subsequently until the late 1920s, Schumpeter worked on a monograph on the topic, which however was never completed though a German edition was published in 1970 as Das Wesen des Geldes. Some commentators have suggested that Schumpeter was upstaged in his effort to make a major contribution on the monetary theory by the publication of Keynes’s Treatise on Money of 1930. Be that as it may, Schumpeter continued to work on his own theory but was never satisfied with his results and declined to authorize publication of his manuscript. The gist of his approach was see the economy as a whole as a system of flows of money expenditure and of goods sold against such outlays. The Walrasian system of interdependent markets is held together by the flow of money. These flows enable the link between successive disbursements of money by entrepreneurs and the payments made for the goods produced by industry to be established through time.26

The Contours of Economic Evolution

On the basis of the grounding analysis as set out above Schumpeter proceeds to synthesize the various elements and to lay out his theory of the business cycle in complete form. Because of the complexity of the phenomena to be explained, he proceeds by a series of approximations each time adding additional features to arrive at an overall theory only at the end. His first approximation starts with the fact that at any given point in capitalist society there exist possibilities for new combinations. The ability to take advantage of these is necessarily unequally distributed and this has important implications. The motivation for taking up these opportunities derives from the possibility of obtaining profit. In the usual situation certain individuals make plans for their new combinations and carry them out with varying degrees of proficiency in anticipation they will make profits in the future. The ability to take the lead in doing this Schumpeter refers to as the “entrepreneurial aptitude”. As a new firm is set up, it constructs new plant or purchases new equipment from existing firms. The money to do this is acquired from banks. In order to acquire the goods, which otherwise would be purchased by existing firms, the entrepreneur must outbid the existing purchasers of producer goods and this has an inflationary effect. Upon

the lead of some entrepreneurs others follow in increasing numbers and, because of
the path-breaking work of the initial innovators, the way is smoothed for those that
follow. Because within the stationary state there are no unemployed resources,
prices of factors of production will tend to rise as entrepreneurs attempt to outbid the
old firms in order to acquire resources. As prices of goods rise, so necessarily do the
costs for all firms, but this of course also means that those industries that are able to
sell goods at these higher costs receive greater receipts. There are clearly gains and
losses but as a whole taken together all old firms together should show a net surplus.

The general effect of new entrepreneurial activity spread over the system as a
whole is that it disrupts the equilibrium that existed before. Clearly some firms and
industries will experience gains of a windfall nature and others will have losses, but
at this stage there is no net increase in total output. This is because in the preceding
period where there was perfect equilibrium firms produced their optimum output
using all their plant up to the point at which the total cost was at a minimum, but as
soon as entrepreneurial activity breaks with the previous state, factors of production
previously used by the old firms must be withdrawn to be deployed by innovating
entrepreneurs. This means that the production of consumer goods must necessarily
be sacrificed in the interest of making producer goods. Even though the net quantity
of consumer goods may decline in this period, this does not mean the demand for
consumer goods will decline, and in fact it is likely to increase because of the
increased purchasing power brought about by the increased payments flowing into
the hands of the consumers. All this continues until the first entrepreneur’s plant
becomes operative at which time an entirely new situation comes onto being. The
new commodities that have been produced now enter the market. All things being
equal these goods are readily taken up by consumers at the price the entrepreneur
anticipates they can be sold. On the assumption the entrepreneur continues to
produce the new consumer goods without any further changes in his operation, he
begins to receive receipts from the sale of these goods that are sufficient to repay the
loans with which he has purchased his plant and equipment. Given that
entrepreneurial activity in its first phase has been successful and that numerous
entrepreneurs have achieved similar successes, the result is that the new firms are
able to place a larger quantity of consume goods into the market than had previously
been the case where there had been a reduction. This increase in consumer goods is
what amounts to the experience of prosperity and gives rise to the appearance, and
indeed reality, of “economic progress.”

The new goods that enter into the market will, as Schumpeter has previously
explained, not be easily absorbed without disruptions. The first wave of new
products entering onto the market will not alter the total business situation but will
clearly affect those firms that are in immediate proximity to the productive area of
the new firm. But as the process continues the effects create disequilibrium and
force a course of adaptation. Whilst the effect on old firms is initially not necessarily
negative because they may benefit from increased prices for their goods, eventually
the competition of the new firms forces a much more difficult adaptation. For some
old firms new opportunities may arise for expansion and they may be able to prosper
for a while, but for others the emergence of new methods and products ultimately
leads to a situation in which it is impossible for them to compete. This latter
situation spells their economic death. Still others are only partially able to adapt and find themselves in decline.  

Eventually a time arises whereby entrepreneurial activity slackens. Why should this be so? First, Schumpeter says entrepreneurial activity characteristically begins in a particular direction. It does not distribute itself equally over all industries. Its possibilities are inherently limited. As more industries develop in the wake of the initial innovations, the point is reached at which the costs of producing the new commodity become equal to the price at which it will sell. Profits are thereby eliminated and hence the impact of the innovation will have spent itself. This then completes the cycle of entrepreneurial innovation and its exploitation.

**Historical Outlines of Business Cycles**

A major concern of Schumpeter, in fact perhaps his ultimate concern, is to show how a mechanism of capitalist evolution underlies the apparent performance of modern economies from their inception down to the present. He is certain he has disclosed convincing evidence that the kind of cyclical phenomena which he has identified as being fundamental were operating as early as the time of the industrial revolution. But he is also interested in whether his mechanism of evolution might be relevant to interpreting the economic history of the period prior to the industrial revolution. This is a particularly important question from our point of view because the consequence of adopting this view would seem to be to deny that there is a fundamental epochal change with the advent of industrialization and the various modern institutions associated with it—such as the corporation, the stock market, mechanization of production, a regulated monetary system, the rational division of labour, the application of science and technology to industrial production and so on. Schumpeter wants to say that his mechanism of capitalist evolution can be divined well back into the pre-history of the modern era. This position is noteworthy because in some ways it is fundamentally at odds with the position of Weber, amongst others. For Weber, the advent of modern capitalist enterprise and the modern market economy constitute a unique and unprecedented development, and he is convinced these have led to an irruption of rationality in economic life to a level not found previously in world history. So the question is to establish whether or not Schumpeter’s implied view that there may be no fundamental difference in the character of economic progress before the industrial revolution and afterwards is correct.

We shall first consider Schumpeter’s definition of capitalist enterprise as set forth in *Business Cycles*. There he defines capitalism as, “that form of private property economy in which innovations are carried out by means of borrowed money, which in general, though not by logical necessity, implies credit creation.” Schumpeter is aware that his definition is in a sense nominalistic. That is, he has chosen to define capitalism in this way for purely heuristic/scientific purposes. In placing the idea of credit creation at the very heart of his definition Schumpeter is in some ways at odds with many if not most other theorists. He distinguishes his own

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position, for example, from those of Marx, Sombart and Böhm-Bawerk. But he insists that the phenomenon of credit creation, whilst not necessarily implying a direct causal relation, nonetheless does suggest all manner of institutions which are typical of the setting in which modern capitalism appears. But the critical thing about credit creation for Schumpeter is that it introduces elements that are determinative of the cyclical character of the capitalist phenomenon. “The only thing that could be controversial about this [our definition] is our proposition that the economic process of capitalist society is identical with the sequence of events that give rise to the business cycle.”

As a result of this definitional starting point, Schumpeter says that for his purposes the beginnings of capitalism can be seen as far back as the phenomenon of credit creation itself, and can be traced to where there have been negotiable credit instruments the presence of which gave the possibility of credit creation. Schumpeter at times appears to want to regress in time even further than this, for he says we must go back to the era of non-negotiable instruments which preceded the imperfectly negotiable ones and to the possibility of transferring by whatever method deposits lodged with banks even though that may have nothing to do with credit creation. So it is his view that the practice of credit creation may be as old as deposit banking as such. He specifically takes issue with those thinkers such as Wesley Mitchell and Arthur Spiethoff who were strongly resistant to the idea that one can speak of business cycles in the requisite sense before the end of the eighteenth century. He concedes that the smaller the capitalist sector is in an otherwise pre-capitalist world the less the fluctuations characteristic of the capitalist process will assert themselves and the more other causes of fluctuations such as external factors will tend to dominate. Thus the impact of innovations will be felt differently in a small-scale capitalist environment than it would in one in which modern corporate capitalism is dominant. Schumpeter admits that it may be difficult to discern phenomena of a cyclical nature in these early periods, but nonetheless he claims they are in principle detectable. In this connection he refers to the bursting of the South Sea Bubble that he suggests bore a striking resemblance to the crises of 1873 and 1929. He says, “While proof must wait upon future research, there is certainly no reason to expect that those ‘crises’ will eventually turn out to have been anything else but incidents of a cyclical movement, distorted no doubt by the action of external factors, exactly as they are today. All evidence from such material as we have points in our direction, certainly as far back as the sixteenth century, down to details of financial practice.”

At this point in his exegesis Schumpeter alludes the history of banking and refers to the fact that the non-negotiable bill of exchange came into existence in the second half of the fourteenth century, an important factor in the credit business of banks. He also refers to the use of the cheque, which was prohibited in Venice as late as 1526, and then refers to the gradual elimination of the prohibition on interest. These developments in banking and commercial culture he wants to say are not merely incidental elements in the history of economic life but may well partake in the operation of a cyclical mechanism. To illustrate the point, he refers to an iconic industrial development—the electrification of the household—and notes the many discontinuities incident upon the setting up of the new production function associated with electrification. He admits that it is true that, if we look at western European

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economic life in the sixteenth century and compare it with the tenth, we cannot but note an enormous difference. However, even in the tenth century, he says, there were rudimentary forms of capitalism—for example, quite definitely in Venice at that time. In general Schumpeter emphasizes the discontinuous character of economic life and the fact that so-called revolutions are often the result of many smaller changes and their cumulative impact. As he explains,

Our theory of the mechanism of change stresses discontinuity. It takes the view that, as we put it, evolution proceeds by successive revolutions, or that there are in the process jerks or jumps which account for many of its features. As soon, however, as we survey the history of any sector of social life, we become aware of a factor which seems, at first sight, to be incompatible with that view; every change seems to consist in the accumulation of many small influences and events and comes about precisely by steps so small as to make any exact dating and any sharp distinction of epochs almost meaningless. Evolution of productive technique may serve as an example. What we designate as a big invention hardly ever springs out of the current events, as Athene did from the head of Zeus, and practically every exception we might think of vanishes on closer investigation. . . . The decisive step in bringing about a new thing or ultimate practical success is, in most cases, only the last straw and relatively insignificant in itself. . . . What is technically called a revolution never can be understood from itself, i.e., without reference to the developments that led up to it; it sums up rather than initiates. 31

Now it is of more than passing interest that at this point in his argument Schumpeter sets out to criticize those theorists who have argued that with the advent of industrialization there came into being a new “spirit” or Geist, and he makes specific reference to Sombart and to Weber in this regard. He says that these thinkers have argued that somewhere between the fourteenth and the sixteenth century there arose an economic system fundamentally different to the preceding one. With Weber specifically in mind Schumpeter explicitly rejects the idea that the “rationalization” of life generally or of economic life in particular was a new phenomenon with far-reaching consequences for the way in which the economy developed. He says, “In particular there is no need to trace what that group of authors entirely unrealistically considers as a new rationalism on the one hand and as a new attitude towards profits on the other hand to religious changes (M. Weber)—which is a way of arguing hardly superior to the economic interpretation of history which it is intended to improve or replace.” 32 Evidently, Schumpeter has in mind here some version or other of the Weber’s Protestant Ethic thesis and is assuming that Weber was attempting to establish that religion was the key to the rise of modern capitalism. He is adamant, on the contrary, that his own position is superior and warns against approaches akin to that of Weber:

The historical sequence of the forms of enterprise, in particular, appears in a different and much more promising light as soon as we drop the attempt to look at each of them as a world of its own incomparable with all other such worlds. The type of mediaeval artisans organization, their organization and behaviour, are fully accounted for by the conditions of their environment and particularly of their market. The way in which they succumbed to what then was a

32 Ibid, p. 228.
commercially superior method, the putting out system, whilst, as will be seen, illustrating well what we mean by the process of new things ‘competing old ones out of existence,’ does not stand in need of an extraneous principle of explanation.\textsuperscript{33}

In other words, Schumpeter is saying that the transition from the putting out system to full-fledged capitalist enterprise is to be explained as yet another manifestation of the impact of innovation, of better methods of production competing out obsolete ones that are not as efficient. It is this mechanism that largely explains the victory of the novel organisational forms associated with the factory system and modern management.

As we have seen in previous chapters, Weber has a deal to say about the way in which the traditionalistic methods of production such as the putting-out system were overtaken by modern capitalistic forms. We shall not repeat those considerations here which we say are sound and remain unshaken by Schumpeter’s criticisms. Therefore, we think that Weber’s position is not refuted by Schumpeter’s argument and remains indispensable to grasping the causal complexity of the rise of the capitalistic system. In short, we say that Schumpeter overstates the case for his capitalist mechanism. He insists that the transition from small-scale production to that typical of the more advanced modern forms of enterprise required no new mentality to emerge. He refers to the early commercialisation of life and claims profits created in pre-modern forms of enterprise were sufficient to bring about later forms: “The entrepreneur of the commercial type imperceptibly shades off into the entrepreneur of the industrial type and the transition of the one to the other does not constitute a problem \textit{sui generis}.”\textsuperscript{34}

We shall argue below that there is not necessarily an irreconcilable incompatibility between the respective positions of Weber and Schumpeter on these issues, because much of what Schumpeter says as to the role of the entrepreneur and the cyclical workings of a fully-fledged capitalist system is perfectly consistent with Weber’s position. In any event, Schumpeter’s more weighty arguments concerning business cycles, which are for him symptomatic of full capitalism (capitalism as a total system of society), really begin with a focus around the time of the industrial revolution despite his remarks concerning pre-modern capitalism.

**The Long Wave from 1787-1842**

The years 1787 to 1842 are a period that Schumpeter claims, in accordance with his schema, constitute a long cycle or “Kondratieff.”\textsuperscript{35} Whilst he does not necessarily see this period as being a first such Kondratieff, it is the first occasion on which he believes there is sufficient data to establish the existence of such a cycle. At the outset, he wants to guard against what he sees as a possible misunderstanding with respect to the relationship between the conventional notion of the “industrial revolution” and this first identifiable Kondratieff. As we have just seen, he rejects

\textsuperscript{33} Ibid.
\textsuperscript{34} Ibid, p. 229.
\textsuperscript{35} Kondratieff’s seminal paper is “Die langen Wellen der Konjunktur”, \textit{Archiv für Sozialwissenschaft und Sozialpolitik} (1926) 56, pp. 573-609.
the idea that “industrial revolution”, or indeed the term of revolution per se, provides an adequate description of the developments he is seeking to identify and explain. His approach appears to be antithetical to the conventional notion of an industrial revolution in the sense of a sudden and dramatic transformation of what was a completely different state of the economic system. He wants to argue that each business cycle is created out of the wreckage of a previous one, so that it is misleading to locate what appear to be singular economic developments in the conditions immediately preceding them. For many of the elements that are part of the so-called industrial revolution have antecedents many years before and are part of a much larger schema of economic evolution. Schumpeter says he has no particular quarrel with Professor Usher who puts the industrial revolution as occurring as early as 1700, except there is no reason even to stop there if the term industrial revolution is to designate the whole process of the emergence of modern industry. He says he is prepared to endorse a dictum of Tugan Baranovsky which goes, “if one wishes to refer the industrial revolution to a definite historical epoch it can be located more justifiably in the second quarter of the nineteenth century than in the end of the eighteenth century”. Schumpeter goes on, “... it is in recession, depression and revival that the achievements initiated in the prosperity phase mature and fully unfold themselves, thus bringing about a general reorganisation of industry and commerce, the full exploitation of the opportunities newly created, and the elimination of obsolete and inadaptable elements, which is exactly what happened and what accounts for what everyone admits to have been a prolonged, though often interrupted, ‘depression’...”\(^{36}\) Thus, the innovations which were relevant to the upswing of economic activity in the eighties and nineties of the eighteenth century in many respects have their origins much earlier, and likewise the twenties and the thirties of the nineteenth century already manifest the innovations that will contribute to the next Kondratieff.

If one is to locate a starting point for the industrial revolution, Schumpeter says the relevant innovations must have begun some time before 1793 when England declared war on France. In discussing the situation of England at that time he refers to the fact that agriculture was by far the most important single industry and site of innovations. Enclosure acts were still being enacted as late as 1810. Intensive cultivation in the neighbourhood of cities had first developed in Flanders but this had begun to occur in places like Norfolk where drainage by the use of steam pumps and the more scientific use of fertilisers became common. English colonial and commercial enterprise exploiting the opportunities of political power was also important in this period. Later, the cotton textile industry became a new leader. Production and trade in cotton goods had been common previously, however, several new innovations can clearly be distinguished. The first of these consisted in the introduction of Indian cotton fabrics by the East India Company. By 1721 the success of this new cotton material threatened the old firms based on wool and silk. There were efforts to prohibit the sale as well as the wearing of printed or painted dyed calicoes. Eventually, English industry began using cotton as weft in woollen warp and the industry gained an exemption from the prohibition on the production of mixed fabrics. Schumpeter says many steps led up to the achievement of the elimination of restrictions on the production of pure cotton fabrics that came in 1774 just prior to a major period of Kondratieff prosperity.

But realization [of this prosperity] that counted quantitatively (for the whole economic system) did not come before the [eighteen] eighties. Experimentation, resistance, failure, and local success (Arkwright’s, about 1760, was the outstanding one) are what we observe before. Spread, induced improvements, dislocation and absorption, copying, following and competing are what we observe afterward, in the down-grade and revival, when the real avalanche of products came.\(^ {37}\)

Many of the most important textile inventions, such as the Flying Shuttle, the Jenny, Barker’s Loom, and Cartwright’s Loom, had been made much earlier, but their true impact was not felt till a subsequent period. A really successful power loom only evolved later from the efforts of Austin, Horricks and Roberts in the early nineteenth century. Schumpeter emphasizes again that invention and innovation are entirely different things and not directly related to each other. Of course, they interact and sometimes invention is an incident in the entrepreneurial achievement. The figure of Arkwright is exemplary in this regard. But invention is not the core of the matter. Again and again Schumpeter insists the evidence shows that the actual setting up of a new production function is a distinct achievement:

> We readily see how every step conditions other steps—yarn and cloth, for instance, alternating in offering new demand to each other and in running up against bottlenecks, the removal of which then makes the next achievement. We see how demand for cotton conditions Whitney’s ginning machine and so on. But we also see that these conditions . . . lead up to other innovations . . . \(^ {38}\)

Schumpeter notes that other historians have often discounted the importance of innovation because the actual extent of industrial change brought by it up to the beginning of the nineteenth century was rather small. But to form an idea as to the quantitative adequacy of the innovations of this period, Schumpeter says one has to consider their effect as “ignition.”

What we see on the surface is largely the effect of what we have called the Secondary Wave, the phenomena of which can in fact be sufficiently expressed in terms of general conditions, growing commercial sectors, independently given demand conditions, and so on. To that ignition we must, hence, always apply a multiplier before confronting it with statistical findings about social aggregates. Looked at in this manner the development in the cotton trade alone would be adequate to explain a Kondratieff upswing.\(^ {39}\)

In general terms what Schumpeter again and again stresses is that the jerkiness and unevenness of economic progress is to be explained in terms precisely of the cyclical process. This process was connected with shorter cycles centred on cotton, textiles, coal, iron and transportation. The course of economic progress was manifested in the spread of improvements in these areas, especially as regards the steam engine, the iron machine, machine tools and mechanical engineering generally. Schumpeter notes that Watt and his partner Boulton eventually achieved success in 1782, but it is not correct to say that the alliance between Boulton and Watt is best described as that between an entrepreneur and a capitalist. Before Wilkinson, who had improved the boring of cannons came to Watt’s aid, his condenser was unworkable because the pistons did not fit his cylinders. Watt’s early machines were wasteful, quickly wore


out and broke down. Even by 1800 the total volume of horsepower from installed steam engines was relatively small compared with other sources of power.

During the period under discussion, Schumpeter says steam ships did not rise to great importance, however the locomotive, particularly after Stephenson’s success, put the alternative forms of railway traction, horses and stationary engines, out of business. The Liverpool and Manchester railroad was the first entrepreneurial achievement of national importance and induced the greater part of Schumpeter’s Secondary Wave. Then followed the spate of railroad construction that he classifies as part of the Jugular prosperity that preceded the crash of 1837. Up to 1838 roughly 490 miles of rail track had been added to the English network. But the really important development in quantitative terms came later in the 1840’s when almost the entire English rail system was created. This “railroadization”, Schumpeter says, belongs to the second Kondratieff, even though the essentials of railroad enterprise already existed in the 1830’s. Here railroad entrepreneurs stand out particularly in sharp relief. Given that the joint stock company did not become the normal means of enterprise prior to the Act of 1856, it was not used as the main means of enterprise prior to that time. Of course, the advances referred to had the effect of crowding out those firms and persons who were tied to the older forms of industry. Even so the impact of the machine, according to Schumpeter, was not to reduce total employment or even to reduce it in the areas that were being revolutionised. What it did was to create cyclical unemployment, primarily in the areas that were being crowded out but also in the innovative sectors when they felt the effects of crises.

As regards to the impact of the joint stock company, Schumpeter notes that in banking the spread of the corporate form was barred until 1826. However, from the beginning of the eighteenth century, promotion of companies with a quasi-corporate character became quite common. This was the period of the Bubble Act following the mania of 1807 and 1808. But throughout the early 1800’s, despite the difficulties of incorporation, many companies were formed, particularly in mining, insurance, gas, canals and a wide variety of trading, building and other industries. Many, of course, did not last and failed almost immediately or within a few years. No less than 15 banks, based on joint stock deposits were founded between 1826 and 1830 and a further 25 were founded in the next three years. But by 1844 when there were nearly a thousand companies in existence, only one was a cotton-manufacturing establishment. Railroads, gas, water and shipping were the major areas of corporate development.

Schumpeter proceeds to make reference to the situation in Germany and America to flesh out his historical outline. We shall not consider his remarks as regards Germany but a few references to America are of value for comparative purposes. He refers to the fact that at the time of English expansion, the United States was largely an agricultural and commercial economy. Nonetheless, industrial enterprise was not insignificant before the American Revolution. Massachusetts, Connecticut and the vicinity of Philadelphia and New York were already industrialized to a considerable extent, and there had even been exports of manufactured goods as early as the middle of the seventeenth century. Schumpeter argues that the process that would transform American industry followed corresponding processes that had already taken place in England. He says the main feature in industry was the introduction of mechanical power that began to turn
workshops into factories. He mentions the development of cotton and woollen mills in New England and Pennsylvania in the 1780’s and the advent of “the cotton mania” of the time. This course of events was connected with the development of water-power that exploited the falls in rivers and created numerous industrial centres. Thereafter followed improved means of communication such as turnpikes and canals. These formed the backbone of a Kondratieff prosperity. The introduction of English innovations was initially slow, though jennies and Arkwright frames came in around 1790. Steam power came later and was slow because of the abundance of cheap water-power. After about 1810, high-pressure engines began to compete with low pressure Watt engines, but the production of engines for industrial use was small at this stage. The transport system improved greatly in the early part of the nineteenth century with Philadelphia becoming the centre of a canal system. The canal between the Hudson and Lake Champlain was opened in 1823 and the Erie Canal followed in 1825. This reduced the cost of transport from the Middle West to the East drastically. The first railroads were local and sponsored by businessmen but later they were developed by public enterprise. The first bank of issue was the Bank of North America established in 1782. Others followed soon after. By 1812 there were 119, by 1829 there were 329 and by 1837 there were 788. A peak of 901 was reached in 1840. The banks lent on promissory notes secured by some collateral or a mortgage keeping only scanty reserves and not being too careful as to the details of repayment. The notes of many banks depreciated seriously in the period around 1814 to 1817 and bank failures were common. Schumpeter refers to the practice whereby some industrial concerns established banks of their own in order to finance themselves by issuing notes, but this led to an inflationist mentality and a certain recklessness in the financing of business. However, as Schumpeter says, “it was the financing of innovation by credit creation—the only method available, as we have seen in the course of our theoretical argument, in the absence of sufficient results from previous evolution—which was at the bottom of that ‘reckless banking.’”

The period 1843 to 1897 is a period Schumpeter refers to as the second of his long waves or Kondratieffs. He notes that there is general acceptance of the idea that in the 1840’s there was a revolutionary course of development associated with the phenomenon of railroadization and clearly that is the outstanding feature of the period. He says this is particularly true of America where the western and middle western parts were basically created by the railroad. For England and even for Germany the importance of railroads was absolutely and relatively smaller, but railroads were very important there also. Railroads are the chief reason Schumpeter wants to date the beginning of his second Kondratieff as he does. Innovations that carried this Kondratieff continued to contribute throughout the period and even into the next Kondratieff.

Criticism of Schumpeter’s Theory of Business Cycles

The most controversial aspect of Schumpeter’s theory of business cycles and the area which has received the most criticism concerns two related problems: Why is it that his innovations occur in clusters, and why are there business cycles with regular

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40 Ibid, pp. 294-5.
wave-like characteristics? The main objection raised against clusterings follows from the proposition that there can only be clusterings if there is discontinuity in the distribution of entrepreneurial activity, but there is no obvious reason why this should be so. A related objection concerns Schumpeter’s view that innovations are concentrated in the neighbourhood of equilibrium. It is argued that in maintaining this view Schumpeter relies too much on the principle that increased risk will deter innovations occurring in boom periods.

A classic exponent of the first criticism is Professor Kuznets, who argues that Schumpeter’s theory requires discontinuity over time in the manifestation of entrepreneurial ability: It “implies cycles in the supply of entrepreneurial ability, whether the supply be conceived in terms of individuals or phases in the life of various individuals.” Kuznets thinks this is improbable:

Given an infinite supply of possible innovations . . . why need entrepreneurial genius defer the next pioneering step until his preceding one has been so imitated and expanded that the upsetting of the equilibrium stops him in his tracks? . . . Why should we not conceive these applications of high entrepreneurial ability, whether represented by one man or several, as flowing in a continuous stream, a stream magnified in a constant proportion by the efforts of the imitators.

This criticism is somewhat misplaced, however, as Schumpeter does not account for innovation exclusively in relation to the presence of the entrepreneurial aptitude, as it is the combination of this with the objective economic conditions that facilitates innovation at a given point in time. For example, unless there are capitalist promoters prepared to finance new combinations, and this entails that the business cycle is at a stage that is opportune for investment, no amount of entrepreneurial drive will suffice.

Kuznets has advanced a further criticism of Schumpeter’s theory in suggesting there are fundamental methodological problems:

One cannot escape the impression that Professor Schumpeter’s model in its present state cannot be linked directly and clearly with statistically observed realities: that the extreme paucity of statistical analysis in the treatise is an inevitable result of the type of theoretical model adopted: and that the great reliance upon historical outlines and qualitative discussion is a consequence of the difficulty of devising statistical procedures that would correspond to the theoretical model . . . The cycle is essentially a quantitative concept. All its characteristics such as duration, amplitude, phases etc., can be conceived only as measurable aspects, and can be properly measured only with the help of quantitative data. To establish the existence of cycles of a given type requires first a demonstration that fluctuations of that approximate duration recur, with

fair simultaneity, in the movements of various significant aspects of economic life (production and employment in various industries, prices of various groups of goods, interest rates, volumes of trade, flow of credit, etc.); and second, an indication of what external factors or peculiarities of the economic system proper account for such recurrent fluctuations.  

Schumpeter’s response to this is to partly concede that such correlations are not always possible. For, strictly speaking, he does not believe that the business cycle is a purely quantitative phenomenon. At one point in Business Cycles he writes: “...it is absurd to think that we can derive the contour lines of our phenomena from our statistical material only. All we could ever prove from it is that no regular contour lines exist.” And he goes on: “General history (social, political and cultural), economic history and more particularly industrial history are not only indispensable but really the most important contributors to the understanding of our problem. All other materials and methods, statistical and theoretical, are only subservient to them and worse than useless without them.” In discussing the nature and use of time series Schumpeter explains that, “The time sequences we observe are, of course, part of our material from which we have to start and for which we have to account. And we have to bring every new factual finding into accord with the rest of the facts of the economic process and not with any poetry of ours. But no statistical finding can ever either prove or disprove a proposition which we have reason to believe by virtue of simpler and more fundamental facts.” His view is perhaps best summarised in this statement: “Analysing business cycles means neither more nor less than analysing the economic process of the capitalist era.” Thus, Schumpeter is saying that the statistical data and the historical data must be analysed together in unison in order to establish the reality of cyclical phenomena. It follows that the criticism that he has not based his theory entirely on the analysis of the quantitative time series data is not to the point.

Related to the Kuznets’s criticisms of Schumpeter’s business cycle theory are those of Angus Maddison in his study of the phases of capitalist development. In a review of the major theorists of business cycles Maddison is especially critical of Schumpeter’s account of the business cycle. He refers to his three types of cycle, the Kondratieff, the Juglar and the Kitchin and raises doubts as regards the empirical regularity of the schema. He maintains it has not been well established by the empirical data. And he doubts the relevance of some of the theory that underlies Schumpeter’s analysis. For example, he says, Kitchin’s paltry contributions to the literature is lean meat indeed compared with that of NBER [the National Bureau of Economic Research of the USA], and Juglar never claimed to have demonstrated the existence of an eight to nine year rhythm. In fact, the NBER had already demonstrated rather wide variance in the length of cycles, so that there was little ground for distinguishing Juglars and Kitchins. Furthermore, Schumpeter distinguished only the length of these three types of cycles and said nothing about their amplitude.

44 Ibid, pp. 266-7.
46 Ibid, p. 33.
Maddison goes on to argue that Schumpeter’s use of statistics is rather cavalier and by modern standards not sufficiently rigorous. He says that judged on the statistical evidence alone the theory would long ago have been discredited. However, somewhat at odds with the criticisms, he admits the theory underlining it is highly imaginative and illuminating. Nonetheless, he says Schumpeter significantly misread certain key events, such as the significance of the 1929-33 U.S. recession. Schumpeter said this had been more or less consistent with a pattern of depressions occurring every 55 years and referred to the 1873-77 recession as being the previous case. But Maddison claims this is not a genuine parallel and is quite misleading because the earlier depression saw a fall in production of only 14.8% whereas the 30’s depression saw production fall 44.7%. Maddison seems to accept that as far as the long wave Kondratieff is concerned Schumpeter is on stronger ground than otherwise; however, his theory still has three fundamental weaknesses:

1) He does not provide a persuasive explanation why innovation (and entrepreneurial drive) should come in regular waves rather than in a continuous but irregular stream, which seems a more plausible hypothesis for analysis concerned with the economy as a whole; 2) He makes no distinction between the lead country and others, but argues as if they were all operating on a par as far as productivity level and technological opportunity is concerned. Thus his waves of innovation are expected to affect all countries simultaneously; 3) He greatly exaggerates the scarcity of entrepreneurial ability and its importance as a factor of production.

In his defence it has to be said that Schumpeter partly anticipated the criticism about the clustering of innovations. One reason why innovations do not occur as a continuous stream is that those who have got the ability to make them usually take a long time to bring them to fruition. Often an innovative venture involves founding a new firm through which the innovation is developed. This can take many years of determined effort, and in order to gain success the entrepreneur must stick at his original project to the exclusion of others. So it is usually not practicable for him to go onto further innovations of a different kind. As to why innovations occur in the neighbourhood of equilibrium, Schumpeter argues this is because equilibrium conditions are the most suited for their introduction. In the neighbourhood of equilibrium the risk of failure is reduced to its minimum. The other aspect of why there are clusters concerns the way in which innovations impact on the field of economic activity. According to Schumpeter, the first breakthroughs have the effect of eliminating resistances that had hitherto prevented progress, and in doing so they smooth the way for others that come after. The initial innovators show that profits can be gained in the new domain of action. Bankers also participate in the matrix of causes that lead to clusters, because they are more likely to lend to ventures that are showing promise than to those that have been completely untested. The question nonetheless arises as to why, given that innovations have begun in the neighbourhood of equilibrium, they do not continue when the enterprise starts to take off and disequilibrium emerges. In the boom the prospect of larger than normal profits may be said to compensate for the increasing risk of a possible downturn and failure. Schumpeter’s answer seems to be that innovations slacken as the boom proceeds because the entrepreneurs become satisfied with the above average returns

49 *Ibid*, p. 103.
they are already receiving and prefer to stay where they are. What does happen in the boom phase of the cycle is speculation, which is a different phenomenon altogether, and this increases because of the prospect of higher than average returns, but with these of course go great risks of failure.

A criticism of Schumpeter from a different direction is that innovation should occur in periods of depression because at these times, because of the decline in profits, business managers will be even more than normally eager to develop new measures of cutting costs and of maintaining profits and will develop innovations as a means of survival. This argument, however, is somewhat misleading because strictly speaking it refers to the reactions of old firms to the circumstance of a downturn in profitability, rather than to the creation of new firms that is what Schumpeter’s innovation is all about. If old firms develop strategies of survival during a recession, this is mere adaptation and does not amount to innovation in Schumpeter’s sense.

Despite the above criticisms, Schumpeter’s theory of the business cycle has received significant support in recent years from a number of commentators. Gerhard Mensch has claimed that around the years 1825, 1886 and 1935 new clusters of innovations occurred and generated completely new product sectors. In those years new markets came into being that allowed these sectors to grow, to improve the products and production processes. He argues competition and rationalization raise the efficiency and output of the new industries until a saturation point in the domestic market is reached. Over capacity may stimulate exports, but less developed countries have limited means with which to buy the goods in surplus and a limit is eventually reached at which time a decline sets in and the long-wave is ended. Mensch concludes, “Basic innovations tend to cluster in periods of discontinuity, when changes in the marginal efficiency of capital (amongst other things) lead to disappointing depreciation in the operative value of installed capital goods in stagnating industries, thus inducing investors to seek alternatives, and so making the economic system ready for new technologies.”

Relying on an extensive list of 120 important innovations for the period from the 1850s to the 1960s compiled by K. B. Mahdavi, Alfred Kleinknecht has analysed these instances of innovation as well as many others and classified them as to whether they constitute more or less radical improvements of already existing products, completely new products or materials, or scientific instruments that are of use primarily for research and development. Some idea of the kind of product innovations that occurred in the 1920s and 1930s can be gleaned from the following examples excerpted from the list of 120:

In the chemical industry:
- Rayon
- Polystyrene
- Oxygen production
- Plexiglass
- Nylon
- Polyethylene
- Freon

In pharmaceuticals:
- Insulin extraction
- Anti-malaria drugs
- Sulphur drugs
- Vitamin C
- Vitamin B
- Vitamin B1

In petrochemicals:

Thermal pressure cracking, Anti-knocking gasoline, colour photography, synthetic oil, synthetic rubber.

In the electrical and communications industry:
Gas turbine, AM radio, Cinema, Record Player, Facsimile, FM radio, Fluorescent lamp, Short-wave radio.

Transport:
Airplane, Helicopter.

Scientific instruments:
Electron microscope, Oscilloscope.

Kleinknecht concludes that there is evidence to support the clustering of basic innovations in both the 1880s and the 1930s. This he suggests is support for the proposition that depressions are triggering both radical product innovation as well as improvements in production processes. He summarizes his conclusions as follows:
Statistical tests on Mahdavi’s data offer weak support for the prosperity-pull hypothesis on important innovations, but they give strong support for the depression-trigger hypothesis: there is a strong clustering of radical product innovations in the period of relatively unstable growth between the two world wars. This appears in sharp contrast to the periods of relative prosperity before the first and after the second world wars, which were obviously poor in initiating (but not in the diffusion of) radical product innovation.52

Jacob van Duijn has made extensive studies of industry innovation over time and believes there is a clear connection between innovation clusters and the occurrence of long-waves. He introduces the idea of innovation life cycles and argues there is strong empirical evidence to support a four-phase model wherein a number of innovations occur leading to acceptance of new products by customers, which is followed by a slowing of growth as competition increases, and which ends finally in a period of declining sales as saturation of the market occurs.53 He concludes that,
Clearly, there is little incentive to embark on risky, innovative ventures during long-wave expansions, when the current crop of growth sectors is still in full bloom. In that respect, the entering of maturity and decline phases of particular industry life cycles can be said to force new product innovations out of necessity. Ultimately, however, innovators need to be convinced that they are tapping new growth markets. That conviction comes easier during recovery than in the midst of depression.54

52 Alfred Kleinknecht, “Observations on the Schumpeterian Swarming of Innovations” in Christopher Freeman, Long Waves in the World Economy, Frances Pinter, 1984, p. 58. Kleinknecht has provided a thorough analysis of all these issues in his book Innovation Patterns in Crisis and Prosperity: Schumpeter’s Long Cycle Reconsidered, Palgrave Macmillan, 1987, where he concludes: “It is our view that waves of important innovations are an endogenous element of the long wave process. The wave-like occurrence of major innovative breakthroughs is a decisive cause of the fairly simultaneous rise of new branches of industry which foster the long wave upswing.” p. 206.
54 Ibid, p. 29.
The issue of whether there is a cyclical pattern of business fluctuations and what the time period of the cycles might be is discussed at length in an informative article by M. N. Cleary and G. D Hobbs. In reviewing the data on this question these authors note that, although it is difficult to correlate the existence of long-waves with industrial output measured in physical terms, for most countries studied "variations in the growth of aggregate industrial production can be seen as broadly consistent with the long-wave hypothesis." They argue,

The strongest empirical evidence in favour of the long-wave hypothesis undoubtedly comes from price series. Supporting evidence can also be found in the behaviour of long-term interest rates, world energy production and innovation. . . . The times at which prices and output growth pass their high and low points are taken from the wholesale price and capitalist world industrial production indices. Their studies indicate that the cycle revolves every 50 to 55 years. Nonetheless, they conclude somewhat equivocally, saying, “It is not easy to reach firm conclusions on the existence, or otherwise, of the long-wave from a direct visual examination of the empirical evidence. The ensemble of time series does suggest that there is some validity in the hypothesis, although no single series on its own carries very much conviction.”

Conclusion

We shall not discuss these problems further in what follows suffice it to say that clearly there are aspects of Schumpeter’s theory which would benefit from additional evidence so as to provide a more solid grounding. His work on time series was in many ways pioneering and necessarily based on the incomplete data and limited methods available in his day. One should also remember that Schumpeter was a founder of the discipline known as econometrics, and he was clearly engaged in this domain of research because it could aid the further analysis of business cycles among other potential uses.

But I shall make some concluding comments in regard to Maddison’s and Kuznets’s criticisms as outlined above. On the issue whether Schumpeter adequately explained why entrepreneurial activities should come in clusters, we note that he was adamant that history clearly shows there are intensive periods of innovation and that these show up to some degree as wave-like effects in the economic indices. The classic examples he gives are railroadisation and electrification. Today we might see similar wave-like phenomena arising in relation to phenomena such as the development of integrated circuits, computers and related innovations surrounding the internet and the mobile phone, and there is no doubt these innovations have given rise to a spate of new products and new economic opportunities. Most of Schumpeter’s key elements would appear to be present, such as the existence of major entrepreneurs (Bill Gates, Steve Jobs, Michael Dell, Mark Zuckerberg, Terry

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Guo, etc.), new companies (Microsoft, Apple, Intel, Samsung, Dell, Nokia, Foxconn, etc.), and a clustering of other entrepreneurial efforts (Google, Yahoo, Facebook, Twitter, etc.).

Today, the theory of business cycles must also deal with phenomena such as the post-war rise of Japan as an economic force, the appearance of the various “Tiger” economies of East Asia and most recently the development of China as an emerging economic superpower. In the case of China, for example, we can clearly identify elements of the Schumpeterian schema: consider the large-scale exploitation of cheap labour and low costs of doing business in China by corporations from all over the world. This opportunity was initially seized by innovative entrepreneurs from the Chinese Diaspora (Foxconn), but many western corporations have followed locating plants in China or outsourcing some or all of their production there (Phillips, GM, Ford, VW, Toyota, Mitzubishi, Nissan). Of course, all this is related to the phenomenon of de-industrialisation in America (Detroit) and elsewhere and the decline of previously prosperous economies (England, France). We are now witness to numerous indigenous Chinese companies that have arisen apparently without major non-Chinese involvement (Haier, Huawei, Lenovo). All of this we suggest supports ideas central to the Schumpeterian project.
CHAPTER FIVE

The Synthetic Combination of Weber with Schumpeter

In what follows I wish to set out lines of intersection and points of complementarity between the respective contributions of Weber and Schumpeter with a view to laying the groundwork for a synthetic combination of their respective theories as to the basis for a general theory. At the outset, however, we must confront a problem arising from certain apparent incompatibilities between the approaches of the two writers. I refer in particular to Schumpeter’s rejection of the relevance of some of what Weber says on methodological matters, especially as regards the religious roots of the spirit of capitalism and on the issue of the progressive rationalization of conduct in the modern West. We have discussed aspects of these issues in earlier chapters, but the question remains whether, given divergences of perspective, it remains possible to combine the approach of Schumpeter. In particular, can Schumpeter’s theory as to the functioning of the capitalist engine be combined with that of Weber concerning the modern vocational ethos and the rationalization of economic activity?

Schumpeter’s Critique of Weber’s Methodology

Before we explore these issues further, it should be born in mind that, despite his criticisms, in general terms Schumpeter was a great admirer of Weber and on several occasions wrote very highly of him. We note Schumpeter’s extremely generous praise of Weber, both as a scholar and a man, contained in an essay he wrote following Weber’s death in 1920 entitled “Max Weber’s Work”. But even in this essay there are equivocations as to Weber’s command of economics and his adequacy on purely economic questions. At one point we read, “Thus, Weber was a sociologist above all. Even though he was a sociologist with a penchant for things that are primarily concerned with economics, he was an economist only indirectly and secondarily. His interest in economics does not focus on the mechanism of economic life as described by economic theory, nor on the real historical phenomenon for its own sake, but rather on the sequence of historical types and their socio-psychological profusion.”\(^1\) While this assessment is not altogether unjustified, one nonetheless detects an element of vanity in Schumpeter’s characterization, for it appears he is reserving for himself authority and expertise in the field of economics and suggesting Weber was not on the same level in such matters.

Undoubtedly, both Weber and Schumpeter made significant contributions to methodological issues and the related debates that raged in their day. We shall first consider Weber’s methodological contributions. As we have seen, Weber began his scholarly career to a certain extent in the camp of the German Historical School led by Gustav Schmoller. Schmoller’s position has been commonly understood as being totally opposed to theory, but this is not strictly correct. He did not believe research should be restricted merely to the collection and description of historical materials and never completely rejected the methods of the natural sciences, general concepts or law-like

theses as developed by economics. However, his basic proposition was that the social sciences must begin with the collection and summarisation of empirical data, and he believed this task had not been developed sufficiently to allow the extensive use of deductive-abstract methods and the related formulation of laws. Schmoller summarised his view in the following statement: “We do not think that we must have laws at once at any price: we do not believe that we can pick them like blackberries, because we look first of all for true knowledge, i.e., necessarily and universally valid judgement. Where no law exists, we must be content with (1) the extensive observation of reality, (2) the classification of these materials and (3) the enquiry of causes”.\(^2\) Though influenced by Schmoller, Weber developed his own unique methodological approach which was much more sympathetic to theory. He is in fact critical of the Historical School for its confusion of theory and reality. Interestingly, from our point of view, it would appear that Weber’s view of theory, and especially of the role of ideal types, was influenced quite directly by Menger.\(^3\) Thus in 1904, we find Weber setting out his methodological approach as follows:

> If one perceives the implications of the fundamental ideas of modern epistemology that ultimately derives from Kant; namely, that concepts are primarily analytical instruments for the intellectual mastery of empirical data and can be only that, the fact that precise genetic concepts are necessarily ideal types will not cause him to desist from constructing them. The relationship between concept and historical research is reversed for those who appreciate this; the goal of the Historical School then appears as logically impossible, the concepts are not ends but are means to the end of understanding phenomena which are significant from individual viewpoints. Indeed it is just because the content of historical concepts is necessarily subject to change that they must be formulated precisely and clearly on all occasions. In their application their character as ideal analytical constructs should be carefully kept in mind and the ideal type and the historical reality should not be confused with each other.\(^4\)

Weber also accepted the method of “understanding” (Verstehen) as necessary for the conceptualisation of motives, desires and emotions of individuals that are assumed to be the source of human actions.\(^5\) Necessarily, this involves the approach called “methodological individualism”, because historical and social phenomena are ultimately interpreted in terms of complexes of these subjective states.\(^6\) The term Verstehen indicates the scientific procedure by which the observer grasps the conduct of


\(^3\) See the useful discussion of the intellectual milieu in which Weber developed his methodological perspectives in F. Ringer, *Max Weber’s Methodology*, pp. 7-35.


\(^5\) It would appear that Weber’s appreciation to the idea of “understanding” was less a result of the direct influence of the work of Wilhelm Dilthey than it was a consequence of his close association with Simmel.

\(^6\) The concept of “methodological individualism” was probably first elaborated by Schumpeter on the basis of Menger’s use of the term in his early work *The Nature and Essence of Economic Theory*, especially Part 1, Chapter 6. The basic idea that, “... we are not interested in the individual process but they help us to describe the mass phenomena in our field,” (p. 62) is possibly consistent with Weber’s methodology, but beyond that the two approaches diverge considerably.
individuals by comprehending their inner subjective states and thereby the meaning of their actions. The theory of the ideal type has the role of clarifying the logical status of socio-historical concepts. Ideal types do not describe the elements that a class of phenomena have in common in the real world but rather those they have in common with a theoretically constructed model. The world described by ideal types is an imaginary world or utopia, and the theory constructed by the means of these concepts is not a copy of reality but an heuristic device to aid the comprehension of reality.

Despite Weber’s evident sympathy for theory, Schumpeter is highly critical of Weber’s use of ideal types. At one point in a footnote he says that Weber in effect created a spurious problem in trying to contrast an ideal feudal man with an ideal capitalist man and then seeking to explain the transition from one to the other. He says, “Unfortunately, Max Weber leant the weight of his great authority to a way of thinking that has no basis than a misuse of the method of Ideal Types. Accordingly he set out to find an explanation for a process which sufficient attention to historical detail renders self-explanatory. He found it in the New Spirit—i.e. a different attitude to life and its values—engendered by the Reformation.” Somewhat patronisingly, Schumpeter goes on to say, “The historical objections to this construction are too obvious to detain us. Much more important is it to see the fundamental methodological error involved.” Clearly Schumpeter shows little or no appreciation of the methodological intricacies in the account of the ideal type and its role in causal analysis advanced in Weber’s extensive methodological essays. As to whether Weber committed any “methodological errors”, as far as the present writer is concerned Schumpeter does not demonstrate any obvious ones in the remarks quoted or anywhere else. Further evidence of Schumpeter’s lack of sympathy for Weber on methodology can be gleaned from a footnote in The History of Economic Analysis in a section that refers to the philosophical background of the period of the late 1800’s in Germany. Schumpeter makes reference to the influence of the philosophers Wilhelm Windelbande and Wilhelm Dilthey. Windelbande had been responsible for the famous dichotomy between the underlying rationale of the historical sciences in comparison to the natural sciences, for which he had developed a distinction between the sciences of cultural life that produce “idiographic” knowledge and the sciences of nature which formulate laws he deemed “nomothetic”. And Dilthey had been responsible for a related though not identical distinction between the intellectual processes of “explanation” (Erklären) in terms of causes and those involving the “understanding” (Verstehen) of meaning. Schumpeter argues that these thinkers made a fundamental mistake when they attempted to use their analytic distinctions to characterise the social sciences as belonging completely to the field of understanding and thus being idiographic because, as he says, “great parts of the social sciences ride astride this dividing line, which fact seriously impairs its usefulness.” He goes on to refer to Weber as having been an unfortunate victim in all this. He claims that Weber failed to see that the distinction between the ideographic and the nomothetic sciences had serious negative consequences: “That this was apt to mislead the many economists who listened to them—Max Weber, e.g., was strongly influenced by Rickert—was as inevitable as it was regrettable. But let us note the striking saying of Dilthey that reads

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7 HEA, p. 80.
8 Ibid, pp. 80-1.
like a motto of Max Weber’s methodology; ‘we explain the phenomenon of nature, we understand the phenomenon of mind (or of culture).’

It is instructive to consider an essay Schumpeter apparently wrote around 1940 and which was found in the papers collected in the Harvard University Archives and published posthumously. It is entitled “The Meaning of Rationality in the Social Sciences” and in it Schumpeter addresses a number of methodological issues connected with the social sciences. I shall not discuss the substance of the essay as such, because its key concerns are outside those of the present work, but note that the analysis of rational action and rationality in economics makes no serious reference to Weber’s important contributions on these topics. The one reference to Weber in the essay, however, is again critical of him. In a section in which he is discussing the difficulty of “understanding” the motives of actors in different and distant cultures we read, “But if we admit that when venturing into the ‘Sinnzusammenhang’ of things so far removed from our own personal experience we are not merely stepping on clouds, we must at least recognize the risks inherent in such undertaking. Max Weber affords a good illustration of the dangers I mean to refer to, when he denies rationality to the ancient Chinese mind on the ground, among others, that examinations in classical literature were tightened as a remedy for shortcomings the bureaucracy displayed in dealing with catastrophic floods.”

I suggest that, not only is this a serious misreading of Weber’s view of the Chinese mentality, not to mention as regards his understanding of the differing types of rationality, it seems to imply that the entire effort to interpret motivations by drawing inferences from the objective circumstances and cultural milieu of a people is unscientific. Such a rejection has far-reaching implications, for it would seem to undermine the very possibility of scientific cross-cultural and historical studies generally. Be that as it may, there is no doubting Schumpeter’s highly disparaging view of Weber’s methodological position. On another occasion we find the following passage: “Sociologists like Max Weber who stand for the interpretive method of social states or changes—that is, who believe that it is our main or sole business to try to understand what things meant to the people concerned—may easily drift into the position that the use of any concepts not familiar to the people under study involved the error of assuming that their minds function just like ours. Now this error may be involved but it need not be.” The subsequent illustration Schumpeter gives of how a businessman, for example, may be described as maximising his profits even though he may not understand that term himself is no criticism of Weber’s approach at all, and in our view displays a complete misunderstanding of Weber’s use of the Verstehen approach. Mistakenly in our view, Schumpeter regarded Weber as having remained under the influence of Schmoller, though he dubbed Weber along with Sombart and Spiethoff as being members of the ‘Youngest’ Historical School. Thus he writes at one point that the work of Schmoller was basically taken up by new men who remained under his influence and did not appear to separate themselves from that influence.

10 Ibid.
12 HEA, p. 34.
lists the most eminent members of the Youngest Historical School as Spiethoff, Sombart and Weber.¹³

In these remarks Schumpeter expresses a distinct ambivalence about Weber’s philosophical and epistemological efforts, contributions we maintain have been decisive for the development of the social sciences from the nineteenth century down to the present. Unfortunately, it is necessary to conclude that some of the statements made by Schumpeter reflect poorly on the quality of his thinking with regard to methodological issues. In the *History of Economic Analysis* he attempts to provide something of an intellectual history of the period of the early twentieth century and clearly demonstrates wide reading of and familiarity with the major thinkers of the day, but he never truly comes to grips with the sophisticated methodological analyses of Weber. It is simply not true to say that Weber’s methodology would be encompassed by the statement of Dilthey quoted, for Weber was fully aware that in social science there is a need not just to “understand” but to provide explanations for conduct that are “causally adequate”. And contrary to Schumpeter’s suppositions, Weber is quite prepared to admit that law-like relationships are to be found in the social domain and these may share some features with causal analysis in the natural sciences. Of course, what he did not accept was that there were “laws” of history or of historical development such as those advanced by figures like Hegel and following him Marx. Weber’s analysis of these questions is extremely perceptive and, to the present writer and to many others remains unsurpassed, so we reluctantly conclude that Schumpeter was insufficiently across this dimension of Weber’s work to make an informed and convincing critique.¹⁴

When Weber talks about the methods of sociology, he sometimes speaks of “explanatory understanding” or of “understanding explanation”, and he saw the need to combine the aspects of both understanding and explanation in order to produce adequate scientific results. And of course all this was brought to the fore in the creation of a completely new approach to social analysis, namely with the advent of “sociology”, of which he is a founding father.¹⁵ From what we have said above it is clear Weber fully appreciated the role of theory in economics and developed theories of his own in socio-historical analysis to a high level. In our view Weber’s achievements in methodology have not been understood or properly recognized by Schumpeter. As Yuichi Shionoya, otherwise an admirer of Schumpeter, says,

¹³ *Ibid*, p. 816. In a footnote to this discussion Schumpeter refers expressly to Weber’s work and speaks favourably of him as a man and as a colleague, but is decidedly ambiguous about his academic achievements: “Max Weber (1864-1920) was one of the most powerful personalities that ever entered the scene of academic science. The profound influence of his leadership—in large measure due to a chivalrous ardour for doing the right thing that sometimes verged upon the quixotic—upon colleagues and students was something quite outside of his performance as a scholar, yet was a vitalising force (milieu-creating rather than school creating) which it was impossible not to mention.” *Ibid*, p. 817.

¹⁴ Shionoya seems to concede as much in his otherwise sympathetic reading of Schumpeter’s methodology when he writes of “Schumpeter’s harsh criticism and partial misunderstanding of Weber’s methodology”, Shionoya (1997), p. 216.

¹⁵ A useful clarification of Weber’s views in this regard is to found in Fritz Ringer’s *Max Weber: An Intellectual Biography*, University of Chicago Press, 2004, at pp. 89-104.
Weber’s notion of the ideal type was essentially intended to reveal the structure of linkage between theory and history, not to exaggerate the distinction or dichotomy between the two. Specifically, it was a solution to the question of how historical concepts can be general and yet not loose their individuality. With regard to this question, Schumpeter had dismissed the importance of the neo-Kantian distinction between the abstract and the concrete, between the general and the individual because the one requires the other in a continual process of concept formation.¹⁶

From the above we can only suggest that Schumpeter completely misunderstood the notion of Verstehen. As we have already claimed, Weber’s methodology is much sounder than Schumpeter allows, and to this day it remains the most comprehensive and adequate account of the methods of the social sciences that we have. I am in agreement with Fritz Ringer whose recent study of *Max Weber’s Methodology* sees it as the most coherent statement of the principles that must govern any serious social scientific research for the time being and into the foreseeable future.¹⁷ Accordingly, I conclude that Schumpeter’s efforts in epistemology are limited and can remain adequate only in regard to the field of economic theory in the strict sense. I say this despite the efforts of Shionoya in his otherwise commendable book *Schumpeter and the Idea of Social Science* where he sets out to sympathetically explicate Schumpeter’s methodology.

Perhaps the impasse between Weber and Schumpeter as to methodology is not so deep and intractable as the above would suggest. In his book on Schumpeter Shionoya has provided by far the most detailed and thorough analysis of Schumpeter’s methodology to date, and he addresses the relationship of Schumpeter to Weber at some length. Despite the apparent divergence of the two methodologies, Shionoya concludes that they are not necessarily incommensurable. He interprets Schumpeter’s

¹⁶ Shionoya (1997), p. 213. On another occasion in his *History of Economic Analysis* Schumpeter’s expresses his view of Weber’s understanding of economics in most unflattering terms. He writes, “As a matter of fact, in the epoch of his ripest thought, M. Weber was not unwilling to declare that, so far as his almost complete ignorance of it enabled him to judge, he saw no objection of principal to what economic theorists actually did, though he disagreed with them on what they thought they were doing, that is, on the epistemological interpretation of their procedure.” (HEA, p. 819) There is a footnote to this passage in which Schumpeter adds, “It was with this motivation that he invited two strong partisans of economic theory, in the Marshallian sense, to write the ‘theory’ and the sketch of the history of doctrine and methods for his *Grundriss der Sozialökonomik.*” (Ibid) In a further note the editor points out the two theorists Schumpeter is referring to were of course himself and Friedrich von Wieser. Schumpeter seems to be saying that Weber’s inviting of himself and Wieser to make the *Grundriss* contributions shows that he was in some way amenable and perhaps sympathetic to economic theory though he did not really understand it. On the contrary, we say Schumpeter was not aware of the depth of Weber’s appreciation of economic theory and of the latter’s acceptance of much if not most of the major theoretical approaches the Austrian Marginalist School.

methodology as basically a version of “instrumentalism” by which he means a pragmatic approach similar to that advanced by philosophers like Mach and Poincaré who were important in the natural sciences. He quotes the following statement on the role of theory from Schumpeter’s early work on methodology *Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie*:

> The crucial point, upon which everything depends, lies in the distinction between two different aspects of the matter: on the one hand, we have fundamental arbitrariness of theories, on which their system, rigor, and exactness are based; on the other hand, we have the conformity of theories to, and their dependence on, phenomena, and this alone gives content and significance to theories. If one distinguishes between these concerns and places them in a proper relationship with each other, a clear interpretation will follow, and thus the difficulties and doubts that we come across in the usual discussion of these questions will be effectively overcome.\(^\text{18}\)

Shionoya argues that Weber too was a kind of instrumentalist from a methodological point of view, and interprets his use of ideal types as indicative of the same basic position on the relation of idea to reality as that held by Schumpeter. Thus he suggests that Weber and Schumpeter reached the same conclusions regarding concept formation but arrived there by different routes: positivism in Schumpeter’s case, neo-Kantianism in Weber’s: “... the methodologies of Weber and Schumpeter parallel one another and were essentially rooted in instrumentalism.”\(^\text{19}\) Further, Shionoya adds support to the thesis of the present writer by implying that the apparent methodological differences between the two thinkers should not prevent their substantive work being seen as basically compatible. He concludes saying, “Weber’s sociology was much more concerned with comparative static social systems than the dynamic process of evolution. This may explain why evolution-minded Schumpeter felt closer to Marx and Schmoller.”\(^\text{20}\) While I do not share Shionoya’s view that Weber was an instrumentalist like Schumpeter, I agree that the substantive work of the two can be brought together despite methodological differences.

### The Complementarity of Weber’s Approach with that of Schumpeter

Schumpeter’s lack of sympathy for the *Verstehen* approach in sociology is all the more remarkable because he places enormous store on his account of the mentality of the entrepreneur. It does not seem to have occurred to him that the origin of the particular aptitude for enterprise, which he so graphically, and shall we say sympathetically, describes requires explaining as such. Despite his depiction of the entrepreneur as having to avoid hedonistic indulgence so as to ensure the funds at his disposal are reserved for new and expanded business activities and despite his acknowledgement of the rationality underlying the entrepreneur’s introduction of novel methods of production, Schumpeter does not appear to recognize the relevance of Weber’s analysis of the work ethic and the problem of its origins in inner-worldly asceticism. Which is all the more puzzling because Schumpeter is adamant that the aptitude of the entrepreneur is not found universally and indeed is sufficiently rare for those suited to entrepreneurship to require being “selected,” in the Darwinian sense as it were. But if

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\(^{19}\) *Ibid*, p. 220.

\(^{20}\) *Ibid*. 

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selection takes place, the aptitude in question must surely be produced somehow, or be
supported by particular cultural conditions or discouraged by others. Once this is
admitted, of course, Schumpeter must find himself on Weber’s methodological territory,
and so the latter’s analysis of the peculiar rationalism of the modern bourgeoisie with its
vocational orientation as well as the diffusion of the work ethic across other strata comes
into play. Schumpeter’s entrepreneur, with his orientation solely to the market situation
and the price mechanism in concert with the rationality of business management and a
calculating mentality, are eminently suited to treatment by the Weberian approach. It is
worth recalling Weber’s description of those that harboured the spirit of capitalism in the
Protestant Ethic: “. . . they were men who had grown up in the hard school of life,
calculating and daring at the same time, above all temperate and reliable, shrewd and
completely devoted to their business, with strictly bourgeois opinions and principles.”
These orientations, we submit, are not a mere reflex of the operation of Schumpeter’s
capitalist mechanism. We are with Weber in saying that such a mechanism by itself
could not conjure up individuals with precisely those qualities that would make them
entrepreneurs and captains of industry; many other factors of non-economic character
were also needed.

But just as Weber’s work can complement Schumpeter’s approach in the fashion
just indicated, I believe Schumpeter adds valuable insights to Weber’s account of
capitalism. This is no more so than as regards his account of the operation of the
capitalist system conceived of as a vast network of exchange relations, ensuring a level
of on-going prosperity but having the discontinuous characteristics described so well in
Business Cycles. Importantly, Schumpeter characterizes this system as one operating at
the most general level as a “process of creative destruction.” In his Capitalism,
Socialism and Democracy he explains what he means by this dramatic phrase as follows:

The fundamental impulse that set and keeps the capitalist engine in motion comes
from new consumers’ goods, the new methods of production or transportation, the
new markets, the new forms of industrial organizations that capitalist enterprise
creates. . . . [However,] The opening up of new markets, foreign or domestic, and
the organizational development from the craft shop and factory to such concerns as
U.S. Steel illustrate the same process of industrial mutation—if I may use that
biological term—that incessantly revolutionizes the economic structure from within,
incessantly destroying the old one, incessantly creating a new one. This process of
Creative Destruction is the essential fact about capitalism. It is what capitalism
consists in and what every capitalist concern has got to live in.

These remarks about “creative destruction” warrant comparison with Weber’s
notion of the ineluctable conflict between formal and substantive rationality. Both
conceptualisations highlight the fact that capitalist progress brings with it inevitable
costs in terms of other values individuals hold. Schumpeter’s notion focuses particularly
on the impact of the capitalist mechanism on the less successful businesses, many of

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21 PE, p. 69.
22 CSD, p. 83.
23 Weber’s idea of the conflict between formal and substantive rationality is only one
dimension of his account of the role of conflict in social relations. In broad terms it is
probably accurate to describe Weber’s sociology as “conflict sociology” as he sees
conflict between individuals and groups as ineluctable and this partly accounts for his
scepticism in regard to any utopian solution to the predicament of the human condition.
which will lose out in the competitive struggle and in one way or another be wound up. Of course, this will entail a specific fate for many individuals who will become unemployed and suffer other related disadvantages. Weber’s insistence of conflict at the heart of rationality fully encompasses these effects, but focuses more broadly on the wider conflict of values that capitalism exacerbates. In comparison with the above quoted remarks of Schumpeter it is perhaps apposite to refer to some concluding comments found at the end of Weber’s *Protestant Ethic* in which he comments about the “mechanical foundations” of modern capitalism in its present incarnation and describes the experience of the individual under such conditions with reference to the celebrated “iron cage” metaphor:

The Puritan wanted to work in a vocation [volte Berufsmensch sein]; we must do so. For when asceticism was carried out of monastic cells into vocational life and began to dominate inner-worldly morality, it helped to build the tremendous cosmos of the modern economic order. This order is now bound to the technical and economic presuppositions of mechanical, machinelike production, which today determines with irresistible force the life style [Lebensstil] of all individuals born into this mechanism, not only those directly engaged in economic enterprise, and perhaps will determine it until the last ton of fossil coal is burned. In Baxter’s view the care for external goods should only lie on the shoulders of the saint like “a light cloak, which can be thrown aside at any moment”. But fate [Verhängnis] decreed that the cloak should become an iron cage.24

Weber does not say that the ascetic legacy of the Puritans has ceased to be of consequence, nor that a vocational ethos no longer has a bearing on the present manner of economic life. Both these elements continue to have significance, but now that the economic cosmos of capitalism has come fully into its own, these initial dispositions of action have been modified and detached from their religious origins. The ultimate effect of the mechanism of the capitalist engine is that it imposes a specific fate on the individual, whether an entrepreneur or an employee/worker, to fashion a work-a-day attitude and to adopt a methodical and disciplined lifestyle, as these are requirements of economic survival. In referring to the unavoidable element of compulsion suffered by the individual forced to live under the competitive conditions of the market system, Weber at one point characterizes it as “masterless slavery.” With this term he recognizes the intense pressure associated with modern economic life but eschews any suggestion of a Marxian class struggle—because both capitalists and workers are subject to this pressure albeit in separate ways. But it is just the operation of this capitalist system in its most developed forms that Schumpeter makes his central task. The arena of economic competition Schumpeter describes with the notion of creative destruction is dominated by the imperative of “economic survival of the fittest,” an idea Weber also employs to summarize his view.25

Of course any enquiry into the relationship of Schumpeter and Weber must consider the compatibility of their respective definitions of capitalism. As we have seen, for Weber capitalism is defined in large measure sociologically, in terms of the orientation of the actor to profit opportunities in the market place and in terms of a rationality expressed in the accounting procedures of double-entry bookkeeping. Weber is referring to the circumstances of the contemporary businessman, calculating each step of

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25 PE, p. 55.
his activity in consideration of the chances of profit estimated in accordance with the
known costs of production inputs and the expected sale prices of the goods produced.
Insofar as his activity achieves a high level of rationality, these calculations are
performed rigorously and systematically. Also at the heart of Weber’s thinking about
modern capitalism is the role of the modern bourgeoisie, a class that he characterises at
some length in the Protestant Ethic. The bourgeoisie is typically oriented to the
acquisition of wealth and profit making through market-oriented business enterprise.
The emergence of this ethos entailed a high valuation of success in the conduct of
worldly affairs—“inner-worldly asceticism”. Its outlook, according to Weber, gives rise
to and sustains the modern work ethic that galvanizes entrepreneurs and capitalists as
well as those who work in the professions, and it even animates the workers where it
finds expression as workplace discipline.26

By contrast, though not necessarily at odds with what we have just said of Weber,
Schumpeter’s definition of capitalism is focused primarily with the workings of the
economic system as conceived by the science of economics. As we have shown, he also
sees capitalism as a system oriented to profit making but his emphasis is on the element
of credit creation and the funding of innovation by bank loans. It is noteworthy that he
does not appear to explicitly acknowledge the crucial relevance of capital accounting, as
does Weber. When Schumpeter conceptualises capitalism, he focuses on the matrix of
interconnections between the elements of the economic system. He accepts most of the
achievements of classical economics, in particular the contributions of Walras and the
marginalist school. Where he may differ from Weber is in his emphasis on the dynamic,
discontinuous character of modern capitalism—his focus on continuous fluctuations.
Weber, by contrast, does not dwell on the instability of capitalism, its inherent tendency
to revolutionize its own achievements and cause crises. If anything, Weber’s emphasis
on rationality, routine and calculation suggests he regarded capitalism as potentially a
good deal more stable and predictable than Schumpeter allows. Speculative booms
followed by collapse and recession are, on the other hand, phenomena absolutely
essential to Schumpeter’s overall vision, and he goes to great lengths to show why these
fluctuations are built into the very logic of the capitalist system.

Weber’s General Attitude toward Modern Capitalism

Generally speaking, Weber took the view that capitalism as a socio-economic system
might persist indefinitely into the future—“until the last ton of fossilized coal is
burnt”27—and thus he rejected the Marxist view that inherent contradictions of
capitalism would cause a final collapse at some point in the not too distant future. This
is an issue upon which Weber’s position would appear to diverge markedly from that of
Schumpeter who to a certain extent accepts the Marxian view that the capitalist era has a
limited life-span. Further, Weber was highly sceptical about Marxist theories
concerning the desirability of socialism due to its superiority over chaotic, crisis-prone
capitalism.28 Marx’s predictions were based on the so-called “pauperisation thesis” in

26 See Weber’s general remarks on discipline in ES, pp. 1148-50.
27 PE, p. 181.
28 At this point it is worth mentioning an anecdote that indicates the respective attitudes
of Weber and Schumpeter as regards the prospect of socialism. Karl Jaspers relates how
Weber and Schumpeter met in a Vienna coffeehouse after the Russian Revolution had
combination with his theory about the inevitable concentration and centralisation of capitalist economic power, all of which he thought would lead to increasingly intense system-wide crises culminating in a revolutionary transformation. Against this Weber in an essay on socialism delivered in 1918 referred to the increasing self-regulation of capitalism through cartels and syndicates, and he suggested that these would reduce the impact of economic crises. He also differed significantly from Marx with his recognition of the significance of the middle classes, persons who do not occupy the same propertyless situation as the working class and who are beneficiaries of capitalist prosperity. Nonetheless, Weber was not unsympathetic to the hopes of workers for greater economic and political opportunities, and he criticized his own bourgeois compatriots for their authoritarianism and unfounded fear of working class liberation. Weber sets out his views in this regard is the following passage:

We reject, partly in principle and partly as inadequate, the point of view of master rule or patriarchalism, the bonds of the welfare institutions and those who would treat the worker as an object for bureaucratic regulation, and insurance legislation that merely creates dependency. We affirm the equal participation of the workers in the collective determination of working conditions, and to this end, we also affirm the strengthening of their organizations, which spearhead this effort; we see the comradeliness and class dignity that develops in this way as a positive value . . . we want to live in a land of citizens, not of subjects.29

But the much-derided separation of the worker from the means of production, which was a focal point of the Marxian critique of capitalism, Weber insisted would not be improved by a socialist transformation of the economy: “It is a serious error to think that this separation of the worker from the tools of his trade is something peculiar to industry, especially to the private industry. The basic state of affairs is unaltered when the person at the head of the machine is changed—when, for example, a state president or prime minister controls it instead of private individuals.”30 Thus Weber argued that a future elimination of private ownership of the means of production would not eliminate the fundamental problems of industrial society, for those in managerial positions would continue to dominate the workers and there would be other undesirable effects. Insofar as he accepts the Marxian idea of the “alienation of the worker,” Weber attributes the problem as much to the effects of large-scale bureaucratic structures and the centralisation of power in the hands of a monopolistic state. Any socialist economy would simply perpetuate these problems and if anything make them worse: “This [problem of alienation] would also be true particularly of any rationally organised


29 Quoted in Wolfgang Mommsen. Max Weber and German Politics, University of Chicago Press, 1984, p.120.
socialist economy, which would retain the expropriation of all workers and merely bring it to completion by expropriating the private owners.”

Weber did not deny that capitalism could be overthrown and in fact he lived to see not only the Russian revolution but also the revolutionary upheaval in Germany in 1918-19. During the latter period of the war and just after, there was intensive debate about possible socialisation of the economic system and there were moves toward the nationalization of industry and banking. Weber was deeply engaged in these debates and made significant contributions to the theory of a socialist economy. He did not hold the view, which other liberal commentators held at the time, that a socialist economic system could not be viable. As he explained,

A progressive elimination of private capitalism is theoretically conceivable, although it is surely not so easy as imagined in the dreams of some literati who do not know what it is all about; its elimination will certainly not be a consequence of this war. But let us assume that sometime in the future it will be done away with. What would be the practical result? The destruction of the iron cage of modern industrial labour? No! The abolition of private capitalism would simply mean that the top management of the nationalised or socialised enterprises would become bureaucratic as well.

Ultimately, the problem of socialism for Weber concerns the fact that it does not effectively resolve the fundamental problem of how, given the tendency towards bureaucratisation of all aspects of social life, “some remnants of ‘individualistic’ freedom of movement” can be retained.

A most interesting argument against socialism is contained in a passage in Economy and Society in which Weber discusses “The Mainspring of Economic Activity”. He raises the possibility of a socialistic planned economy in which decision-making would be in the hands of a central authority and then invites the reader to consider the ideal state in which some right of “co-determination” is given to the population at large. But immediately this is envisaged, Weber insists, it must result in “the fighting out of interest conflicts centring on the manner of decision-making and, above all, on the question of how much should be saved . . . “. But, he goes on, “What is decisive is that in socialism, too, the individual will under these conditions ask first whether to him, personally, the rations allotted and the work assigned, as compared with other possibilities, appear to conform with his own interests. . . . violent power struggles would be the normal result . . . ” These would be struggles over ration allocations, extra rewards for heavy labour, work conditions, unpopular supervisors and many other issues, and they would be fought through the development of organized groups. Just as under capitalism, the interests of individuals would underlie the motivation of the majority, even where ideological commitment to socialist values in enjoined. This pessimism about human nature is justified because the mass of men do not act from such self-sacrificing motives, “and it is an induction from experience that they cannot do so and never will.”

31 ES, p. 139.
32 See for example the section 14 of Chapter 2 of Economy and Society that deals with the concept of planned economy.
33 ES, pp. 1401-2.
34 ES, p. 203.
Weber also differed from Marxism in regard to the nature of classes and class struggle. He did not deny altogether the significance of class struggle and recognized that in certain circumstances naked class interest could lead to mass action and even be decisive for political outcomes, but generally speaking this was not the case. Also, Weber did not think that the distinctions between classes were as straightforward and that class interests were as polarized as Marx believed. So, for example, Weber distinguished between property and commercial classes and pointed out that property classes tend to cause the economic system to stagnate because they have less interest in change whereas commercial classes, on the other hand, contribute to a more volatile situation. The key positively privileged classes are made up of entrepreneurs, managers and those in the professions whose skills and expertise based on education are crucial for the development of the modern industrial system.

Overall, Weber took the view that, rather than abolishing capitalism, the better option is to adapt and humanize it. Thus, he defended capitalism in a qualified way by arguing that, in spite of its problems, for the foreseeable future it remains the most practical way of maintaining a measure of both freedom and prosperity. He therefore sought to reinforce the same dynamic features of the capitalist system that Schumpeter celebrated, and he promoted measures designed to limit the bureaucratisation accompanying a growing state. At the same time, he supported the emancipation of the working class both in political and in social terms, seeking in particular reforms that would allow socialist political parties full participatory rights in a parliamentary system based on the English model. Paradoxically, at the same time he encouraged the “bourgeoisification” of the socialist parties and welcomed their preparedness to forego revolution and engage with the electoral process. He not only advocated measures to extend working class political rights, he was also sympathetic to the working class movement and unions in the struggle with entrepreneurs over better wages and conditions. He supported progressive social legislation in order to improve health and safety standards and protection of the weak, in part for ethical reasons, in part because it would increase the power position of the weaker classes.\(^{35}\)

Wolfgang Mommsen has suggested that Weber’s attitude to cartels and monopolies represents something of a contradiction within his position on capitalism because in some ways these are the natural outgrowth of a competitive situation in which sooner or later the strong come to dominate. So the question arises whether Weber favoured a radical laissez-faire economy, as later advocated by Mises, Hayek and others, or whether in seeking to curb the excesses of capitalism he was advocating a kind of regulated capitalism and was thus closer to social democracy than to classical liberalism. Mommsen suggests Weber never systematically discussed this contradiction. He argues it is difficult to know whether Weber would have favoured a liberal or an interventionist policy in the present—to put it bluntly, “would he have given preference to Keynes or Friedman”?\(^{36}\) Mommsen says that Weber took the view that the role of politics in a capitalist society is to foster dynamic economic growth so as to avoid a situation in

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which a dominant class can perpetuate itself by holding society in a state of petrification. This of course assumes that the state under bourgeois conditions will not suffer adversely from authoritarian control by the dominant economic interests. This concern was precisely that of Marx for whom the capitalist state was nothing but a committee for organising the common affairs of the bourgeoisie. For Weber, on the other hand, the state in bourgeois society retains a certain level of autonomy vis à vis the interests of the dominant classes.

Hence, Weber’s position is not that capitalism should be defended at all costs on quasi-ideological grounds, that it should be justified as an ideal system as, say, in Manchester liberalism. In any event, a pure form of laissez-faire capitalism did not exist in Weber’s day and has probably never existed anywhere. But major elements of the ideal-type of competitive capitalism are present in many societies and to a degree they underpin the ongoing efficiency and productivity of the modern economic system. The challenge for Weber was to retain the liberal values and human rights that have come down to us from the era of the rise of the modern bourgeoisies along with the benefits of the dynamic economy. Unfortunately, some substantive values can only be achieved at the cost of curtailing the formal rationality of the capitalist system. Hence, Weber’s insistence that formal and substantive rationality are in eternal conflict and that an ultimate resolution of this antinomy is not possible.

Weber’s attitude toward capitalism must be situated by consideration of his general political stance, especially as regards his view of the nation state and his support for Germany’s emergence as a leading world power. His politics was tempered by his appreciation of the ultra realism and anti-utopianism of figures like Machiavelli and Nietzsche. According to Scaff, . . . political economy (Nationalökonomie) had a strong national component for Weber, much as it had had earlier for List. In contrast to the classical theory of value and exchange, Lists’s theory of the “national system” stressed the development of “productive forces” and acceptance in principle of protectionism and state intervention. . . . Weber placed political economy in the service of “the permanent economic and political power interests of the nation,” insisting that the popular “economic point of view” contained no standards of practical judgement.37 These ideas were notably set out in Weber’s Inaugural Lecture of 1895 “The National State and Economic Policy”. His general perspective on the role of the economy can be gleaned from the following passage:

The economic policy of a German state, and the standard of value adopted by a German economic theorist can therefore be nothing other than a German policy and a German standard. . . . we should not abandon ourselves to the optimistic expectation that we have done what is necessary once we have developed economic progress to the highest possible level . . . Processes of economic development are in the final analysis also power struggles, and the ultimate and decisive interests at whose service economic policy must place itself are the interests of national power. . . .

Whether Weber held completely to these attitudes expressed so forcefully in his early career through his more mature years is questionable, but later works such as “Politics as

a Vocation” and “Parliament and Government in a Reconstructed Germany” are decidedly more nuanced and have a very different tone and quite other emphases. Weber’s political position, especially in the light of the fate of Germany subsequent to the two World Wars, has of course been subject to significant criticism, but we cannot explore these questions further here. Suffice it to say that we do not consider Weber’s broad contributions to the theory of capitalism to be seriously flawed as a consequence of his strong nationalist predilections.

Schumpeter’s View as to the Prospect of Socialism

In contrast to Weber, Schumpeter viewed socialism, somewhat like Marx, as an ultimate outcome of a capitalist society. Furthermore, again like Marx, he does not think a transition to socialism would necessarily undermine the progressive achievements of the capitalist era. This is because he believed a central bureaucracy could in the future carry on the innovative role that has hitherto been born by the entrepreneur, and further, that this need not otherwise be negative for liberty. In an essay entitled “Can Capitalism Survive?” based on a talk given in 1936 Schumpeter discusses the long-term prospects for the capitalist economic system at some length. He comes to the conclusion that, despite the phenomenon of business cycles and the tendency for periodic crises, the underlying progressiveness of capitalist development is something that will continue into the foreseeable future. On the basis of tendencies operating in the 1930’s he projected what the likely performance of the economy might be in fifty years hence: “Now I hold that there is no reason to assume that if the system is left to itself distribution will change very much, and if we apply the distribution and functioning which we get now to 1978, we should stand to get an income a head which would do away with the phenomenon of poverty, in whatever sense it is useful to speak of poverty. This does not mean that there will be no people suffering from poverty.” But despite this prospect of ongoing development and prosperity, Schumpeter comes to the paradoxical conclusion that capitalism is unlikely to survive in the long term. He gives two reasons for this:

The first reason is that other aides to the forms of life present themselves to humanity, just as Christianity presented itself at a time in the Roman world when nobody could have foretold its decline from its economic process. . . . Capitalism so transforms our requirements, our cultural scheme and values, as to make those economic adjustments which economic machineries demand unbearable, as to draw away the beliefs, the social psychological basis from under the institutions of property and so on for good or for ill. And as soon as that happens, we make another discovery . . . capitalism is an organization which can’t stand on its own feet. It did well for a time in Europe as long as it was protected by an aristocracy and a monarchy which had free capitalistic rules, [but it] tumbled down at once when these things were removed. If it came to stay for a time here [in the United

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39 FMW, pp. 77-128.
40 ES, pp. 1381-1469.
41 The most detailed and nuanced critique of Weber’s politics is Wolfgang Mommsen, Max Weber and German Politics, University of Chicago Press, 1984.
States] it was only because the fascinating sound of the opportunities for new millions drew the minds of people from other things but it probably can’t stand by itself yet. And so I come to the diagnosis that the system will not survive, if by an entirely different line of reasoning [than Marx]. But the result as far as prediction goes, is very much the [Marxian] one, although I am not a Marxist and although I have no tendency for socialist systems at all. It is of course that . . . such a process of dying off takes time, and that in the process of dying off many intermediate points and intermediate forms of organization are likely to occur. It is futile to think that regulated capitalism can stand any more than unregulated capitalism. Political support would not be forthcoming for either.43

He goes on to speculate that the building of an efficient well-trained civil service and the creation of a form of socialism managed by such a body is the likely outcome. In *Capitalism, Socialism and Democracy*, Schumpeter explores these themes at some length. There he writes:

> Progress itself may be mechanized as well as the management of the stationary economy, and this mechanization of progress may effect entrepreneurship and capitalist society as much as the cessation of economic progress would. . . . Thus economic progress tends to become depersonalised and automatized. Bureau and committee work tends to replace individual action. . . . Since capitalist enterprise, by its very achievements tends to automatize progress, we conclude that it tends to make itself superfluous—to break to pieces under the pressure of its own success.44

There are further features that will lead eventually to the demise of capitalism. Most significant among these is the impact of monopolistic, large-scale business organization. As we have seen, as capitalism matures it creates organizations that depersonalise and/or atomatize what had initially been the function of the entrepreneur: “innovation is being reduced to routine”.45 Many things that were once visualised by the genius of the entrepreneur can now be strictly calculated. There are processes of rationalisation and specialisation at work. The entrepreneur is displaced and the bourgeoisie are reduced to mere stockholders without any unique creative role. This transforms the economy into a state that is in effect a form of socialism. He defines socialism as “an institutional pattern in which the control over the means of production and over production itself is vested with a central authority.”46 Though not an advocate as such of socialism, Schumpeter is nonetheless convinced it is a perfectly feasible way of coordinating an industrial economy, that it will appear sooner later in the modern West, and furthermore, that it is not necessarily incompatible with democracy.

In these discussions Schumpeter developed a more sociological approach to his analysis of the capitalist system, which in some sense contradicts his focus on developments arising only from within the capitalist mechanism per se. He makes an important distinction between capitalism understood as the economic system proper and the “capitalist order” by which he means the political and social conditions that underpin the economic system. And increasingly as he develops his argument as to the future of capitalism the analysis depends on the role of the socio-political order. In the case of England, Schumpeter argues that the support of the aristocracy was crucial for the

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44 CSD, pp. 131-4.
46 CSD, p. 167.
capitalist order in its infancy; for it, "made itself the representative of bourgeois interests and fought the battles of the bourgeoisie."  

Today, this support no longer exists and instead there are significant social forces aligned against the capitalist system. In particular, Schumpeter believes that the intellectuals have become increasingly hostile toward capitalism and are undermining belief in the system. His reasoning on this involves a number of steps: “One of the most important features of the later stages of capitalist civilization is the vigorous expansion of the educational apparatus and particularly facilities of higher education.” This creates an oversupply of services in professional, quasi-professional and in the end in all white-collar positions causing unemployment or “unsatisfactory” employment—that is, low paid work or work in substandard conditions. These individuals swell the ranks of the intellectuals who become increasingly disaffected and resentful at a society that has disappointed their career expectations. The intellectuals’ role is particularly important in the trade unions, for, “they verbalized the movement, supplied theories and slogans for it—class warfare is an excellent example—made it conscious of itself and in doing so changed its meaning . . . and radicalised it, eventually imparting a revolutionary bias to the most bourgeois trade-union practices, a bias which most non-intellectual leaders at first resented.”

In summing up all these developments Schumpeter writes somewhat contradictorily:

Capitalism, whilst economically stable, and even gaining in stability, creates, by rationalising the human mind, a mentality and a style of life incompatible with its own fundamental conditions, motives and social institutions and will be changed, although not by economic necessity and probably even at some sacrifice of economic welfare, into an order of things which will be merely a matter of taste in terminology to call Socialism or not.

Schumpeter’s theory of the transition to socialism has obvious affinities with Marx insofar as both see the ultimate end towards which the capitalist mechanism is heading as one in which the state and/or a planning organization of some kind displaces the entrepreneur. For both this spells the death knell of capitalism. But for Schumpeter the underlying causes of this outcome are not so much Marx’s class struggle but a range of other factors. Schumpeter argues, somewhat akin to certain themes in Weber, that the more thoroughly the natural and social worlds are mastered theoretically the more perfect is control of the realm of economic affairs. As this happens the significance of the function of entrepreneurship and the entrepreneur’s economic leadership decreases and accordingly the importance of the entrepreneur type diminishes. Unlike his fellow Austrians, especially Hayek and Mises, and at odds with Weber as well, Schumpeter took the view that at least in theory a socialist economy was just as capable of functioning efficiently as was a capitalist one. To support his position he adopted the perspective outlined classically by Pareto in his Cours d’Economie Politique following the original contributions of Enrico Barone. These thinkers had shown that under the conditions of a feasible socialist system it is possible “to derive, from its data and from the rules of rational behaviour, uniquely determined decisions as to what and how to produce . . . [that] those data and rules, under the circumstances of a socialist economy, yield equations which are independent and compatible . . . and sufficient in number to

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47 CSD, p. 136.
determine uniquely the unknowns of the problem before the control board or ministry of production.”

Barone’s position, according to Schumpeter, was in effect nothing but the Walrasian system applied to a centrally planned economy. The idea that a central bureaucracy could set prices sufficiently rational to be capable of generating an efficient allocation of resources, as is known, was later refined by figures like Oscar Lange and A.P. Lerner. Indeed Schumpeter goes further than simply saying that a socialist economy is perfectly feasible and suggests it may even be capable of quite high levels of rationality. Somewhat contraditorily given the thrust of his analysis of capitalism he suggests that socialism may actually be an improvement on the efficiency of the capitalist economic system because central direction will avoid “the uncertainty about the reaction of one’s actual and potential competitors and about how the general business situations are going to shape.”

Further, a socialist economy could potentially eliminate economic cycles and the associated problems of unemployment and inflation. Indeed, “socialist management may conceivably prove to be as superior to big business capitalism as big business capitalism has proved to be to the kind of competitive capitalism of which English industry of 100 years ago was the prototype.”

The tendency towards socialism is brought in part by the rationalism of the bourgeoisie itself. It is the peculiar role of bourgeois intellectuals to engage in a kind of imminent critique of a capitalist order. “The bourgeois finds to his amazement that the rationalist attitude does not stop at the credentials of kings and popes but goes on to attack private property and the whole scheme of bourgeois values. The bourgeois fortress thus becomes politically defenceless.” There is no longer any passion to defend the capitalist order. Schumpeter obviously has in mind here the role of intellectuals such as those he must have encountered on a regular basis in his academic career and who foster an anti-capitalist ideology. Bureaucrats are open to conversion to the thinking of these intellectuals with whom, through similar education, they have much in common. All of this leads to a kind of despair in which the bourgeoisie is simply unable to defend his world: “the only explanation for the meekness [of the bourgeoisie] we observe is that the bourgeois order no longer makes sense to the bourgeois himself and that, when all is said and nothing is done, it does not really care.”

In the absence of an effective protective stratum the capitalist system is left without the conditions of its ongoing existence into the future.

It must be said that this account of the role of intellectuals and of the self-destruction of the bourgeois order although suggestive is far from convincing. For it does not seem to have occurred to Schumpeter that the rationalism of the bourgeoisie may not be so inclined to self-destructive critique, especially when much of its intellectual energy has hitherto been devoted promoting the benefits of the capitalist

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50 CSD, p. 172.
51 Ibid, p. 186.
52 Ibid, p. 196.
53 Schumpeter’s views are quite prophetic given the rise of the counterculture in the sixties and the related social movement based on rejection of capitalist values that arose in western societies at that time. Nonetheless, capitalism did not collapse, the socialist movement was not able to sustain the momentum it gained through that explosion of sentiment and has atrophied.
54 Ibid, p. 155.
order. In other words, why should the bourgeoisie choose to undermine their own power and economic wellbeing and become advocates of socialism? Surely Marx’s view is closer to the reality when he argues that perhaps a few bourgeois intellectuals may detach themselves from their class allegiance and, seeing the future lies with socialism, become supporters, but the majority of this class will remain loyal to the capitalist order and most likely need to be eliminated via revolution. According to Schumpeter, as with Weber, it is fundamental to the way in which the mentality of the bourgeoisie class developed that it has fostered a rationalist ethos. But rather than seeing calculating rationality as something emergent which helped to create modern capitalism, as Weber claims, Schumpeter inverts the relationship and argues that it is capitalism that generates rationality. The “inexorable definiteness” and “quantitative character” that distinguishes the economic form from other spheres of human action engenders the “rational habit” giving rise to “the towering monument of double entry bookkeeping”. In a broad ranging historical discussion, Schumpeter refers to a whole panoply of individual achievers and early entrepreneurs—such as Galileo, Leonardo Da Vinci, Alberti, Celini, Dürer, Jacob Fugger, Agostino Chigi—as persons in some sense conjured up by the capitalist engine. And he refers to the growth of rational science and modern medicine as being bi-products of the capitalist process just as is modern education. Finally, even democracy is said to have developed in the wake of modern capitalism. But surely, in these passages Schumpeter is exaggerating the causal efficacy of his capitalist mechanism. He risks completely inverting the proper relationship of cause and effect by insisting that all these phenomena are products of capitalism—which is not to deny that capitalism may, for example, further develop the rational orientation of action once it has come into being, as Weber acknowledges. Schumpeter seems to engage in a contradiction of his own theory because in placing so much emphasis on the entrepreneur and his unique role in the course of capitalist development he does not allow for an historical process whereby that individual and his characteristics were brought into being.

Schumpeter’s theory of rationality and its involvement in the long-run course of historical development surprisingly appears to imply a kind of “negative dialectic” in the fashion of the famous thesis of Adorno and Horkheimer. For, paradoxically, he appears to argue that it is the very rationality of capitalism that causes its ultimate demise, because the bourgeois class through the criticism of its avant guard intellectuals will ultimately lead to the break down of the capitalist framework of society. It has to be said, however, that this idea is highly questionable resting as it does on the view that the capitalist order of society requires buttressing by an aristocratic residue of the pre-capitalist era. According to Schumpeter, capitalism requires a society that has a

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56 Ibid. p. 123.
57 Ibid, p. 126. Schumpeter’s views here warrant the corrective of Weber’s repeated warnings that pre-modern capitalisms ought not be confused with rational capitalism proper, however much entrepreneurial elements may have arisen in earlier times. For example, Weber explains that “patrimonial capitalism” involving the royal monopolistic founding and protection of new industries was not uncommon in the pre-modern era in England under the Stuarts, in France under the Bourbons, in Russia with Peter the Great and in Prussia with Frederick the Great, but these developments did not turn the countries concerned into industrial states. See ES, pp. 1098-99.
protective social stratum. He points out that it emerged in the “steel frame” of feudalist
society. He says that in the course of history, “with the utmost ease and grace the lords
and knights metamorphose themselves into courtiers, administrators, diplomats,
politicians and into military officers of a type that had nothing to do with that of the
medieval knight.”

The symbiosis of the two strata, the medieval knights and the
capitalist bourgeoisie, created the conditions under which capitalism could flourish
because the capitalist class needed a master and it could not provide this itself. But this
lack is fatal for the ultimate future of capitalism because capitalist progress destroys the
protective strata that it depends on.

These views prompt further comments. In the first place, the view that with
progressive rationalization the entrepreneurial function becomes redundant is somewhat
simplistic and from the perspective of the present seems unlikely. It brings to mind
Engels’s notoriously naive remarks about the prospects for the elimination of the state
under socialism and its simple replacement by a planning authority.

Clearly, Schumpeter completely underestimated the difficulty of operating an industrial economy
without the structures of the modern business firm and its peculiar forms of
entrepreneurial management, and curiously, what he says about this seems utterly at
odds with much of what he has argued previously. Secondly, there seems to be a
fundamental contradiction in the structure of Schumpeter’s argument as to the basis of
the capitalist system. For until he had raised the issue of the possible demise of
capitalism and begun to speculate on its ultimate trajectory into socialism, Schumpeter
had been adamant that capitalism was to be understood in terms of the functioning of an
internal economic mechanism and that external non-economic factors were decidedly
secondary. Now it appears that capitalism is highly dependent on a range of external
factors including the attitudes of the population towards private property, support of an
aristocracy and a compliant intelligentsia. And further, Schumpeter had previously
argued that various features of the capitalist mechanism such as monopolization and the
collapse of inefficient enterprises are not at odds with its underlying rationale because
these facilitate increases in efficiency and productivity and are integral to “progress”. In
his later speculations he argues that the demise of small-scale business is a threat to the
survival of capitalism: “The political structure of the nation is profoundly affected by the
elimination of a host of small and medium-sized firms the owner-managers of which,
together with their dependents, henchmen and connections, count quantitatively at the
polls and have a hold on what we may term the foreman class that no management of a
large unit can ever have; the very foundation of private property and free contracting
wears away in a nation in which its most vital, most concrete and most meaningful types
disappear from the moral horizon of the people.”

Admittedly, Schumpeter says that
for the immediate future “. . . enterprise is still active, the leadership of the bourgeois
group is still the prime mover of the economic process.” However, the tendency toward
another entirely different structure of civilization, namely socialism, “slowly works deep

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59 Ibid, p. 137.
60 The classic statement appears in his essay “On Authority” in Marx and Engels:
Collected Works, Vol 1, Moscow, 1950, p. 663.
61 Ibid, p. 140-1.
It has to be realized that, through much of the period that Schumpeter was writing and thinking about these issues, the presence of social movements and political parties directed to bringing about a socialist outcome were prominent in the political landscape. Of course in 1917, the Soviet Union came into being, and throughout Europe in the 1930’s and into the 1940’s there were experiments with various socialist systems. The idea that capitalism was likely to be replaced at some point in the future by a socialist society was a widely held view and Schumpeter was evidently captured by the prospect. Although he does not discuss their work at great length, he certainly came into contact with and was to some degree influenced by a number of prominent socialist and Marxist thinkers of his day. In particular, he personally knew Rudolph Hilferding whose influential book *Finance Capital* was published in 1910. He had a close association with Friedrich von Wieser, who was very sympathetic towards socialism, and also with Otto Bauer, who had been elected as president of the Socialisation Commission of the Austrian government. It is worth briefly recounting Schumpeter’s career in government affairs to show the extent to which he was intimately acquainted with the problems of a socialized economic system. He had at one stage in 1919 acted for a few months as a consultant to the Socialisation Commission in Berlin, a body in which Hilferding was a fellow participant. Then, also in 1919, Schumpeter took the position of Finance Minister in the first Austrian republican government and was effectively supported in that position by the socialist party. The socialist party at that time had as its object the socialisation of all branches of its economy. Schumpeter continued to advocate views that had remarkable coincidences or parallels with the ideas of Marx and Hilferding, especially insofar as he recognised the increasing concentration of capital with the formation of large corporations. To some degree Schumpeter’s discussion of these processes, involving as they do the further rationalisation and bureaucratisation of capitalist organizations, also relied on the unacknowledged influence of Weber.

Some commentators have thought that Schumpeter’s involvement with Austrian socialization efforts, his role as a minister and his predictions about the demise of capitalism meant that he had become a committed socialist, but this is not so. This is made clear in the pamphlet he wrote in 1918 entitled in English “The Crisis of the Tax State” that contained an outline of his policy recommendations just prior to his becoming Finance Minister. On the issue of how best to transition from war to peacetime production, Schumpeter advocated that the best thing the government could do was to refrain from interfering so as to,

release the tremendous reserves of energy which in Austria are wasted by the incessant battle against the shackles by which foolish legislation, administration and politics restrain every economic move, and which deflect the entrepreneur from his organization, technical and commercial tasks, leaving him as the only way to success the backstairs to political and administrative bureaus. . . . I do not want to extol the free enterprise economy as the last word or wisdom. Nor am I an uncritical admirer of the bourgeoisie. But what needs to be done now, is exactly what it can do best . . . The hour of socialism will come, but it has not arrived as yet.

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62 Ibid, p. 163. For a detailed critique of Schumpeter’s ideas on the demise of capitalism, see Richard Coe and Charles Wilbur, *Capitalism and Democracy; Schumpeter Revisited*, University of Notre Dame, 1985.
The hour that is, belongs to free enterprise. Only at the price of heavy sacrifice even for the working classes could the free enterprise system be given up at this time.63

Later, Schumpeter took the view, as we have seen, that, as the economic system was becoming increasingly impersonal and bureaucratised, it was developing into a single great machine operating in an automatic and organised fashion and that in such circumstances the role of the entrepreneur would eventually be eclipsed. He surmised that the entrepreneur would be replaced by officials operating within large bureaucratic organizations, individuals who would be capable of systematically introducing innovations without the need for the individual entrepreneurial types that had characterised capitalism in its heyday. He at one point even posits the existence of two fundamental stages of capitalism, the first that in which the entrepreneur is predominant, and a second, coming stage which is possibly a precursor of socialism in which the entrepreneur will cease to be a leading force. Thus, in 1928, he wrote that despite his reluctance to divide economic history into epochs, “... it is still permissible to date the prevalence of capitalist methods from about the middle of the eighteenth century (for England), and to call the nineteenth century ... the time of competitive, and what has so far followed, the time of increasingly ‘trustified’, or otherwise ‘organised’, ‘regulated’ or ‘managed’ capitalism.”64

Schumpeter’s views on the whole question of socialism would appear, with hindsight and from the point of view of the present writer, to have been significantly mistaken on the big issue of the overcoming of capitalism and it replacement by socialism. This is especially the case in the light of the Stalinist terror and eventual economic collapse of the Soviet Union and events such as the Great Leap Forward and the Cultural Revolution in the People’s Republic of China, not to mention the other abortive attempts at bringing about true socialism during the twentieth century in Europe and the Third World. And Schumpeter’s view of the diminishing role of the entrepreneur under the conditions of late capitalism also seems largely mistaken. Arnold Heertje writes: “... on the whole, there are traces of a Schumpeterian development in our Western economies, but mechanization and routinization of entrepreneurial function is by no means the general picture. ... In short, it is [as before] the dynamic, ever-changing scene for entrepreneurs who have to be inventive and sensitive to new opportunities.”65 By contrast, Weber’s oft-expressed concerns about the likely impact of socialist experiments, the present writer believes, have been largely born out by events since his day. This is the case in particular in respect to his forebodings about the prospects for individual freedom with state domination of the economy, as the ravages of Stalin and Mao are all too tragic testimony.

Schumpeter’s Critique of Keynes

Leaving to one side Schumpeter’s speculations regarding socialism, his writings otherwise seem to presuppose the continuation of capitalism for the foreseeable future.

64 “The Instability of Capitalism”, p. 48.
and his analyses are generally supportive of an un-regulated market system. In this regard it is worth considering at some length his views on the emerging role for the interventionist/welfare state, views that are closely bound up with his response to Keynes’s celebrated book *The General Theory of Employment, Money and Interest*. It is apparent that Schumpeter had a competitive and somewhat combative relationship with Keynes. As already pointed out, the publication of *The General Theory* to some extent appears to have gazumped Schumpeter insofar as its “success” caused Keynes to steal the limelight and overshadow his own achievements that were to culminate only later with *Business Cycles*. The enthusiasm for the Keynesian perspective and the adoption of its policy implications by successive governments in the post-war period irritated Schumpeter who believed *The General Theory* was seriously flawed. Oddly, he does not address Keynes at length in any of his works, though there are several short pieces that discuss his writings. There is no doubt that Schumpeter acknowledged, perhaps begrudgingly, the importance, even greatness, of Keynes who he described as a person of brilliance and originality, but he remained a staunch critic.

Schumpeter gives a brief summary of Keynes’s *The General Theory* in a review essay of 1936 and considers Keynes the man in a longer more biographical piece first published in 1946.\(^{66}\) He also referred to Keynes’s work on numerous occasions in his *History of Economic Analysis*, but did not treat his theory at the length and detail that might be expected of such a figure. He argued that Keynes employed a highly simplified model of the economic system that enabled him to portray his vision more acutely. As is known, Keynes adopted the use of three schedule concepts, the consumption function, the efficiency of capital function and the liquidity preference function, from which he developed a fully-fledged aggregative schema. Expressing his basic difference from Keynes and to some extent indicating the line of criticism that he was to adopt, Schumpeter claimed Keynes’s simplified structure had the disadvantage of avoiding all the complications arising from process analysis. Thus Keynes’s approach was basically one of macro statics as against macro dynamics. Although there are some dynamic elements, such as the role of expectations, generally speaking the concern is with static equilibrium. Related to this is a focus on the range of short-run phenomena. As against Schumpeter’s long-term historical view of the development of the entire capitalist era, the Keynesian approach is very much preoccupied with the immediate period of the present and a few years either side. Schumpeter claims, this “limits the applicability of his analysis to a few years at most—perhaps the duration of the ‘40 months cycle’—and, in terms of phenomena, to the factors that *would* govern the greater or smaller utilisation of industrial apparatus *if* the latter remains unchanged. All the phenomena incident to the creation and change of this apparatus, that is to say, the phenomena that dominate the capitalist processes, are thus excluded from consideration.”\(^{67}\) Though Keynes claimed his approach was “general”, indicating he had sought to establish a theory of wide application dealing with the long-term course of the capitalist economy, he basically operated with a short-run model and did so by reasoning largely about a stationary process that oscillates about the level at which full employment is the limit. As against Marx who saw the evolution of capitalism leading to its breakdown and collapse, Keynes took the view that in its worst stages the capitalist

\(^{66}\) See his “Review of Keynes’s General Theory” in EJAS, pp. 153-7, and “Keynes, the Economist” in *Three Views of Keynes the Economist*, Kessinger (the same text under the title “John Maynard Keynes (1883-1946)” is also in TGE, pp. 260-94).

\(^{67}\) “Keynes, the Economist”, p. 93.
economy leads to a stationary state that threatens to break down but does not necessarily do so. Nonetheless, as with Marx, and also with Schumpeter, the capitalist breakdown arises from causes inherent to the working of the economic system itself and not by the action of external factors.

Schumpeter argues that Keynes picture of reality comes closest to being accurate for the case of depression and thus Keynes has rightly been described as an economist of depressions. But the other area in which Keynes’s theory has become significant and in which it seeks to make a decisive contribution is in relation to the ‘secular stagnation thesis’. This theory concerns itself with the predicament of economies that appear to be stuck in a stage of little or no growth, in which there is under utilisation of available resources, in particular of labour, and there appears to be no foreseeable likelihood of the economy returning to a state of equilibrium. But the fundamental criticism from Schumpeter’s point of view remains that the Keynesian system cannot truly describe itself as a “general theory”. No doubt in some of the analyses of particular situations of the economy that Keynes examines there are genuine insights but they cannot hold for more than that. Keynes’s analyses do not amount to a theory that would account for the operation of the capitalist system over the long term, by which Schumpeter means a period extending over centuries at least from the advent of modern capitalism to a distant future point in time.

Schumpeter notes with a certain sense of annoyance that The General Theory became an instantaneous success and developed a school of followers who loyal defended and even propagandised it. He suggests that there are only two other analogous cases where an economic theory has become the basis of a kind of movement or school, namely, with the Physiocrats and the Marxists. The implication of this is to suggest that Keynes’s “success” owed more to its appeal as an ideology than to its scientific soundness. Schumpeter opines:

Before the appearance of the General Theory, economics had been growing increasingly complex and increasingly incapable of giving straightforward answers to straightforward questions. The General Theory seemed to reduce it once more to simplicity, and to enable the economist once more to give simple advice that everybody could understand. But, exactly as in the case of Ricardian economics, there was enough to attract, to inspire even, the sophisticated. The same system that linked up so well with notions of the untutored mind proved satisfactory to the best brains of the rising generations of theorists. Some of them felt—still feel for all I know—that all other work in “theory” should be scrapped. All of them paid homage to the man who had given them a well defined model to handle, to criticise, and to improve—to the man whose work symbolises at least, even though it may not embody, what they wanted to see done. In general Schumpeter took the view that, as with Marx, it was possible to admire Keynes even though his social vision was mistaken and many of his propositions were misleading.

69 “Keynes, the Economist”, p. 99-100.
Schumpeter’s more specific criticism of the Keynesian approach concerns its reliance on aggregative concepts. He points out that the major variables Keynes chooses, with the exception of employment, are monetary quantities or expressions and, as national income is the central variable, income analysis. He claims that Quesnay’s *tableau économique* was Keynes’s true predecessor. He is adamant that aggregative analysis, if not backed by deeper theoretical and empirical work, is an extremely questionable basis for economic theorising. Hence, in regard to the emphasis on expectations he says,

But expectations are not linked by Mr. Keynes to the cyclical situations that give rise to them and hence become independent variables and ultimate determinates of economic action. Such analysis can at best yield purely formal results and never go below the surface. An expectation acquires explanatory value only if we are made to understand why people expect what they expect. Otherwise expectation is a mere *deus ex machina* that conceals problems instead of solving them.

A further point of criticism advanced by Schumpeter concerns Keynes’s claims that the economy stagnates due to excessive saving. Far from saving being excessive so as to affect the propensity to invest, Schumpeter argues and the real impetus for investment is the drive to finance changes in the production function, and this drive as a motive force precedes decisions about saving. Thus the propensity to consume and the inducement to invest are not as Keynes argues independent of one another; for there are always opportunities for further investment, in part because there are always unsatisfied wants but also because new needs are always capable of being generated. Hence, Schumpeter was strongly critical of the Keynesian solution to economic stagnation that suggested even wasteful spending was worthwhile as long as it created new demand.

But perhaps the most basic criticism of the Keynesian policy prescriptions concerns the fact that he was fundamentally recommending that problems in the economic sphere should be addressed by actions originating in the political sphere. As Schumpeter puts it in *Capitalism, Socialism and Democracy*, “Nothing should be more obvious than that the business mechanism cannot function according to design when its most important ‘parameters of action’—wages, prices, interest—are transferred to the political sphere and there dealt with according to the requirements of the political game or . . . according to the ideas of some planners.” In other words, Schumpeter is saying that, if politicians interfere with the self-adjusting mechanisms of the capitalist system, we should hardly be surprised that the results do not produce a state of employment at the equilibrium level. If anything, interference by the political authorities is likely to cause more problems than it solves, with the likelihood that price regulation, irrational taxation and questionable administrative actions will give rise to disruptive effects in their own right. This is not to say that Schumpeter refused to accept that there maybe situations in which something akin to a Keynesian policy prescription would be justified, but this is more in the exception than in the rule. Thus he did not reject deficit financing in every case and accepted that it may be a justified where there is a danger of what he calls a downward cumulative process. The underlying problem with the Keynesian approach to policy, however, is that it leads to continual manipulation of the market by so-called “demand management”. Thus, if the rate of interest increases, this means that

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70 “Keynes, the Economist”, p. 92.
71 “Review of Keynes’s General Theory”, p. 154, n. 3.
72 CSD, p. 386.
73 Ibid, p. 397.
investment will fall because individuals will choose to hold their money as savings rather than invest. Keynes believed that the employment situation was more likely to be exacerbated the wealthier a society becomes because in such a society the rate of saving will increase as incomes increase and opportunities to invest gradually diminish. Thus the key problem to be solved is that of finding outlets or opportunities for new investment with the savings that are held. An underlying difficulty confronting a modern capitalist economy is that the rate of interest cannot be reduced sufficiently low to give rise to enough investment to create full employment.

In the final analysis Schumpeter concludes that the assumptions Keynes relies on are questionable because he assumes in effect that technology is a given and not subject to progress, so that as the ordinary business activity proceeds it leads to decreasing returns to scale. Thus, the only solution Keynes could recommend was governmental intervention in the economy, both by central regulation of investment and by direct government spending financed through loans. This would artificially stimulate demand and thereby raise economic activity to a level that would reinstate full employment. Of course, Keynes’s supposed success in part depended on the circumstances in which his prescriptions were made, coming as they were at the time of the Great Depression with its massive unemployment that persisted year after year. His policy program offered a solution that addressed the despair of many and on the face of it appeared to be a solution to the crisis of the times. But it did not, according to Schumpeter, really solve any economic problems, and the theory failed to grasp the character of capitalism considered as a general system.

The Problem of Monopoly

Having seen that Schumpeter offered broad support for the capitalist system and for a non-interventionist state, it may come as a surprise to find him accepting that some measure of monopoly is an inevitable and not necessarily undesirable feature. He argues that, for economic progress to persist, it must be conceded that monopoly is sometimes more efficient that perfect competition. The most important field of competition underlying progress is not that between existing firms but that between old and new firms. Thus, as against the approach of figures such as Joan Robinson and E. S. Chamberlain who sought to condemn the growth of large-scale enterprises, Schumpeter accepted this as normal. The idea of a clash between the old and the new, of course, is connected to Schumpeter’s idea of creative destruction, for it is only with the disruptive introduction of new enterprises with their inescapably destructive effects on existing enterprises that it is possible to create ever new production functions, with novel products and the novel forms of life associated with their consumption. Paradoxically, Schumpeter claims monopoly is sometimes more conducive to innovation than a system in which there is perfect competition. This is because he regards the monopoly situation as one that gives the firm enjoying such power unique opportunities that are not available to enterprises involved in a more intense competitive relation with their rivals. As he puts it, “...there are superior methods available to the monopolist which either are not available at all to a crowd of competitors or not available to them so readily: for there are advantages which, though not strictly unattainable on the competitive level of enterprise, are as a matter of fact secured only on the monopoly level, for instance, because monopolisation may increase a sphere of influence of the better, and decrease the sphere of influence of the inferior, brains, or because the monopoly enjoys a
Thus Schumpeter took the view that it was not necessarily a good thing for governments to break up monopolies with anti-trust type policies, for industry concentration in the form of monopolies may foster a greater level of innovation than would happen in a perfectly competitive industrial environment. In any event, Schumpeter regarded perfect competition as something that has probably never obtained and certainly was not present in the capitalism of his own day. Thus he writes,

> If we look more closely at the conditions—not all of them explicitly stated or even clearly seen by Marshall and Wicksell—that must be fulfilled in order to produce perfect competition, we realise immediately that outside of agricultural mass production there cannot be many instances of it. A farmer supplies his cotton or wheat in fact under those conditions: from his standpoint the ruling prices of cotton and wheat are data, though very variable ones, and not being able to influence them by his individual action he simply adapts his output . . . but this is not so even with many agricultural products . . . as regards practically all the finished products and services of industry and trade, it is clear that every grocer, every filling station, every manufacturer of gloves or shaving cream or hand saws has a small and precarious market of his own which he tries—must try—to build up and to keep by price strategy, quality strategy—“product differentiation”—and advertising. . . . in these cases we speak of monopoly competition.\(^75\)

As we have already explained, insofar as there is real competition in the capitalist system, Schumpeter says it lies not so much with lower prices but with competition from new commodities, new technology, new sources of supply and new types of organization. This is the competition that strikes at the margins of profits of existing firms and threatens their very existence—it is the real basis upon which the process of creative destruction works itself out. Schumpeter does not deny that monopoly causes certain losses in efficiency because a firm enjoying a monopoly position may be under less pressure to keep its prices within limits, but these losses are outweighed by the dynamic gains from innovation. In any event, he says history does not suggest that somehow there was an imaginary Golden Age of perfect competition in the past and that today we have the phenomenon of monopoly due to a fundamental distortion in the way in which capitalism works. Monopoly has always existed more or less, and yet all through the period of capitalist development there has been constant progress, constant innovation and development. So monopoly can hardly be inimicable to progressive trends. Schumpeter’s key idea is that innovation requires the exploitation of new opportunities, so the question is which organizations, which firms are best placed to take advantage of such opportunities. The fact that the improvement in the standard of life of the masses has taken place relatively uninterruptedly during the period of big business shows that, far from monopoly being the cause of extortionate pricing and restricting innovation, on the contrary, it has in general reduced prices and made many goods that were once luxuries items of mass consumption. Thus he concludes,

> What we have got to accept is that it [the large-scale establishment] has come to be the most powerful engine of that progress and in particular the long-run expansion of total output not only in spite of, but to a considerable extent through, this strategy [of using excess capacity to deter entry by competing firms] which looks so restrictive when viewed in the individual case and from the individual point of time.

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\(^74\) Ibid, p. 101.

\(^75\) Ibid, p. 78.
In this respect perfect competition is not only impossible but inferior, and has no title to being set up as a model of idea efficiency. It is hence a mistake to base a theory of government regulation of industry on the principle that big business should be made to work as the respective industry would work in perfect competition. Schumpeter maintains that over the long term capitalism has been able to continually increase its industrial output roughly at about the rate of two percent per annum. And he can see no reason why this rate will not continue into the foreseeable future. He is dismissive of theorists, such as the neo-marxists and Keynesians, who argue capitalism is approaching a crisis point because of what has sometimes been referred to as “the vanishing investment opportunity” and that in order to foster further progress it is necessary for the state to intervene and create new enterprises. This does not mean that Schumpeter rejected deficit financing in every situation, as we have already said. But he does not think that capitalism is in imminent danger of collapsing or of being stuck in stasis because of either the presence of monopoly or due to the absence of potential investment outlets. Indeed, he says the record shows capitalism has over time continually improved the standard of living of the masses, especially when compared with its earlier period.

The indictment [that capitalism creates unemployment and a class of workers who are chronically poor] stands in the past—say, roughly, to the end of the nineteenth century—the capitalist order was not only unwilling but also quite incapable of guaranteeing this. But since it will be able to do so if it keeps up its past performance for another half century this indictment would in that case enter the limbo filled by the sorry spectres of child labour and sixteen-hour working days and five persons living in one room, which it is quite proper to emphasize when we are talking about the past social cost of capitalist development but which are not necessarily relevant to the balance of alternatives for the future.

Above we have referred at length to the fact that Weber’s analysis of modern capitalism assumes the existence of a market system in which there is the largely unrestricted exchange of economic assets through share ownership and free labour and in which there are other institutional features such as a legal structure that enforces contractual obligations, secures private property and so on. And Schumpeter takes for granted that the competitive marketplace remains the dominant reality of modern capitalism in spite of the fact that there may well be numerous actual monopolies. So the question arises as to whether an economy which is truly laissez-faire in the sense that there is negligible external regulation of economic transactions is the only way in which a truly capitalist society can exist, or whether regulation of the market system via the

76 Ibid, p. 106.
77 Ibid, p. 70. Though it is a complex topic, we shall refer to the treatment of the relationship between competition and monopoly in a capitalist system, in a celebrated essay by Piero Sraffa, "The Laws of Returns under Competitive Conditions", Economic Journal, 1926, 36 (144), pp. 535–50 and later the focus of the work of Joan Robinson, The Economics of Imperfect Competition, Macmillan 1933. Sraffa had pointed to the dynamic relationship between monopoly and competition by showing that the monopoly situation is inherently unstable because it calls forth new businesses seeking to better a dominant market player. So whatever monopolies may exist at any one time, they cannot enjoy their advantage indefinitely.
state or its agents might under certain conditions be said to create a more productive system. It has to be acknowledged that virtually all the advanced capitalist countries have developed various types of anti-monopoly legislation. In America there was anti-trust legislation under auspices of the Sherman Act that led to the break-up of numerous large monopolies. And in Australia, there is the so-called Take-overs Panel that investigates the anti-competitive effects of takeovers. Other countries such as England, France and Germany have equivalent types of regulatory regimes, and these appear to be now a normal feature of a capitalist economy. Weber never addressed these developments at any length, in part because they were only in their infancy at the time he wrote and possibly because he assumed that a largely unregulated market system would remain the dominant reality whatever the role of the state. Schumpeter, on the other hand, was aware of some of the regulatory arrangements referred to but still does not discuss them at length. However, it is worth remarking that in recent times much of the state regulation of the economy in advanced capitalist states has been directed to maintaining a state of affairs that approaches as far as is practicable an ideal model of laissez-faire capitalism under the rubric of various forms of “competition policy” and “fair trading” laws. Hence, modern states typically limit the formation of super monopolies and institute policies limiting the undesirable effects of unregulated market forces. Paradoxically, these interventions directed against unbridled capitalism by restricting the market power of any one group or limiting market freedom through consumer protection laws of are implicitly designed to render capitalism as such more legitimate and sustainable in the long term.

The Schumpeterian Concept of Evolution

We must now say something about the concept of “evolution”. It is apparent that this term is not only commonly employed by Schumpeter in his attempt to describe the overall pattern of development of the capitalist system, but the idea of evolution is in a way central to his whole schema. Obviously, there is a parallel between his use of the term and the Darwinian notion, and perhaps there is a more direct connection as well. Darwin’s notion, as is well known, was oriented to explaining the long-term course of development of life forms on earth and in particular to accounting for how various animal species have come into being or in the course of time become extinct. The process of “natural selection” is presented as being the key to explaining of how species arise, survive and prosper, and the schema is deemed sufficient by itself for this purpose, as supernatural causes are not required. If we turn to the use of the term evolution in the Schumpeterian system, there are some obvious analogous features, but things are also somewhat different.

Before we explore Schumpeter’s use of the term evolution further it is well to consider his own remarks on Darwin and the influence, if any, of evolutionary biology in economics. In general terms, Schumpeter seems to deny any direct connection between evolution in biology and economics. In his History of Economic Analysis at one point he discusses Darwin briefly and specifically considers the possibility of a relation to his own ideas but is quite wary of embracing a close association:

. . . we notice the attempts that were made to apply the Darwinian concepts of Struggle for Existence and Survival of the Fittest to the facts of industrial and professional life in capitalist society. . . . it may be—we cannot argue the case here—that certain aspects of the individual-enterprise system are correctly described
as a struggle for existence, and that a concept of survival of the fittest in this struggle can be defined in a non-tautological manner. But if this be so, then these facts would have to be analysed with reference to economic facts alone and no appeal to biology would be of the slightest use . . .

Schumpeter could perhaps be said to be following Darwinian notions because of his emphasis on how over the course of time various companies, industries, products and even whole national economies have come into being, grown and prospered, and then in some cases declined and even disappeared altogether. It is not difficult to see the obvious correspondence between the two theories in these respects. For example, just as one would say that for a time certain animal creatures such as the dinosaurs, mammoths or Neanderthals arose and were successful survivors, so Schumpeter can point to the rise of products such as the razor or the gas lamp, or to innovations such as horse drawn implements or steam power, as likewise having as it were “evolved” and, for a time at least, having prospered. Changes in both the biological and the economic domains have numerous other features in common. In each case there is no necessary or inevitable reason why a phenomenon appears at a given time; success or failure is always somewhat fortuitous. The advent of new types occurs in an uneven fashion, while incremental adaptation to the surrounding environment occurs continually. Later developments are in part built upon the achievements of earlier ones. In the case of both economic and biological evolution there are powerful elements of competition at work that determine how successful an emerging entity will be and how long it may survive. Finally, there are many instances where a species, or an industry, fails to adapt to the ever-changing environment, ceases to prosper and possibly becomes extinct.

We know from surveying recent examples that many products and even whole industries have appeared but have had a relatively short span during when they were successful and remained profitable. For example, the production of jute, crucial for production of hessian bags, was a very important industry for a period in the early twentieth century because it was the only effective means by which certain bulk commodities like wheat, barley, cotton and wool could be handled in long distance trade. Now, of course, with advances in bulk handling the production and use of jute is of much less significance. The material Bakelite was initially important owing to its use in electrical fittings but today plastics have largely replaced it. There are countless other examples of this type of change. The steam engine, once so crucial in mining, transport and agriculture, has totally disappeared from the landscape of the modern economy. And we know that whole regions previously central for the production of particular goods have subsequently gone into decline. One can point to cities such as Sheffield, Belfast, or Newcastle where steel products and ships were once made in large volumes. Equivalent illustrations can be found all over the world. Classic cases one can cite include Pittsburgh in America where steel was once king or Detroit where automobile production was huge. One could even say that there are whole economies that have gone into relative decline while others have risen. The British economy has relatively speaking become less prosperous whereas the economies of China, Brazil and South Korea have to some extent overtaken it. Schumpeter wants to say these occurrences are perfectly “normal” for the capitalist system, even though they cause dramatic and sometimes quite negative consequences for many individuals. It is worth noting some other examples whereby new technologies and new products have emerged and to some degree revolutionised economic circumstances. Consider the development of the transistor that, although an American invention, was innovatively taken up by the
Japanese. To a large degree its use was responsible for the huge increase in exports of carried by companies such as Sony, Hitachi, Sharp, National-Panasonic, Toshiba, Canon and others. Later, companies from South Korea such as Samsung and LG began to achieve huge export volumes in electronics and whitegoods. At the same time as these economies were taking off, there was a corresponding decline in what were previously highly successful companies in America, such as Eastman Kodak, Bell & Howell, and Xerox. The ability of the Japanese and South Koreans to take up new inventions, to innovate and create cheaper and better products than the corresponding American companies is a classic illustration of Schumpeter’s creative destruction at work.\(^{78}\)

Schumpeter also emphasizes the importance of the process of adaptation that occurs alongside innovation. For example, older companies may respond to the heightened pressure of the competitive environment by adapting. Where they have lost ground they may fight back by upgrading their production processes or modifying the products that they make. Some of the classic American success stories of the past such as General Motors and Ford are more focused on adaptation than innovation. Where once these companies were the world leaders in innovative production technologies, today they face enormous difficulties and even risk becoming bankrupt. In the case of General Motors, recently hit by the effects of the global financial crisis, it effectively did go bankrupt and was only belatedly salvaged, whether permanently who knows, by government intervention. Firms may attempt to adapt to a new situation by strategies of merging with stronger firms or submitting to takeovers such as has occurred with Chrysler, Volvo, International Harvester, Land Rover, IBM and many others. One could list countless examples of this type of adaptive conduct. Schumpeter’s main point in using the concept of evolution is to say that relentless contest and struggle is part of a never-ending struggle for economic survival. It is the very success of a given business that fosters the will and the drive of new entrepreneurs to outdo an existing market leader, to develop new products or find better ways of doing things. No company or industry is immune from this contest, just as no animal species can consider that its niche is secure for all time. We see that even the most successful economies of the very recent past now face real difficulties of maintaining a position of dominance. The Japanese economy, which was powering ahead in the 1970’s and 1980’s, has in the last ten years slowed considerably such that its growth is now stagnant. Newer economic developments in Asia, South America and elsewhere are beginning to have a major impact on world trade. The older established economies are attempting to maintain their growth by focussing their energies on services and high technology products, in part because they cannot compete in the mass production of labour intensive goods.\(^{79}\)

\(^{78}\) One graphic statistic is that of ninety TV manufacturers that previously operated in America, none remain as of today. Of course, there are many American companies that have come into being in recent times and are extremely successful, such as Apple, Intel, Dell, Google, and Amazon, and still others that have remained prosperous throughout, such as Caterpillar, General Electric, Coca Cola and Boeing.

\(^{79}\) It is even possible to see analogies between economics and biology in the concept of reproduction. In Darwin’s theory it is crucial for the survival of species that a species be able to maintain its population numbers each generation. For this to occur an adequate mechanism of reproduction is essential to ensure that new offspring are always in excess of replacement numbers, as there is always an attrition rate owing to limited resources. In the same way, one can say that each business entity requires a mechanism that enables it to reproduce itself. The profit mechanism fulfils this function because unless
having explored the parallels between biological and economic evolution, care must be taken to avoid any suggestion that either Weber or Schumpeter was endorsing competitive struggle from an ethical point of view or adopting a social-biological perspective.

At this point it for comparative purposes may be useful to consider Weber’s approach to the concept of “progress”, for in his reflections on this concept Weber raises issues relevant to the long-term dynamic of the capitalist system. He touches on this topic at several points in his methodological writings and especially in his essay “Science as a Vocation”. He is concerned in his methodological writings to criticize the idea that there is a logic of inevitable progress at work in history owing to “laws of development”. And yet he wants to account for the phenomena of rationalization and modernisation and the evident appearance of “progress” in economic affairs; his theory of the advance of rationalization in the modern West is built on the idea that forms of technical progress are palpable and cannot be denied. He also largely accepts Simmel’s arguments about the experience of “progressive differentiation” in modernity and that this is progress of a kind. Nonetheless, Weber insists that “progress”, however conceived, by no means equates to an increase in the inner value of human existence. Indeed, as he argues in his seminal essay “Religious Rejections of the World and Their Directions”, progressive differentiation if anything causes the fragmentation of lived experience into different value spheres (“the economic”, “the political”, “the aesthetic”, “the erotic”, “the intellectual”) and these unavoidably come into conflict with each other. Thus the individual living in modern society is confronted with the “warring gods”, as each of the value spheres makes separate and irreconcilable demands.

Schumpeter’s remarks on evolutionary progress do not have the depth of these reflections of Weber. Generally speaking, Schumpeter was not as disposed toward philosophical reflection as Weber, the latter who could be said to have developed and even embodied a unique philosophical outlook—this allowed figures such as Karl Jaspers to credit Weber, both in his person and in his writings, with manifesting a form of “existentialism”. Schumpeter was more influenced by positivist notions of philosophy of science, which led him to focus almost exclusively on what he believed the sciences could establish by rigorous analysis while excluding metaphysical and religious speculation. The point of my bringing the two writers thoughts on historical progress together is to recognize that, despite similarities on the issue of evolutionary progress in economics, there remains a basic divergence of perspective—Weber was decidedly pessimistic about the immediate future, especially for post-war Germany, and

there is sufficient profit there is no capacity for on-going investment and innovation, and without this a company loses its ability to maintain market share. In order to ensure its very existence, innovative products, improvement of design, reduction of costs, cheapening of retail prices, and advances in processes of production are continually required. For unless the market is fully satisfied by one company’s efforts, another will take up the slack and become a successful rival. So economic growth in the sense of achieving larger market share and being ever more profitable is a key driver of the capitalist mechanism.

80 See Weber’s extensive discussion of these issues in MSS, pp. 27-38.
81 See “Religious Rejections of the World and Their Directions” in FMW, passim
advanced what has been called a tragic view of the historical process, whereas Schumpeter’s view of the capitalist future was relatively speaking optimistic.

**The Continuing Relevance of Schumpeter’s Theory of Business Cycles**

Even though we have not carried out an exhaustive empirical study of the matter, we submit that in broad terms Schumpeter’s work on business cycles presents a highly plausible account of the way in which capitalist progress has proceeded in a continuous but uneven manner. As we have seen, one of Schumpeter’s key notions is the idea that innovations occur in clusters and these produce spurs of economic development. He describes the overall outcome as manifesting wave-like patterns that can be discerned by statistical analysis of time series. In his historical analyses he highlights the advent of steam power/railroadization and electrification as paradigmatic cases where initial inventions coupled with further innovations had far-reaching economic effects. Since Schumpeter’s day, we can point to numerous other examples of this kind of advance, as we shall see, and these are amenable to analysis in terms of wave-type patterns of the kind he posited. Thus, for example, one can see that the development of the transistor in the 1950s, and later the microprocessor and the associated electronic advances that followed constitute another cluster of innovations which gave rise to a whole host of novel products and processes. Associated with the advent of the transistor were new products such as the transistor radio and other audio and communication equipment, and these were soon followed by the use of integrated circuits in electrical appliances such as televisions, stereos, telephones and then the computer. Further advances have been occasioned by intensive miniaturization and complexification. The mobile telephone, CD player, ipod, laptop and tablet computer are the most well known of these developments, but the technology of using microprocessors is now utilized in almost every household appliance such as flat-screen televisions, washing machines and air conditioners, not to mention a vast array of industrial applications. Yet another advance is associated with the further development of the computer that followed approximately 20 years after its initial development. The full potential of the computer and perhaps the high point of its economic significance should probably be dated around 1995 when the Internet became fully functional in its current form. This last innovation has given rise to innumerable possibilities of further enhancement, all dependent on exploiting the advantages this hyper-communication facilitates. These last include such things as e-commerce, email, advanced telephonics, video streaming, remote conferencing, information storage, word processing, document transfer, “GPS” and digital photography, to name but a few. And there are many related socio-economic impacts that are made possible from such advances, such as globalisation of economic reach, language translation, internationalisation of institutions, increased computing power for research purposes, not to mention benefits for business management, record keeping and accounting. It is apparent that the advances referred to are partly connected with the success of Japan, the Asian tigers, Bangalore, and California as centres for the economic exploitation of these technologies, though of course their effects are global.

Despite the prima facie success of the Schumpeterian system in explaining such developments, the question must nonetheless be put as to whether the advances in question are amenable to analysis in terms of the wave periods (Kondratieffs, Kitchins, Juglars) that Schumpeter insists are a regular feature of capitalism. The advances of transistorization, miniaturisation, printed circuit boards and computerisation, as well as
so-called recent applications of nano- and bio-technology, might suggest, rather than Schumpeter’s clustering of innovations, a process of steady progress arising from a continuous stream of innovation. In other words, there may be no “clustering” as such, or any clustering that is deemed to exist can only be presumed by artificially insisting on particular developments being central and emblematic. In defence of Schumpeter, however, one can point to economic fluctuations and recent crises that appear to be correlated with the innovations referred to. Thus, we have seen major downturns in the economic performance of many companies and even whole economies following changes in technology—the dot.com bubble, the OPEC crisis, the Asian Financial Crisis, and the crash of the NASDAQ are examples of partial collapses, whereas Japan’s economic stagnation during the last decade, and recent American and European slowdowns are examples of nationwide downturns. There are obvious possibilities for new clusterings of innovation around the bio-technical advances associated with unravelling the mysteries of DNA and the discovery of the genetic code of living beings and organisms. Such innovations have many potential applications in novel areas, such as the production of new foods or new ways of growing foods or improving the yields, new ways of producing fuels and energy with developments such as biofuels, ethanols, solar power, and finally new medical treatments associated with organ transplantation, cell renewal or treatments to cure cancer and other diseases.

Advances in the tertiary sector with the provision of new types of services can also be said to open novel fields of innovation that can be understood using a Schumpeterian point of view. There has been steady expansion of service industries since they began to take-off with the rise of the middle classes and the increased access to education and leisure opportunities in the post-war period. A notable field in which service industries have flourished is tourism. In some countries tourism has become the single most important GNP earner, and it is becoming a significant component of many national economies. Related to the tourist industry are a whole series of related service industries such as the restaurant trade, resorts, eco-tourism, international transportation, trekking, and sporting-related travel. As some economies have begun to decline significantly in terms of their manufacturing capacity, most noticeably in the first industrial nations such as England and now America and Australia, these countries are attempting to retain economic strength by intensifying and expanding their service industries. We see educational institutions in particular becoming a major source of national income, and in America the entertainment industry in the form of television, film production and music are important.
The Continuing Relevance of Weber’s Account of the Work Ethic

We believe that Weber’s contribution to the understanding of the institutional basis of capitalism is not merely of consequence for historical understanding but remains relevant for understanding contemporary issues, especially as regards the role of the work ethic in fostering economic growth. It is of more than passing interest that the term “work ethic” has become part of the vernacular of modern industrial society. We even find it used by sporting commentators and team coaches when they refer to the diligence with which players carry out their tasks on the field of play. Although Weber was primarily concerned with the origins of the work ethic, it is now possible consider whether a given culture and its institutional structures continue to inculcate and foster a work ethic of sufficient intensity to have an impact. It has often been noted that depressed social groups, sometimes whole nations, experience difficulty in developing the requisite work discipline that will enable their economies to prosper. This is particularly apparent in the case of some non-Western societies where cultural practices revolve around ritualistic, religious activities that do not value routinized work. The problem is also evident even in the modern West in certain ghettoised or marginalised groups, such as aboriginal groups in Australia, native and ethnic cultures in North America, or the marginalised and depressed communities of England. In many other societies, which are otherwise quite advanced from an economic point of view, it is apparent that a work ethic is not cultivated in the youth and this in part explains why many of these individuals revert to socially dysfunctional behaviours such as drug abuse. The situation in the various Islamic countries of North Africa and the Middle East also shows a distinct lack of a developed work ethic. In these latter cases work in an organized industrial setting is typically shunned and if possible avoided altogether.

On the other hand, it is somewhat surprising, and not something that was anticipated by the commentariat, that in China, which had not perhaps experienced anything equivalent to the Protestant Reformation, a highly motivated orientation to rational economic activity seems to have developed. Whether this can be described as a work ethic in Weber’s sense remains to be seen. No doubt some of this energy is reactive and can be attributed to a more basic concern for economic survival; in an environment still influenced by the legacy of Maoist authoritarianism individuals know full-well that starvation or extreme poverty is the fate of many millions. Once a market system began to develop in the 1990s after the reforms of Deng Xiaoping, the forces suddenly unleashed seem to have promoted a highly competitive and individualistic ethos, in which the pursuit of economic success, ostentatious consumption and amongst the elite the cultivation of luxury lifestyles have become manifest. An in-between situation is perhaps illustrated by the case of Russia, whose communist regime engendered a kind of survival ethic wherein intense work effort work was only capable of being extracted from the population via various forms of more or less brutal repression. Now that this system has collapsed and a kind of quasi-capitalism has come into being, the motivation to work lacks intensity because under the extremely corrupt circumstances prevailing it is uncertain that the financial rewards an individual can expect from work will be

83 Though on the problem of whether China developed an ethics capable of transforming its traditional culture in a modern direction, see my essay “Max Weber’s Orient”, pp. 172-85.
proportional to the effort put in. This is a consequence of the fact that workers are often not paid their nominal wages, or have their earnings frittered away by inflation or through various forms of criminal extortion and so on.

In the advanced West Weber’s work ethic has perhaps found a new lease of life in the movement to reform business management in accord with ethical principles. This is has arisen in part in reaction to the exorbitant salary payments made to many corporate elites and their failure to exercise sound judgement in the events leading up to the so-called Global Financial Crisis. Related to this is the growth of business studies as an academic disciple and the teaching of “business ethics”, both of which seek to transform the acquisitive orientation of the businessman into something akin to a vocation grounded in part at least on ethical norms. These movements are unfortunately at variance with the imperative of impersonal competition that is enjoined by the logic of market struggle under capitalist conditions.

Towards a Synthesis of Weber and Schumpeter

Having pointed to the differences between Weber and Schumpeter on the nature of capitalism, it should nonetheless be recognized that there are clearly a great many commonalities and points of agreement. First and foremost, both thinkers see capitalism is the most fateful force of modern society and the key institution requiring our understanding. Both thinkers accepted that capitalism as an economic system has achieved a high level of prosperity for the mass of the population and that any socialist transformation in the short-term is unlikely to be an improvement in this respect. But both saw socialism as an understandable reaction to the deprivations wrought by the advent of capitalism, and as a predictable response to the inequality flowing from the ravages of the competitive market situation, especially depressions and economic crises. Nonetheless, despite such negatives, as we have seen, to a considerable extent both Weber and Schumpeter provide qualified justifications for the capitalist system as a whole. For they both argue that the free market system deserves support, for the time being at least, be supported; despite the undeniable fact of inequality that is its inescapable consequence, it ensures economic progress in the broad sense.

As we have seen, the role of the entrepreneur is central for both Schumpeter and Weber. Weber gives an elaborate account of the development of this type of individual, but he also provides analyses of the rational social structures that have facilitated the emergence of the capitalist economic system as a whole, particularly those of the state and law. To a certain degree Weber’s work is a corrective of Schumpeter’s over estimation of the explanatory power of his “mechanism” as an account of the course of European economic development down to the present. Weber in our view convincingly describes the way in which various institutional developments occurring in the Middle Ages and the Reformation were essential to the advent of the modern world generally and the capitalist system in particular. Some of these phenomena, it has to be said, are not adequately addressed in the work of Schumpeter. On the other hand, Weber did not embark on a detailed examination of the functioning of capitalism conceived as a dynamic economic system with its own inherent logic of development. Nor does he focus on the fact that capitalism is subject to regular and far-reaching fluctuations of the kind that Schumpeter shows are integral. Furthermore, Weber did not address some of the issues to do with the regulation of the capitalist system that Schumpeter began to
address, particularly as a consequence of the Great Depression and his encounter with the work of Keynes.

Both Schumpeter and Weber conceived of modern capitalism as a system in which economic regulation and state ownership were of relatively minor significance. But both were aware of the expanding role of the state, and in particular they recognized its increasing manipulation of economic conditions and the related growth in bureaucratic administration. But neither built into their theory a detailed account of what is now understood by concepts such as “organized capitalism”84, the “managed economy”85, the “mixed economy”86 or the “welfare state.”87 And neither considered at length the role of the state in directly fostering economic activity and in operating economic enterprises short of full socialisation. Had both Weber and Schumpeter developed conceptions around these ideas, they would of course have had to modify their existing theories in some ways. But as the developments referred to were only in their infancy in the 1920’s and 1930s, it is understandable that neither addressed them at any length.

The Problem of Rationalization

One area in which there are appear to be points of synthesis between Weber and Schumpeter is in regard to the phenomenon of economic and societal rationalization. This may be true even though, unlike Weber, Schumpeter does not generally use the concept “rationalisation.” In what follows I shall argue that Weber’s concepts of rationality and rationalisation are directly applicable to the way in which Schumpeter describes the functioning of the capitalist system. Firstly, in regard to rational calculation generally, Schumpeter refers in his description of the manager’s role in the Stationary Flow to his ability to conduct business in a routine and efficient fashion reproducing the same outcomes in a mechanical fashion. There are known suppliers, known resources, known processes of production, known needs and customers, and there is existing technology that is proven and reliable. This system, totally lacking the impact of the innovative entrepreneur, could in theory go on producing in the same manner indefinitely into the future. Though he does not appear to recognize the fact, the regularity and efficiency of the Stationary Flow must depend directly upon a capacity for rational calculation on the part of the manager in the fashion of Weber’s rationally calculating actor; for without this ability the whole process of management, of obtaining the necessary inputs, applying them in production and selling the products thereafter, would not be possible. The manager of a business must apply himself to his tasks by systematically attending to the factors of production, adjusting them, buying and selling inputs in accordance with the market prices, and so on—in effect conducting the enterprise in a fashion similar to that implied in Weber’s analysis of double-entry bookkeeping. Even more so in the circumstances of modern capitalism the

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The entrepreneur’s innovation requires an advanced capacity for rational calculation, though his situation is somewhat different to that of the manager. In the former case the actor sets out to take advantage of a new situation by developing a new product and exploiting a novel market opportunity. There are more unknown variables than in the situation of the manager in the Stationary Flow, as some aspects require estimating the prospects of a future course of action probabilistically on the basis of uncertain data. Yet, to maximize the chances of success, the entrepreneur must still act in accordance with the dictates of rationality, as far as possible calculating the costs and prospective profitability of a proposed venture in a systematic and rational fashion.

Schumpeter refers to the need to understand a capitalist system in relation to its theoretical equilibrium state and to the fact that at certain stages in the business cycle the economy will be approaching toward, or departing from, equilibrium. For this to be the case the economy must be functioning most of the time in such a fashion as to allocate resources and to dispose of products so as to at least partially balance supply and demand. This means of course that the prices at which the inputs are acquired and outputs are sold must be more or less “rational”. Rational here means amenable to actions guided by the intellect, as against tradition or emotion. When the innovating entrepreneur appears on the scene and breaks with the existing production function forcing the economy away from the neighborhood of equilibrium, he operates with prices that have been set by the preceding period of production. He purchases inputs by outbidding existing producers to acquire labour and other resources. So the rationality of the price mechanism is crucial and underpins economic activity. The entrepreneur must adopt a rational approach in Weber’s sense by the very nature of his innovative activity, that is, insofar as he has seeks to exploit a new process, a new product, or a new market. He must envisage market possibilities in accordance with his imagined new venture, which leads to a plan through which a project is to be realized. The entrepreneur will not adopt a new means of producing goods simply because it is more technically efficient without considering the surrounding economic circumstances. If he is to be successful, his cost estimations must based on reliable data and be realistic. The entrepreneur who develops such new approaches must do so in accordance with Weber’s notion of “ends-rational” or “instrumentally-rational” action. Weber’s detailed explication of this concept is found in *Economy and Society* where he defines it as action wherein “the end, the means, and the secondary results are all taken into account and weighed. This involves rational consideration of the alternative means to the end, of the relations of the end to the secondary consequences, and finally of the relative importance of different possible ends.”

It is important to recognize that this definition does not focus solely on the rational choice of means to an end, which for Weber is a merely “technical” question. In economics equally important is rational choice between ends, so that for action to be truly instrumentally rational the means, the ends themselves and the possible consequences must all be weighed. And “weighing” entails some process of reasoning or control by the intellect—throwing dice, resorting to intuition or seeking a magical answer will not do. Weber clarifies what he means by instrumentally rational action by radically distinguishing it from another type of rational action, namely, value-rational action (wertrational), which involves making a choice of ends based on conformity with ultimate values: “In this case, action is instrumentally rational only in respect to the choice of means.”

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merely to pursue a particular end solely with the best technical means available, for he is equally concerned to decide between ends given the available means to achieve them as well as in the light of the secondary consequences that include both actual costs and opportunity costs. The rationality of decision making can be enhanced by techniques of various kinds, such as double-entry bookkeeping, the use of technical manuals, reference to scientific reports, management conferences, computer simulations, strategic thinking, budgeting and so on. Weber’s general view is that these types of action are becoming more and more significant in the modern world, especially in the sphere of economic life, and this is partly what he means by the progressive rationalization of society.

Another question on which we may discover points of compatibility between the perspectives of Weber and Schumpeter is the question of the place of welfare and the role of the so-called welfare state. Neither of our two thinkers employed the concept of the welfare state to any great extent, as the idea has only come into full effect in the post World War Two period. This is not to say that the phenomenon in question was not known before as there were important early welfare reforms going back to the nineteenth century with Bismarck in Germany and Lloyd George and Beveridge in England. Furthermore, theoretical reflection had begun at least as early as Marshall’s *Class, Citizenship and Social Development*. Weber did not provide detailed discussion of the idea of the welfare state as such, but he did briefly consider the role of such a state in regulating a capitalist economy in certain sections of *Economy and Society*. His discussion is in very broad historical terms, but at one point he notes the following: “What is important for profit-making enterprises with fixed capital and careful capital accounting is, in formal terms, above all, the calculability of the tax load. Substantively, it is important that there shall not be unduly heavy burdens placed on the capitalistic employment of resources, which means, above all, on market turnover.” This statement would appear to set an upper limit as to how far a state might interfere in the regulation of a capitalist economy and to what extent it could satisfy its needs through taxation without paralysing the economy. On the other hand, as we have already stated, Weber was a strong supporter of welfare reforms in the Germany of his day, and he clearly believed that, provided the state did not overtax or haphazardly make excessive requisitions at the expense of business, it could afford to finance its programs without compromising the formal rationality of the economy. He does not appear to have addressed the issue of how far the state should directly regulate the market economy by, for example, providing counter-cyclical stimulus spending or other interventions that would alter the free play of market forces. Again these are problems that have only come to the fore in the period after Weber’s death, especially with the experience of the Great Depression and later with phenomena like “stagflation” and now the so-called Global Financial Crisis.

Schumpeter was similarly supportive of a non-interventionist state, at least in his earlier days when, as we saw above, he took such a position while the Austrian Finance Minister. However, he seems to have modified his view somewhat in his later years, as

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91 ES, p. 200.
is apparent from the following passage from his History of Economic Analysis where he considers the theoretical justification for free trade.

Modern theory no longer undertakes to show that free trade is the right policy for all times and places. But it shows much better than could have been shown by Smith or Mill what will be the effects of a particular measure of protection on the interests of all classes of society. Modern theory no longer undertakes to prove that perfect competition is an ideal. But it can show what the effects of given deviations from competition will be. Modern theory no longer recommends saving under all circumstances. But it gives to economic policy a complete description of the process of saving and of the effects that different kinds of saving will exert upon the economic situation of a country.\(^{92}\)

This statement would appear to represent a concession to the Keynesians and others who have advocated welfare spending and protectionist trade policies to cope with the problems of declining economic performance.

**The Question of “High” or “Late” Capitalism**

Weber’s attitude to and account of the capitalism of his day in contrast to the early era of modern capitalism is the subject of a useful discussion of Wolfgang Schluchter. Schluchter notes that up to a point Weber seems to utilise a distinction that Sombart had used between early capitalism and “high capitalism.” As early as The Protestant Ethic, Weber made a distinction between a period in which the ethos of the Protestant ethic had been an effective force and was constitutive of the worldview of the bourgeois classes and that of his own day. At the time Weber was writing The Protestant Ethic, this ethic as the motivating force of capitalism is already in the background. This time is the period, if one likes, of “advanced” or “high” capitalism. Schluchter quotes a remark of Sombart that goes: “In the age of early capitalism, capitalism is made by the entrepreneur; in that advanced capitalism, the entrepreneur is made by capitalism.”\(^{93}\)

Schluchter says that, despite appearances, Weber does not adopt the same approach as that of Sombart. Nonetheless, he does seem to imply that once capitalism has come into being and may no longer require the bourgeois mentality with its vocational ethic, it rests on an objective set of relations and institutional structures that creates the individuals it requires to function. Weber says that, whereas the puritan wished to become a man of vocation because of his religious convictions, “we are compelled to be.”\(^{94}\) Schluchter argues that in this way the vocation risks losing its inner support and that there is a danger that victorious capitalism will create a kind of new house of bondage. He says, “This bondage is, in contrast to the old, one of golden chains. Its defining marks are mechanised petrification and a frantic effort to take oneself seriously, combined with vanity, that ‘deadly enemy of all devotion to a cause and all detachment, including above all detachment toward oneself.’”\(^{95}\) For Weber the Protestant Ethic involved the idea that man has an obligation towards the possessions he owns and that he acts as a steward of these to which in a sense he owes obligations. The prospect of advanced capitalism is that this feeling may be lost and that the pursuit of wealth

\(^{92}\) HEA, p. 1145.


\(^{95}\) Ibid.
becomes formally meaningless. This is probably what Weber had in mind when in *The Protestant Ethic* he speaks of the present stage of capitalism as having the character of sport.  

96 What then is going to motivate the individual’s working life now that the bourgeois era has been transformed such that there are no longer a powerful religious forces structuring conduct? What will be the meaning of a vocation in a world of technically trained specialists? Or, as Schluchter asks,

Where and how can the vocational ethos still be realised under the conditions of victorious capitalism? What can be done in this sense to maintain vocation as a cultural force? If one allows free reign to the advanced-capitalist developmental tendencies, there would ultimately be only those ‘last of men’ in a godless and profitless age that are spoken of in the end of *The Protestant Ethic* and in Nietzsche at the beginning of his *Zarathustra*.  

97 These reflections touch on ultimate philosophical questions to which Weber offered a number of answers, though he did not devote a detailed study to their analysis and solution. It is beyond the scope of the present work to put together an account of Weber’s philosophical position in relation to these matters that are linked to larger questions of ethics and the nature of modernity, but the reader should be aware that the works of Schluchter, Hennis and Scaff offer interesting analyses of these issues.

But the question can be raised as to whether capitalism as it is found even in the most advanced economies of the modern West has been so transformed as to now require entirely new theories such that the achievements of Weber and Schumpeter could be said to have been partially, or perhaps totally, eclipsed. At this point in time, it is worth referring to some remarks of Guenther Roth. He writes:

But the dynamics of capitalism relentlessly transform established ways of doing things and continually put pressure on the institutional framework of the democratic countries. The new “electronic capitalism,” which speeds up transactions and permits smaller enterprises, undermines the bureaucratic capitalism that was for Weber a major feature of modernity. The expectation of prominent social scientists of the 1950’s and 1960’s, from Talcott Parsons to Clark Kerr, that “industrial man” would spend half his life in bureaucratised large enterprises and half in the realm of leisure have proved utopian. Weber’s assertion that “the whole developmental history of modern Hochkapitalismus is identical to the increasing bureaucratisation of economic enterprises” is no longer valid. Full development (*Vollentwicklung*), which seems to have been reached, has been followed by devolution. The “most advanced structures of capitalism” (ES, p. 956) are today subject to de-bureaucratisation and the decentralisation of innovation, production and service. Finally, as at various points in the nineteenth century the distance is growing between the “real economy” and “financial economy,” between real output and speculative value.  

98 These questions raise a number of issues that we cannot explore in any detail in the present work. Nonetheless, there are aspects of modern capitalism in its present configurations that suggest the respective perspectives of Weber and Schumpeter warrant some qualification and amendment. Among those suggested by Roth are the

96 PE, p. 182.  
role of financial institutions, the service economy and the impact of intellectual technology. These phenomena have of late given rise to a considerable literature of commentary and analysis that unfortunately we cannot consider now.
Conclusion

In this chapter we have sought to bring the separate contributions of our key thinkers Weber and Schumpeter together so as to produce a coherent overall theory. We have considered their general views of capitalism, views that are necessarily associated with their corresponding attitudes toward socialism and the possibility of radical economic change. We have pointed to the fact that there are many elements of similarity/correspondence between the two sets of views; especially as regards the fact that both thinkers regarded capitalism as a structure that would not likely collapse of its own accord and that had potentially a long life-span. To this extent both Weber and Schumpeter rejected the Marxian hypothesis that the internal logic of capitalism would soon lead to a system-wide crisis that would sound its death knell.

In spite of the similarity of perspectives, Schumpeter differed markedly from Weber in his willingness to anticipate, and to a degree to accept, the prospect of a socialist transformation, which he predicted might well continue to foster innovative initiatives and maintain on-going prosperity. In this regard there are important differences because Schumpeter saw the bureaucratisation of the entrepreneurial function as not inherently contradictory. In our view, he naively regarded a future socialism as being capable of taking over the better aspects of capitalist dynamism without considering the possible negative consequences of a restructuring of society along socialist lines. By contrast, Weber regarded the extensive bureaucratisation of society, which he believed inevitably would accompany any transition to socialism, to be a highly questionable development. In particular he was concerned at the threat to the liberty of the individual were socialism to become the dominant system. By eliminating the private entrepreneur and substituting state organization at the commanding heights of the economy, the state would be placed in a position of unlimited power vis à vis the individual. Workers under conditions of full socialism would be totally at the state’s mercy and would have no alternative but to seek employment in state-owned firms, as there would be no others. Although he did not expressly champion the ideals of laissez-faire and economic liberty, Weber appears to been sympathetic to these broad principles, notions later developed at some length by Hayek and Mises. But in spite of these differences of perspective, we have argued that Schumpeter’s overall position diverges less from Weber’s than might be thought from the above. This is because, although Schumpeter appears to accept the inevitability of socialism as the telos of the capitalist phenomenon, he nonetheless regards capitalism as a system that has many virtues and for the time being must have its due.

99 I do not wish to imply that Weber would have agreed with all the ideas of Hayek and Mises, which made economic liberty and the free market the central plank of their philosophy.
CHAPTER SIX

Conclusion: Toward a General Theory of Modern Capitalism

We have argued that within the writings of Weber and Schumpeter are contained the elements of a comprehensive theory of the origins, foundations and operation of modern capitalism. We have attempted to establish that these writings are not only largely compatible but complement each other and can be synthesized to produce a coherent theory of the totality of modern capitalism. In essence, we have sought to show that Weber’s account of the institutional framework of capitalism is largely adequate in relation to Schumpeter’s account for the operation of the market system. In other words, Weber provides the sociological complement to Schumpeter’s economic theory, whereas Schumpeter provides the economic theory that accounts for the on-going operation of the system Weber believed had first arisen in the modern era. Finally, we claim that the synthetic combination of the two separate contributions outlined can form the basis of a General Theory of Modern Capitalism.

In making these claims we recognize there are distinct limitations in regard to each thinker’s contribution. In the case of Weber we can point to the fact that in his work there is an evident lacuna concerning the problem of how capitalism functions as an economic system once it has come into being. His work is rich in detail on the origins of capitalism and as to its essential characteristics as a socio-economic formation, but he does not explore in any detail how a capitalist economy operates once it comes into being, nor does he investigate the long-term trajectory of capitalist development. Of course, he presumes these matters are to an extent the province of the burgeoning science of economics, which we must presume he left for others to deal with. In the case of Schumpeter a major criticism we have made is that he tends to overestimate of the universality of his “capitalist mechanism”. His insistence that elements of the capitalist mechanism in the requisite sense were present even as far back as medieval times in our view fails to adequately account for the changes that were brought by the Reformation, which we say with Weber was a watershed that ushered in more rationalized forms of everyday life. The way Schumpeter deploys his notion of the capitalist mechanism risks making progress in history appear to be an inevitable outcome driven by the propensity of human beings to invent and innovate, whereby sooner or later the market system in its fully modern form was destined to emerge. 1 Weber’s writings, especially his comparative works dealing with the civilisations of India and China, indicate there was nothing inevitable about the outcome that we now accept as “western modernity”. In our view, Weber has conclusively established there were profound cultural barriers to the development of a modern-type economic system in those civilisations—and by extension of the argument, elsewhere, for example in the Islamic world. Weber’s analysis of the economic life of the medieval period convincingly shows that the banking and business activities of figures such as the Medici or the Fuggers do not amount to capitalism in the modern sense. He points to illustrations of similar types of

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1 A recent attempt to locate the presence of significant market forces as far back as Roman times which lends some support to a Schumpeterian perspective in this regard is Peter Temin, *The Roman Market Economy*, Princeton University Press, 2013. This work, however, exaggerates the role of market forces in antiquity and does not deal with the problems of oikos economy and political capitalism, questions dealt with extensively in my *Antiquity and Capitalism*. 

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pre-modern capitalism going back to ancient times, but there was no necessary development from these early capitalisms to the modern form. I have discussed this issue at some length in a previous work *Antiquity and Capitalism: Max Weber and the Sociological Foundations of Roman Civilization*. There I explain how in Ancient Rome various forms or types of capitalism were present, and even constituted an economic system of a kind, but these did not culminate in nor tend toward rational capitalism. So Schumpeter’s account of the capitalist mechanism, we say, is valid for the modern era but should not be pressed to account for developments occurring in pre-modern times.

There are other deficiencies in the writings of both Weber and Schumpeter that derive from the fact that to some degree their works have inevitably become dated by the passing of the years. There have, of course, been many developments in the nature of the economic system and in economic theory that have occurred since their time. We have referred, for example, to the development of the so-called welfare state and the related phenomenon of the “mixed economy” in the socio-economic systems of modern Europe, North America and Australia. Nonetheless, we maintain that these are cases of economic systems that still remain capitalistic in most, if not all, relevant respects, and would in all likelihood be readily recognized as essentially capitalist by both Weber and Schumpeter. However, these writers could not fully appreciate the extent to which the state was to become involved in regulating and partially operating enterprises of a capitalistic kind without this amounting to socialism. Nor did they anticipate the extent to which modern governments would develop a range of bureaucratic agencies and departments with the express purpose of “managing” the market economy, with the goal of maintaining steady, uniform economic growth, full employment etc. Here we confront the issue of so-called “organized capitalism”, a state of affairs that is no doubt typical of many modern societies.

Furthermore, neither Weber nor Schumpeter was able to anticipate many of the institutional innovations that have occurred in the post-war era—such as the development of “wage-earner funds”, “sovereign wealth funds”, compulsory superannuation, “future funds”, industrial arbitration, worker-participation, currency regulation, “just-in-time”, “quality circles”, work insurance, environmental protection, “corporatisation” and “privatisation”—to name but a few. Nor did they fully appreciate the significance of a development such as the separation of ownership and control, classically analysed by Berle and Means in their famous treatise *The Modern Corporation*. There are still other changes that were only partially foreseen by Weber and Schumpeter in their various writings, for example, the extensive development of the service economy or the large-scale investment by the state in educational, training and research institutions. These last mentioned developments were not addressed at length by Weber though Schumpeter was cognizant of them because of the later time in which he was writing. Yet another domain in which novel developments have arisen since Weber’s and Schumpeter’s era concerns the case of Japan where in the post-war era there has arisen a very close collaboration between the state and the leading industrial conglomerates via the institution of the Ministry of International Trade (MITI). For a time this style of “corporate capitalism” appeared to be highly successful in forging high rates of economic growth and enabling Japan to emerge as a capitalist super power.2

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Nonetheless, the recent stagnation of the Japanese economy suggests the Japanese model is by no means a sure way of maintaining such results.

But despite these novel developments, we maintain that the basic mechanism of the capitalist system, operating on the basis of the private profit-seeking firm and oriented to the profit opportunities of the free market, remains essentially the dominant structure in the West and elsewhere. We say that the list of developments alluded to above, which largely post-date the era of Weber and Schumpeter, do not alter the fundamentals as we have described them. For today, most progressive economic activity, not just in the western world but also increasingly in the East Asian economies not to mention those elsewhere in the developing world, is substantially oriented in a capitalist fashion in the sense in which this was understood by Weber and Schumpeter. And further, such capitalism is not only already present or emergent in the developing world under the impact of globalisation, but is being actively encouraged and facilitated by all manner of economic policies. For several decades now, the promotion of capitalism has been a key feature in a range of undeveloped nations eager to grow and prosper, and these policies are strongly supported by international organizations such as the Organization for Economic Cooperation and Development, The European Economic Community, the World Bank, the International Monetary Fund and the World Trade Organization. The more influential leaders of developing countries and many of their intellectual elites seem to assume that in one way or another their progress depends on the advance of the capitalist business engine. It would appear that the socialist model of rapid economic development has now been largely abandoned in all but a few instances; contemporary China is a fascinating hybrid case that raises complicated questions of analysis and interpretation in this regard but we cannot explore these for the moment. Of course, there are particular national characteristics and unique cultural factors that can be discerned in the various developing economies undergoing capitalist modernization that will determine more exactly how a particular society will foster business enterprise and organize its economy, and there may well be differing social values that impact on these arrangements. For example, some societies require recognition of special cultural norms, such as those required by Islam in respect to the charging of bank interest, or those that are increasingly expected in the advanced West with regard to environmental protection. But even given these restraints, it would appear that most emerging economies are likely to become significantly capitalistic in the requisite sense. And it needs to be realized that much of the regulation of the economy in the West in recent years has in part had the aim of ensuring mass support for capitalist institutions, so as to guarantee their essential legitimacy. This is clearly the case with the so-called “triple bottom-line” approach referred to above.

There is perhaps a limit to the trend toward capitalism that needs to be recognized and which seems to follow from our argument above. If we accept that according to Weber, modern capitalism required the unique set of conditions that he sets out in The Protestant Ethic, General Economic History and Economy and Society, is it possible for societies that have not passed through similar historical phases with corresponding conditions to reach the same capitalist outcome as West? For example, is it feasible for societies that have not achieved a legal system with high levels of formal rationality to develop modern institutions such as the limited liability corporation and the elaborate legal structures regulating its operation? The cases of Russia and China mentioned above are more ambiguous than they at first appear, for it may be that they are not mere hybrids combining aspects of market capitalism with central control but they are
ultimately antithetical to fully-fledged market capitalism. This is because they lack the crucial preconditioning factors that the West experienced and they may not be able to find an alternative route to full capitalist modernization. Such societies may therefore remain for the foreseeable future in a “half-way house” in that they will not fully become free-market systems regardless of how much they advance their economies. This predicament may affect many other developing societies as well, so that the goal of achieving a market capitalist system may not be obtainable for a long time to come—or possibly it will never be achieved. In the case of Russia, it is conceivable that it can prosper and develop its economy to a degree without embracing a completely free market because it can rely upon the export of its vast natural resources. Similarly, China may continue to grow at high rates for some time because it is able to exploit its vast supplies of cheap labour in combination with taking advantage of foreign technology but without becoming a truly capitalist system.

From the point of view of interpreting the peculiar nature of modern capitalism, we have argued that, despite its having been made nearly a century ago, Weber’s contribution remains essential to grasping the institutional structure of modern capitalism. We note in particular his emphasis on the role of the state and a rational legal system as decisive for the advent and continuing operation of such capitalism. Only under these conditions is a realm of peaceful market-oriented activity on a large-scale possible, and only then are all the other conditions for a market system possible. The rational state not only guarantees a domain of peace in which the private entrepreneur can count on the rewards of his activity being secured against irrational requisitions of one kind or another, it also enables the behaviour of the masses to be oriented to the peaceful consumption of goods (so-called “consumer society”). Weber explains how under modern capitalism the acquisition of material goods has become a value of an order not previously found in history. Schumpeter, on the other hand, is more focused on the fact that the consumer is to a significant degree “manipulated” by the entrepreneur into acquiring goods that at first he does not think he needs. It is the entrepreneur who in a real sense “creates” new needs. Of course, there are various criticisms of capitalism that have been made from the point of view of the apparent “irrationality” of this kind of manipulation of subjective needs, a criticism usually directed at advertising and other media which induce the individual to desire things regarded as unnatural or “false”. Neither Schumpeter nor Weber addressed this particular aspect of capitalist irrationality at length though they are aware of it. This was a criticism made forcefully at a later point in time by the so-called Frankfurt School of neo-marxism classically elaborated by Herbert Marcuse. Nonetheless, however irrational capitalism may appear from these points of view, both Weber and Schumpeter were in the end of the view that the material progress of capitalism was overall an undeniable social good.

And today it remains generally accepted that capitalist economic growth and the accompanying material progress are socially desirable despite the presence of negative features of various kinds such as increasing inequality, mindless consumerism, climate

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3 Though mention should be made of Weber’s sardonic remarks at the end of The Protestant Ethic in which he refers obliquely to Nietzsche’s “last men” who think they have found happiness in the modern world. PE, p. 182.
change, exhaustion of resources, etc.\textsuperscript{5} There are still other negative consequences of economic progress that might be cited—such as the obesity epidemic, the drug trade, the destruction of ethnic identities, the homogenisation of culture, or the spoiling of the natural environment—features which might be said to have arisen directly from too much progress, too much disposable income and excessive consumption. But, on the other hand, the developing world is pleading for greater material progress and especially for improvements in welfare measures relating to health, education and housing that it is hardly possible to argue should not be met. Thus it has been universally recognised that enormous economic progress shown by China, especially since the late 1990’s in bringing many millions of people out of poverty, is an achievement to be applauded. Clearly, balancing economic progress with its human costs remains an on-going task for social and economic policy now and into the foreseeable future.

\textsuperscript{5} Of course, we note that some critics have recently argued that the world is heading for some kind of apocalypse because the unrestrained development of capitalism threatens the survival of human kind because of environmental limits on the exploitation of the planet’s resources.
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