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On Schumpeter, Services and Economic Change: *His Evolutionary Economics Could Not Have Foreseen the Burgeoning of Issue-specific Consulting*

By DAVID L. MCKEE*

ABSTRACT. *Joseph A. Schumpeter*, the Austrian-American economist, worried about “Can capitalism survive” a generation ago, and so far it has. But his work poses these questions: How do *growth* and *change* take place in a *free enterprise economy*? Can his model for expansion through *innovation* and *creative destruction* through the competitive process be a basis for understanding present-day *industrial economies*? He emphasized that *capitalism* was an *evolutionary system* and that the very need for newness or rejuvenation should insure continual change in it. With respect to declining industries and firms the task of economics was to turn what might have been a rout into orderly retreat. And so he gave a limited blessing to certain *monopoly* practices deriving from a broader strategy, *risk avoidance*. Schumpeter’s *entrepreneurs* have disappeared but innovative ability still is exercised, largely through issue-specific *consulting services* in the burgeoning *service* sector, services that foster *stability* as well as change.

I

Questions Arising from Schumpeter’s Work

“CAN CAPITALISM SURVIVE?” was a question that was very much on the mind of Joseph Schumpeter during the final decade of his life. (Schumpeter, 1950). Despite his strongly held views concerning the advantages of that system he arrived at the personally troubling conclusion that the only honest answer to his question was no. The reasons that he cited for his pessimistic prognosis were more sociopolitical than economic but nonetheless potentially fatal to the system.

The years since his death have seen the strengthening of the social and political attitudes which he feared, not to mention the bureaucratization of entrepreneurial functions within large business organizations. Indeed his much vaunted concept of entrepreneurship has all but disappeared from the pages of economics textbooks. Despite these noticeable changes most of the advanced economies in the western world place substantial reliance upon the market mechanism in

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ordering their economic affairs, thus indicating that capitalism can hardly be considered to be a dead letter.

Today the appropriate question is hardly the one asked by Schumpeter, nor is it productive to criticize him in light of the fact that capitalism seems to have survived. A more useful question might be whether or not his explanation of how growth and change take place in an economy based upon free enterprise has been supported by events in the capitalistic world since his death. A related question revolves around whether or not his model can be used as a basis for understanding present day economies and their components and thus as a basis for predicting the future course of such economies.

Historically it was Schumpeter's treatment of the entrepreneur as innovator and risk taker that attracted the most attention among non-economists. Too much attention to those considerations may have detracted to some extent from the understanding of the totality of his contribution to explaining the automatic processes at work in profit motivated economies. Those processes are still at work today despite the disappearance of the entrepreneur from elementary economics texts and in spite of Schumpeter's own predictions concerning the dire consequences of innovation by committee.

II

Capitalism as an Evolutionary System

STRIPPED OF ITS ELITISM and sociopolitical content, Schumpeter's major economic contribution may have been his focus on the processes of growth and rejuvenation which he felt were central to a free enterprise economy. More specifically his major contribution may have been his identification of change as central to the continuing viability of the system coupled with his explanation of how change takes place.

Any scenario involving the survival of the system must be considered against the back-drop of change which in present day terms may be the genetic print of capitalism itself. In the Schumpeterian explanation of the system change occurs through creative destruction which he identified as the "process of industrial mutation . . . that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." (Schumpeter, 1950: 83).

To Schumpeter the very essence of capitalism was a dialectic, played out against the rhythm of the business cycle which in turn is directed by the processes of innovation and subsequent reactions to them. Thus over the swings of the cycle innovations cause upward movements which are magnified by secondary waves of activity until the upward thrust is exhausted by over expansion and/

or the strictures of full employment, at which time the cycle reverses itself and in the ensuing debacle the system is cleansed of inefficiencies, thus setting the stage for the next advance.¹

For the system to sustain itself over time it seems as though the secular trend must show a continuing real expansion. Since such a long term expansionary mode is the collective result of the thrusts of a continuum of innovative groupings within the temporal constraints of each ensuing cycle it would be unrealistic to assume that specific industries or activities by their very nature can be expected to sustain leadership roles within the system over time. Indeed the dialectical nature of the system suggests a continual changing of leading industrial sectors with the ebb and flow of ensuing cycles. Thus a decline in the fortunes of traditionally strong industrial sectors in a capitalistic economy is not necessarily an indication of weakness in that economy. It may simply mean that the Schumpeterian dialectic is at work and that other industries have assumed the leadership mantle.

Schumpeter emphasized the evolutionary nature of capitalism. He saw the system as "by nature a form or method of economic change" which "not only never is but never can be stationary" (Schumpeter, 1950: 82). The process of change would presumably insure that leadership roles within the economy shift over time. In Schumpeter's words, "The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates" (Schumpeter, 1950: 83). Thus the very need for newness or rejuvenation should insure continual changes in importance for the individual components of the economic mix.

If Schumpeter's analysis is valid the fears elicited by the process of deindustrialization may be exaggerated. The visible effects of that process, however painful, may simply herald changes in direction in the economies concerned. Even in cases where foreign competition is involved this may be true, for capitalism is essentially an international system which is no respecter of political boundaries. That Schumpeter recognized the international element is evident in his writings. Speaking of change he suggested that "The opening up of new markets, foreign or domestic, and the organizational development from the craftshop and factory to such concerns as U.S. Steel illustrate the same process of industrial mutation" (Schumpeter, 1950: 83). If the changes that are raising the concerns of economists today can be attributed to creative destruction then a close examination of the Schumpeterian system may allay their fears.

Schumpeter did not base his pessimistic prognosis for capitalism upon anecdotal evidence garnered from industries and/or time frames. He was explicitly

suspicious of such a procedure. "Since we are dealing with a process whose every element takes considerable time in revealing its true features and ultimate effects there is no point in appraising the performance of that process *ex visu* of a given point of time" (Schumpeter, 1950: 83). He was careful to stress that performance must be judged "as it unfolds over decades or centuries." The use of specific time frames in the assessment of industrial performance much less that of the economy as a whole, focuses on "how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them" (Schumpeter, 1950: 83).

III

Change, the Competitive Process and Innovation

IN SCHUMPETER'S VIEW change occurs, *i.e.* firms and industries are created or destroyed, as a direct result of the competitive process which is fueled by innovation. The process is hardly benign, meaning that it produces casualties. Schumpeter spoke of competition "which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives" (Schumpeter, 1950: 83). He was speaking of competition so potentially devastating that the very threat of it conditions business behavior. The competitors themselves are in a very real sense gladiators, who each day face economic annihilation, irrespective of their historical successes. None of these players are indispensable, all are expendable in the inexorable rhythm of the free enterprise dialectic (Schumpeter, 1950: 83ff).

Schumpeter's business climate was essentially Darwinian. "Old concerns and established industries, whether or not directly attacked, still live in the "perennial gale" (Schumpeter, 1950: 90). He recognized that in particular instances the force of that gale could bring down competitors that might have been able "to live on vigorously and usefully" (Schumpeter, 1950: 90) in less acute presumably accidental circumstances. Evidently creative destruction and the violence of the cycle it initiates can on occasion inflict "functionless losses" in the sense that they may be unnecessary to the continuing efficiency of the system. On a personal level Schumpeter reaped no pleasure from the pain inflicted by change, merely viewing failed competitors as a necessary concomitant of the dialectic which insures growth and efficiency. He realized that "there is certainly no point in trying to conserve obsolete industries indefinitely" (Schumpeter, 1950: 90). Yet he recognized the logic "in trying to avoid their coming down with a crash and in attempting to turn a rout, which may become a center of cumulative depressive effects, into an orderly retreat" (Schumpeter, 1950: 90).

With this line of reasoning he placed his limited imprimatur upon certain monopoly practices. Of course such behavior patterns are singular examples of a wider behavioral syndrome known as risk avoidance which has become quite prevalent in business circles. Risk avoidance in general would appear to be unacceptable in a system based upon creative destruction—change elicited by entrepreneurial innovation. If it cuts down upon entrepreneurial zeal it cannot help but abridge the dialectic and contribute to the bureaucratization of enterprise that Schumpeter so feared.

If risk avoidance parameters are built into the firms themselves, Schumpeter's most serious fears for the health and continued success of the system appear to be realized. These essentially artificial strictures in conjunction with size hasten the process of bureaucratization and stifle the entrepreneurial function. Writing in 1986 R. D. Norton referred to the famous Schumpeterian paradox whereby "capitalism's transition to socialism would occur not with a bang, but with a whimper—as a by-product of industrial capitalism's success." Norton was writing about the United States and in his evaluation of that particular economy he saw a reprieve from the paradox—"competition from less developed capitalist economies, both within the U.S. and worldwide, has rocked the foundations of mature economies, forcing them to retreat to the more competitive, pro-business policies of the past."

Of course Norton was quite correct in suggesting the importance of international linkages. Under his scenario, systemic failure in certain advanced economies may be postponed. Nonetheless Schumpeter's silent apocalypse may be gathering momentum on a world scale. The pursuit of that particular proposition is beyond the scope of the current discussion. It must be remembered that many of the international linkages that have evolved since the time of Schumpeter are the product of both the needs and the activities of multinational firms. Because of that fact the concept of deindustrialization and the flight of jobs from advanced nations may have been overemphasized. Corporations which are headquartered in the United States are still in control of many of the jobs that have been exported and profits earned by those corporations are frequently repatriated which undoubtedly means new employment opportunities.

The loss of assembly line jobs in the United States and other advanced economies does not necessarily mean that those nations are on a downslide, much less that the free enterprise system is changing. Many non-assembly line opportunities have been created within traditionally strong manufacturing industries. This change may be an indication of increased international managerial responsibilities rather than the internal socialization predicted by Schumpeter. Despite that possibility it is understandable that the changes under discussion have caused considerable concern.

IV

The Ascendancy of Services in Advanced Economies

INCREASING THE UNEASINESS occasioned by the decline of assembly line jobs, has been the observation that the United States and various other advanced nations have become service oriented. The juxtaposition of manufacturing declines and service expansion has lent an unearned suspicion of default to the service activity set. The ascendancy of services in advanced economies may be the most notable post-Schumpeterian change that has occurred in those economies. If the relevance of Schumpeter's insights for contemporary capitalism is to be ascertained the role of services must be explored.

Schumpeter was effective in making the point that creative destruction was essential if the free enterprise system was to continue and prosper. Through that process, activities relinquish leadership roles in the economy over time, thus making way for new lines of endeavor. Following Schumpeter's lead the pole theorists, a group of European economists, emphasized how leading activities influence the dialectic. In that regard they were somewhat more explicit than Schumpeter.

Writing in 1955, Francois Perroux declared that "Growth does not appear everywhere at the same time, it becomes manifest at points or poles of growth, with variable intensity; it spreads through different channels, with variable terminal effect on the whole of the economy." (Perroux, 1955, reprinted 1970: 94) Through this statement, Perroux has gone a long way towards operationalizing Schumpeter's view of change—creative destruction. Tormod Hermansen saw Perroux's view of growth or perhaps change "as a tool to explore the process by which economic activities . . . appear, grow and, as a rule, stagnate and sometimes disappear" (Hermansen, 1972: 21).

How does the massive ascendancy of profit oriented service activities square with the Schumpeterian dialectic? Despite the fact of that ascendancy, few specific services have become key industries in a growth pole sense. Instead their most important role has been that of a flux or facilitator. "As the ebb and flow of industrial activities takes place . . . service activities generally maintain the flexibility to accommodate the needs of new leading industrial sectors." (McKee, 1987: 173). In this way whole cadres of business and professional services actually contribute to the free enterprise dialectic. "By doing so they extend their role of flux to the actual growth process, encouraging expansion and to some extent cushioning industrial retreat." (McKee, 1987: 173). Thus it would appear that these categories of services contribute to both growth and stability.

Such a performance would have elicited at least mild applause from Schumpeter. To the extent that they facilitate an orderly retreat, thus avoiding a violent

demise for redundant competitors, they may make risk avoidance behavior less necessary. It is clear that they do facilitate the actions of leading industrial sectors but it may be that regarding them as juxtaposed to those industries obscures the actual centrality which they have come to enjoy in the Schumpeterian system.

Schumpeter himself feared the bureaucratization of the processes of production and the effect of such circumstances upon the ability of the system to innovate. The relatively new service facilitators have made possible innovations in manufacturing which could hardly have been possible in their absence. For example there is little doubt that advances in transportation and communications services have revolutionized the organization of certain industries. An obvious example of this is in the realm of decisions with respect to the location of facilities. Today there is much less need for the concentration of production activities. Thus, within advanced economies, companies have been able to shift the sites of their operations to less congested, more salubrious surroundings, which may contribute to economies in the cost of resources which in turn strengthen the competitive position of firms involved. Thus innovations in transportation and communications have in turn facilitated innovations in the organization of industry.

On the international level these service innovations have had considerable impact upon the development of multinational firms. Of course those firms required considerable inputs from specialized financial, legal and professional service cadres to facilitate their operations. It seems clear that extensive innovations in these sophisticated service operations have actually facilitated the rise of multinational firms, not to mention their continued existence and growth. Whether or not these multinational firms constitute the leading sectors of the economies of their home countries is probably immaterial to the current discussion. The pertinent point is that they appear to be continuing profitable operations because of cooperating services, which, in turn, profit from the symbiotics of the situation.

It would appear that the development of the types of services under discussion has made the industrial environment in the United States somewhat less of a mine field. "The linkages that services provide in manufacturing chains add jobs to the national economy but they also add a certain amount of stability." (McKee, 1987) This is true because their customers are not confined to specific firms or industries. Thus, as the dialectic progresses, services acquire new clients to replace those that may have disappeared.

Actually in an economy as diversified as that of the United States, the Schumpeterian dialectic may be less readily apparent than it seemed to be in theory. The dramatic language employed by Schumpeter, coupled with the refinements

of his system developed by the pole theorists, seem to conjure up images of banished industrial heavy weights knocked out in the very arena that had housed their earlier successes. Sidelined by younger, more vigorous opponents they have nothing to look forward to but continuing declines in viability ending in their removal from the list of active competitors.

Such analogies and the perceptions they generate grossly oversimplify the realities of the competitive process under capitalism. Certainly performance leaders can be identified amongst the lists of corporate giants provided annually by various business publications but once the finalists have been selected based upon size, profitability or other criteria, it would be less than productive to ignore the very real impact of other large firms. If the finalists change from year to year, Schumpeter himself would be cautious in attributing too much meaning to such circumstances, based upon his belief that the system must be viewed over time if the subtleties of change are to be correctly interpreted.

Perhaps the methodology of the pole theorists with its emphasis on leading sectors (growth poles) and their linkages has an implicit bias towards the sorting of current facts which detracts from its ability to make change understandable. The risk of such a pitfall is heightened when input-output data are used as a basis for the ordering of economic activity. The implication seems to be that key industries or growth poles control the direction of the economy. If that supposition is correct, then in Schumpeter's view of the system those same activities are undoubtedly the focal point of the innovations which elicit growth and/or change.

Despite the fact that service activities account for more than half of the labor force in advanced economies, there is little to suggest that service subsectors have become increasingly prominent among periodic listings of key industries (growth poles). Nonetheless it is evident that they facilitate profit-motivated activities of various types and that certain service categories which are consumer oriented owe their existence, at least in part, to rising levels of income. Perhaps a better understanding of the service role in advanced free enterprise economies can be garnered by returning to Schumpeter's formulations. It seems evident that innovative processes have changed considerably from their basic Schumpeterian format. Among the 500 companies listed by *Fortune* Magazine as the leading ones, Schumpeter's entrepreneurs have largely been replaced by professional managers, yet the economy of the United States is still growing and changing. The fact that it has become service oriented occurs hardly through the default of the industrial leadership or the internal bureaucratization of their managerial functions. A more plausible explanation may be that services have simply been the seat of considerable innovation. They have not grown by default, rather they have become an impact zone for the Schumpeterian dialectic.

The System's Innovative Ability—Its Drive

SERVICES DIRECTED TOWARDS BUSINESS have been profitable in their own right and thus have generated considerable competition. It can even be said that the phenomenon of creative destruction is undoubtedly at work within the private service sector. To the extent that large manufacturing concerns avail themselves of the expertise of these emergent service groupings they retard the development of the type of internal socialization which Schumpeter felt would help to bring down the system. Industrial firms may even be able to avail themselves of innovations from the service sector.

If the locus of innovation has changed to some extent so too has the locus of risk bearing. Large firms are able to utilize expertise without sharing the major risks of its development. That industry has recognized this is evidenced by an increasing willingness to offload various permanent staff bureaucracies in favor of the utilization of issue-specific consulting services. The service cadres which deal with industry grow and prosper because they perform useful functions. Large manufacturing operations benefit from the increased availability of specialized expertise. Through its utilization they reduce their permanent staffing needs, cut down on their risks, expand the market potential of their products and no doubt improve their potential for maintaining acceptable levels of profitability well into the future.

Thus business related services and their clients have developed a symbiotic bond. Not only do both parties to this bond benefit, the system itself benefits by reducing uncertainties. Creative destruction can still take place but it does so in such a way that it may benefit large segments of the economy. Under this new regime it seems less likely that large firms will come crashing down in a manner that Schumpeter found repugnant and unnecessary. Endeavors that have passed their prime are better able to beat an orderly retreat, another item on the Schumpeterian wish list.

It may be that the innovative process that Schumpeter considered to be indispensable has changed its thrust. Of course it will never be totally absent from industry but by eliminating some of the violence formerly associated with it, it has found a way to allow and perhaps encourage change while at the same time providing for a certain amount of stability. Although services play a major role in the new processes of capitalism, few of them may ever reach the status of growth poles. Still they have emerged at the very center of the processes of change. The fact that they have done so suggests that Schumpeter was correct in focusing on the ability of the system to innovate. It is this ability that drives the system more than the ever changing cast of industrial leaders with their very

real linkages. Despite the fact that professional managers direct the fortunes of most large companies, innovative ability still exists in the system. It is simply being applied in ways in which Schumpeter could not have foreseen.² Whether or not the changes that have materialized since his death can sustain the system indefinitely remains to be seen. Suffice it to say that the immediacy of the question of survival seems less acute.

Notes

1. For a detailed explanation of the Schumpeterian system see Francois Perroux, *La Pensée Economique de Joseph Schumpeter: Les Dynamiques du Capitalisme*, Genève: Librairie Droz, 1965. A popular account of Schumpeter's views on change can be found in William Baldwin, "Creative Destruction," *Forbes*, July 13, 1987, pp. 49–50. For how change affects regional and local economies see William H. Leahy and David L. McKee, "A Schumpeterian View of Regional Development," *Growth and Change*, Volume 3, Number 4, October 1972, pp. 32–35; "On Goldfields, Libraries, Cities and Schumpeter," *The American Economist*, Volume XVIII, Number 1, Spring 1974, pp. 142–44; and "A Note on Urbanism and Schumpeter's Theory of Development," *Growth and Change*, Volume 7, Number 1, January 1976, pp. 45–47.

2. An International Joseph A. Schumpeter Society has been organized. For information, see "Group Carries on Schumpeter's Work," *American Journal of Economics and Sociology*, Vol. 47, No. 2 (April, 1988), pp. 221–22.

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