

# The Limits of Schumpeter's *Business Cycles*

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**Abstract:** Schumpeter designed *Business Cycles* as his major work, but it has never received much attention. The problem is partly related to its complex treatment of the theory of waveform economic evolution and the related study of the statistics and history of 150 years of capitalist evolution, but the book also makes a deliberate analytical delimitation: the emphasis on economic evolution and the placement of institutional change as an external factor. This definition of the task did not allow Schumpeter to make a full-blown study of the history of capitalist evolution. To some extent, he overcame that problem in *Capitalism, Socialism and Democracy*, but we have to return to the works of his youth to understand his conception of the coevolutionary processes of socio-economic life.

Schumpeter's research programme not only covered economic evolution but also the coevolution between economic life and socio-political life. We find the latter part of his programme in *Capitalism, Socialism and Democracy*, but it dates back to the first German edition of *The Theory of Economic Development* (Schumpeter, 1912). The original presentation was concentrated to the later omitted seventh chapter on 'The Economy as a Whole', and the present journal made an important service to the research community by publishing the translation and related discussions (Mathews et al., 2002). William Kingston's (2006) paper in the present issue of this journal serves to demonstrate that Schumpeter in his *Business Cycles* ignored the second part of his research programme—although the attempts to cover at least 150 years of waveform capitalist evolution seems to have called for this broader approach. This problem has troubled many readers of *Cycles*, and its exploration is the purpose of the present paper. Thus, it complements a previous paper (Andersen 2002) that mainly tried to formulate Schumpeter's coevolutionary approach within the economic system.

## The delimitation of *Business Cycles*

William Kingston considers the failure of systematically including institutions ‘a remarkable gap in Schumpeter’s own thinking’, which has had some influence on neo-Schumpeterian evolutionary economics. He depicts Schumpeter as being incapable of acknowledging the role of institutions, and he concentrates on the thesis that ‘Schumpeter failed to grasp the importance of legislation’. Since Schumpeter during his studies at the University of Vienna in the beginning of the twentieth century had much more law than economics, this would be a remarkable failure, indeed. However, since Kingston concentrates on Schumpeter’s *Business Cycles*, the thesis is about the failure of that book to include the role of institutions in explaining the Kondratieff Long Waves. By invoking Simon Kuznets’s (1940) famous and devastating criticism of *Cycles*, he adds to the impression that the book was a general failure. This sets the stage for Kingston’s own theory of Kondratieff Waves as influenced by reforms in the legal conditions for entrepreneurship.

There are two quick answers to Kingston’s account for *Cycles*. The first answer is that Schumpeter (1939: 7; 1962: 1) explicitly omitted exogenous causation from the analysis of his book:

Among the factors which determine any business situation there are some which act from without the economic sphere. ... [They] must be accepted as data and all we can do about them is to explain their effects on economic life. ... [W]e must try to abstract from [these external factors] when working out an explanation of the causation of economic fluctuations ... which are inherent in the working of the economic organism itself.

On institutions, Schumpeter (1939: 11; 1962: 4–5) wrote:

[W]e have had examples (changes in tariff policy, taxation, and so on) of what we may term changes in the institutional framework. They may range from fundamental social reconstruction ... down to changes of detail in social behavior or habits ... It is entirely immaterial whether or not such changes are embodied in, or recognized by, legislation. In any case they alter the rules of the economic game and hence the ... systematic relations of the elements which form the economic world. (Schumpeter 1939: 11; 1962: 4–5)

Thus, *Cycles* fully recognised the role of institutions, whether embodied

in law or not. Actually, Schumpeter (1939: 11; 1962: 5) emphasised that ‘it would be possible to write, without any glaring absurdity, a history of business fluctuations exclusively in terms of external factors’. However, as any analyst, he had to define the boundary of the system under study. In *Cycles*, most of law happened to be outside the analytical boundary, but it was included in *Capitalism, Socialism and Democracy*, where he defined the analysed system much more broadly.

The second quick answer to Kingston is that Kuznets was hardly an unbiased reviewer. Therefore, it might be better to start from other reviews. For instance, the German economic historian Hans Rosenberg (1940: 96) started his review by pointing out that Schumpeter could be seen as following Wesley Mitchell’s ‘strong plea for the mutual penetration and permanent, harmonious co-operation of theory, statistics, and history as applied to a realistic, nonspeculative analysis of the cyclical *modus operandi* of the economic life process of capitalist society.’ Unfortunately, Schumpeter’s ‘monumental publication ... cannot be merely read; it must be studied.’ (p. 96) The reason is that ‘[h]ardly a page makes sense unless he reader masters the abstract patters as well as the concrete contents of both volumes and treats them as an inseparable whole.’ (p. 96) Furthermore, this whole is defined by a ‘self-imposed limitation’, namely that it does not ‘admit the significance of “external factors” ... as generators of historic “economic evolution”.’ (p. 97) Therefore, Rosenberg considered *Cycles* of relatively little direct interest for those historians who wanted large-scale accounts for the history of capitalism.

Kuznets probably shared some of Rosenberg’s views, but his criticism was less forgiving. Actually, Mark Perlman (2001) has shown that Kuznets had been criticising Schumpeter from his early studies in Russia via his graduate and post-graduate work under Wesley Mitchell to the time when he wrote his review. Kuznets based his critique on his dislike for theory that he could not quickly verify or falsify by empirical data. Since *Cycles* tried to combine general evolutionary theory with statistics and history that covered more than 150 years, it was easy for Kuznets to demonstrate that this combination was not very solid. However, this was just what was to be expected, so the problem was that his review scared readers from continuing

the work. The revenge from the theoretically minded economists came when Tjalling Koopmans (1947) wrote a devastating review of Mitchell's *Measuring Business Cycles* with the title 'Measurement without Theory'.

These two immediate answers do not cover all of Kingston's argument, however. The main problem is that the analysis of the statistical and historical information in *Cycles* had to make judgements about whether the influence of exogenous institutional change was so strong that it totally explained business cycles. Not surprisingly, Schumpeter argued that this was not the case. Let us take the example of the Second Kondratieff in which the railway system emerged. This Long Wave started in the 1840s, and around that time, there were many legislative initiatives in England, which he took as a paradigmatic example. However, Schumpeter did not consider these initiatives—'Free Trade, the Bank Act, and the Company Acts'—independent and sufficient explanations of business cycles. Concerning independence, Schumpeter (1939: 306; 1962: 203) argued that they 'grew much more clearly out of the immediate economic situations than such changes did at any other time'. In the case of the Company Acts, he did not consider them independent because they codified and enhanced business practices that had already been developing. Concerning sufficiency, he suggested that the legal initiatives did not qualitatively change cyclical evolution. These judgements, of course, are open for Kingston's discussion, but it should be noted that Schumpeter made them cautiously and that he had considerable knowledge about the activities in both Parliament and industry. Furthermore, the delimitation of the analytical task of *Cycles* hindered the development of his argument.

### The theory, statistics, and history of waves of evolution

Although *Capitalism, Socialism and Democracy* became Schumpeter's most cited book and *The Theory of Economic Development* has emerged as his *magnum opus*, there is little doubt that he had planned *Cycles* to form the crown of his work. Contrary to the implicit suggestion in Kingston's paper, the main reason why this plan failed was that he was too ambitious. Schumpeter (1935) presented his first outline of the book project in small

and elegant article on ‘The Analysis of Economic Change’, but four years later *Business Cycles: A Theoretical, Historical, and Statistical Analysis of the Capitalist Process* came out with its 1100 pages and an architecture as complex as that of a gothic cathedral. Actually, *Cycles* looks more like a huge research report than a coherent scientific monograph. In the Preface, he emphasised that it

took longer than I thought to turn that scaffolding [*Development*] into a house, to embody the results of my later work, to present the historical and statistical complement, to expand old horizons. Nevertheless I doubt whether the result warrants that simile. The house is certainly not a finished and furnished one—there are too many glaring lacunae and too many unfulfilled desiderata. ... The younger generation of economists should look upon this book [*Cycles*] merely as something to shoot at and to start from—as a motivated program for further research. (Schumpeter 1939: v)

What Schumpeter could not manage is still more unmanageable for his readers, but this is not the only reason why the book received little attention. There are also problems of bad editing, bad timing, and a bad title. A good editor should have pressed Schumpeter to focus his book in its strengths: the clarification of his idea that economic evolution largely takes place in waves and the historical evidence about the waveform history of the capitalist economic system. However, the book shows no sign of such an editorial effort, and this effort instead had to be performed twenty years later by Rendigs Fels. By focussing on Schumpeter’s evolutionary theory and his account for the economic history of the USA, Fels produced a fairly condensed and readable abbreviation (which has not received sufficient attention). However, as Fels emphasised (in Schumpeter 1962: viii–ix), there was still the problems of timing and title. The book came out in 1939 when the attention turned to the exploitation of the given economic system for war purposes, and it would probably have been judged very differently if it had come out when long-term issues were at the centre of interest in the beginning of the Great Depression or immediately after World War II. Furthermore, the first part of the title—*Business Cycles*—does not really reflect the core strengths of the book. Here the subtitle is more saying, and the interpretation of the book might have been more favourable if it had

been called 'A Theoretical, Historical, and Statistical Analysis of the Capitalist Process: Business Cycles'. This version of the title, however, still misses the point that Schumpeter is not primarily contributing to business cycle analysis in the narrow sense, and it fails to emphasise that *Cycles* is closely related to *Development*. So one might speculate about the reception of the book if it had been called 'The Theory, History, and Statistics of Economic Development'.

The theoretical parts of *Cycles* had roots back to Schumpeter's student years. At that time, the problem of cycles and crises engaged the members of the Historical School and the neo-Marxists, and it was a hot issue in Vienna at the seminars of Schumpeter's teachers, the historian and statistician Inama-Sternegg and the economic theorist Böhm-Bawerk. In this context, Schumpeter (1954: 1135) developed a basic strategy that was close to what he found in Marx's work, namely 'to look to business cycles for material with which to build the fundamental theory of capitalist reality.' His specific connection between business cycles and the theory of the capitalist process was simple. Capitalism was an engine of a form of economic evolution that did not take place gradually and continuously but rather in waves. Thus, his task was to connect the waves of evolution with the business cycles of the capitalist economy. His starting point was that, in a highly stylised model, a wave of evolution emerges when the evolutionary process in the economic system has come to a halt. Such a situation is favourable for the introduction of innovative projects since it is easy to calculate their expected profits and since a low rate of interest promotes their profitability. However, the introduction of a swarm of innovations increases interest rates and disturbs calculability to an extent that hinders further innovation. At the same time, the already introduced innovations give rise to a sharp competition with parts of the economic system that follows old routines. This competition will end with a state where no further evolution takes place, and this is the ideal starting point for the next wave of innovative projects.

This basic model, however, was only Schumpeter's (1939: 130; 1962: 105) 'first approximation' to analysis of business cycles, and he developed models that are more complex. From a theoretical viewpoint it is important

that Schumpeter included something like an ‘accelerator effect’ of the demand from innovative investment on the investment activity of the old and routinised parts of the economy. This effect serves to produce a ‘boom’ during the first part of a wave of evolution and a ‘depression’ when innovative investment collapses. Thereby, Schumpeter might appear as opening up a dialogue with the Keynesians, but such a dialogue hardly developed because they thought in terms of macro aggregates while he was a ‘staunch opponent of aggregation’ (Fels in Schumpeter 1962: ix). Furthermore, this opposition meant that he did not really relate to the emerging range of macrodynamic analyses from Paul Samuelson’s standard models to the Marx-inspired models of Michal Kalecki.

Schumpeter’s hostility to aggregation also explains the apparent failure of the statistical parts of *Cycles*. His very first papers were on statistical measurement, and one of them included the warning: ‘Beware of Statistical Aggregates’ (Haberler 1950: 338). He had stuck to this warning ever since, but in *Cycles* he had to include a large number of aggregate time series (for instance, of prices, output, and employment). The treatment of them fills many of the pages, but they mainly had a very limited purpose: to date the turning points of the empirically observable business cycles. Schumpeter’s lack of success in finding and analysing statistical data meant that he put an enormous burden on the 450 pages of the historical part of *Cycles*. This part is based on the same provocative idea that Schumpeter just before his death presented to the leading American theorists and econometricians: that historical facts are the ultimate driving force of the science of economics:

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. (Schumpeter 1939: 13; 1962: 7)

Through this statement, Schumpeter related to discussions within the German Historical School. This school, which had some similarity with American Institutionalism and was very strong in Schumpeter’s youth, engaged in studying the socio-economic structure capitalist system and its evolution. In that connection, several of its members emphasised the

importance of business cycles and economic crises. It is probably the reason why it has been suggested that ‘*Business Cycles* may, in fact, be considered the last (and one of the most important) monographs of the Younger German Historical School.’ (Streissler 1994: 37) However, while they were interested in the long-term evolution of the capitalist institutions, *Cycles* was following a much more narrow research agenda than this school. Thus, the historical parts of *Cycles* are primarily an attempt to study waveform evolution within *given* capitalist institutions.

Schumpeter’s historical analysis of waveform evolution within capitalism raised major difficulties for him. One of them was that ‘he is no more a historian than he is a mathematician’. (Schumpeter 1939: 223) The major difficulty, however, was that the historical data reflected an evolution of the institutions of capitalism while he assumed a more or less given capitalist framework. This problem became obvious when he moved from the shorter—Kitchin and Juglar—cycles to the Kondratieff Waves that lasted nearly 60 years. Here he made the best performance with respect to the Kondratieff Wave that he dated 1842–1897 (Schumpeter 1939: 303–397; 1962: 201–246). This period of the ‘railroadization of the world’ had clearly influenced his theory, so it was hardly surprising that it gave rise to his best ‘reasoned history’. In contrast, he had greater difficulties in handling the ‘neomercantilist Kondratieff’, which he dated as starting in 1898 and with a recovery that was still not over in 1939. One of his problems was that he came to see socio-political change as the main explanation for the long-term ‘stagnation’. Keynes had hinted at this theory in the *General Theory*, and it was being developed by Schumpeter’s Harvard colleague Alvin Hansen. The only way of reinterpreting and criticising this Keynesian theory from the viewpoint of Schumpeter’s evolutionary framework was to turn to the hindrances to entrepreneurship by public resentment and long-term institutional change.

### Socio-economic coevolution in Schumpeter’s other works

Before Schumpeter had finished his *Cycles*, he received a letter asking about his sociologically oriented studies of the destiny of capitalism. This letter

specifically inquired about the last paragraph of his paper on ‘The Instability of Capitalism’. Here Schumpeter (1928: 395) emphasised

that no account whatsoever has been taken [in the paper] of any but purely economic facts and problems. Our diagnosis is, therefore, no more sufficient as a basis for prediction than a doctor’s diagnosis to the effect that a man has no cancer is a sufficient basis for the prediction that he will go on living indefinitely. Capitalism is, on the contrary, in ... a process of transformation into something else[.]

The question was how to study this process of transformation, and Schumpeter (2000: 309) replied that although he had never worked out the analysis in detail, he had ‘repeatedly thought about the subject and spoken about it in addresses’. Furthermore, his project on *Cycles* had persuaded him to move forward:

For if one thinks of business cycles as the typical form of capitalist evolution and if one looks upon these long time movements, which are sometimes called industrial revolutions, as one species of cycles, it is but natural to link up with the cyclical phenomenon practically the whole of the economics and sociology of capitalist society. (Schumpeter 2000: 309)

After completing *Cycles*, Schumpeter designed a series of essays on these issues, and although he could draw on previous writings, it took him nearly three years to finalise *Capitalism, Socialism and Democracy*. In *Cycles*, Schumpeter had assumed that economic evolution takes place within a more-or-less given capitalist framework, but in *Capitalism* he turned to a full-blown historical, economic, and sociological analysis of the characteristics of the waveform evolution of the capitalist system, and its potential transformation into socialism. By applying his analysis of economic evolution, Schumpeter tried to demonstrate that both the Keynesians and the neo-Marxists were wrong in their bleak predictions, but then he turned to a sociologically oriented analysis that explained why they, nevertheless, might be right.

Schumpeter’s well known argument is that although the long-term consequence of the evolutionary process is a raise of the general standard of living, the problem is the socio-political reactions to the immediate losses and gains. These reactions are influenced by the fact that capitalism has

been ‘the propelling force of the rationalization of human behaviour’ (Schumpeter 1942: 125). This ‘rationalization’ is related to a ‘rationalist attitude’ that dismisses notions of fate and sacred institutions and demands some degree of predictability of social life. However, capitalism still includes the instability of ‘creative destruction’. Those who lose tend to react with strong resentment and to ignore the issue of long-term gains: ‘Secular improvement that is taken for granted coupled with individual insecurity that is acutely resented is of course the best recipe for breeding social unrest’ (p. 145). This type of reaction leads to the labour movement, and it is supported by intellectuals whose ‘hostility increases with every achievement of capitalist evolution’ (p. 154).

Those who gain from creative destruction, in contrast, are not effective defenders. The entrepreneurs and capitalists were never such defenders, so the capitalist system survived because of the support from other classes like the remnants of feudalism, but these ‘protecting strata’ are being destroyed (Schumpeter 1942: 135–139). Furthermore, the driving force of economic evolution tends to lose its vigorousness. The owner-managed firm and the paternalistic bourgeois family—with its long-term interests in the destiny of its progeny—are disintegrating, and this weakens the motivation for entrepreneurial activity (p. 159). The large corporation may appear as an excellent substitute that ‘tends to automatize progress’, but it also ‘ousts the entrepreneur and expropriates the bourgeoisie’. Thereby it becomes clear that the ‘true pacemakers of socialism were not the intellectuals or agitators who preached it but the Vanderbilts, Carnegies and Rockefellers.’ (p. 134)

Thus, Schumpeter thought that the Marxian ‘prognosis’ was right, but Marx gave the wrong reasons for it. Furthermore, the rightness of the Marxian vision concerned very long-term trends that had gone ‘in no country far enough to allow us to say with any confidence how far they will go’. The problem was that ‘in these things, a century is a “short run”’, so capitalism may still ‘have another successful run’ (Schumpeter 1942: 163). His main reason for doubting such a ‘run’ was that the social reality of the 1930s and 1940s was characterised by ‘big-business capitalism *in fetters*’ (p. 201)—with tax lawyers, bureaucracy, and other ‘wastes that result from the conflict of structural principles in a social body.’ (p. 198)

The above account for *Capitalism, Socialism and Democracy* is by far complete, but it serves to emphasise that it is not easy to evaluate the scientific contributions that are found Schumpeter's most read book. This is partly explained by his use of polemics and irony and by the carefully guarded predictions, and we begin to understand why he told his friends that it was an 'off-the-cuff pot-boiler' (Samuelson, 2003, 465). However, *Capitalism* is much more than a rough sketch written to make money. In the present context, it is especially important to note that it contains a sketchy implementation of Schumpeter's theory of the troublesome coevolution between economic life and socio-political life. This aspect of *Capitalism* has not received sufficient attention in the literature. Instead, we he find an irresistible urge to compare Schumpeter's 'prediction' with later events. This urge even dominated a volume celebrating *Capitalism* with 40 years of hindsight and with contributions by, for instance, Paul Samuelson, Gottfried Haberler, Arthur Smithies, Robert Heilbroner, and Tom Bottomore (Heertje 1981). As Herbert Gintis (1983: 85) remarked in his review of that book, this kind of assessment is a major error: 'We have long abandoned the attempt to assess Marx' social theory on the basis of his "predictions", and would never conceive of applying such an approach to Weber, Ricardo, Smith, or Marshall. Why then apply such a criterion to Schumpeter?' Gintis suggested an explanation: 'Schumpeter can be taken seriously only within the context of a commitment to the development of a science of social change', but his economic and sociological reviewers did not even recognise 'that there *is* such a science'.

Schumpeter's ambition to develop 'a science of social change' dated back to his young years in Austria. Here he studied at the Faculty of Law and Government Sciences, and members of the Historical School and the Austrian School as well as scholars of jurisprudence taught him. A major aim of the Historical School was to develop theories of social change, and this aim influenced the Austrian School. Thus, Carl Menger increasingly moved into sociology in order to explain the concrete features of economic and social institutions that he had hitherto only explained functionally. The most famous example is Menger's (1892) attempt to explain the concrete forms of money by evolutionary processes in a paper that serves as

argument against the view that money is the simple outcome of the activities of Great Lawgivers. In a statement quoted by Kingston, Schumpeter (1956: 160–161) related to Menger's view by stating that

money is as little and in no other sense a creature of the law than is any other social institution such as marriage or private property. The comparison is instructive. Marriage and property, too, are regulated by law and to that extent their concrete forms are of course creatures of the prevailing legal system. But no-one can explain marriage or property by this legal system. ... Similarly, money transactions are regulated or shaped by the legal system, but as an object of regulation they retain a separate existence apart from the legal system and can be explained only by their own nature or by the inner necessities of the market economy.

The problem, of course, was how to explain that the legal system reflected the needs of economic and social life. Schumpeter's formulations seem to indicate that he did so by a simplistic version of the Marxian (and Mengerian!) interpretation of socio-economic history, but this was hardly the case. We recognise his sophistication from the 'lost' seventh chapter of the German edition of *The Theory of Economic Development*, where the argument, however, was made at a much more abstract level than the one Kingston seems to prefer.

The argument developed in five steps. First, Schumpeter (2002: 135) observed 'noticeable analogies in other areas of social life' to the processes of economic evolution that he had studied throughout *Development*. His examples were 'the areas of politics, of arts, of science, of social life, of moral considerations'. Second, he emphasised the relative independence of the evolutionary process in each of these areas. The reason was specialisation. For instance, 'in the area of politics ... we find people whose main interest ... is rooted in this area and who are characterised thereby.' (p. 135) Within each area, this sets the stage for an evolutionary process driven by routinised behaviour and innovative leadership. Third, he turned to the problem that we, despite the 'relative autonomy of each single field', may describe the '*social culture*' as 'static state' in which 'the processes and relations in any area of social life are codetermined by the processes and relations in any other area.' (p. 140) Fourth, evolution brings disturbance to

this system of general social equilibrium. The reason is that ‘the developments of the individual areas of social life are ... not a unity’ (p. 141). Thus, when the ‘leading group’ in one of the areas performs a major innovation, all the other areas are induced to change. Fifth, Schumpeter suggested that his analysis ‘free the matters from their rigid causal chains and give them back their true life’ and he refused to say anything ‘about the driving forces of cultural development’ (p. 141) Thus, he was as far as possible from any a priori commitment to the economic interpretation of history. However, in his later studies, he often found useful the Marxian approach to the evolution of social culture. The main reasons, probably, were that he needed heuristic rules to focus on the most relevant sources of change of the general social equilibrium and that the alternatives were much less convincing than the emphasis on economic innovation as the main driver of history.

## Conclusion

*Business Cycles* has been a major challenge for researchers who want to exploit the Schumpeterian heritage. The comments on Kingston’s paper served as a starting point for an attempt to characterise the deliberate analytical delimitations of that book. Schumpeter’s emphasis on economic evolution and the placement of institutional change as an external factor did not allow him to make a full-blown study of 150 years of capitalist evolution. To some extent, he overcame that problem in *Capitalism, Socialism and Democracy*, but we have to return to the works of his youth to understand his conception of the coevolutionary processes of socio-economic life. It is here that we find the vision and basic analysis to which *Business Cycles* was a substantial but, nevertheless, limited contribution. In other words, if we want to understand Schumpeter’s work, we must understand it as a whole.

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