



The Father of Creative Destruction

Why Joseph Schumpeter is suddenly all the rage in Washington.

Adam Smith, make room: Joseph Schumpeter has come to Washington. Capital policy wonks may not yet be wearing Schumpeter ties, but the Harvard economist's ideas are cited by everyone from Federal Reserve chief Alan Greenspan to the warring parties in the Microsoft antitrust case.

Schumpeter argued that capitalism exists in the state of ferment he dubbed "creative destruction," with spurts of innovation destroying established enterprises and yielding new ones. This view seems far more current than Smith's Newtonian notion of an "invisible hand" generating stability in the marketplace.

Smith was a conceptual breakthrough for Europe, but he didn't say much about bone-jarring technological shifts or the crucial role of entrepreneurship. "It's not difficult to be for Adam Smith and Joseph Schumpeter at the same time," maintains House majority leader Dick Armey. "The market must clean itself out by taking resources away from the losers, so it creatively destroys the losing companies and reallocates resources to the winning companies. That's really what's going on."

Schumpeter, who came of age in the Vienna of Sigmund Freud, once declared his ambition to become Europe's greatest lover and greatest horseman, "and perhaps also its greatest economist." (Later he said coyly he'd achieved two out of three.) In 1932, he left Europe for Harvard. There he argued that it's entrepreneurs who drive economies, generating growth and, through successes and failures, setting business cycles in motion - a provocative claim in the '30s, when capitalism seemed bankrupt. Even after publishing his landmark *Capitalism, Socialism, and Democracy* in 1942, Schumpeter was overshadowed by John Maynard Keynes, who preached government spending as a way out of the Depression. "Schumpeter probably was right all along," says Michael Powell, "but it's only now, at Moore's law speed, that you can actually observe it."

In a paper presented at a recent Fed retreat, former treasury secretary Lawrence Summers and his ex-deputy Bradford DeLong observed that "the economy of the future is likely to be 'Schumpeterian,'" with creative destruction the norm and innovation the main driver of wealth. Products based on ideas - music, software, pharmaceuticals - require an enormous investment to develop but very little to keep making. And they're often subject to network effects, which reward those that achieve critical mass. Together, these factors - high cost to create, minimal cost to produce, and a winner-take-all environment - tend to generate natural monopolies, at least until the next innovation comes along. How regulators should respond is debatable, but clearly the rules that governed manufacturing economies don't apply.

Yet creative destruction is only half of Schumpeter's message. Far less in vogue is his projection that entrepreneurs will disappear as innovation becomes mechanized in corporate labs - as it has today in Japan - and that ultimately the very success of capitalism will beget socialism. Will creative destruction give way to central planning? Not necessarily, says Harvard's Clayton Christensen. "What happened in Japan is exactly what Schumpeter envisioned," he argues. "But here, folks just leave - they pick up venture capital on the way out, and they start new disruptive corporations." So as long as Washington encourages an infrastructure that supports entrepreneurship, creative destruction

can continue after all.

- *Frank Rose*

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