

## Chapter 3

# Creative Destruction: Schumpeter's Perennial Gale

The fundamental new 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 ... 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.

Joseph A. Schumpeter (1942), *Capitalism, Socialism, and Democracy*: 82–84.

If you could get into a time machine (perhaps a DeLorean) and travel back to visit a typical shopping mall in the 1980s, it would have been packed with shoppers. Had you interviewed a store owner about their worries for the future, they would have probably mentioned the fear of facing competition from new stores opening in that mall or from a new mall opening in the same town that might drive them out of business. Indeed, if you visited that same mall today most of the stores in that mall are probably closed and it is depressingly empty, with many vacancies. It turns out, of course, that it was not a new competing mall or other stores in that same mall that the owners should have been worried about driving them out of business ... it was the coming of the Internet, and Amazon in particular. But, of course, in the 1980s, there was no such thing as the Internet to worry about, nor did the store owners imagine such a thing would ever exist.

The Internet has not just taken business away from shopping malls. The traditional newspaper industry has been in rapid decline since 2010, as has traditional radio broadcasting. The printing of phone books (directories listing

the phone numbers of individuals and businesses) is now a thing of the past and hard-copy books and textbooks are probably next. Schumpeter stressed that it was the threat from the introduction of new goods and services that results in these types of fundamental changes that is the true nature of dynamic competition. This view stood in stark contrast to the competition depicted in textbook economics that focused on competition in price, quality, or location among rival firms producing similar goods in the same industry.

We tend to think of entrepreneurship as creative—the creation of something new. In Schumpeter’s words it is the creation of a new combination of resources. We also think of it as progress—something that makes the future better than the past: like the invention of the time-saving clothes dryer, microwave oven, or the rapid transportation afforded by the airplane. What we do not always remember is that it is destructive in that the old way of doing things often dies off as a result. Perhaps the most well-known contribution of Joseph Schumpeter is his discussion of this evolutionary process and the term “creative destruction” that he used to describe it in his 1942 book *Capitalism, Socialism, and Democracy* (CSD).<sup>4</sup>

Before continuing, let us consider more examples of Schumpeter’s process of creative destruction. Perhaps the most frequently used is the case of the automobile replacing the horse and buggy. Again, while we tend to think of how wonderful the introduction of the automobile was for the transportation needs of people, we tend to forget that it resulted in hundreds, if not thousands, of other businesses (in the horse and buggy industry) going out of business, and their employees and owners losing their jobs. This displacement was greater than you might imagine. People who raised the horses, workers who cut timber and made it into wagons, leather shops that made the harnesses and equipment, and blacksmiths who shod the horses and forged and repaired the metal fittings. There were individuals who owned small businesses, late in their careers, who suddenly found themselves and their businesses bankrupt, with few other employment options using their skills. There were sons and daughters who had planned to work in, and one day take over, the family business who now had to find a new career path, and maybe move to a new city. This is the destructive part

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4. The term “creative destruction”, while sometimes attributed to Schumpeter, was actually first used by a German economist and sociologist named Werner Sombart, in his 1913 book, *War and Capitalism*. Nonetheless, Schumpeter is the one who popularized the term and brought it to the forefront of economic theory in his writings about capitalism as an evolutionary process.

of the process—and it is likely visible in your town now as you drive by vacant buildings once occupied by retailers who have been driven out of business by the growth of online shopping or new retailers coming to town.

There is perhaps no industry in the private sector untouched by the process of creative destruction in the last two centuries, with the pace accelerating recently due to the Internet and cell phones. The old movie-rental industry, once dominated by Blockbuster Video, has been replaced with streaming movies on Netflix; vinyl records were replaced by cassette tapes and compact discs and these were replaced by music downloads, and now streaming music on demand. The cell phone has replaced digital cameras and video recorders, alarm clocks, portable music players, paper address books and pocket calendars, has resulted in watch sales plummeting, as well as caused a large decline in the use of old land-line home telephones, among many other things.

At this point, it is worthwhile to quote a longer version of Schumpeter's description of creative destruction to explore his view of the concept in more detail.

The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process ... Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary ... The fundamental new 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 ... the same process of industrial mutation ... 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 ... Every piece of business strategy acquires its true significance only against the background of that process and within the situation created by it. (CSD: 82–84)

Note that Schumpeter's use of the term is specifically the way in which he understood the economic system of capitalism as an evolutionary process. Let us briefly discuss the distinction between evaluating something based on *outcomes* alone rather than evaluating the *process* that generates the outcomes.

Suppose you see that a recent basketball game had a final score of 108 to 75. That final score is the outcome of the game. The game itself is the process that generated that outcome. What information would you need to answer the question of whether the game was a fair game? Can you tell from the outcome alone if the game was fair? I think most of us would want to know if the teams were treated fairly in the game itself, in the officiating and rules under which the players competed. That is, we would assess the fairness of the outcome by asking whether it was generated by a fair process. A fair process can produce very lopsided outcomes. In contrast, one can have very equal outcomes (say, in a game with a final score of 76 to 75) while the process that produced that outcome was unfair, with cheating or unbalanced officiating.

Schumpeter himself was much more concerned with the market system as a process than any specific outcome it may generate at a point in time—and to him, this process is “never stationary” but is continuously ongoing—*perennial*. To Schumpeter it is also a major force in the economy and in economic development and progress that is reminiscent of a strong wind blowing—a *gale*. Thus, creative destruction is sometimes called “Schumpeter’s perennial gale”.

On average, roughly 700,000 new establishments open and another 600,000 fail each year in the United States. Similarly, workers become unemployed as they lose jobs at these failing firms, and in dying industries, and then become re-employed at new firms in new and growing industries. To Schumpeter it is this process of recycling labour and other productive inputs that is the result of entrepreneurs experimenting with new combinations of resources—the topic of our previous chapter.

Creative destruction is indeed central to Schumpeter’s theory of economic development—how market-based societies progress through time. In his 1934 book, *The Theory of Economic Development* (TED), he discussed the different types of changes he considered part of this process of creative destruction:

This concept covers the following five cases: (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. (TED: 66)

Obviously, Schumpeter's view of this process included not just one new good (the automobile) replacing an old one (horse and buggy), but also included changes to production processes (like the assembly line or franchising), as well as the opening of new sources of supply or new markets.

Schumpeter's view of entrepreneurship as a disruptive process of creative destruction is often contrasted with the view of Israel Kirzner, another famous economist who is known for his contributions to our understanding of entrepreneurship. Unlike Schumpeter, Kirzner stressed the role of entrepreneurs in discovering profit opportunities, acting on them, and in the process closing arbitrage gaps that exist in markets, and bringing markets closer to the competitive equilibrium. However, these two views are better viewed as complementary. Schumpeter's entrepreneurs innovate and bring disruptions to existing markets, with the firms at the forefront earning above-average profits that subsequently draw imitation and entry from Kirzner's type of entrepreneurs, reducing excess profits through competition and bringing the new market toward equilibrium.<sup>5</sup>

Because the introduction of new goods and services often results in the failure or obsolescence of the old way of doing things, it generates conflict—enemies of the process itself. For example, throughout Europe and even America, taxi drivers have protested (sometimes violently) the coming of Uber and have been successful in getting governments to place restrictions on ride sharing. For a variety of reasons, both political and cultural, different cities, states, and countries have different levels of toleration for these disruptions and transitions. According to Schumpeter, this disruptive process of creative

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5. Readers interested in this distinction and Kirzner's views can find more details in Kirzner (1999).

destruction is the foundation of the economic progress of society through time. Thus, Schumpeter provides a road map to the policy environment conducive to economic development—jurisdictions that allow the process of creative destruction to unfold, rather than those that put up barriers to protect the *status quo*, are the ones that grow faster and have stronger economic progress and development.