

# **Schumpeter and Lederer on Growth, Technology, Credit and Business Cycles**

by:

Panayotis G. Michaelides\*, John G. Milios and Angelos Vouldis

\*Laboratory of Theoretical and Applied Economics  
Department of Humanities, Social Sciences and Law  
School of Applied Mathematics and Physical Sciences  
National Technical University of Athens  
Zografou Campus, 157.80, Athens, Greece  
Tel.: +30210771624, Fax: +30210771618,  
Email: [pmichael@central.ntua.gr](mailto:pmichael@central.ntua.gr)  
(Contact author)

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Panayotis G. Michaelides

*National Technical University of Athens*

John G. Milios

*National Technical University of Athens*

Angelos Vouldis

*University of Athens*

**Abstract:** It is the purpose of the present paper to compare Emil Lederer and Joseph Schumpeter with respect to their visions concerning the notions of economic growth, technology, credit and business cycles. Lederer, just like Schumpeter, used the distinction between statics and dynamics. Also, according to Lederer, technical progress leads to economic growth and is necessarily linked to fluctuations, an insight that we have already encountered in Schumpeter. They both emphasized the role of credit expansion and linked it with innovation. The endogenous character of economic fluctuations is another common point between the two great theoreticians. Moreover, the roots of some of Schumpeter's and Lederer's common views are traced back to Rudolf Hilferding and Mikhail Ivanovich Tugan-Baranowsky. Our analysis shows that despite the fact that the two economists are traditionally classified in different schools of thought, their theoretical investigations in a great number of thematic areas seem to converge to similar views since they developed certain of their theories in the same social, political, theoretical and ideological environment and were well acquainted with each other's ideas. We may conclude, therefore, that the similarities of certain Schumpeterian elaborations with theoretical theses and analyses delivered by Emil Lederer are not accidental, but the outcome of this long interaction between them and other leading economists of that period like Rudolf Hilferding and Tugan-Baranowsky.

**Key words:** Schumpeter, Lederer, Hilferding, Tugan-Baranowsky, development, fluctuations, technology, credit.

**JEL classifications:** B15, B25, B31, B52

**EAEPE classifications :** D, T, P.

## **1. Introduction**

Undoubtedly, Joseph Alois Schumpeter “was one of the greatest economists of all time” (Haberler 1950, p. 1) who made seminal contributions to economics. Scitovsky (1980, p. 1) placed him at the top of economic thought. Kessler (1961, p. 334) argued that, apart from Keynes, Schumpeter was “the only truly great economist” of the 20<sup>th</sup> century. Morgenstern (1951, p. 203) claimed that he “belongs to that small top group where further ranking becomes almost impossible”. Chandler (1962, p. 284) regarded Schumpeter as the economist with the best understanding of the role of innovation and entrepreneurship. Also, the works of Rosenberg (1982), Lazonick (1990), Scherer (1984) and Porter (1985) are influenced by the Schumpeterian doctrine.

However, some important aspects of Schumpeter’s works remain less widely discussed. Given the presence of central elements of Schumpeter’s works in the analyses of other great theoreticians, it is surprising that so little attention has been paid to them. For instance, Schumpeter’s affinities with other great theoreticians such as Emil Lederer or Schools of economic thought, such as the German Historical School, have been unexplored. This paper focuses on Schumpeter’s affinities with Emil Lederer, “the leading academic socialist of Germany in the 1920’s” (Schumpeter 1954, p. 884), while two companion pieces look in detail at Schumpeter’s affinities with the prominent Marxist theorist Rudolf Hilferding and the German Historical School, respectively (Michaelides and Milios 2004, 2005a, 2005b, 2007).

There are two main reasons why studying the potential relationship between them is of great interest. First, because Schumpeter ranks among the “most important and enduringly influential economists of all time” (Hodgson, 2007, p. 2) and had a major impact on the development of economics. Second, it is an important key for understanding his economic writings. Obviously, understanding the origins of these important ideas in economics helps clarifying the contrasts between orthodox economics and the heterodox approaches. In this framework, this essay focuses on the conceptual relationship between Joseph Schumpeter and

Emil Lederer. Moreover, the roots of some of Schumpeter's and Lederer's common views are traced back to Rudolf Hilferding and Mikhail Ivanovich Tugan-Baranowsky.

The paper is structured as follows: section 2 offers a brief biographical presentation of the two economists' life and work; section 3 explores their respective theses on economic change; section 4 investigates the role of technology in their writings, section 5 analyzes the role of credit; section 6 presents their views on economic fluctuations; section 7 discusses the influence of Rudolf Hilferding and Tugan-Baranowsky on some of Lederer's views; finally, section 8 concludes the paper.

## **2. Brief Biographical Notes**

### *2.1 Joseph Schumpeter*

Joseph Alois Schumpeter (1883-1950), the son of a cloth manufacturer, was born in Triesch in the Austrian part of Moravia, in what was then the Hapsburg Empire and died in Taconic, Connecticut. In 1901 Schumpeter enrolled in the faculty of law at the University of Vienna, and continued his studies in Berlin and London. He studied economic theory under Friedrich von Wieser, Eugen von Philippovich and Eugen von Böhm-Bawerk. In 1905 he took part in Böhm-Bawerk's seminar, where the latter's criticism of Marx was one of the topics of debate. A year later, in 1906, he took the degree *Doctor utriusque iuris*. In 1909, thanks to Böhm-Bawerk (Kirsch 1979, p. 143), Schumpeter became an Assistant Professor at the University of Czernowitz. Between 1911 and 1919 he taught Political Economy as a Full Professor in Graz, while in 1913 and in 1914 he was an Exchange Professor at Columbia University. In 1918, Schumpeter became member of the *German Socialisation Commission* (*Sozialisierungskommission*), and in 1919 he was appointed Minister of Finance in the new government formed by the Social Democrats (Haberler 1950, p. 346). In 1921 he became

president of a highly respected private banking house (*Biederman Bank*) in Vienna, and when the bank collapsed in 1924 after the great inflation in Germany, he returned to the academic world and in 1925 accepted a professorship at the University of Bonn in Germany. From 1932 until his death he taught at Harvard University, and he served as president of the American Economic Association, the first foreign-born economist to attain this distinction. Schumpeter's writings cover a broad range of topics including the dynamics of economic development, the feasibility of capitalism and the history of economic analysis.

## 2.2 *Emil Lederer*

Emil Lederer was born in Pilsen (Bohemia) in 1882 to a merchant family. He studied law and economics at the University of Vienna from 1901 on and took his doctoral degree in law in 1905. Among others, his professors were Carl Menger, Friedrich von Wieser, Eugen von Böhm-Bawerk and Eugen von Philippovich, while Ludwig von Mises, Otto Bauer, Joseph Schumpeter and Rudolf Hilferding were among his friends (or classmates). Although educated at Vienna, Lederer is not regarded as a member of the Austrian School. Lederer could be considered as one of the last members of the "Austro-Marxists". In 1905, Lederer was promoted to *Dr. iur.* in Vienna, and in 1911 *Dr. rer. pol.* at Ludwig Maximilians University of Munich. The next year, he habilitated at Ruprecht Karl University of Heidelberg. In 1918, he was appointed Assistant Professor at Heidelberg University, but remained in Austria until 1920. Lederer was active in Social Democratic circles in Austria and Germany. In 1919, he was appointed member of the *German Socialisation Committee*, along with Hilferding and his old Vienna classmate, Joseph Schumpeter. At Heidelberg University, Lederer became full professor in 1920. From 1923 to 1925 he held lectures as guest professor at Tokyo Imperial University. From 1923 to 1931, Lederer and Alfred Weber were directors of the *Institute for Social and State Sciences*. In 1931, he succeeded Werner Sombart at the *German Faculty for National Economy and Financial*

Lederer was suspended by the Nazis.<sup>1</sup> In addition, university members had denounced Lederer for being a member of the Social Democratic Party of Germany and for being “non-Aryan”. Lederer immigrated to Japan, and then to the USA where he co-founded in 1933 the *University in Exile* at The New School for Social Research in New York City under Alvin Johnson’s leadership (Johnson 2000), which would become the Graduate Faculty of Political and Social Science.<sup>2</sup> Emil Lederer was its first dean until his sudden death in 1939, in the aftermath of an operation.<sup>3</sup>

Lederer was considered an important supporter of interdisciplinary social sciences in Heidelberg. He published the social democratic theory magazine *Die Neue Zeit*, he did not support an unregulated free market, he was critical to the inefficiencies caused by monopolies, and he denounced the positive effects of technical progress.

### **3. Economic Development**

In the Japanese edition of his *Theory of Economic Development*, Schumpeter noted that, when first writing the book, his purpose had been to create “a theoretic model of the process of economic change in time [. . .] to answer the question how the economic system generates the force which incessantly transforms it” (Clemence, 1951, pp. 158–159). Schumpeter started his *The Theory of Economic Development* with a treatise of circular flow which, excluding any innovative activities, leads to a stationary state. The stationary state is, according to him,

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<sup>1</sup> For Lederer’s attempt to sociologically understand the main features of war, especially World War I, see Lederer (1979).

<sup>2</sup> Most of the members of this circle wrote interesting essays on the so-called *new* middle class (i.e. white-collar workers). However, the so-called *old* middle class (i.e. artisans, farmers and other self-employed representatives of small business) was relatively neglected (see e.g. Lederer and Marschak, 1926).

<sup>3</sup> In the United States, Lederer established a lasting collaboration with Marschak, a former pupil of Lederer’s who had taught at the Universities of Heidelberg, Oxford and then in the United States (New School of Social Research). Then, he moved to the University of Chicago and later became president of the American Economic Association.

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described by Walrasian equilibrium.<sup>4</sup> The Walrasian approach took account of the interdependences of economic variables but was applicable only to a stationary process, i.e. one which adapted itself to forces acting on it.

Schumpeter described this equilibrium as “the circular flow of economic life” or the “stationary flow” (Schumpeter 1912, ch.1). This state refers to simple reproduction and is characterized by the absence of any change. But Schumpeter made clear that this “stationary flow” is only a theoretical abstraction and serves as a reference point (Schumpeter 1928). Yet, while Schumpeter was a great admirer of Walras’ scientific method and technique, he apparently believed that this vision of the economy was incomplete in that there should be a source of movement within the economic system. Schumpeter defined economic development as “such changes in economic life as are not forced upon it from without but arise by its own initiative, from within” (Schumpeter 1912, p. 63). It was a phenomenon foreign to what might be observed in the circular flow or in the tendency towards equilibrium (*ibid*, p. 64). It involved spontaneous and discontinuous change in the channels of flow, disturbance of equilibrium, which forever altered and displaced the equilibrium state previously existing”.

According to Schumpeter, economic development is accompanied by growth, however quantitative growth does not constitute development *per se*. He wrote: “[W]hat we are about to consider is that kind of change arising from [...] 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 coaches as you please, you will never get a railway thereby” (Schumpeter 1912, p. 64). Real economic growth and development depend primarily upon productivity increases based on innovation. More precisely, for Schumpeter this concept covered the following cases: “1. The introduction of a new good [...] or a new quality of a good. 2. The introduction of a new method of production [...]. 3. The opening of a new market [...]. 4. The

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<sup>4</sup> It is well known that Schumpeter was a great admirer of Walras. In his *History of Economic Analysis* he wrote: “[S]o far as pure theory is concerned Walras is in my opinion the greatest of all economists” and suggested that Walras’s work “will stand comparison with the achievements of theoretical physics” (Schumpeter, 1954, p. 827).

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conquest of a new source of supply [...]. 5. The carrying out of the new organisation of any industry” (Schumpeter 1912, p. 66).

The hero of his story was, in fine Austrian way, the entrepreneur. What made these individuals look special was the fact that they had the ability to exploit fully the new possibilities which were offered by the surrounding environment (Schumpeter, 1912, pp. 79–80). Schumpeter clearly distinguished this process from growth due to the gradual increase in population and capital. He wrote: “The slow and continuous increase in time of the national supply of productive means and of savings is obviously an important factor in explaining the course of economic history through centuries, but it is completely overshadowed by the fact that development consists primarily in employing existing resources in a different way, in doing new things with them, irrespective of whether those resources increase or not” (Schumpeter 1942, p. 65).

In practice, economic systems do not achieve equilibrium. They just move into what Schumpeter calls “neighborhoods of equilibrium [...] in which the system approaches a state which would, if reached, fulfil equilibrium conditions” (Schumpeter 1936, p. 45). In fact, in his *Business Cycles* Schumpeter (1939, p. 106) emphasized that major innovations, which initiate new expansions, are introduced around the neighborhood of equilibrium because conditions are, in a sense, ideal. It is in this neighborhood of equilibrium that economic conditions are stable and therefore possible to make reliable calculations. Consequently, uncertainties are at their lowest.

As regards the market structure favoring economic evolution, Schumpeter believed that perfect competition is not favorable, for two reasons: (a) it cannot lead to high profitability and thus it cannot create real incentives for innovation; (b) it cannot create incentives for the capitalist and the enterprise to undertake risky and uncertain projects, because it is unable to guarantee, as a reward, an *extra profit*. More precisely, by incorporating new technologies, new types of organization, etc., innovations create surpluses of revenues over costs. Competition, however, tends to eliminate these extra revenues (extra profits), but the “spread of monopolist

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structures” and the ability of big enterprises to promote innovation constantly recreates them (Schumpeter 1942, p. 81 ff.).

In fact, in his *Theory of Economic Development*, the predominant role of large oligopolistic firms in technical innovation was acknowledged: “And if the competitive economy is broken up by the growth of great combines, as it is increasingly the case today in all countries, then this must become more and more true of real life, and the carrying out of new combinations must become in ever greater measure the internal concern of one and the same economic body. The difference so made is great enough to serve as the water-shed between two epochs in the social history of capitalism’ (Schumpeter 1912, p. 67).

Lederer’s conception of economic development is very close to Schumpeter’s approach. In brief, for Lederer economic development constitutes: “the opening up of new markets, the manufacture of new products, and improved methods of production in the broadest sense of the term” (Lederer 1938, p. 230). Lederer’s vision seems to converge significantly. He considers the concept of equilibrium insufficient to analyze properly an economic system. He notes that for it to have any meaning we must fix the data and “the inherent or observed tendencies towards change would have to be ignored.” According to him “the idea of economic equilibrium can be effectively applied under a static system, but such a system is based on assumptions that remove it from most of the problems that have to be dealt with in actual practice” (*ibid*, p. 78). However, the examination of a static system is not worthless because in the short-term, when most of the dynamic factors can be considered fixed, it is not devoid of explanatory power. In his own words: “Perhaps theory of a stationary system is necessary in its general outline as the basis for any dynamic scheme-but this requires a theory of its own, and cannot be fertilized by further refinements of abstract and pure theory” (Lederer 1936, p. 159).

Lederer advocated the definition of the static system in the narrowest sense (the growth of population and capital is assumed to be zero) because “the static system must serve as a basis for comparison” and “the accidental inclusion of one or more elements of the dynamic system

creates confusion in which it is difficult to distinguish the essentials of a static system and the consequences of disturbances from the outside” (Lederer 1938, p. 86). The same methodological principle was followed by Schumpeter in the exposition of his *Business Cycles* where he used the concept of a static equilibrium defined in the narrowest sense, in order to explain the mechanism which sets the system into motion from a state of immobility.

Lederer used the insights that a static system can offer to prove the existence of permanent unemployment that may ensue even in an actual dynamic system “if there are structural obstacles to any rapid change in quantitative ratios or in prices in the dynamic system” (*ibid*, p. 81). For Lederer the utilization of all factors of production is not a justifiable proposition even for a static system. The full utilization would presuppose the destruction or neglect of all surplus factors that exist in a system. Lederer noted that the optimistic view which delineates the static equilibrium as a state characterized by the absence of idle factors “comes from the attitude of the *laissez faire* school, which invested the economic system with a harmony that is entirely unjustified within the dry and precise framework of the static system” (*ibid*, p. 81).

In practice, however, it is necessary to “consider a longer period, with the changes that may normally be expected to occur within it. In that case the concept of static equilibrium has no meaning. That is why the concept of moving equilibrium was developed in its place” (*ibid*, p. 91) and “this moving equilibrium means a system of ‘disturbances’” (*ibid*, p. 91) the combination of which produces a dynamic system where any regressive movements, which might occur, do not preclude further progress.

Just like Schumpeter, Lederer explicitly earmarked technical development as the distinguishing characteristic of a real dynamic system compared to a static or a harmonious dynamic system: “the most important factor in the dynamic process [...] is technical development” (*ibid*, p. 89). And made clear that technical progress should be excluded in order to define his own stationary state: “The combination of (a) [psychological factors] and (b) [growing population] without technical progress would make it possible to have a uniformly developing

dynamic system without cyclical fluctuations – that is, a system in which population, plant, and production would increase uniformly from year to year” (*ibid*, p. 88),

Later on, he added: “Here again therefore we must use the method of isolation and try to study the effects of technical progress in an atmosphere of economic calm. We cannot indeed make pure statics our starting point, but must assume a steadily progressive economy in which no disturbances take place and which may be said to be in a state of “dynamic equilibrium” or growth. In accordance with this concept, we must also assume that our system is organized to ensure a uniform expansion of the process of production (e.g. by 1 per cent yearly), accompanied by a parallel increase in the number of workers employed” (*ibid*, p. 162).

His view was, in general terms, consistent with the Schumpeterian approach of “moving equilibrium”. Of course, he noted that it “might lead to confusion, because what actually happened was a disturbance of equilibrium in the ordinary sense of that term” (*ibid*, p. 91). In order to make things clear he added: “It is quite true to say that dynamic development can be adequately understood only if its essential feature is taken as being not a tendency to equilibrium but a series of impulses constantly driving it beyond the point it has reached. In this movement the tendency towards equilibrium exists only as an undercurrent” (*ibid*, pp. 91-92). Conclusively, he argued that the concept of moving equilibrium is not very satisfactory because “movement is such an important feature of the system that the idea of equilibrium would have to take on an entirely new aspect” (*ibid*, p. 92).

The emergence of monopolies and cartels occupy an important role in Lederer’s work. In his *Technical Progress and Unemployment* Lederer used a numerical example on the adoption of a new cost-reducing technique by a small number of firms within a branch of industry. He concluded that these firms would quickly obtain excessive profits and will dominate the market. Lederer conceived the relation of technical progress and monopolies in a way similar to Schumpeter: “[O]wing to its command and knowledge of the market and its power of deciding freely and with full knowledge of the circumstances on the technique to be adopted, a monopoly will be

better able to transfer its operations to a lower level of costs and prices than one operating under free competition. Even assuming that under free competition too firms can react immediately to every opportunity of reducing their costs, monopoly undertakings are still more likely to make a change when it involves heavy investment (and therefore a greater need for capital) and a very large expansion of output, as in the case of mass production” (*ibid*, p. 133)<sup>5</sup>. Lederer also, mentioned the tendency for cartelization and monopolization of the market and considered this market structure to have destabilizing effects, due to the rigidity they introduce to the price system thus prolonging the depression period (see further Allgoewer 2003, p. 333; pp. 335-336).

## **4. Technology**

### *4.1 On Innovation*

As we have seen, for Schumpeter economic development was mostly the result of innovation, i.e. “the outstanding fact in the economic history of capitalist society” (Schumpeter 1939, p. 61). For him, innovation is the leading force in what he calls “evolution”. Economic evolution is however discontinuous because of a discontinuity in the introduction of major innovations into the economic system.

However, Schumpeter’s concept of innovation was different than is generally assumed because he stressed that innovation *per se*, i.e., simply as new ideas or new combinations, is not a force in economic development. Rather the true force in economic development is the *consequences* of these innovations (Schumpeter 1928).

These consequences make innovations a force in economic evolution and innovations which do not produce these consequences could not be a force in the economic development of a social formation. Economic evolution begins when an exceptional entrepreneur introduces an

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<sup>5</sup> For a discussion of the central importance of trust in a market economy, the unstable nature of market economies and the “corporatist” approach see Perelman (1998, 1994, 2006).

innovation. This enables him to make monopolistic profits and stimulates the borrowing of capital in order to increase the investment. This activity of the first entrepreneur smoothes the path for other entrepreneurs to introduce innovations. This “swarming of entrepreneurs” is financed through credit creation, i.e. “the monetary complement of innovation”. Credit permits these firms to “bid away” factors of production from older non-innovating firms.

The innovations produce qualitative changes in the economic system: “[The] historic and irreversible changes in the way of doing things we call “innovation” and we define: innovations are changes in production functions which cannot be decomposed into infinitesimal steps. [...] The kind of wave-like movement, which we call the business cycle, is incident to industrial change and would be impossible in an economic world displaying nothing except unchanging repetition of the productive and consumptive process” (Schumpeter 1935, p. 4).

However, for Schumpeter, an explanation of economic development is not simply explaining innovation, as the result of other *economic* factors. Instead, an explanation consists in finding a causal relation (Schumpeter 1912, p. 5). In other words, innovations are not the cause of economic development. According to Schumpeter, causality is to be found in motives. Motives are the adequate explanation of the causes of economic phenomena which link economic conduct to motives (*ibid*, p. 10). Thus, the real cause of development is to be found at the level of what motivates the entrepreneur to undertake innovation.

Just like Schumpeter, Lederer emphasized technical development as the distinguishing characteristic of the economic system (see e.g. Lederer 1931; Lederer 1933, pp. 1-26). But why is technical change so important according to Lederer? Because, compared to other causes of change, technical development brings about sudden change which cannot be absorbed with readjustments and adaptation in a harmonious process, just like in the Schumpeterian system (Lederer 1938, p. 89). Technical development is, thus, responsible for “the extensive ups and downs in production that are typical of our modern capitalist process” (*ibid*, p. 90). See also Lederer (1931, p. 112).

Then, he stressed the fact that “[i]t is idle to consider technical development simply as non-economic phenomenon and therefore of relatively little importance, involving merely a change in data which cannot change the nature of economic process” (*ibid*, p. 90). A little later Lederer, in a Schumpeterian spirit, added that: “technical progress [...] is therefore a real factor which alone could have moulded the course of modern economic development along the lines in which we know it” (*ibid*, p. 90). See also Allgoewer (2003, pp. 336-340).

Lederer, just like Schumpeter, looked behind the crucial role of innovations to detect the very motive of economic acts inducing economic evolution. According to him, a possible motive is the “[d]ynamic psychology on the part of individual economic subjects. Persons who are not satisfied with the beaten track strike out along new lines when they see a prospect of profit. This dynamic attitude may be deduced from the economic principle that man always endeavouring to better his situation” (*ibid*, p. 86).

Lederer followed Schumpeter, in a fine Austrian fashion, and the entrepreneur was, for once again, the hero: “This particular kind of initiative is restricted to the entrepreneur type. The desire for advancement which people who are not entrepreneurs also experience induces them to save.[...] Saving, however, only pays the people who perform this function in so far as the entrepreneurs invest and they themselves are willing to hand over their savings to the entrepreneurs for this purpose” (*ibid*, p. 86).

#### *4.2 On Technological Unemployment*

Regarding the relation between technological change and unemployment, the views of both Schumpeter and Lederer converge. Schumpeter considered technological unemployment as an inevitable side-effect of evolution based on innovative activity. Schumpeter gave a broad definition to the term “technological unemployment” analogous to the definition of “innovation”:  
“[F]or the special case of unemployment arising from disturbance by innovation within the

system we will set up a distinct class, to be called *Technological Unemployment*. This term [...] has always been intended to cover displacement of workmen by machinery. We make it cover a much wider range and include not only the effects on employment of every kind of change in industry and commerce – organizational change, for instance – but also the effects which changes have on employment in firms or industries that are competed with by the firms of industries that introduce new production functions” (Schumpeter 1939, Vol 2, p. 514, emphasis added).

Schumpeter went on to define cyclical unemployment as the “total by which unemployment varies in the course of cycles” (*ibid*, p. 515) and then continued noting that “cyclical unemployment *is* technological unemployment”. The emergence of dislocations is explicitly connected to the readjustments that take place during the cyclical process: “Technological unemployment [...] linking up as it does with innovation is cyclical by nature. [P]eriods of prolonged supernormal unemployment coincide with the periods in which the results of innovations are spreading over the system and in which reaction to them by the system is dominating the business situation” (*ibid*, p. 515).

According to Schumpeter this kind of unemployment may be called “frictional” since the “instantaneous adaptation of the system would kill it at birth”. Despite this, he did not deny “the importance of the phenomenon or the sufferings it inflicts” but conclusively noted that “the primary long-run interest of the working class is in the effects of innovation on the total real wage bill and not in the incident variation of employment, which is but an element of the mechanism that produces the changes of the former and can be separately handled by public policy” (*ibid*, pp. 515-516). Clearly, Schumpeter did not believe that equilibrating forces of the free market can secure automatically the re-absorption of the displaced workers, however he saw in innovation a disruptive force but with a positive net result in the long-run.

Lederer is also clear about the existence of technological unemployment, induced by the introduction of labor-saving techniques<sup>6</sup>, and in *Technical Progress and Unemployment* made a

<sup>6</sup> In his book about Japan, Lederer notes that “the low wages, both money and real, have been favorable to the expansion of Japan’s international trade. But the low wages are due to the oversupply of workers, and as a result of mechanization and improving efficiency they are not likely to find employment easily” (Lederer

detailed examination of this phenomenon. In the first place, he raised an objection against claims that automatic adjustment is ensured by the market mechanism. According to his argument there is a contradiction in the contention that technical progress does not alter the demand for labor due to increased profits or reduced costs which will both bring about new investments and expansion of production on the one hand, and the allegation that “labour-saving technical improvements by which workers are displaced diminish the marginal productivity of labour and thus necessitate a reduction of wages” (Lederer 1938, p. 9) which characterizes the argumentation of *laissez faire* school. His criticism to that line of thought rests also upon the social effects of labor displacement: “[E]conomists often admit that technical progress may involve dislocation, although their logical arguments point to the opposite direction. They explain this by saying that the dislocation is only temporary. But is this a valid argument? Human life itself is also temporary, and in matters of economics, interest will accordingly always be centered in changes which are of vital importance to any one generation, even if they will ultimately be assimilated to the general process” (*ibid*, p. 147). The only important question, therefore, is if medium-term unemployment can be attributed, at least partly, to technological progress (see also Diebolt 2006, pp. 6-7).

Initially, Lederer rejected the compensation theory which was based on the arguments that the displaced workers would be absorbed by the industries producing the same machines that are responsible for their unemployment and on the fact that technical progress does not reduce total purchasing power and thus the demand for labor cannot diminish. With regard to the first argument Lederer noted that it is practically irrelevant because it would presuppose “an accelerating expansion of capital accumulation and investment” which is only possible for short term periods and with the aid of external factors like “export to other economic territories” (*ibid*, p.149). As far as the second statement is concerned, Lederer argued that there is no connection essentially between the preservation of the total purchasing power and the sustention of the

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and Lederer-Seidler, 1938, p. 255).

demand for labor in the same level. In fact demand for labor could perfectly well decrease (*ibid*, p. 151). Overall, his analysis pointed to the absence of automatic compensation mechanisms and he finally came to the conclusion that the introduction of labor-saving techniques “set(s) in motion a lengthy process of adjustment, and it is not until the final stages of this process are reached that the unemployment can be reabsorbed” (*ibid*, p. 218). See also Allgoewer (2003, pp. 339-340).

It should be noted that there is a difference in the way Schumpeter and Lederer defined technological unemployment. Schumpeter’s definition covers all the cases where an innovation is applied and, as was discussed earlier, encompassed a very wide range of phenomena (‘inventions’ and ‘technical improvements’ as defined by Lederer both come under that same heading). Meanwhile, Lederer considered technological unemployment as the result of technical improvements and in particular of labor-saving technical improvements. Overall, Lederer considered the effects of labor-saving technical improvements to be more closely linked with medium-term unemployment than inventions because the later “will not reduce the volume of employment but may even increase it temporarily during the period of actual investment” (*ibid*, p. 25).

To sum up, there is a common tendency to Schumpeter and Lederer to regard innovation as a determining factor of the evolutionary process of the economic system. Schumpeter’s and Lederer’s visions are very similar with respect to the subjective motives that are responsible for the introduction of innovations. They also agree on their disruptive character and more specifically on the effects that the introduction of innovation is bound to have on the labor market.

## 5. Credit

Schumpeter was realist enough to see that if someone wants to function as entrepreneur, he must raise funds. The provision of credit comes from the capitalist. The capitalist may, of course, use funds which are themselves the result of successful innovation and entrepreneurial profit (Schumpeter 1912, p. 72). The capitalist bears the financial risk (the entrepreneur risks his job and his reputation) and, because capital utilization is nothing but the diversion of the factors of production to new uses (*ibid*, p. 116), the capitalist has some power to dictate new directions to production (te Velde 2001, p. 7).

In his *Theory of Economic Development* Schumpeter defined economic development as a phenomenon “entirely foreign to what maybe observed in the circular flow or in the tendency toward equilibrium”; it is a “spontaneous and discontinuous change in the channels of the flow, disturbance of equilibrium, which forever alters and displaces the equilibrium state previously existing” (Schumpeter 1912, p. 64), so that the “new combination of means of production” and “credit” were the “fundamental phenomena of economic development” (*ibid*, p. 74).

Schumpeter stressed the importance “of credit means of payment created *ad-hoc*, which can be backed neither by money in the strict sense nor by products already in existence” (*ibid*, p. 106). In this manner, credit performs the functions of “enabling the entrepreneur to withdraw producers’ goods which he needs from their previous employments, by exercising a demand for them, and thereby to force the economic system into new channels” (*ibid*, p. 106). For Schumpeter credit provided an additional purchasing power that enables to foster development “Granting credit in this sense operates as an order on the economic system to accommodate itself to the purposes of the entrepreneur” (*ibid*, p. 107). However, according to de Vecchi (1995, p. 27), the assumption of the entrepreneur funding his enterprise by savings or previous profits is a

very realistic one but would not provide an adequate explanation for the process of economic change.<sup>7</sup>

Lederer's view is consistent with Schumpeter's thesis that anyone who wants to act as entrepreneur in the pursuit of profit, he must raise funds, the provision of which comes from the capitalist. The capitalist may, of course, use funds which are themselves the result of entrepreneurial profit or just the incentive for new profit: "Heavy demands on the credit market are therefore only likely to arise as the result of sudden prospects of large profits" (Lederer 1938, p. 230). In this context, Lederer regarded credit as an indispensable phenomenon of economic expansion just like Schumpeter did: "fresh opportunities arise of expanding production through credit" (*ibid*, p. 230). In fact, the possible absence of credit from the economic system would be catastrophic for many industries (Stern 1938). In Lederer's words: "without any credit expansion the static industries would have contracted" (*ibid*, p. 230). Consequently, the only way of preventing a capitalist enterprise from expansion would be the absence of credit: "the introduction of a new process of production can only be held up by the absence of extra means of payment" (*ibid*, p. 224). See also Lederer (1925, pp. 354-413).

Economic activity is not financed by the savings of the past (i.e. of the recession phase) but only from additional credit (or new savings) which is equal to the creation of supplementary production capacity : "Der zusätzliche Kredit mit der bekannten Wirkung des erzwungenen Sparens ist mit der Erzeugung von zusätzlichen Produktionsmitteln gleichbedeutend" (Lederer 1930, p. 514). For Lederer, additional credit is what matters as far as the business cycle is concerned. "[N]o cyclical development can be explained or described without taking account of the monetary aspect, additional credit providing the fuel without which any dynamic power would spend itself very quickly" (Lederer 1936, p. 156, emphasis added) and: "Es wird also

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<sup>7</sup> De Vecchi analyzes the interaction of individuals and institutions in Schumpeter's work and most specifically that between entrepreneurs and credit: "With credit [...] what counts in explaining economic change is the bank's method of permitting some innovation projects to be carried out, rather than others: this is creating credit *ex novo*, presented by Schumpeter as one of the distinctive features of the capitalist form of production. All other bank activities in a capitalist system (starting from the intermediary operations between saving and investment) are secondary from this point of view" (de Vecchi 1995, p. 6).

immer dort, wo eine Möglichkeit dazu vorhanden ist, solcher zusätzlicher Kredit die Wirkung zusätzlicher Produktion nach sich ziehen” (Lederer 1925, p. 382). See also Dielbolt (2006, p. 7-9).

Lederer’s thesis has striking similarities with Schumpeter’s respective thesis emphasizing the discontinuous character of the need for credit which is one of the driving forces of economic development: “In the more advanced stages of economic development [...] the demands for credit [...] arise spasmodically on the capital market” (*ibid*, p. 230). Lederer stressed the importance of innovation in raising credit since technical improvements is the main reason for credit creation by the part of the entrepreneur: “Heavy demands on the credit market are therefore only likely to arise as the result of sudden prospects of large profits, created in particular by the opening up of new markets, the manufacture of new products, and improved methods of production in the broadest sense of the term. But [...] technical progress [...] may be regarded as the main cause of the demands for credit which arise” (*ibid*, p. 230).

To sum up, credit is given special attention by both theoreticians and it is considered as indispensable for the functioning of capitalism. Schumpeter and Lederer linked credit creation with entrepreneurship and regarded it as a precondition for the introduction of innovations.

## **6. Economic Fluctuations**

The two theoreticians’ views on the nature of economic fluctuations converge considerably, as was the case with their respective theses analyzed in the previous sections. The popular interpretation of Schumpeter’s theory is that long waves are caused by the clustering of innovations. However, to be more precise, according to Schumpeter the clustering of innovations is not the cause of long waves *per se*. Instead, long waves are due to the consequences of this clustering.<sup>8</sup> Schumpeter conceptualized long waves as disturbances in the equilibrium and a

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<sup>8</sup> Here Schumpeter refers to: (1) the construction of new plants and the rebuilding of old plants, (2) new firms which are founded for the purpose of capitalising on specific innovations, and (3) the rise to

return to a new equilibrium point which gives the process its cyclical character.<sup>9</sup> All economic systems have an esoteric tendency towards equilibrium and move toward these “neighborhoods” after the disruptions have exhausted themselves. The most important characteristic of these “neighborhoods” is that economic conditions are stable (Schumpeter 1912, p. 214).

Economic evolution begins when an entrepreneur introduces an innovation, which enables this exceptional entrepreneur to make (monopolistic) profit and stimulates the borrowing of capital in order to finance new investments. The activity of the first entrepreneur smoothes the path for other entrepreneurs. This “swarming of entrepreneurs” is financed through credit creation. Credit permits these firms to “bid away” factors of production from older, non-innovating firms. In turn, this produces a rise in the level of prices and a general economic expansion which characterizes the first phase (i.e. prosperity) of Schumpeter's model. Prosperity reaches its upper point for several reasons. Older non-innovating firms, which are unable to compete with new firms, suffer losses. New investments are halted and it is impossible to make calculations. The possibilities offered by the innovations are exhausted. The subsequent downturn marks the second phase (i.e. recession) of the cycle. The decline continues attributed to “errors, excess of optimism [...]. Reckless, fraudulent and otherwise unsuccessful enterprises created in the optimism of expansion cannot stand the test administered by Recession” (Schumpeter 1939, p. 122). They are liquidated and these liquidations cause a “panic”. Meanwhile, deposits shrink and credit tightens. Because of this situation, firms which would have been able to sustain the pressure are liquidated and there is “a shrinkage of operations that reduces them, quite erratically, below their equilibrium levels” (*ibid*, p. 125). These liquidations and the shrinkage of enterprises constitute the third phase (i.e. depression) of the cycle. Depression continues until all (unsuccessful) invest-

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leadership of new men (Schumpeter 1939, pp. 68-71).

<sup>9</sup> According to Schumpeter, economic systems do not achieve equilibrium but, rather, move into “neighborhoods of equilibrium [...] in which the system approaches a state which would, if reached, fulfill equilibrium conditions” (Schumpeter 1939, p. 45).

ments are liquidated, and once this point is reached, a movement towards a new “neighborhood of equilibrium” signifies the fourth phase (i.e. revival).<sup>10</sup>

Schumpeter stressed actors in his analysis of economic fluctuations. He wrote: “Social facts are the result of human conduct, economic facts result from economic conduct and the latter may be defined as conduct directed towards the acquisition of goods [...]. The field of economic facts is first of all delimited by economic conduct” (Schumpeter 1912, pp. 3-4). After all: “instability may arise from particular influences from without, which cannot properly be charged to the economic system at all” (Schumpeter 1928, p. 362)<sup>11</sup>.

Hence, an acceptable explanation has to link economic conduct to motives (Schumpeter 1912, p. 10). Thus, the cause of long waves lies at the level of what motivates the entrepreneur. Thus, it is necessary to explain *what drives* entrepreneur to innovate. These factors could be accounted but the subjective meanings of the individual entrepreneurs cannot. In other words, entrepreneurs may innovate for reasons of ambition, greed, hate, etc but these reasons remain, practically, unknown. In his own words: “Economic conduct may have *any* motive” (Schumpeter 1939, p. 10, emphasis added).

Lederer, too, attempted to provide a theoretical explanation of the business cycle, an issue which he regarded as being of great importance: “We can say without exaggeration that the bulk of modern theory is business-cycle theory” (Lederer 1936, p. 157). Lederer’s vision of business cycles, as an endogenous phenomenon inseparably linked with the growth process of a capitalist society, remains unchanged in all his works. However, Lederer’s conceptualization of business cycles underwent modifications in certain aspects and when his 1925 article *Konjunktur und Krisen* is compared to his 1938 book *Technical Progress and Unemployment* the differences are discernible. See also Allgoewer (2003).

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<sup>10</sup> Schumpeter emphasized that a cycle is “a historical individual and not merely an arbitrary unit created by the observer” (Schumpeter 1939, p. 131). Each wave is a break with the past and the economic system which emerges is qualitatively different from the economic system previously existing. In other words, long waves are not “imperfections” in the economic system. Instead, the innovations propelling these waves produce real qualitative changes in the economic system (Schumpeter 1935, p. 4).

<sup>11</sup> For a discussion on entrepreneur’s motives and personality in early Schumpeter’s works see also de Vecchi (1995, pp. 16-19).

Lederer's conception of the business cycle in *Technical Progress and Unemployment* (1938) is, apparently, very 'Schumpeterian'. The initiation of a boom is explained by supply-side factors, and more specifically by technical change. Technical change is decomposed into two types, which have entirely different effects, namely 'rationalization' and 'inventions'.

The term 'inventions' was used by Lederer to describe "technical innovations as led to the production of goods which enlarge the scale of needs" (Lederer 1938, p. 7) and create "hitherto unknown 'genuine' or 'social' needs" (Lederer 1938, p. 24). The new firms, which adopt inventions compel 'old' firms to react to the new situation or become obsolete: "most of these commodities have a double character: they lead on the one hand to the realization of new necessities and lead so far to an expansion of the total production, but in most cases they compete with other branches of production too" (Lederer 1938, p.23). The introduction of inventions leads to a general expansion of the economic system: "inventions lead to an expansion of the whole system of production and a parallel increase in the total purchasing power of the community, through the creation of money or a rise in the velocity of circulation. These effects cannot be regarded as disturbances but must be recognized as one of the fundamental forms of the growth of the industrial system" (Lederer 1938, p. 135). Lederer's analysis of the booming period after the introduction of inventions does not mention the possibility of a depression phase following it.

Rationalization is the second type of technological change responsible for the appearance of fluctuations. In Lederer's work it is a general concept covering every cost-saving process (either capital-saving or labor-saving) related to increased efficiency in organization. In contrast to the application of inventions, rationalization and especially labor-saving technical improvements do not ensure unhindered growth and can have serious social repercussions. The boom period signaled by the application of technical progress "creates a new initial situation enabling employment capacity to be enlarged by a fresh combination of capital and labor, which can be financed by recourse to extra short and long-term credit" (Lederer 1938, pp. 233-4).

As we have noted repeatedly, for Lederer credit expansion was a necessary complement to the new undertakings in a way analogous to the Schumpeterian description of the process. He even stressed the importance of credit creation in explaining business cycles by emphatically arguing that: “The discussions of the last fifteen years, however, have led to the general conviction that no cyclical development can be explained or described without taking account of the monetary aspect, additional credit providing the fuel without which any dynamic power would spend itself very quickly” (Lederer 1936, p. 156, emphasis added).

However, when the initial wave of expansion, caused by rationalization, new investments and credit creation, has subsided, and firms are forced to repay the loans from their profits, depression will set in, resulting in unemployment: “the decline in employment in the mechanized industries, which was concealed by the general increase in employment and activity while the boom lasted, will begin to make itself generally felt” (Lederer 1938, p. 244). His analysis is mainly focused on the prospects of re-absorption of the displaced workers that rationalization has produced and so he does not provide a detailed theoretical description of the depression phase.<sup>12</sup>

Regarding the prospects of a revival that are reinforced through the course of the depression phase, Lederer explicitly mentioned the possibilities of a new phase of expansion that are created during phases of depression in the monetary sphere: “Every depression [...] will, owing to the severe shrinkage of production, renew the possibilities of monetary expansion; the total circulation of money diminishes, the velocity of circulation is retarded, and reserves increase. This means that side by side with the displacement of the factors of capital and labour from production, fresh opportunities arise of expanding production through credit” (*ibid*, p. 227).

Despite Lederer’s lack of a complete theoretical exposition of the business cycle phases and effects, he shared common insights with Schumpeter. One theme they have in common was the role that unsound credit plays in the *causation* of a depression phase. Lederer warned that

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<sup>12</sup>Lederer analyzes various cases in which the form of the production function (increasing or decreasing returns to scale), the elasticity of demand (greater, lower or equal to unity) the structure of the market (perfect competition or cartels) and the existence of unused reserves are taken into account in their different combinations to examine the conditions that will enable re-absorption of the displaced workers.

there are dangers inherent in the process of credit expansion which takes place in the prosperity phase. As was already mentioned, the function of credit expansion is the financing of new investments especially during boom periods. The initial credit expansion will be spent on working capital but in the long-run the need will arise for additional fixed capital. This need will manifest itself first of all as increasing demand for working capital in the capital goods industries and later on as an investment demand both in the consumption goods and in the capital good industries. The danger inherent in this sequence of events was, according to Lederer, the inability to consolidate the provoked credit expansion from the savings (profits): "It is true that every expansion of production implies a possible increase in the volume of savings, but dangerous stresses may arise if the reserves of idle savings are small and if business credit is expanded to an extent exceeding the rise in savings which may be expected as a result of the boom, an eventuality which is all too probable, because modern systems of payments permit of a rapid increase in the supply of money and therefore in business credits" (*ibid*, pp. 230-1). The process described here parallels with the phase of depression in Schumpeter's schema which is characterized by unsound credit and ill-founded undertakings (Schumpeter 1928). Both writers attributed this state to the uncertainty which prevails during booms and may lead to erroneous expectations.

Another obvious similarity exists in the abstract model that both Lederer and Schumpeter used to describe the onset of the boom period. They both conceptualized a stationary economy without savings and unused reserves. As it has been mentioned, the impulse which sets the system in motion is the application of innovations. Both writers in their exposition of their respective model made the simplifying assumption that these innovations will be implemented by the setting up of new enterprises and the building of new plants. The new enterprises demand the creation of new credit in order to finance their plans. Due to the assumptions concerning the initial state, the materialization of their business plans forces them to exercise a demand for producer's goods and labor force. Prices of producer's goods and wages rise up (wages will rise at a slower rate) and a shift of demand from consumer's to producer's goods will be observed leading

simultaneously to an increase in the price of consumer's goods (Dielbolt 2006, p. 10). Differential profits will be earned in the course of the prosperity period (Schumpeter 1939, Vol. 1, pp.130-8; Lederer 1938, pp. 236-8).

Lederer's analysis of the business cycle in 1938 was differentiated from that of his earlier work. In his first attempt, in *Konjunktur und Krisen* (1925), Lederer had constructed an explanation consistent with the so-called "disproportionality theory" introduced by Tugan-Baranovsky and later adopted by Hilferding and others (see Section 7)<sup>13</sup>. Lederer argued that: "Almost all the cycle theories agree about the nature of these disturbances-they are disproportionalities" (*ibid*, p. 156).

In this work, the boom period starts due to an increase in effective demand<sup>14</sup>, which is attributed to the social groups with fixed incomes (i.e. public employees and rentiers). Credit creation follows as an essential component of the booming period. This phase is characterized by an increase in prices although this increase is disproportional in the various sectors of the economy: prices in the producer's goods sector will typically raise more compared to consumer's goods.<sup>15</sup> In addition to this, the increase in wages will be also at lower rates compared to those of prices thus the real wages will decrease. The slower rate of increase in wages is the explanation for the existence of *extra profits* during this phase of the cycle. A redistribution of income will take place from wage-earners to capitalists. The composition of demand will as a result, contain a greater part of demand for investment goods than demand for consumer goods (on the assumption that profits are invested and wages are spent on consumption). The general trend will therefore be a disproportional growth rate between the sectors of producer goods and consumer

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<sup>13</sup> Disproportional developments in the producer and consumer goods sectors in the course of the business cycle are considered in Allgoewer (2003, p. 333) to be one common point between Lederer's 1925 analysis and Schumpeter's work on business cycles. While Schumpeter acknowledged the importance of disproportionality ("[T]his idea [...] is moreover easy to substantiate from certain very obvious facts" [Schumpeter 1954, p. 1133]) he avoids attributing a causative role to them. He stressed the importance of looking for "the definite factors that are to account for it" and concluded that "those factors and not disproportionality per se will individuate an author's theory" (*ibid*, p. 1133).

<sup>14</sup> Unlike his 1938 contribution where, as it was explained before, he placed emphasis in supply-side factors.

<sup>15</sup> This immediate change in prices is typical of Konradieff's analysis (1992, p. 389).

goods. This discrepancy will be revealed at the turning point of the cycle when it will become clear that the growth which took place in the producer goods sector is not matched by a corresponding growth in the demand for final goods.

The insufficiency of demand, which signals the initiation of the depression phase, will be felt, according to Lederer, most probably in heavy industries. However it will spread through the whole of the economy and decreases in prices and profits will be observed. Wages will fall at a slower rate than prices and the explanation offered is that the contracts which determine them are less prone to change than prices. The redistribution of income will be reverse compared to the prosperity period. The real wages will rise in parallel with the increase in purchasing power of the fixed income group. The later social category is again considered to play a pivotal role in the revival of the economy. The relative stability of their incomes is a decisive factor in restoring the levels of effective demand and initiating a new prosperity period.

However, in Lederer's early explanation of the business cycle, it is not very clear what the ultimate cause of the boom period is. Allgoewer (2003, p. 331) described Lederer's vision of the business cycle as demand-driven and assigned the leading role to classes with fixed incomes, the purchasing power of which increases during the crisis phase. Meanwhile, Allgoewer (2003) regarded credit as an essential precondition but not as the ultimate cause of the cycle. On the other hand, Moszkowska (1935), classified Lederer's analysis as a credit theory of the cycle. These conflicting views probably reflect Lederer's ambiguity on the issue (Moszkowska 1935, p. 69).<sup>16</sup>

Up to this point, we have emphasized the affinity between Schumpeter's and Lederer's analyses regarding the issues of economic change, technology, credit and economic fluctuations<sup>17</sup>. In the next section, we are going to discuss the affinities between Schumpeter's and Lederer's views and the theories delivered by Hilferding and Tugan-Baranowsky.

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<sup>16</sup> According to Diebolt (2006, p. 4) the deeper roots of Lederer's views could be traced back to Malthus (1836) and Sismondi (1827).

<sup>17</sup> De Vecchi (1995, pp.164-165) also commented very briefly on Lederer's and Schumpeter's views with respect to the concept of 'rationalization of life'.

## 7. The influence of Rudolf Hilferding and Mikhail Ivanovich Tugan-Baranowsky

### 7.1 Rudolf Hilferding

Rudolf Hilferding (1877-1941) was born in Vienna into a “Jewish mercantile family” (Sweezy 1949, p. xv) and died in Paris. He studied medicine at the University of Vienna, where Joseph Schumpeter was also a student, and obtained his doctorate in 1901. However, he practiced medicine only until 1906 and thereafter devoted himself exclusively to politics and the study of economics. At the age of fifteen, he joined the socialist movement and from 1902 he contributed frequently to *Die Neue Zeit*, the theoretical journal of the German Social-Democratic Party (S.P.D.). Between 1904 and 1923 he published, along with Max Adler, the *Marx Studien*. In 1905, Hilferding participated in the Seminar on economic theory directed by Böhm-Bawerk. In 1906, he accepted an invitation from the S.P.D. and tutored for a year at the party school in Berlin, along with Rosa Luxembourg. Afterwards, he was appointed to editor of the party’s newspaper, *Vorwärts*. In 1914, Hilferding joined the Independent Social Democratic Party of Germany (U.S.P.D.), which emerged from a split with the S.P.D. In 1918, he became member of the *German Socialisation Commission* and in 1922, after the majority faction of the U.S.P.D. had been transformed to the German Communist Party (K.P.D.), he returned to the S.P.D. He became editor of the party’s journal, *Die Gesellschaft* and served as Weimar’s Minister of Finance, in 1923 and 1928-9. When Hitler came to power in 1933, Hilferding went into exile. He fled to Denmark in 1933, then stayed in Switzerland and in 1939 went to Paris. In 1941 he was handed over to the Nazis by the Vichy government and died in Paris either by suicide or from injuries inflicted by the Gestapo.

In his *Finance Capital* (1910), the great Marxist theoretician Rudolf Hilferding introduced the notion of a “latest phase” of capitalism, characterized by: (a) the formation of monopolistic enterprises, which put aside competition; (b) the fusion of bank and industrial

capital leading thus to the formation of finance capital, which was considered to be the ultimate form of capital; (c) the subordination of the state to monopolies and finance capital; and finally (d) the formation of a protectionist and expansionist policy.

Despite being a prominent Marxist thinker, Hilferding did not attribute capitalism's doom to the tension between the progressive reduction of socially necessary labor time and the fact that labor power constituted the sole source of profit (Darity and Horn 1985). He foresaw a transformation of the capitalist economy with growing centralization and concentration of capital as the normal outcome (see Michaelides and Milios, 2005). For Hilferding economic development depended on large non-competitive enterprises, the technological superiority of which derives from their ability to attain profits high above the average. Just like Schumpeter, Hilferding believed that: "Cartelization brings exceptionally large extra profits" (Hilferding 1910, p. 233) that function as incentives for undertaking such entrepreneurial acts, which, in turn, will lead to the further empowerment of the non-competitive, monopolistic formations.<sup>18</sup>

Hilferding repeatedly affirmed the position that the big corporation is able to create the conditions which may assure its market supremacy as well as its extra profits for a long period: "An industrial enterprise which enjoys technical and economic superiority can count upon dominating the market after a successful competitive struggle, can increase its sales, and after eliminating its competitors, rake in extra profits over a long period" (*ibid*, p. 191).

As in Schumpeter's theory, the most important aspect of growth of corporations is the "liberation of the industrial capitalist from the function of industrial entrepreneur". This transformation has several consequences. One is the emergence of "promoter's profit" (Gruendergewinn), which arises from the possibility of selling shares in a joint stock company

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<sup>18</sup> According to Hilferding, the elimination of free competition and monopolies came, historically, in a similar way: "Finance capital signifies the unification of capital. The *previously separate* spheres of industrial, commercial and bank capital are brought under the common direction of high finance, in which the masters of industry and of the banks are united in a close personal association" and consequently: "The basis of this association is the *elimination of free competition among individual capitalists by the large monopolistic combines*" (*ibid*, p. 301, emphasis added). Thus, "it is also clear that monopolistic combines will control the market" (*ibid*., p. 193).

for considerably more than the capital invested in the enterprise, if the yield on that capital is higher than the current rate of interest on investment. Promoter's profit is an incentive to the formation of joint stock companies and a source of wealth which becomes available for further investment. In other words, it stimulates the centralisation of capital, the growth of large corporations and eventually the formation of cartels and trusts controlling whole industries.<sup>19</sup>

On the other hand, Hilferding linked technological change to the formation of monopolies, which mark a distinct phase in capitalist development and are the main feature of economic development. He considered technical progress to be the condition *sine qua non* for assuring a cartel's or a trust's supremacy in the market: "[O]nce a combination has come into existence as a result of economic forces it will very soon present opportunities for the introduction of technical improvements in the process of production" (Hilferding 1910, p. 197). In fact: "They are obliged to introduce these [technical] improvements, for otherwise there is a danger that some outsider will use them in a renewed competitive struggle [...]. [I]n this case technical improvements mean an extra profit, which is not eliminated by competition" (*ibid*, p. 233).

It is this technical superiority that makes the monopolistic formations able to maintain and constantly reproduce their dominant role: "These technical advantages, once achieved, in turn become powerful motive for forming combinations where purely economic factors would not have brought them about" (*ibid*, p. 197). "The corporation can thus be equipped in a technically superior fashion, and what is just as important, can maintain this technical superiority" (*ibid*, p. 123).

As far as the hypothesis that perfect competition is an unstable market structure where only large enterprises can push technological progress forward, Hilferding's views are very interesting. For Schumpeter, once big corporations are formed, the imperfectly competitive

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<sup>19</sup> Hilferding's analysis treated dividends and promoter's profit as distinct economic categories, and worked out the significance of the separation between ownership and the control of production, which allows a small number of people to acquire control over a large number of companies, and to establish personal connections which then facilitate the formation of cartels and trusts.

market structure becomes stable, as large firms become increasingly conducive to technological progress and change: “There are superior methods available to the monopolist which either are not available at all to a crowd of competitors or are not available to them so readily” (Schumpeter 1942, p. 101). “The perfectly bureaucratized giant industrial unit [...] ousts the small or medium-sized firm” (*ibid*, p. 134). On the same line of argument, the large firm is considered to possess the ability to attract superior “brains”, to secure a high financial standing (*ibid*, p. 110), and to deploy an array of practices to protect their risk-bearing investments.<sup>20</sup>

In his *Finance Capital*, Hilferding had developed a similar approach: “The expansion of the capitalist enterprise which has been converted into a corporation [...] can now conform simply with the demands of technology. The introduction of new machinery, the assimilation of related branches of production, the exploitation of patents, now takes place [...] from the standpoint of their technical and economic suitability. [...] Business opportunities can be exploited more effectively, more thoroughly, and more quickly [...] A corporation [...] is able, therefore, to organize its plant according to purely technical considerations, whereas the individual entrepreneur is always restricted [...] The corporation can thus be equipped in a technically superior fashion, and what is just as important, can maintain this technical superiority. This also means that the corporation can install new technology and labour saving processes before they come into general use, and hence produce on a large scale, and with improved, modern techniques, thus gaining an extra profit, as compared with the individually owned enterprise” (Hilferding 1910, pp. 123-4). Consequently, “The introduction of improved

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<sup>20</sup> The thesis regarding the limited ability of free competition to promote technological progress is supposed to be a conclusion drawn from past historical experience. More precisely, Schumpeter argued that the capitalist era could be divided into two distinct periods (Screpanti and Zamagni 1993, p. 243 ff.): (a) The era of ‘competitive capitalism’ when small enterprises dominated, an era which declined in the 1880s and (b), the era of monopolistic or ‘big-business capitalism’ during which large enterprises, trusts and cartels dominated, starting roughly from the 1880s and having consolidated its fully fledged form by the time Schumpeter’s book was written. In Schumpeter’s own words: “[i]t is still permissible [...] to call the nineteenth century *κατ’ ἐξοχήν* the time of *competitive*, and what has so far followed, the time of increasingly *‘trustified’* or otherwise *‘organized’*, *‘regulated’*, or *‘managed’*, capitalism” (Schumpeter 1928, p. 363).

techniques [...] [benefits] the tightly organized cartels and trusts. [T]he largest concerns introduce the improvements and expand their production” (*ibid*, p. 233).

Hilferding also emphasized in his analysis the crucial role of “credit money”. However, he differentiated between paper money “which emerges from circulation as a social product”, and credit money which is a “private affair”, not backed by the government (Hilferding 1910, p. 66). In this last case, money can be replaced by a promise to pay. The development of capitalism is followed by a rapid increase in the total volume of commodities in circulation: “the expansion of production, the conversion of all obligations into monetary obligations, and especially the growth of fictitious capital, have been accompanied by an increase in the extent to which transactions are concluded with credit money”. So, Hilferding concluded that credit money required “special institutions where obligations can be cancelled out and the residual balances settled, and as such institutions develop so is a greater economy achieved” (*ibid*, p. 66).

For Hilferding credit originated as a consequence of the changed function of money as a means of payment. A purchase not followed by direct payment, i.e. a delay in payment “means that one capitalist has enough surplus capital to wait for payment for the purchaser, the money due is credited” and “money is [...] merely transferred” (*ibid*, p. 82). However, when a promissory note functions as a means of payment, money capital has been saved, and this type of credit is called “circulation credit” (*ibid*, p. 83). According to Hilferding, this credit form increases transactions between capitalists and so an increased demand for production capital emerges.

He believed that an increase in production means a simultaneous expansion of circulation and “the enlarged circulation process is made possible through an increase in the quantity of credit money” (*ibid*, p. 83). However, circulation credit does not “transfer money capital from one productive capitalist to another” (*ibid*, p. 87). This role is played by another form of credit, which converts idle money into active money capital, and is called “capital credit”. This credit form constitutes a transfer of money to those who use it as money capital, i.e.

for the purpose of purchasing the elements of productive capital. Conclusively, credit “puts money into circulation as money capital in order to convert it into productive capital” (*ibid*, p. 88). This expands the scale of production with the simultaneous expansion of circulation. Thus, the scale of circulation is enlarged by utilization of *previously idle money*.

Rudolf Hilferding, in his own discussion of economic crises (*ibid*, ch. 16-17) argued that “such expressions as ‘overproduction of commodities’ and ‘underconsumption’ tell us very little” (*ibid*, p. 241). He, thus, investigated the specific causes of economic crises and, in particular, the disproportionality between the capital goods and consumer goods industries which was according to him the real cause of instability and crises (see also Milios 1994; Milios *et al.* 2002, ch. 6, 8). More precisely, Hilferding, in a fine Austrian fashion, emphasized the distortions in the structure of prices as fundamental to the propagation of capitalist crises. After presenting his disproportionality theory, Hilferding made comments about the changes in the character of crises because of the growth of monopolies and cartels.

He created a theory of economic fluctuations based on the notion of disproportionality crises. This disproportionality theory, delivered by Hilferding (1910) in his *Finance Capital*, is based on a two-sector model with the difference in organic composition of capital between sectors producing a time lag structure in production and capacity expansion. This (asymmetric) time lag structure causes, in turn, an (asymmetric) price structure across the various sectors, which causes, in the end, a disruption in the proportionality relations required for smooth capital accumulation. Hilferding argued that if changes in prices are uniform then there is no redistribution of capital among the various branches and the conditions of smooth capital accumulation are satisfied. Crises occur only if the increase in prices has a non-uniform character.

Hilferding explained how this asymmetric price structure leads to a period of crisis: As investment increases and the organic composition of capital increases in the 1<sup>st</sup> sector, the time it takes for installation becomes longer, creating time lags in investment and expansion. The time lag in this sector causes supply to adjust to demand with delay, leading to an increase in prices at

a faster rate than the 2<sup>nd</sup> sector and hence to a pressure to invest in these industries. Thus, the increase in the organic composition of capital will, in the long run, lead to a decline in profits. However, in the short run, the asymmetric rise in prices will lead to asymmetric increases in profits between the two sectors. This causes over-investment and accumulation in the sector with the higher organic composition of capital, and because production in the other sector (i.e. with the lower capital intensity) has not increased proportionally, prices and profits drop and crisis sets in.<sup>21</sup>

Apparently, Lederer's early description of the business cycle is consistent with Hilferding's disproportionality crisis analyzed above. After all, Lederer himself emphatically stressed that "even a blind man can see that that [the lack of proportion between producers' and consumers' goods production] is characteristic of every cycle" (Lederer 1936, p. 157) and acknowledged the work of the great Marxist thinker: "That the lack of right proportions between the different branches or spheres of production breeds the cycle is the view of the theory on Marxian lines, also (f.i. R. Hilferding, R. Luxemburg)" He even went on to admit that: "This and similar views were widely discussed [...] and shared by theorists who would not subscribe to the revolutionary implications of that theory" (*ibid*, p. 157). Also, in his 1925 work, Lederer clearly implied that Schumpeter (among other theoreticians such as Bouniatian) was his initial inspiration: "Die Depression [...] wird in der neueren Literatur, so bei Bouniatian und Schumpeter als ein statischer Zustand der Volkswirtschaft aufgefasst" (Lederer 1925, p. 361).<sup>22</sup>

## *7.2 Mikhail Ivanovich Tugan-Baranowsky*

Mikhail Ivanovich Tugan-Baranowsky was born in Kharkov, Ukraine in 1865. He studied Natural Sciences at the Kharkov University but by 1890 his interests had shifted towards

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<sup>21</sup> According to Darity and Horn (1985, p. 364) Hilferding's attitude towards prices is clear in his last publication (Hilferding 1963).

<sup>22</sup> Meanwhile, according to Dielbolt's (2006, p. 4) brief comment Lederer seemed to underestimate Marx's respective analysis (Lederer 1925, p. 368).

Political Economy and he continued his studies at the Faculty of Law and Economics in the same university. In 1889 he married Lydia Karlovna Davydova<sup>23</sup> editor of the journal *Mir Bozhy* (*The World of God*) that was sympathetic towards Marxist views.

In 1894 Tugan published in Russian his *Studies on the Theory and History of Trade Crises in England* after spending six months in London to gather material. In this work, Tugan expounded a radical critique of the underconsumptionist theory then predominant among Russian (and German) Marxists. Following this publication, he was granted a Master's Degree at the Moscow University and he was appointed at the St. Petersburg University in 1895. In 1914 he was elected to the chair of Political Economy and Statistics of St. Petersburg Polytechnical Institute. However, he could take this chair only in 1917 due to the government's non-endorsement of his election<sup>24</sup>. After the Russian Revolution, he moved to Ukraine becoming Minister of Finance from August to December 1917 in the short-lived Ukrainian Government. In 1918 he was one of the founders of the National Academy of Science of Ukraine in Kiev. During the same year, he was appointed dean of the Law Faculty of Kiev University. He died in 1919, by heart attack while traveling by train from Kiev to Paris where he had decided to emigrate.

Tugan-Baranowsky is considered to be one of the most influential Russian economists of the pre-revolutionary era. In the words of Schumpeter (1954, p. 1126): "Tugan Baranowsky [...] was the most eminent Russian economist of that period" and concerning his 1894 book that it "did make a mark and did exert influence far and wide". The questions he raised in relation to the link between the Marxist theory of reproduction and the theory of crises were of particular importance and remained in the forefront of discussion between Marxists for many years.<sup>25</sup>

Tugan-Baranowsky (1894) formulated a theoretical analysis of economic development based on the reproduction schemas of Vol. II of *Capital*. In this work he gave an extensive theo-

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<sup>23</sup> Lydia Kralovna Davydova was at the same school with Lenin's wife, Nadezhda Krupskaja.

<sup>24</sup> According to Barnett (2001) this was due to Tugan's activities as a leading member of the 'Legal Marxists'.

<sup>25</sup> According to Barnett (2004), Tugan – Baranowsky is also regarded as a member of the "Russian Historical School", i.e. the Russian strand of "historical political economy", in parallel with the more famous German and Irish examples.

retically and empirically grounded presentation of his arguments, criticizing the underconsumptionist theory, then predominant among Russian (and German) Marxists. There, just like Lederer, Tugan-Baranowsky argued that a capitalist society can exist and reproduce itself on an expanding scale.

The only prerequisite, according to Tugan and shared by Lederer for unimpeded expansion of production is that the “right” proportion be maintained between production in the two basic sectors (production of means of production and production of consumption goods) which are described in the reproduction schemes of Vol. II of *Capital*: “The general view, which to a certain extent was also shared by Marx, that the poverty of the workers, i.e. of the great majority of the population, makes it impossible to realize the products of an ever expanding capitalist production, since it causes a decline in demand, is mistaken. [...] Capitalist production creates its own market – consumption being only one of the moments of capitalist production” (Tugan-Baranowsky 1969, p. 33; translated in Luxemburg 1971 pp. 312). In other words, the idea of unequal expansion rates between the two sectors of production is common to Tugan-Baranowsky and Lederer.

Probably the most fundamental difference between Tugan and Lederer is that Tugan-Baranowsky in his work adopted the absolute immiseration thesis reckoning a gradual deterioration of the standard of living of the working class (Milios *et al.* 2002 ; Milios and Sotiropoulos 2007). On the other hand, Lederer believed that in the capitalist system crises are inseparably linked with economic growth<sup>26</sup> and that every depression phase results in a higher level of social product without some clear trend regarding the relative shares of wages and profits.

Tugan-Baranowsky viewed the concept of technology from a Marxian perspective and examined the relationship between technological progress and the rate of profit. In fact, he

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<sup>26</sup> This view is reflected in his regard of the pre-capitalistic foundations of Japanese society: “[in Japan] precapitalistic and full capitalistic elements have thus been amalgamated into a single historical whole. The precapitalistic foundation, which is feudal in an ideological as well as an economic sense, is on the one hand a curb on further capitalistic development and, on the other, a source of security in time of crisis” (Lederer and Lederer-Seidler 1938, p. 225).

subjected to criticism the “law of the falling tendency” of the rate of profit and attempted to substantiate the view that the introduction of technological innovations in every case result in a rise and in no case a fall in the rate of profit. The increase in the rate of profit following mechanization of production is brought about by the increase in the productivity of labor and in the rate of surplus value, the later being effected by the reduction in the labor-value of variable capital (Milios *et al.* 2002).

According to Colacchio’s analysis (Colacchio 2005), credit and investment play a key role in Tugan’s explanation of the business cycle, too. In a way practically echoing Lederer, Tugan attaches a distinctive economic role to the social groups the income of which does not fluctuate during the different phases of the cycle. The savings of this part of the population lead to the accumulation of free loanable capital at an approximately constant rate. However, the demand for free capital (i.e. credit, although not in the sense of *additional credit* as in Lederer’s theory) is discontinuous and there lies the actual cause of business cycles. During a recession phase, free capital lies idle in the banks and interest rates fall. This creates favorable conditions for investment and a moment is bound to come where a revival will occur, when demand for loanable funds increases again. Investment in physical capital which has been accumulated during the depression phase will have multiplier effects in the total economy. Expansion of the economy will take place, especially in the capital goods sector. The expansionary phase will come to an end when demand for capital exceeds supply. During the recession phase, the conditions for a new boom period will be re-created (see further Colacchio 2005).

Lederer and Tugan share the view that a symptom of the upper-turning point of the cycle is that credit contracts (Colacchio 1998, quoted in Besomi 2006). However, the explanation for credit contraction varies between the two authors. For Tugan this halt is due to the disproportion between productive departments while Lederer attributes it to bank policy (and bank profit) matters.

Despite the profound similarities in Lederer's view on the subject, Tugan's hypothetical assumption that savings remain idle in the banks during the recession phase provoked Lederer's criticism. According to Lederer, savings are invested during all phases of the business cycle. For Lederer, *additional credit* is what matters as far as the business cycle is concerned. Economic activity is not financed by the savings of the past (i.e. of the recession phase) as Tugan's theory implies but only from *additional credit* or new savings. However Lederer's view on the unavoidability of investment of all savings is not explained in a very persuasive manner.

For Tugan-Baranowsky capitalist crises are the result of temporary disproportions between production in the two main sectors of the economic system (the one producing capital goods and the other producing consumer goods). "If social production is proportionately organized, there is no limit to the expansion of the market other than the productive forces available" (cited in Luxemburg 1971, p. 313). Thus: "The underconsumption of the popular masses can be an obstacle for the realization of the social product only insofar as it hinders a proportional distribution of the social production. Yet, the lack of proportionality is, also in this instance, the only cause of an insufficient demand. Therefore, one should not consider both, the lack of proportionality and underconsumption, as two particular causes of the crises since, strictly speaking, both are one and the same" (Tugan-Baranowsky 2000, p. 86). Tugan-Baranowsky in this way provides us with an interesting conception of cyclical fluctuations in capitalism.

Lederer's theory of the business cycle is similar in many respects to Tugan Baranowsky's approach. On the one hand, the idea of unequal expansion rates between the two sectors of production is common to both. Moreover, they both link this process with a redistribution of income from the working class to the capitalists. The role of credit is stressed by both theoreticians as an essential element of economic fluctuations. Furthermore, they share similar views in some other less central aspects. They both emphasize on the fluctuations characterizing the prices of products in the heavy industries (raw materials) and consider this phenomenon indicative for the initiation of the various phases of the cycle. Besides, they describe in a very similar

manner the transmission mechanisms taking effect when a positive change of prices (in the boom period) or otherwise, propagates throughout the economy as a whole.

Lederer differentiated his disproportionality theory from other explanations of the business cycle that come under the same heading, especially that of Tugan-Baranowsky, on the grounds that they explain the differences in the expansion rates between the two main sectors of the economy as a result of absence of central planning in the capitalist system with respect to the growth process. In contrast, his theory conceptualized the emergence of disproportions as economically “correct” and necessary for economic growth. Lederer ascribed the function of economic development to the capitalist class and thus the alteration in the income distribution during the boom period is a logical consequence of this fact. The disproportionality in the expansion rates of the two sectors is a reflection of this income redistribution as it was explained before. The re-establishing, to a certain extent, of the previous income shares of the different classes will take place in the crisis period when accumulation rate decreases.

Lederer referred to Tugan’s disproportionality theory when discussing policy measures for coping with economic crises. There he drew a parallel between the proposal for granting credit during the crisis period in order to sustain enterprises which are unable to withstand the decrease in profits<sup>27</sup> and Tugan’s view of an unimpeded expansion process conditioned only on the preservation of the right proportions between the two sectors of the economy. The affinity between such proposals and Tugan’s expansion process lies in their perception of the possibility of “producing for the sake of production”, i.e. that sufficient levels of demand for consumer’s goods is not a necessary condition for the expansion of the economic system. Lederer thought that such granting of unlimited credit would have inflationary effects, unsustainable by any credit system. He regarded Tugan’s vision unrealistic for the reason that accumulation and individual consumption are not independent (see Milios *et al.* 2002 and Milios and Sotiropoulos, 2007).

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<sup>27</sup> Another alternative, based on a similar argument, is the granting of credit to the consumers in order to restore adequate levels of demand.

## **8. Conclusion**

It was the purpose of the present paper to compare Joseph Schumpeter and Emil Lederer, with respect to their visions concerning the notions of economic development, technology, credit and business cycles. Despite the fact that the two economists are traditionally classified in different schools of thought, their theoretical investigations in a great number of thematic areas seem to converge to similar views. Moreover, the roots of some of Schumpeter's and Lederer's common views were traced back to Rudolf Hilferding and Mikhail Ivanovich Tugan-Baranowsky.

For instance, Schumpeter, Lederer and Hilferding used similar arguments to emphasize the link between economic development and technological change. In their analyses, Schumpeter and Lederer referred to psychological factors motivating the entrepreneur, in order to explain the forces that set in motion the process of innovation and thus economic development. The effects caused by the introduction of innovation in the labor market and the concept of technological unemployment are described in a similar manner by both of them. Hilferding stressed the importance of technology but mostly with respect to market structure and, more specifically, the emergence of monopolies and cartels. Both Schumpeter and Lederer regarded the domination of the market by monopolies as a motivating force for technological change, due to the possibility of extra profits which are not possible under conditions of perfect competition.

Overall, there is a common tendency to Schumpeter, Lederer and Hilferding to regard innovation as a determining factor of the evolutionary process of the economic system. Schumpeter's and Lederer's visions are very similar with respect to the subjective motives that are responsible for the introduction of innovations. They also agree on their disruptive character and more specifically on the effects that the introduction of innovation is bound to have on the labor market. Schumpeter and Lederer share with Hilferding the view that the market structure promoting technological change is the one defined by the domination of great monopolistic

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concerns. Tugan-Baranowsky's contribution concerning the link between technological progress and the increase in the rate of profit was also significant.

The function of credit is another central theme in the works of the two theoreticians. Besides, they all comprehended in a similar manner the way that credit expansion infuses dynamism into the economic system, creating, thus, on the one hand new growth prospects, and on the other financial and economic instability.

Also, regarding the issue of economic crises and fluctuations, Schumpeter and Lederer argued that economic fluctuations arise from the disruptions created by innovations, which are introduced discontinuously into the economic system, whereas Hilferding focused on the role of disproportionality between sectors producing capital goods and those producing consumer goods. At this point it is interesting to note that, in his early writings, Lederer had adopted many of Hilferding's theses presented in his disproportionality theory. However, the theory of economic crises and fluctuations formulated by Tugan-Baranowsky was probably the precursor of all disproportionality theories.

Finally, as far as their methodological approaches are concerned, they seem to converge significantly, since both economists tended to support their arguments with empirical data and exhaustive discussions, exhibiting a strong link of theoretical reasoning and empirical evidence.<sup>28</sup>

Conclusively, Schumpeter and Lederer have delivered theses which are similar in scope and conclusions. We may, thus conclude that both theoreticians developed certain of their theories in the same social, political, theoretical and ideological environment and were probably well acquainted with each other's ideas. We may suppose, therefore, that the similarities of certain Schumpeterian elaborations with theoretical theses and analyses delivered by Emil Lederer are not accidental, but the outcome of this long interaction between them and other leading economists of that period like Rudolf Hilferding and Tugan-Baranowsky.

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<sup>28</sup>However, it should be noted here that according to Lederer's analysis statistical data alone cannot offer a sufficient explanation of purely theoretical issues (Lederer 1925, 354n).

Apparently, much of this similarity can be attributed to their common socioeconomic environment and to the common influences by certain theoreticians and schools of thought (e.g. Austrian tradition, Austro-Marxist economics, etc), not always acknowledged in the literature. Part of the explanation why this similarity in visions has been inadequately acknowledged until today is the product of ignorance outside Germany of the approaches on which Schumpeter built his treatises, given that German non-Marxian economics was represented, in the Anglo-Saxon world, almost entirely by Schumpeter.

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