SCHUMPETER’S CRITICISM TO THE NEOCLASSICAL   
THEORY OF CAPITAL AND INTEREST

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**INTRODUCTION**

Schumpeter’s theory of interest is one of his most original contributions. It is subject to systematic treatment in the first, second, third and fifth chapters of his greatest work, *The Theory of Economic Development* (hereinafter, TED). As Harbeler acknowledges, his starting point is the refusal of the neoclassical theory of abstinence[[1]](#footnote-1). This interpretation has been turned into a radical criticism of neoclassical theory of distribution, expressed in the claim that the interest is not a category of stationary equilibrium and is inconsistent with the circular flow.

This criticism has a theoretical value, despite its importance to Schumpeter´s dynamic theory. But it is far from being irrelevant to the latter[[2]](#footnote-2). The conclusion that the interest is not a category of stationary equilibrium is the center of the distinction proposed by Schumpeter between the “normal” reversion - when the depression of profits associated with the dissemination of innovations do not jeopardize the payment of debts and interest hired during the expansion - and the cyclical pattern of “abnormal” reversion - coupled with the emergence of financial crisis. His theory of interest is therefore inseparable from its peculiar theory of crisis.

Nevertheless, this contribution is one of the least valued, debated and developed by his followers. And, in contrast to the attention it received from orthodox economists during the first half of last century, it is virtually ignored in contemporary neoclassical literature. In a recent work written in defense of the abstinence theory of interest, Giannetti pretends to prove that “as well as the gravity, the photosynthesis and the genetic mutations, to remember phenomena that do not depend on human presence in the world, the interest is part of the natural order of the things” (Giannetti, 2005, p. 11 and 12). A “prove” that is developed without any mention to Schumpeter’s name.

We believe that this virtually universal underestimation of Schumpeter’s contribution to the theory of interest has two roots. The first is ideological: Schumpeter’s theory resembles too much the old fashioned and primitive classical theories of stationary equilibrium and the Marxist criticism of “capital reification” to receive any attention from up-to-date positivist economists. The second is strictly theoretical: the path that leads to full equilibrium without positive interest rate is not fully and consistently presented by Schumpeter. In this paper we try to solve the second problem making it, we intend to show that the first source of resistance – the ideological one – is the strongest one. But to defeat this source is beyond the scope of science.

**SCHUMPETER’S THEORY OF INTEREST REVISITED**

Like virtually all Schumpeter’s theoretical contributions, his theory of distribution is, simultaneously, unique and original, on one hand, and traditional and orthodox, on the other hand. It is the late and isolated recovery of Smithian and Ricardian theories of distribution. These theories will be unified and developed by the imposition of the theoretical and methodological apparatus of Austrian School of Economics. And the result is so heterodox and surprising that Schumpeterian theory of interest has been misunderstood and underestimated from its appearance to our days.

As a matter of fact, the Schumpeter’s circular flow corresponds almost perfectly to the Ricardian steady state. In both, there are only wages and rent[[3]](#footnote-3). In both the profit and interest were denied by raising wages and prices decreasing. Both are derived from compulsive accumulation, imposed by producers involved in a competitive process that is incompatible with any “minimal profit”[[4]](#footnote-4). But the way the competitive system arrives to the “steady state” is quite different in the two authors. In Schumpeter the path is Smithian, virtually opposite to the trajectory supposed by Ricardo. According to the latter, if restrictions of natural resources do not exist, the accumulation may happen without modifying the distributive structure, once the supply of labor is perfectly elastic. In Schumpeter - as in Smith - the accumulation occurs with depression of the profit margin over direct cost (wages plus raw materials). This depression is caused by an increase in real wages (determined, as in classical and neoclassical traditions, in the labor market) and by the depression of prices (determined in the markets of goods and services, by the free entry of competitors). Indeed, in Schumpeter (as in Walras), these two processes are inseparable: they are the two sides of a single movement: the movement toward the new equilibrium, after the innovative shock. The process of balancing is reflected in the increase of services prices of scarce factors (labor force and land) and the gradual reduction of earnings surplus (which do not correspond to any costs) of firms. But, as Smith and Ricardo before, Schumpeter concludes (in contrast to Walras) that in full balance the economic system does not provide, nor profit, nor interest.

This idea sounds original only because, since the publication of *Das Kapital* and the emergence of Marginalist Revolution, virtually all economists adopted the perspective that interest is a perennial category of the system. A movement that will be reinforced by the empirical inflection of Economics from the early 20´s. This movement culminated with the creation of Macroeconomics and Industrial Organization as special areas of our science with relative autonomy. And in those fields the capitalist distributive structure is not questioned; they are just accepted as a fact.

To Schumpeter, this movement may lead to a capitulation to the appearance. The interest “seems” to be perennial; because unlike the profit (a category that is open to any result), interest is set up contractually when money is borrowed[[5]](#footnote-5). But this category of income does not correspond to a structural cost of production (as the wage) or the ownership of a monopoly essential factor of production (such as rent or monopoly revenues). It is not, therefore, a category of income compatible with equilibrium.

As you have already pointed out, this characterization is consistent with the “full equilibrium” of Ricardo. But in Ricardo it is understandable why the steady state is such that it allows the consolidation of only two categories of income (wage and rent). To this author, there are three classes in the economy. The working class is so poor that cannot save virtually anything and is destined to the condition of “non-owner”. So, it is prey to the condition of a (flexible and docile) supplier of labor force to the capital. The rent receivers are so rich that have no interest in the poor and unstable income of productive capital. And the third - the capitalist class - is too poor to buy land, but rich enough to command means of production and take office directives on market production. While the accumulation occurs with stable technical standards[[6]](#footnote-6) without expanding the real rate of wages (in terms of consumer goods for workers), profits will be determined by the rising cost of production of wage-goods. So, the increasing marginal costs will determine the persistent fall of the profit rate[[7]](#footnote-7). When the “profit” is so small that is nothing but a wage of managing, the accumulation and saving ceases and, simultaneously, ceases all the credit relation and all the interest payment.

But the Ricardian course is long. Which paths lead Schumpeter´s economy to the Ricardian “steady state”? And why is this path travelled over a single cycle. What determines this recurrent depression/exhaustion of interest rates and profit?

The answer to this question is not simple but composed of multiple determinations. Among all the entries to the Schumpeterian theory of interest, one seems to be the main gate. This gate is a particular version of his criticism of the abstinence theory. His criticism is not usually appropriately appreciated. Schumpeter himself depreciates it, repeatedly announcing his debt to Böhm-Bawerk[[8]](#footnote-8). However, their particular version of this criticism generates completely different results. According to Schumpeter:

In the normal course of an economic system in which year in year out the process of production follows the same route and all data remains the same, would there be a systematic undervaluation of means of production as compared with products? […] [Or] abstracting from objective and personal coefficients of risk, in such an economic system can future satisfactions be systematically and generally valued at less than equal present satisfaction? This question is subdivided into two others: abstracting from objective and personal coefficients of risk, in such an economic system can future satisfactions be systematically valued at less than equal present satisfactions? […] If possible, imagine the following case. Someone enjoys a life-annuity. His wants remain absolutely constant in kind as well in intensive throughout the rest of his life. The annuity is big and secure enough to relieve him of the necessity of creating funds for special emergencies and for the possibility of loss. He knows himself secure from responsibilities arising towards others and proof against sudden desires. Now will a man in such a position esteem future instalments of his annuity less less than those nearer in time? Would he - always abstracting from the personal risk of life - give up the future more easily than present instalments? Obviously not, for if he did, that is if he gave up a future instalment for smaller compensation than one nearer in time, he would discover in due course that he had obtained a smaller total satisfaction than he might have done. His conduct would therefore cause him loss; it would be uneconomic. Such a course may nevertheless be taken, just as in other respects offences against the rules of economic reason frequently occur. But it is not an element of these rules themselves that they should occur. Of course, most of the exceptions which we meet with in practical life are not “offences” but are to be explained by our assumptions failing to fit the facts. However, where we find quite striking overestimation of present enjoyments, as particularly in the case of children and savages, what we have before us is merely a discrepancy between the economic problem to be solved and economic outlook of the subject: children and primitive men know only instantaneous production. Future wants do not appear smaller to them; they do not see them at all. Therefore, they will not stand the test of decisions which require a wide horizon. This is obvious; but ordinarily they have not to make such decisions. He who grasps the double rhythm of wants and means of satisfaction can perhaps in a particular case scorn the conclusion that a one-sided displacement of either means loss of satisfaction, but he cannot reject in principle (Schumpeter, 1961, p. 34-6).

It is easy to note that the Ricardo-Malthusian workers act as if they were the child/savage quoted by Schumpeter. In Ricardo, the stability of wages in terms of goods is derived from the virtually perfect elasticity of supply of labor. In the other hand, according to Schumpeter, the supply of workforce is a variable that: 1) accounts with exogenous and cultural determinations; but, as well, 2) is influenced by the logic of rational administration of present and future income by workers. And the result of this mix of cultural and rationalist determinations is the claim that there is no reason to tell a "Ricardo-Malthusian" story of balancing the labor market: elements of foresight and desire to improve the living standards can and should affect the supply of workforce in the short and long term, resulting in a radically different balance. To make a long story short, the main result is that the workers will earn an income that enables them not only to survive, but survive and save.

The rationalist spirit of this parable is clear. This is based on the assumption that family life and reproduction is the object of economic rationalization and systematization. Since now to save and to be rational are virtually synonymous. And once the workers are rational economic men, they will save without demanding any positive interest. As Joan Robinson argues in her peculiar style:

Equilibrium prevails when the stock of capital is such that the rate of profit is equal to the supply price of that quantity of capital. But this notion is a very treacherous one. Why should the supply price of waiting be assumed positive? […] The rate of interest (excess of repayment over original loan) would settle at the level which equated supply and demand for loans. Whether it was positive or negative would depend upon whether spendthrifts or prudent family men happened to predominate in the community. There is no a priori presumption in favor of a positive rate. Thus, the rate of interest cannot be accounted for as the “cost of waiting”. The reason why there is always a demand for loans at a positive rate of interest in an economy where there is property in the means of production and means of production are scarce, is that finance expended now can be used to employ labor in productive processes which will yield a surplus in the future over costs of production. Interest is positive because profits are positive […] (Robinson, 1956, p. 87).

By introducing the precautionary rationality for savings, Robinson is refusing the hypothesis on which rests Harbeler’s criticism of Schumpeter’s stationary equilibrium. According to Harbeler, *if the incomes of agents do not change over time*, it would be irrational to evaluate equally the present and the future[[9]](#footnote-9). As Robinson points out, the rationality of savings without positive interest lies upon the recognition that the flows of income and expenditures of economic actors change over time. The function of those savings is therefore only precautionary.

But if workers are foresighted and save, they come to be owners. The question that remains is: what are the consequences of such a subversion of Ricardian parable? How the (neo)Schumpeterian balance of labor market affects the balance of stock market? ... From our point of view, the consequences are revolutionary. But it was not properly perceived by Schumpeter. And his miscomprehension helped his critics. Like Robbins, that wrote:

[...] if abstinence is to be regarded merely as that degree of refraining from present consumption which gives rise to net addition to the supply of capital, we can agree with him. But if abstinence is to be regarded, not only as a refusal to consume in the present in order that sources of future income may be *enlarged*, but also as a refusal to enhance one’s consumption now in order that the income of the future may not be depleted, then it seems to me that he is at fault […]. But Schumpeter has foreseen some such objection as this, and he proceeds to argue that under static conditions there is no reason to alter the distribution of one’s income through time. Given constant needs, he argues, […]. the maximum satisfaction will be attained by a constant flow through time. […] The argument is valid, but it does not prove that interest is absent when conditions are not changing. On the contrary, it is the most important part of the case for the view that there must be interest in such circumstances. *For if there were no yield to the use of capital* (no *reinertrag*) *there would be no reason to refrain from consuming it*. […] Schumpeter can argue that there will be no *ac*cumulation will be made once stationary equilibrium has been attained. But he is not entitled to argue that there will be no *de*cumulation unless he admits the existence of interest (Robbins, 1930, p. 213).

The Robbins questioning is reasonable. But his challenge would be easily solved if Schumpeter had conceded that, in moving toward the circular flow, raising wages and decreasing profits would ultimately impose the subversion of agents’ portfolio structure. So, the fact that the depression of net investments denies any net savings[[10]](#footnote-10) would be aligned with the expansion of the financial savings of workers, which would be offset by “unsavings” of the former owners of assets.

Schumpeter doesn’t deny the possibility of depression come to impose a redistribution of property. As a matter of fact, this hypothesis is consistent with his interpretation of the depression as the period when the benefits of development are socialized. And it is consistent with his claim that the entrepreneur may come from any social background[[11]](#footnote-11)

**CONCLUSION**

Many questions may be addressed to Schumpeter’s theory of interest that weren’t event mentioned here. Specially important is the relation between Schumpeterian theory and the most famous and accepted monetary theory of interest: the Keynesian one. Equally important is if the empirical evidence supports or denies Schumpeter’s view. Unfortunately, we cannot deal with those questions here.

Nevertheless, we believe that our response to the Neoclassical counter-criticism of Schumpeter’s theory of interest is valuable in itself. First, cause it shows up what probably is the main debility of the orthodox distribution theory. Second, cause it contributes to deep our comprehension of Schumpeter’s theoretical system, revealing the classical and Marxist roots of his reasoning.

As Schumpeter himself recognized, in his system capital is not defined by its role in production, but by its role in commanding goods and subverting the circular flow. Exactly as in Marx, capital is no more than “money in process of self expansion” to Schumpeter. It has been obvious and is very well known.

But there is something more that, despite linked to latter assertive, is far from consensual: the fact that the interest (like capital) is a social and historic category. A category that can (and that should be) put under social control through the construction of consistent “Financing National Systems”. *Hic Rhodus, hic salta*.

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1. According to Schumpeter “there is no systematic time preference” (Harbeler, 1951, p. 123). [↑](#footnote-ref-1)
2. Even though the explicit discordance of Harbeler (1951) and the implicit one of all Schumpeter’s followers that don’t mention his controversial theory of interest. [↑](#footnote-ref-2)
3. “The individual industrial business is not a permanent source of any other income than wages and rent” (Schumpeter, 1961, p. 208). [↑](#footnote-ref-3)
4. “The real income of labor [in circular flow] would then still be higher, not only than in the previous approximate equilibrium position, but also than in the boom. For what was previously entrepreneurial profit flows […] to the services of labor and land, in so far as it is not absorbed by the fall in the price of the product (Chapter IV)” (Schumpeter, 1961, p. 249). [↑](#footnote-ref-4)
5. “Interest is, as experience teaches, a permanent income. It originates in the hands of the entrepreneur. Consequently, permanent income sui generis originates in the hands of the entrepreneur. And the question confronting the traditional theory of interest is: where it comes from? For more than a century, theorists have been attacking this possible, indeed meaningless, question” (Schumpeter, 1961, p. 182). [↑](#footnote-ref-5)
6. This is the true heroic assumption by Ricardo, only surpassed by his remarkable chapter “On Machinery”. [↑](#footnote-ref-6)
7. The fact that marginal costs in Ricardo these are long term (because the supplies of all factors of production are varying simultaneously) not disqualifies the use of “marginal” to express the pattern of adjustment to the balance of this author. [↑](#footnote-ref-7)
8. For example, as in the first section of the fifth chapter, when he says: “[…] namely conceiving interest as an element of cost in the narrower and special sense which was formulated in the first chapter. This is equivalent to constituting a third original productive factor, which bears interest as labor receives wages. If this were satisfactorily achieved, our three questions, the question of the source, of the basis, and of the non-disappearance of interest, would obviously all be answered at once, and the dilemma would be escaped. Abstinence might be such a third factor. If it were an independent productive service all our requirements would be fulfilled in a manner free from objection, and the existence and source of a permanent net income as well as its assignment to definite individuals would be explained beyond doubt. Only it would still have to be proved that in reality interest does rest upon this element. But unfortunately, this explanation is not satisfactory, because such an independent element does not exist, as shown by Böhm-Bawerk, and need not be discussed here” (Schumpeter, 1961, p. 161). [↑](#footnote-ref-8)
9. “I should like first to draw attention once more to the fact that **I define time preference [...] under the assumption that present and (expected) future incomes are about equal**”. (Harbeler, 1951, p. 124; bolds are ours). [↑](#footnote-ref-9)
10. “In the circular flow there would be on the one hand no such rich source, out of which to save, and one the other hand essentially less incentive to save” (Schumpeter, 1961, p. 52). [↑](#footnote-ref-10)
11. “In fact, the upper strata of society are like hotels which are indeed always full of people, but people who are forever changing. They consist of persons who are recruited from below to a much greater extent than many of us are willing to admit” (Schumpeter, 1961, p. 156). [↑](#footnote-ref-11)