

# Cross-current, or change in the direction of the mainstream?\*

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## Abstract

Economic history was the source of Schumpeter's insight that creative destruction is the essential fact about entrepreneurial capitalism. Since Schumpeter's death, the mandated formalism of economic method has constrained the depth and breadth of understanding of creative destruction among economists, policymakers, and citizens. Ironically, Schumpeter himself enabled, and later partly regretted, the mandated formalism. Although in recent decades there have been calls for a more tolerant pluralism, they have remained only cross-currents. But Schumpeter's success in enabling the formalist revolution, is a proof-of-concept that major changes in method and ideas can occur; which in turn provides a flicker of hope that James Heckman's recent defense of pluralism could help shift the direction of the mainstream.

## 1. Introduction

My Wabash College mentor Ben Rogge was a good friend of George Stigler and Milton Friedman. But the economist he admired most was Joseph Schumpeter. Like Schumpeter, Rogge was a friend of entrepreneurial capitalism, but a pessimist about its future. He would quote with approval Schumpeter's admonition that even when you are sure that the ship is going to sink, it is still noble to run for the pumps (Rogge, 1979, p. 35; Schumpeter, 1950, p. xi). I was never fully convinced – if you are sure the ship is sinking, maybe you should run for a good bottle of brandy and start sipping?

What I most wanted was to part the clouds of gloom with some ray of hope. When I thought I had found such a ray, I would take it triumphantly to Rogge. He would always look at me with his sad smile, gently shake his head, and say something like: "Diamond, every river has its cross-currents and eddies; but you must never mistake them for the main direction the water is flowing" (see also: Rogge, 1979, p. 35).

Much evidence supports Schumpeter's claim that creative destruction is the essential fact of capitalism (Schumpeter, 1950, p. 83; Diamond, 2006, 2019). And yet 70 years later, the profession still mainly ignores this fact. Creative destruction was originally generalized from Schumpeter's careful reading of economic history. The process of creative destruction cannot be understood without understanding the goals, thought-processes, actions, and obstacles of the innovative entrepreneurs who are the key agents of creative destruction. Although attempts have been made to formally model creative destruction (e.g., Aghion and Howitt 1992), they generally do not provide new, sound, policy relevant knowledge (Diamond 2009a). At best, they summarize in a stylized way the aspects of creative destruction that the modeler chooses to emphasize.

The knowledge that can inform and persuade economists and citizens of the truth and importance of creative destruction is most often the empirically richer knowledge that can be

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\* Part of the penultimate section of this paper makes use of unpublished research I presented at the History of Economics Society meetings in 2009, in which I discuss some illuminating Schumpeter letters in the Harvard University Archives.

found in economic history, in business case-studies, and in the biographies of entrepreneurs. The same richer knowledge that can persuade, also contains the details that support policies to unbind and enable the entrepreneur.

If the ship of entrepreneurial capitalism is to be saved, it will only be through economists, policymakers, and citizens better understanding how the process of creative destruction results in human betterment. That understanding, in turn, crucially depends on acceptance of a methodological pluralism that warrants the truths that can be generalized from the stories of innovative entrepreneurs.

Although respecting Rogge's tough-minded pessimism, I still seek rays of hope. In the remainder of this essay, I begin by discussing past rays that so far have remained cross-currents. I proceed to discuss how the flow of economic methods and ideas can change direction, looking especially at the formalist revolution as a proof-of-concept. I end by discussing a recent defense of pluralism that can give us hope that a future change in direction is still possible.

## 2. Past rays of hope

Past rays of hope consisted of the growing number of economists and business practitioners who found the process of creative destruction to be useful in understanding how capitalism works. In 1983, on the 100<sup>th</sup> anniversary of the birth of both J.M. Keynes and Joseph Schumpeter, the highly-respected management expert Peter Drucker penned a cover story for *Forbes* in which he argued that a majority of academics and policy makers placed far greater value on the theories and policy advice of Keynes than Schumpeter. The *Forbes* cover shows a portrait of Keynes well-illuminated by many large, medium, and small candles, next to a darker portrait of Schumpeter lit by a single modest candle. But, Drucker argued, as is often the case in life, the majority had gotten it wrong. Schumpeter, much more than Keynes, asked the right questions – questions about innovation, and dynamic economic growth (Drucker 1999a [1<sup>st</sup> published in *Forbes* in 1983]).

Drucker's 1983 article has been given credit (and he himself gave it credit) for the Schumpeter revival that some date from the mid or late 1980s.<sup>1</sup> Whether that is the case, it is true that in recent decades, distinguished mainstream economists occasionally have been acknowledging the limitations of the static, equilibrium-based model of competition, and are suggesting that more attention needs to be given to entrepreneurship and creative destruction.

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<sup>1</sup> Steve Forbes attributes the increased attention to Schumpeter largely to Drucker's article: "Almost everyone today is aware of the phrase of another Austrian-born economist, Joseph Schumpeter: 'creative destruction', which describes the process in a capitalist economy whereby new technology and new companies messily supplant the old. Nearly 20 years ago Laury realized that 1983 would mark the centennial birthday of not only the towering John Maynard Keynes but also the obscure Joseph Schumpeter. The result was *Forbes'* commissioning Peter Drucker to write about these two extraordinary men. The landmark cover story started the process of bringing Schumpeter out of the shadows" (Forbes, 2001).

Drucker himself seemed to share Forbes's view of the article's impact: "Of all my essays this may have had the greatest impact – and where I least expected it, that is among economists. Schumpeter was of course, all along a very big name in economics. Economists bowed their heads when his name was mentioned. But few actually read him. This essay touched off a 'Schumpeter boom'" (Drucker, 1999b, p. ix).

I have documented elsewhere that in the last few decades several major mainstream economists have advocated less focus on equilibrium models and more focus on the innovative entrepreneur (Diamond, 2009a). These included Martin Neil Baily (2001), William Baumol (e.g., 2001, 2002, 2006), Gary Becker (1998), Zvi Griliches (2000), Paul Krugman (2003), Sherwin Rosen (1997), and George Stigler (1988, p. 101). Mainstream economists Bradford DeLong and Lawrence Summers went so far as to predict: “if we call the economy of the last two centuries primarily ‘Smithian,’ the economy of the future is likely to be primarily ‘Schumpeterian’” (DeLong and Summers, 2001, p. 33).

To these we can add Edmund Phelps whose 2006 Nobel Prize lecture (Phelps, 2007) is said to have included more uses of the word “entrepreneur” than the sum total of uses in all previous Nobel Prize lectures (Hubbard, 2008, p. 598). Besides individual examples of the sort just mentioned, there is also some broader crude evidence of growing serious attention given to creative destruction. In the literature of the social sciences, as measured in the *Social Sciences Citation Index*, citations to Schumpeter’s main book (the main source of his account of creative destruction) continued to grow after its publication and finally surpassed citations to Keynes’s main book for the first time in the mid-1990s (Diamond, 2009b).<sup>2</sup>

McCraw has observed that “creative destruction” has become a “byword” in business (2007, p. 497). Several business experts could be cited in support of McCraw’s observation, including Andy Grove, the former CEO of Intel, who made use of Schumpeter’s central ideas in his business best-seller *Only the Paranoid Survive* (1999). The use of “creative destruction” by practitioners is discussed at greater length in Diamond 2007.

### **3. What causes major changes in ideas and methods?**

Major changes in ideas and methods can occur in three ways. The first is through some change in the economy that demands explanation or action. The second is through some change in the funding, or availability of research materials, for economists. The third is through a major figure in the current mainstream who shifts positions to defend the new direction.

The first way can be illustrated by several changes in the external economy that re-directed the channel of economic ideas.

1. The Phillips Curve posits a trade-off between inflation and unemployment. Economists gave the curve much more skeptical scrutiny only after the stagflation of the 1960s and 1970s in the United Kingdom and the United States when, instead of trading off, inflation and unemployment both rose at the same time.

2. Economists wrote several papers explaining the reasons for the “Great Moderation” in the business cycle, which some expected would persist. These papers became much less common after the economic Crisis of 2008.

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<sup>2</sup> When citations are restricted to those from economics journals, the gap between Keynes and Schumpeter closes, starting roughly in the early 1990s, but with Keynes’s *General Theory* still usually receiving more citations. A new study updating the comparison up to 2016, finds the *General Theory* regaining a more substantial lead roughly following the economic Crisis of 2008 (Dalton and Gaeto, 2019).

3. Venture capital and private equity firms were not created at the suggestion of economists. Rather economists studied them only *after* they were well-established and widely reported in the business press.
4. Milton Friedman said his floating exchange rate research was not given much attention until a crisis left policy makers more open to a new solution (Friedman and Friedman, 1998, pp. 376-377).

The second way that ideas and methods can change is through changes in the funding for different kinds of research, and in the availability of different kinds of research inputs. Milton Friedman argued that the growth in National Science Foundation funding for economics, made economics too mathematical and less innovative (Friedman, 1981). Nobel laureate Robert Solow thinks the growth in econometrics was mainly due to an increase in the amount of data available for analysis (Solow, 1997, p. 47).

#### **4. How Schumpeter enabled and regretted the formalist revolution**

The third way the channel of ideas can change course is when a major economist changes his mind and convinces others to change their minds. A major economist who has an epiphany that leads them to change sides, can have a big effect. Nobel laureate George Stigler reports that when fellow Nobel laureate Ronald Coase first presented to the distinguished economists at the University of Chicago what came to be known as the Coase Theorem, they all began by rejecting it as “heresy” (Stigler, 1988, p. 76). But as the night progressed, Nobel laureate Milton Friedman started asking questions and pondering out loud. He changed his mind, and by the end of the evening, everyone there accepted the Coase Theorem as a major discovery. Stigler says this “exhilarating” evening was the only “Eureka!” experience of his professional life (Stigler, 1988, pp. 73, 76). Stigler himself changed his mind (perhaps gradually) on antitrust policy in part as a result of reading Schumpeter’s *Capitalism, Socialism and Democracy*. Stigler said “we economists mostly rebelled against such heresy, but it left its mark” (Stigler, 1988, p. 101).

Schumpeter was depressed late in life because he had not changed the direction of ideas (McGraw, 2007, p. 403). But he was wrong, and not just because of Stigler. The third way the channel of ideas change, can be illustrated by what happened in the formalist revolution in economics. Schumpeter blessed it, enabled it, and eventually partly regretted it. The economist Paul Samuelson, and the journal *Econometrica*, played key roles in what Hutchison (2000) and Blaug (2003) have called the “formalist revolution” in economics. Schumpeter was important in the success of both Samuelson and *Econometrica*, and so he was an enabler of the revolution.

Throughout his career, Schumpeter was a methodological pluralist, believing that economic knowledge could come from theory, econometrics, and history. The superficial appearance that Schumpeter shifted from one methodology to another, may be due to his vocally defending whichever branch of a balanced methodology was currently under attack. In the Schumpeter archives at Harvard, one can find several letters from Schumpeter to colleagues, trying to support the career of the young Paul Samuelson. Schumpeter defends Samuelson as a brilliant mathematician, and fears that, given the then-current state of the profession, Samuelson might not be able to find a job. Other evidence would be Schumpeter’s early support of the Econometric Society, including begging the Rockefeller Foundation to save

*Econometrica* from bankruptcy. Early on, the practice of mathematical methods received fragile support in the profession, so Schumpeter defended mathematical methods.

Near the end of his career, Schumpeter delivered a lecture at the National Bureau of Economic Research (NBER) in which he outraged many distinguished econometricians by arguing that they needed to take economic history more seriously. There was even a claim that Schumpeter had gone senile, a claim that Paul Samuelson much later rebutted (Samuelson, 2003, pp. 465-466). Late in Schumpeter's career, the practice of economic history received fragile support in the profession, so Schumpeter defended economic history, perhaps partially regretting his role in empowering the econometricians.

Revolutions in academic institutions are rare, because the incumbents within the institutions have an interest in preserving them. For those who believe that another change in method would lead economics to be more sound, more useful, and to progress more quickly, it is of interest how such a revolution could come about. Thomas Mayer (1993) points out that the formalist revolution should provide hope for the possibility of such a change. If so, then one lesson from the formalist revolution, is that major change can occur when a powerful incumbent of the currently dominant school (Schumpeter, in this case) endorses and defends the change; and helps provide resources (fellowships, faculty positions, publication outlets) to those willing to join him.

## **5. A current ray of hope**

So are there any figures today whose epiphanies, or evolving views, could result in a major change in economic method? A highly distinguished Nobel Prize recipient, celebrated for his application of mathematics to economics, recently has co-authored an article that may give hope. James Heckman's paper with Burton Singer argues for the use in economics of philosopher C.S. Peirce's method of "abduction" (Heckman and Singer, 2017). The more familiar concept of "induction" had been discredited within philosophy on the grounds that no matter how many observations inductively support the proposition "all swans are white," you never have certainty, because the next observation could always be a black swan. In "abduction" we learn from observations, but never claim to reach certainty.

"The abductive approach to empirical economics... privileges no source of data, style of research, or mode of inference for learning about the economy provided the analyst produces useful knowledge that survives critical public scrutiny. It values factually-rich descriptions as major sources of knowledge" (Heckman and Singer, 2017, p. 301).

Heckman and Singer see the abductive method as a reform of the methodology of economics. The method would allow the rich, fine-grained empirical case-studies and biographies that most reveal how the process of creative destruction works.

The question is whether Heckman's proposed reforms will remain cross-currents, or might they grow to become changes in the direction of the mainstream? What happens will depend on some factors that Heckman can influence and some that are beyond his control. Changes in the economy can matter and are beyond Heckman's control. Changes in how economics is funded can matter and are likewise beyond his control.

One factor that Heckman can control is whether he makes his proposed reforms a central message or an ephemeral aside. Don Patinkin long ago noted that credit mainly is due to those who emphasize and repeat a central message, not to those who briefly and obscurely mention an idea once (Patinkin, 1983). So what are Heckman and we to do? We do our research on problems that matter. We seek the truth wherever it can be found. When we find important truth, we argue for it professionally and publicly, knowing that it *can* matter, but not knowing if it *will*.

If it is possible that the ship can be saved, we rush for the pumps.

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