THE THEORY OF ECONOMIC DEVELOPMENT

An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle

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the whole economic system but only to that of the individual. The social fact, here as in all valuations, is in the circumstance that individual values are interrelated and are not independent of each other. The totality of the economic relations constitutes the economic system, just as the totality of social relations constitutes society. If one may not speak of social values, there is yet a social value system, a social system of individual values. These values are interrelated similarly with the values within the individual's economy. They operate upon one another through the exchange relation so that they influence and are influenced by all the values of other individuals.[1] In this social value system all the conditions of life in a country are mirrored, in particular all "combinations" are expressed in it. The sediment of the social value system is the price system. It is a unit in the same sense. To be sure, prices do not express a kind of estimate of the social value of a good. Indeed they are not at all the immediate expression of a definite value, but only the results of processes which work under the pressure of many individual valuations.

[1] There is general interdependence between them. Cf. Wesen, bk. II, for more extensive details on this point.

CHAPTER II

THE FUNDAMENTAL PHENOMENON OF ECONOMIC DEVELOPMENT

I

THE social process, which rationalises[1] our life and thought, has led us away from the metaphysical treatment of social development and taught us to see the possibility of an empirical treatment; but it has done its work so imperfectly that we must be careful in dealing with the phenomenon itself, still more with the concept in which we comprehend it, and most of all with the word by which we designate the concept and whose associations might lead us astray in all manner of undesirable directions. Closely connected with the metaphysical preconception — more precisely with the ideas which grow out of metaphysical roots and become preconceptions if, neglecting unbridgeable gulfs, we make them do the work of empirical science — even if not itself such a metaphysical preconception, is every search for a "meaning" of history. The same is true of the postulate that a nation, a civilisation, or even the whole of mankind, must show some kind of uniform unilinear development, as even such a matter-of-fact mind as Roscher assumed and as the innumerable philosophers and theorists of history in the long brilliant line from Vico to Lamprecht took and still take for granted. Here, too, belong all kinds of evolutionary thought that centre in Darwin — at least if this means no more than reasoning by analogy — and also the psychological prejudice which consists in seeing more in motives and acts of volition than a reflex of the social process. But the evolutionary idea is now discredited in our field, especially with his-

[1] This is used here in Max Weber's sense. As the reader will see, "rational" and "empirical" here mean, if not identical, yet cognate, things. They are equally different from, and opposed to, "metaphysical," which implies going beyond the reach of both "reason" and "facts," beyond the realm, that is, of science. With some it has become a habit to use the word "rational" in much the same sense as we do "metaphysical." Hence some warning against misunderstanding may not be out of place.

torians and ethnologists, for still another reason. To the reproach of unscientific and extra-scientific mysticism that now surrounds the "evolutionary" ideas, is added that of dilettantism. With all the hasty generalisations in which the word "evolution" plays a part, many of us have lost patience.

We must get away from such things. Then two facts still remain: first the fact of historical change, whereby social conditions become historical "individuals" in historical time. These changes constitute neither a circular process nor pendulum movements about a centre. The concept of social development is defined by these two circumstances, together with the other fact: that whenever we do not succeed in adequately explaining a given historical state of things from the preceding one, we do indeed recognise the existence of an unsolved but not insoluble problem. This holds good first of all for the individual case. For example, we understand Germany's internal political history in 1919 as one of the effects of the preceding war. It also holds good, however, for more general problems.

Economic development is so far simply the object of economic history, which in turn is merely a part of universal history, only separated from the rest for purposes of exposition. Because of this fundamental dependence of the economic aspect of things on everything else, it is not possible to explain *economic* change by previous *economic* conditions alone. For the economic state of a people does not emerge simply from the preceding economic conditions, but only from the preceding total situation. The expository and analytical difficulties which arise from this are very much diminished, practically if not in principle, by the facts which form the basis of economic interpretation of history; without being compelled to take a stand for or against this view, we can state that the economic world is relatively autonomous because it takes up such a great part of a nation's life, and forms or conditions a great part of the remainder; wherefore writing economic history by itself is obviously a different thing from writing, say, military history. To this must be added still another fact which facilitates the separate description of any of the divisions of the social process. Every sector of social life is, as it were, in-

habited by a distinct set of people. The heteronomous elements generally do not affect the social process in any such sector directly as the bursting of a bomb "affects" all things which happen to be in the room in which it explodes, but only through its data and the conduct of its inhabitants; and even if an event occurs like the one suggested by our metaphor of a bursting bomb, the effects only occur in the particular garb with which those primarily concerned dress them. Therefore, just as describing the effects of the Counter Reformation upon Italian and Spanish painting always remains history of art, so describing the economic process remains economic history even where the true causation is largely non-economic.

The economic sector, again, is open to an endless variety of points of view and treatments, which one can array, for example, according to the breadth of their scope — or we might just as well say according to the degree of generalisation which they imply. From an exposition of the nature of the economic life of the Niederaltaich monastery in the thirteenth century to Sombart's exposition of the development of economic life in western Europe, there runs a continuous, logically uniform thread. Such an exposition as Sombart's is theory, and indeed theory of economic development in the sense in which we intend it for the moment. But it is not economic theory in the sense in which the contents of the first chapter of this book are economic theory, which is what has been understood by "economic theory" since Ricardo's day. Economic theory in the latter sense, it is true, plays a part in a theory like Sombart's, but a wholly subordinate one: namely, where the connection of historical facts is complicated enough to necessitate methods of interpretation which go beyond the analytic powers of the man in the street, the line of thought takes the form offered by that analytical apparatus. However, where it is simply a question of making development or the historical outcome of it intelligible, of working out the elements which characterise a situation or determine an issue, economic theory in the traditional sense contributes next to nothing.[1]

[1] If economists, nevertheless, have always had something to say on this theme, this is only because they did not restrict themselves to economic theory, but — and

We are not concerned here with a theory of development in this sense. No historical evolutionary factors will be indicated — whether individual events like the appearance of American gold

indeed quite superficially as a rule — studied historical sociology or made assumptions about the economic future. Division of labor, the origin of private property in land, increasing control over nature, economic freedom, and legal security — these are the most important elements constituting the "economic sociology" of Adam Smith. They clearly relate to the social framework of the economic course of events, not to any immanent spontaneity of the latter. One can also consider this as Ricardo's theory of development (say in Bücher's sense), which, moreover, exhibits the line of thought which earned the characterisation of "pessimist" for him: namely the "hypothetical prognosis" that in consequence of the progressive increase of population together with the progressive exhaustion of the powers of the soil (which can according to him only temporarily be interrupted by improvements in production) a position of rest would eventually appear — to be distinguished *toto coelo* from the ideal momentary position of rest of the equilibrium of modern theory — in which the economic situation would be characterised by an hypertrophy of rent, which is something totally different from what is understood above by a theory of development, and still more different from what we shall understand by it in this book. Mill worked out the same line of thought more carefully, and also distributed color and tone differently. In essence, however, his Book IV, "Influence of the Progress of Society on Production and Distribution," is just the same thing. Even this title expresses how much "progress" is considered as something non-economic, as something rooted in the data that only "exercises an influence" upon production and distribution. In particular his treatment of improvements in the "arts of production" is strictly "static." Improvement, according to this traditional view, is something which just happens and the effects of which we have to investigate, while we have nothing to say about its occurrence *per se*. What is thereby passed over is the subject matter of this book, or rather the foundation stone of its construction. J. B. Clark (Essentials of Economic Theory), whose merit is in having consciously separated "statics" and "dynamics," saw in the dynamic elements a disturbance of the static equilibrium. This is likewise our view, and also from our standpoint an essential task is to investigate the effect of this disturbance and the new equilibrium which then emerges. But while he confines himself to this and just like Mill sees therein the meaning of dynamics, we shall first of all give a theory of these causes of disturbances in so far as they are more than mere disturbances for us and in so far as it seems to us that essential economic phenomena depend upon their appearance. In particular: two of the causes of disturbance enumerated by him (increase of capital and population) are for us, as for him, merely causes of disturbance, however important as "factors of change" they may be for another kind of problem just indicated in the text. The same is true of a third (changes in the direction of consumers' tastes) which will later be substantiated in the text. But the other two (changes in technique and in productive organisation) require special analysis and evoke something different again from disturbances in the theoretical sense. The non-recognition of this is the most important single reason for what appears unsatisfactory to us in economic theory. From this insignificant-looking source flows, as we shall see, a new conception of the economic process, which overcomes a series of fundamental difficulties and thus justifies the new statement of the problem in the text. This statement of the problem is more nearly parallel to that of Marx. For according to him there is an *internal* economic development and no mere adaptation of economic life to changing data. But my structure covers only a small part of his ground.

production in Europe in the sixteenth century, or "more general" circumstances like changes in the mentality of economic men, in the area of the civilised world, in social organisation, in political constellations, in productive technique, and so forth — nor will their effects be described for individual cases or for groups of cases.[1] On the contrary, the economic theory the nature of which was sufficiently expounded to the reader in the first chapter will simply be improved for its own purposes, by building onto it. If this were also to enable this theory to perform better than hitherto its service to the other kind of theory of development, the fact would still remain that the two methods lie in different planes.

Our problem is as follows. The theory of the first chapter describes economic life from the standpoint of a "circular flow," running on in channels essentially the same year after year — similar to the circulation of the blood in an animal organism. Now this circular flow and its channels do alter in time, and here we abandon the analogy with the circulation of the blood. For although the latter also changes in the course of the growth and decline of the organism, yet it only does so continuously, that is by steps which one can choose smaller than any assignable quantity, however small, and always within the same framework. Economic life experiences such changes too, but it also experiences others which do not appear continuously and which change the framework, the traditional course itself. They cannot be understood by means of any analysis of the circular flow, although they are purely economic and although their explanation is obviously among the tasks of pure theory. Now such changes

[1] Therefore one of the most annoying misunderstandings that arose out of the first edition of this book was that this theory of development neglects all historical factors of change except one, namely the individuality of entrepreneurs. If my representation were intended to be as this objection assumes, it would obviously be nonsense. But it is not at all concerned with the concrete factors of change, but with the method by which these work, with the *mechanism of change*. The "entrepreneur" is merely the bearer of the mechanism of change. And I have taken account not of one factor of historical change, but of none. We have still less to do here with the factors which in particular explain the changes in the economic organisation, economic custom, and so on. This is still another problem, and although there are points at which all these methods of treatment collide, it means spoiling the fruit of all if they are not kept apart and if each is not allowed the right to grow by itself.

and the phenomena which appear in their train are the object of our investigation. But we do not ask: what changes of this sort have actually made the modern economic system what it is? nor: what are the conditions of such changes? We only ask, and indeed in the same sense as theory always asks: how do such changes take place, and to what economic phenomena do they give rise?

The same thing may be put somewhat differently. The theory of the first chapter describes economic life from the standpoint of the economic system's tendency towards an equilibrium position, which tendency gives us the means of determining prices and quantities of goods, and may be described as an adaptation to data existing at any time. In contrast to the conditions of the circular flow this does not mean in itself that year after year "the same" things happen; for it only means that we conceive the several processes in the economic system as partial phenomena of the tendency towards an equilibrium position, but not necessarily towards the same one. The position of the ideal state of equilibrium in the economic system, never attained, continually "striven after" (of course not consciously), changes, because the data change. And theory is not weaponless in the face of these changes in data. It is constructed so as to be able to deal with the consequences of such changes; it has special instruments for the purpose (for example the instrument called quasi-rent). If the change occurs in the non-social data (natural conditions) or in non-economic social data (here belong the effects of war, changes in commercial, social, or economic policy), or in consumers' tastes, then to this extent no fundamental overhaul of the theoretical tools seems to be required. These tools only fail — and here this argument joins the preceding — where economic life itself changes its own data by fits and starts. The building of a railway may serve as an example. Continuous changes, which may in time, by continual adaptation through innumerable small steps, make a great department store out of a small retail business, come under the "static" analysis. But "static" analysis is not only unable to predict the consequences of discontinuous changes in the traditional way of doing things; it can neither explain the occurrence of such productive revolutions nor the phe-

nomena which accompany them. It can only investigate the new equilibrium position after the changes have occurred. It is just this occurrence of the "revolutionary" change that is our problem, the problem of economic development in a very narrow and formal sense. The reason why we so state the problem and turn aside from traditional theory lies not so much in the fact that economic changes, especially, if not solely, in the capitalist epoch, have actually occurred thus and not by continuous adaptation, but more in their fruitfulness.[1]

By "development," therefore, we shall understand only such changes in economic life as are not forced upon it from without but arise by its own initiative, from within. Should it turn out that there are no such changes arising in the economic sphere itself, and that the phenomenon that we call economic development is in practice simply founded upon the fact that the data change and that the economy continuously adapts itself to them, then we should say that there is *no* economic development. By this we should mean that economic development is not a phenomenon to be explained economically, but that the economy, in itself without development, is dragged along by the changes in the surrounding world, that the causes and hence the explanation of the development must be sought outside the group of facts which are described by economic theory.

Nor will the mere growth of the economy, as shown by the growth of population and wealth, be designated here as a process of development. For it calls forth no qualitatively new phenomena, but only processes of adaptation of the same kind as the changes in the natural data. Since we wish to direct our attention to other phenomena, we shall regard such increases as changes in data.[2]

[1] The problems of capital, credit, entrepreneurial profit, interest on capital, and crises (or business cycles) are the ones in which this fruitfulness will be demonstrated here. Yet it is not thereby exhausted. For the expert theorist I point, for example, to the difficulties which surround the problem of increasing return, the question of multiple points of intersection between supply and demand curves, and the element of time, which even Marshall's analysis has not overcome.

[2] We do this because these changes are small per annum and therefore do not stand in the way of the applicability of the "static" method. Nevertheless, their appearance is frequently a condition of development in our sense. But even though they often make the latter possible, yet they do not create it out of themselves.

Every concrete process of development finally rests upon preceding development. But in order to see the essence of the thing clearly, we shall abstract from this and allow the development to arise out of a position without development. Every process of development creates the prerequisites for the following. Thereby the form of the latter is altered, and things will turn out differently from what they would have been if every concrete phase of development had been compelled first to create its own conditions. However, if we wish to get at the root of the matter, we may not include in the data of our explanation elements of what is to be explained. But if we do not do this, we shall create an apparent discrepancy between fact and theory, which may constitute an important difficulty for the reader.

If I have been more successful than in the first edition in concentrating the exposition upon essentials and in guarding against misunderstandings, then further special explanations of the words "static" and "dynamic," with their innumerable meanings, are not necessary. Development in our sense is a distinct phenomenon, entirely foreign to what may be observed in the circular flow or in the tendency towards equilibrium. It is spontaneous and discontinuous change in the channels of the flow, disturbance of equilibrium, which forever alters and displaces the equilibrium state previously existing. Our theory of development is nothing but a treatment of this phenomenon and the processes incident to it.[1]

[1] In the first edition of this book, I called it "dynamics." But it is preferable to avoid this expression here, since it so easily leads us astray because of the associations which attach themselves to its various meanings. Better, then, to say simply what we mean: economic life changes; it changes partly because of changes in the data, to which it tends to adapt itself. But this is not the only kind of economic change; there is another which is not accounted for by influence on the data from without, but which arises from within the system, and this kind of change is the cause of so many important economic phenomena that it seems worth while to build a theory for it, and, in order to do so, to isolate it from all the other factors of change. The author begs to add another more exact definition, which he is in the habit of using: what we are about to consider is that kind of change arising from within 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 mail coaches as you please, you will never get a railway thereby.

II

These spontaneous and discontinuous changes in the channel of the circular flow and these disturbances of the centre of equilibrium appear in the sphere of industrial and commercial life, not in the sphere of the wants of the consumers of final products. Where spontaneous and discontinuous changes in consumers' tastes appear, it is a question of a sudden change in data with which the businessman must cope, hence possibly a question of a *motive* or an opportunity for other than gradual adaptations of his conduct, but not of such other conduct itself. Therefore this case does not offer any other problems than a change in natural data or require any new method of treatment; wherefore we shall neglect any spontaneity of consumers' needs that may actually exist, and assume tastes as "given." This is made easy for us by the fact that the spontaneity of wants is in general small. To be sure, we must always start from the satisfaction of wants, since they are the end of all production, and the given economic situation at any time must be understood from this aspect. Yet innovations in the economic system do not as a rule take place in such a way that first new wants arise spontaneously in consumers and then the productive apparatus swings round through their pressure. We do not deny the presence of this nexus. It is, however, the producer who as a rule initiates economic change, and consumers are educated by him if necessary; they are, as it were, taught to want new things, or things which differ in some respect or other from those which they have been in the habit of using. Therefore, while it is permissible and even necessary to consider consumers' wants as an independent and indeed the fundamental force in a theory of the circular flow, we must take a different attitude as soon as we analyse *change*.

To produce means to combine materials and forces within our reach (cf. *supra*, Chapter I). To produce other things, or the same things by a different method, means to combine these materials and forces differently. In so far as the "new combination" may in time grow out of the old by continuous adjustment in small steps, there is certainly change, possibly growth, but neither a new phenomenon nor development in our sense. In so far as this is not the case, and the new combinations appear discontinuously, then the phenomenon characterising development emerges. For reasons of expository convenience, henceforth, we shall only mean the latter case when we speak of new combinations of productive means. Development in our sense is then defined by the carrying out of new combinations.

This concept covers the following five cases: (1) The introduction of a new good — that is one with which consumers are not yet familiar — or of a new quality of a good. (2) The introduction of a new method of production, that is one not yet tested by experience in the branch of manufacture concerned, which need by no means be founded upon a discovery scientifically new, and can also exist in a new way of handling a commodity commercially. (3) The opening of a new market, that is a market into which the particular branch of manufacture of the country in question has not previously entered, whether or not this market has existed before. (4) The conquest of a new source of supply of raw materials or half-manufactured goods, again irrespective of whether this source already exists or whether it has first to be created. (5) The carrying out of the new organisation of any industry, like the creation of a monopoly position (for example through trustification) or the breaking up of a monopoly position.

Now two things are essential for the phenomena incident to the carrying out of such new combinations, and for the understanding of the problems involved. In the first place it is not essential to the matter — though it may happen — that the new combinations should be carried out by the same people who control the productive or commercial process which is to be displaced by the new. On the contrary, new combinations are, as a rule, embodied, as it were, in new firms which generally do not arise out of the old ones but start producing beside them; to keep to the example already chosen, in general it is not the owner of stage-coaches who builds railways. This fact not only puts the discontinuity which characterises the process we want to describe in a special light, and creates so to speak still another kind of discontinuity in addition to the one mentioned above, but it also explains important features of the course of events. Especially in a competitive economy, in which new combinations mean the competitive elimination of the old, it explains on the one hand the process by which individuals and families rise and fall economically and socially and which is peculiar to this form of organisation, as well as a whole series of other phenomena of the business cycle, of the mechanism of the formation of private fortunes, and so on. In a non-exchange economy, for example a socialist one, the new combinations would also frequently appear side by side with the old. But the economic consequences of this fact would be absent to some extent, and the social consequences would be wholly absent. And if the competitive economy is broken up by the growth of great combines, as is increasingly the case to-day 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.

We must notice secondly, only partly in connection with this element, that whenever we are concerned with fundamental principles, we must never assume that the carrying out of new combinations takes place by employing means of production which happen to be unused. In practical life, this is very often the case. There are always unemployed workmen, unsold raw materials, unused productive capacity, and so forth. This certainly is a contributory circumstance, a favorable condition and even an incentive to the emergence of new combinations; but great unemployment is only the consequence of non-economic events — as for example the World War — or precisely of the development which we are investigating. In neither of the two cases can its existence play a fundamental rôle in the explanation, and it cannot occur in a well balanced circular flow from which we start. Nor would the normal yearly increment meet the case, as it would be small in the first place, and also because it would normally be absorbed by a corresponding expansion of production within the circular flow, which, if we admit such increments, we must think of as adjusted to this rate of growth.[1] As a rule the new combinations must draw the necessary means of production from some old combinations — and for reasons already mentioned we shall assume that they *always* do so, in order to put in bold relief what we hold to be the essential contour line. The carrying out of new combinations means, therefore, simply the different employment of the economic system's existing supplies of productive means — which might provide a second definition of development in our sense. That rudiment of a pure economic theory of development which is implied in the traditional doctrine of the formation of capital always refers merely to saving and to the investment of the small yearly increase attributable to it. In this it asserts nothing false, but it entirely overlooks much more essential things. 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 the 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. In the treatment of shorter epochs, moreover, this is even true in a more tangible sense. Different methods of employment, and not saving and increases in the available quantity of labor, have changed the face of the economic world in the last fifty years. The increase of population especially, but also of the sources from which savings can be made, was first made possible in large measure through the different employment of the then existing means.

The next step in our argument is also self-evident: command over means of production is necessary to the carrying out of new combinations. Procuring the means of production is one distinct problem for the established firms which work within the circular flow. For they *have* them already procured or else can procure them currently with the proceeds of previous production as was explained in the first chapter. There is no fundamental gap here

[1] On the whole it is much more correct to say that population grows slowly up to the possibilities of any economic environment than that it has any tendency to outgrow it and to become thereby an independent cause of change.

between receipts and disbursements, which, on the contrary, necessarily correspond to one another just as both correspond to the means of production offered and to the products demanded. Once set in motion, this mechanism works automatically. Furthermore, the problem does not exist in a non-exchange economy even if new combinations are carried out in it; for the directing organ, for example a socialist economic ministry, is in a position to direct the productive resources of the society to new uses exactly as it can direct them to their previous employments. The new employment may, under certain circumstances, impose temporary sacrifices, privations, or increased efforts upon the members of the community; it may presuppose the solution of difficult problems, for example the question from which of the old combinations the necessary productive means should be withdrawn; but there is no question of procuring means of production not already at the disposal of the economic ministry. Finally, the problem also does not exist in a competitive economy in the case of the carrying out of new combinations, if those who carry them out have the necessary productive means or can get them in exchange for others which they have or for any other property which they may possess. This is not the privilege of the possession of property *per se*, but only the privilege of the possession of disposable property, that is such as is employable either immediately for carrying out the new combination or in exchange for the necessary goods and services.[1] In the contrary case — and this is the rule as it is the fundamentally interesting case — the possessor of wealth, even if it is the greatest combine, must resort to credit if he wishes to carry out a new combination, which cannot like an established business be financed by returns from previous production. To provide this credit is clearly the function of that category of individuals which we call "capitalists." It is obvious that this is the characteristic method of the capitalist type of society — and important enough to serve as its *differentia specifica* — for forcing the economic system into new channels, for putting its means at

[1] A privilege which the individual can also achieve through saving. In an economy of the handicraft type this element would have to be emphasised more. Manufacturers' "reserve funds" assume an existing development.

the service of new ends, in contrast to the method of a non-exchange economy of the kind which simply consists in exercising the directing organ's power to command.

It does not appear to me possible to dispute in any way the foregoing statement. Emphasis upon the significance of credit is to be found in every textbook. That the structure of modern industry could not have been erected without it, that it makes the individual to a certain extent independent of inherited possessions, that talent in economic life "rides to success on its debts," even the most conservative orthodoxy of the theorists cannot well deny. Nor is the connection established here between credit and the carrying out of innovations, a connection which will be worked out later, anything to take offence at. For it is as clear *a priori* as it is established historically that credit is primarily necessary to new combinations and that it is from these that it forces its way into the circular flow, on the one hand because it was originally necessary to the founding of what are now the old firms, on the other hand because its mechanism, once in existence, also seizes old combinations for obvious reasons.[1] First, *a priori*: we saw in the first chapter that borrowing is not a necessary element of production in the normal circular flow within accustomed channels, is not an element without which we could not understand the essential phenomena of the latter. On the other hand, in carrying out new combinations, "financing" as a special act is fundamentally necessary, in practice as in theory. Second, historically: those who lend and borrow for industrial purposes do not appear early in history. The pre-capitalistic lender provided money for other than business purposes. And we all remember the type of industrialist who felt he was losing caste by borrowing and who therefore shunned banks and bills of exchange. The capitalistic credit system has grown out of and thrived on the financing of new combinations in all countries, even though in a different way in each (the origin of German joint stock banking is especially characteristic). Finally there can be no stumblingblock in our speak-

[1] The most important of which is the appearance of productive interest, as we shall see in Chapter V. As soon as interest emerges somewhere in the system, it expands over the whole of it.

ing of receiving credit in "money or money substitutes." We certainly do not assert that one can produce with coins, notes, or bank balances, and do not deny that services of labor, raw materials, and tools are the things wanted. We are only speaking of a method of procuring them.

Nevertheless there is a point here in which, as has already been hinted, our theory diverges from the traditional view. The accepted theory sees a problem in the existence of the productive means, which are needed for new, or indeed any, productive processes, and this accumulation therefore becomes a distinct function or service. We do not recognise this problem at all; it appears to us to be created by faulty analysis. It does not exist in the circular flow, because the running of the latter presupposes given quantities of means of production. But neither does it exist for the carrying out of new combinations,[1] because the productive means required in the latter are drawn from the circular flow whether they already exist there in the shape wanted or have first to be produced by other means of production existing there. Instead of this problem another exists for us: the problem of detaching productive means (already employed somewhere) from the circular flow and allotting them to new combinations. This is done by credit, by means of which one who wishes to carry out new combinations outbids the producers in the circular flow in the market for the required means of production. And although the meaning and object of this process lies in a movement of goods from their old towards new employments, it cannot be described entirely in terms of goods without overlooking something essential, which happens in the sphere of money and credit and upon which depends the explanation of important phenomena in the capitalist form of economic organisation, in contrast to other types.

Finally one more step in this direction: whence come the sums

[1] Of course the productive means do not fall from heaven. In so far as they are not given by nature or non-economically, they were and are created at some time by the individual waves of development in our sense, and henceforth incorporated in the circular flow. But every individual wave of development and every individual new combination itself proceeds again from the supply of productive means of the existing circular flow — a case of the hen and the egg.

needed to purchase the means of production necessary for the new combinations if the individual concerned does not happen to have them? The conventional answer is simple: out of the annual growth of social savings plus that part of resources which may annually become free. Now the first quantity was indeed important enough before the war — it may perhaps be estimated as one-fifth of total private incomes in Europe and North America — so that together with the latter sum, which it is difficult to obtain statistically, it does not immediately give the lie quantitatively to this answer. At the same time a figure representing the range of all the business operations involved in carrying out new combinations is also not available at present. But we may not even start from total "savings." For its magnitude is explicable only by the results of previous development. By far the greater part of it does not come from thrift in the strict sense, that is from abstaining from the consumption of part of one's regular income, but it consists of funds which are themselves the result of successful innovation and in which we shall later recognise entrepreneurial profit. In the circular flow there would be on the one hand no such rich source, out of which to save, and on the other hand essentially less incentive to save. The only big incomes known to it would be monopoly revenues and the rents of large landowners; while provision for misfortunes and old age, perhaps also irrational motives, would be the only incentives. The most important incentive, the chance of participating in the gains of development, would be absent. Hence, in such an economic system there could be no great reservoirs of free purchasing power, to which one who wished to form new combinations could turn — and his own savings would only suffice in exceptional cases. All money would circulate, would be fixed in definite established channels.

2.7 %
savings

Even though the conventional answer to our question is not obviously absurd, yet there is another method of obtaining money for this purpose, which claims our attention, because it, unlike the one referred to, does not presuppose the existence of accumulated results of previous development, and hence may be considered as the only one which is available in strict logic. This method of obtaining money is the creation of purchasing power by banks. The form it takes is immaterial. The issue of bank-notes not fully covered by specie withdrawn from circulation is an obvious instance, but methods of deposit banking render the same service, where they increase the sum total of possible expenditure. Or we may think of bank acceptances in so far as they serve as money to make payments in wholesale trade. It is always a question, not of transforming purchasing power which already exists in someone's possession, but of the creation of new purchasing power out of nothing — out of nothing even if the credit contract by which the new purchasing power is created is supported by securities which are not themselves circulating media — which is added to the existing circulation. And this is the source from which new combinations *are* often financed, and from which they would have to be financed *always*, if results of previous development did not actually exist at any moment.

These credit means of payment, that is means of payment which are created for the purpose and by the act of giving credit, serve just as ready money in trade, partly directly, partly because they can be converted immediately into ready money for small payments or payments to the non-banking classes — in particular to wage-earners. With their help, those who carry out new combinations can gain access to the existing stocks of productive means, or, as the case may be, enable those from whom they buy productive services to gain immediate access to the market for consumption goods. There is never, in this nexus, granting of credit in the sense that someone must wait for the equivalent of his service in goods, and content himself with a claim, thereby fulfilling a special function; not even in the sense that someone has to accumulate means of maintenance for laborers or landowners, or produced means of production, all of which would only be paid for out of the final results of production. Economically, it is true, there is an essential difference between these means of payment, if they are created for new ends, and money or other means of payment of the circular flow. The latter may be conceived on the one hand as a kind of certificate for completed production and the increase in the social product effected through it, and on the other hand as a kind of order upon, or claim to, part of this social product. The former have not the first of these two characteristics. They too are orders, for which one can immediately procure consumption goods, but not certificates for previous production. Access to the national dividend is usually to be had only on condition of some productive service previously rendered or of some product previously sold. This condition is, in this case, not yet fulfilled. It will be fulfilled only after the successful completion of the new combinations. Hence this credit will in the meantime affect the price level.

The banker, therefore, is not so much primarily a middleman in the commodity "purchasing power" as a *producer* of this commodity. However, since all reserve funds and savings to-day usually flow to him, and the total demand for free purchasing power, whether existing or to be created, concentrates on him, he has either replaced private capitalists or become their agent; he has himself become the capitalist par excellence. He stands between those who wish to form new combinations and the possessors of productive means. He is essentially a phenomenon of development, though only when no central authority directs the social process. He makes possible the carrying out of new combinations, authorises people, in the name of society as it were, to form them. He is the ephor of the exchange economy.

III

We now come to the third of the elements with which our analysis works, namely the "new combination of means of production," and credit. Although all three elements form a whole, the third may be described as the fundamental phenomenon of economic development. The carrying out of new combinations we call "enterprise"; the individuals whose function it is to carry them out we call "entrepreneurs." These concepts are at once broader and narrower than the usual. Broader, because in the first place we call entrepreneurs not only those "independent" businessmen in an exchange economy who are usually so designated, but all who actually fulfil the function by which we define

the concept, even if they are, as is becoming the rule, "dependent" employees of a company, like managers, members of boards of directors, and so forth, or even if their actual power to perform the entrepreneurial function has any other foundations, such as the control of a majority of shares. As it is the carrying out of new combinations that constitutes the entrepreneur, it is not necessary that he should be permanently connected with an individual firm; many "financiers," "promotors," and so forth are not, and still they may be entrepreneurs in our sense. On the other hand, our concept is narrower than the traditional one in that it does not include all heads of firms or managers or industrialists who merely may operate an established business, but only those who actually perform that function. Nevertheless I maintain that the above definition does no more than formulate with greater precision what the traditional doctrine really means to convey. In the first place our definition agrees with the usual one on the fundamental point of distinguishing between "entrepreneurs" and "capitalists" — irrespective of whether the latter are regarded as owners of money, claims to money, or material goods. This distinction is common property to-day and has been so for a considerable time. It also settles the question whether the ordinary shareholder as such is an entrepreneur, and disposes of the conception of the entrepreneur as risk bearer.[1] Furthermore, the ordinary characterisation of the entrepreneur type by such expressions as "initiative," "authority," or "foresight" points entirely in our direction. For there is little scope for such qualities within the routine of the circular flow, and if this had been sharply separated

[1] Risk obviously always falls on the owner of the means of production or of the money-capital which was paid for them, hence never on the entrepreneur *as such* (see Chapter IV). A shareholder *may* be an entrepreneur. He may even owe to his holding a controlling interest the power to act as an entrepreneur. Shareholders *per se*, however, are never entrepreneurs, but merely capitalists, who in consideration of their submitting to certain risks participate in profits. That this is no reason to look upon them as anything but capitalists is shown by the facts, first, that the average shareholder has normally no power to influence the management of his company, and secondly, that participation in profits is frequent in cases in which everyone recognises the presence of a loan contract. Compare, for example, the Graeco-Roman *foenus nauticum*. Surely this interpretation is more true to life than the other one, which, following the lead of a faulty legal construction — which can only be explained historically — attributes functions to the average shareholder which he hardly ever thinks of discharging.