

A Vision for a Dynamic World: Reading *Capitalism, Socialism and Democracy* for Today*

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Abstract

This paper was written for a symposium on “Reconsidering the Classics.” Rereading Joseph Schumpeter’s *Capitalism, Socialism and Democracy* (*CSD*) for today, we argue Schumpeter’s vision for a dynamic world remains essential for understanding the world. We begin the paper by briefly describing some background on Schumpeter and the context in which *CSD* was written. Then, we summarize the book, which Schumpeter divided into five separate parts on Marx, capitalism, socialism, democracy, and a history of socialist parties. Throughout our summary, we highlight the key arguments and touch on many ideas in the book, such as Schumpeter’s description of socialism and his theory of democracy. Instead of tackling all these ideas in depth, we discuss the book’s usefulness for readers today by focusing on Schumpeter’s Big Idea—“creative destruction.” We conclude by discussing how influential *CSD* has been, and continues to be, in the social sciences and then provide suggestions for those interested in reading *CSD* today.

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1 Introduction

Published in 1942, *Capitalism, Socialism and Democracy* (*CSD*) represented the culmination of a lifetime of scholarly activity by one of history’s most erudite social scientists, Joseph A. Schumpeter. Ranging from economics, Schumpeter’s home discipline, to history to sociology to political science to law to philosophy to business and entrepreneurship to seemingly everything else in between, *CSD* is a masterwork dealing with questions surrounding the logic of economic, social, and political change and organization.

This essay attempts the impossible task of trying to do justice to such a work. We begin by briefly describing some background on Schumpeter and the context in which *CSD* was written. Then, we summarize the book, which Schumpeter divided into five separate parts on Marx, capitalism, socialism, democracy, and a history of socialist parties. Throughout our summary, we highlight the key arguments and touch on many ideas in the book, such as Schumpeter’s description of socialism and his theory of democracy. Instead of tackling all these ideas in depth, we discuss the book’s usefulness for readers today by focusing on Schumpeter’s Big Idea—“creative destruction.” We conclude by discussing how influential *CSD* has been, and continues to be, in the social sciences and then provide suggestions for those interested in reading *CSD* today. We argue reading *CSD* remains essential for understanding the world.

2 Background and Context of the Book

By the time he began writing *CSD* in 1939, Schumpeter was a fifty-six-year-old Harvard professor and world-famous economist. He was in the “American” phase of his career, having already held academic positions in Europe, as well as brief stints in government and business in Vienna. Schumpeter achieved lasting fame early in his career with the publication of *The Theory of Economic Development* (*TED*) in 1911. Dissatisfied with existing economic theories relying on static analysis, Schumpeter set out to describe a theory of economic change, or development. The result was a novel theory based on entrepreneurship. Entrepreneurs, funded by credit from the banking sector, produced innovation, which fueled the dynamics of capitalism in Schumpeter’s theory. *TED* remains a powerful introduction to the study of entrepreneurship to this day.

TED's importance for putting *CSD* into context is twofold. First, it provided Schumpeter with a specific theory of economic development based on entrepreneurship which he would use and expand upon in *CSD*. Second, *TED* highlights the central feature of Schumpeter's approach to economics and the social sciences more broadly: an emphasis on dynamics. Schumpeter was obsessed with understanding the logic undergirding change, first in terms of economic change in *TED* and then later expanded to include not only economic but also social and political change in *CSD*. *TED* represented Schumpeter's early vision of the economic world, which provided the foundation for his vision of the social world as a whole he would describe in *CSD*.

Why the concern with dynamics? One likely explanation is that Schumpeter grew up and began his career during a time of immense social and economic change and, as a social scientist, sought to explain the world around him. Schumpeter was born in 1883 in the town of Triesch located in the Austro-Hungarian Empire in what is now the Czech Republic. After the death of Schumpeter's father, Schumpeter's mother remarried, and the family moved to Vienna in 1893. Vienna would be the backdrop for much of Schumpeter's life before his permanent departure for the United States in 1932. His formative years were spent in fin de siècle Vienna, a time of flourishing culture, modernism, and technological change which inevitably came into conflict with the existing order of monarchy, aristocracy, and the last remnants of the feudal world. One of Schumpeter's biographers describes this period in the city as "techno-romantic Vienna," a term designed to capture the time of transformation in which Schumpeter grew up (McCraw 2007, p. 34). As the new ways of being encroached upon and replaced the old, Vienna in the last days of the Austro-Hungarian Empire provided Schumpeter with a laboratory of creative destruction, the term he would later introduce in *CSD* to describe the incessant change taking place in the economy as old ways were replaced by new.

Schumpeter's vision of a dynamic and ever-changing economy fueled by entrepreneurs and innovation would not necessarily have given rise to the writing of *CSD* if it had not been for the tragedies and horrors of the twentieth century—World War I, the Great Depression, and World War II. The social changes these events wrought, from the collapse of empires to the rise of socialism and fascism, very much called into question the future of the capitalist world Schumpeter so much admired. With the rise of Hitler and the outbreak of World War II, Schumpeter began working on *CSD* in 1939. The future was uncertain. But, Schumpeter

would attempt to describe the dynamics of the capitalist world, whether those dynamics would ultimately tend towards socialism, and how democracy, if at all, would fit into such a system. *CSD* would be the result of Schumpeter’s vision colliding with what was happening in the world at large. As a result, that vision of a dynamic economy needed to be expanded beyond economics to include a much broader view of the social world. Schumpeter would need to wrestle with laws not just to describe the trajectory of the economy but of history, of the future. And, so, he began his book by considering Karl Marx.

3 A Summary of *Capitalism, Socialism and Democracy*

Schumpeter begins *CSD* by addressing Marx, because Marx’s theory about the evolution of capitalism into communism was the most prominent at the time. Schumpeter needs to first address the inadequacies of Marx’s theory in order to clear the way for his own theory. Over the course of four chapters, Schumpeter offers Marx a healthy degree of respect while still managing to contest the validity of many of his arguments. In the chapter “Marx the Prophet,” Schumpeter identifies Scientific Socialism as a set of beliefs that must be embraced uncompromisingly and wholeheartedly by its followers—much like the system of organized religion it seeks to replace. “Marx the Sociologist” celebrates Marx’s ability to tie together sociology and economics and discusses the intellectual currents his theory of class warfare flow from. “Marx the Economist” analyzes and criticizes Marx’s economic arguments, such as the labor theory of value and Marx’s inability to distinguish between capitalists and entrepreneurs. Schumpeter argues capitalism is not best described by capital accumulation but rather innovation, which, when recognized, overturns many of Marx’s gloomy implications about the future, innovation being able to drive economic growth and, thus, continual increases in living standards.¹ “Marx the Teacher” tests Marx’s theories against the historical record, concluding that they ultimately lack explanatory power for many events of the past, and throwing doubt on Marx’s ability to explain the future.

The capitalism section of *CSD* makes three claims: first, that capitalism is an inherently

¹“Capital accumulation” is not the key component of “capitalism?” No, innovation is. The use of the term capitalism has caused much confusion about this point. Deirdre McCloskey argues we should drop the term capitalism altogether and replace it with something like “trade-tested betterment” (McCloskey 2006, McCloskey 2010, McCloskey 2016). We use the term capitalism throughout this essay to be consistent with Schumpeter’s writing in *CSD*.

dynamic process; second, that this dynamism has brought incredible prosperity to the average citizen; and, third, and most startlingly, that the internal contradictions this dynamism creates will ensure capitalism's collapse. Schumpeter critiques the traditional conception of the economic process as a static circular flow described by the model of perfect competition. In its place, he exposes how the rhythms of the economy are dynamic, with entrepreneurs creating innovations that change the nature of the production process. It is here that he coins the iconic term creative destruction, noting that the structure of the economy is incessantly revolutionized from within as antiquated firms fall victim to entrants bearing new innovations. Schumpeter then outlines how creative destruction encourages a Darwinian struggle for survival between firms that leads to lower costs and higher quality products for the average citizen. For Schumpeter, capitalism is ultimately an engine of production for the masses, noting that absolute standards of living have risen across the capitalist world. However, capitalism's dynamism and the fruits of prosperity it bears do not come without costs. Schumpeter argues that capitalism is riddled with internal contradictions that will ensure its downfall and pave the way for socialism. Thanks to creative destruction, capitalism will tend towards a few, highly concentrated monopolies. As these corporations grow in size, they will become increasingly bureaucratized, a phenomenon that leads to the mechanization of progress and the elimination of the entrepreneur—the dynamic bedrock upon which the spirit of private property and the very essence of capitalism rely. Under these conditions and lacking any emotional affinity for capitalism, citizens will become apathetic as a sympathetic bureaucracy directed by an anti-capitalist intellectual class ushers in the socialist economic system.

As a result, Schumpeter begins the socialism section of *CSD* posing a question whose pithy response inevitably invites readers to debate: “Can socialism work? Of course it can.” Schumpeter argues that socialism is not only feasible, it is desirable—and that capitalism will create the conditions for it to be realized. In defending socialism's feasibility, Schumpeter assumes a central planning board has total control over the economy. This board will allocate goods according to a voucher system, force producers to produce beyond the profitable output, and mandate a certain level of private savings, among other steps necessary to ensure that the economy functions. Observing that capitalism creates no natural affinity for those who live in it, Schumpeter argues that those who exist in a socialist system will derive utility merely from its

presence. Furthermore, the central planning board's access to perfect information will enable it to perfectly plan progress, eliminating the economic downturns endemic to the capitalist system and permanently eradicating unemployment.

Schumpeter's description of the feasibility of socialism stretches credulity and suggests what he really meant in answering his question about whether socialism can work was, "Of course it can't."² The consensus today is that the socialism part of *CSD* is a brilliant example of satire by Schumpeter, a way to not turn off pro-socialist readers, embed his critiques about socialism in an ironic manner, and get readers to think critically about socialism's feasibility.³ If this part of the book leaves readers skeptical about socialism, then part of what Schumpeter hopefully has accomplished is to shake the reader free of the type of apathy towards anti-capitalist thinking and policies which Schumpeter fears will lead to capitalism's erosion.

Schumpeter next turns his focus to a discussion of democracy. He first examines the classical conception of democracy, defined as a political method for reaching a decision that realizes the common good, where the people elect representatives to carry out their will. Schumpeter objects to this definition, arguing that there is no common definition of the common good and that the very idea of the common good is a utilitarian generalization which assumes that individual wills will align. Instead, he introduces his own definition of democracy, which defines it as a process by which individuals struggle for public support for their views, and, if they successfully make their case, they gain office and implement them. According to Schumpeter, this definition accounts for the importance of individual political leaders that hold incredible sway over the electorate and emphasizes an agency-based form of politics where voters are free to pick the best candidate's policies. Further, Schumpeter observes that political parties seek power, not values, which is why they will always be responsive to the public. Schumpeter also describes four conditions required for democracies to be a success. His list should give even the most casual observer of democratic societies today plenty to consider: 1) high quality individuals selecting into politics, 2) the range of political decisions should not extend too far, 3) a well-trained and well-functioning bureaucracy, and 4) democratic self-control.

Schumpeter finishes *CSD* by painting a history of socialist parties from pre-Marxist times

²"Of course it can't" comes from McCraw (2008, p. XXIII).

³Muller (1999) provides a good overview of the case that Schumpeter was using irony and satire in *CSD*.

to the years following World War II in order to trace the extent to which socialism has already emerged.⁴ This history focuses on Russia, the United States, and many other countries. Out of all the parts of *CSD*, this last part is the least essential for understanding Schumpeter’s vision, so, for space reasons, we do not elaborate any further.⁵

4 Schumpeter’s Big Idea—Creative Destruction

How might readers profit from reading *CSD* today? *CSD* offers many ideas worth contemplating and using to understand the world, but, as alluded to in our introduction, we cannot touch on nearly as many as we would like. Instead, our strategy focuses on discussing what we think most readers would consider the most lasting idea in *CSD*: the introduction and use of the term creative destruction. This key idea drives the argument in the book. We describe the term, the role the idea plays in understanding economic growth, and discuss two applications from the world today, Blockbuster/Netflix and Uber/taxicabs.

Schumpeter introduces his famous phrase creative destruction in Chapter 7 of the capitalism part of the book. As lead-in, Schumpeter describes the fundamental ideas behind his vision of the economy. Capitalism is defined by change: “Capitalism . . . is by nature a form or method of economic change and not only never is but never can be stationary” (Schumpeter 1950, p. 82). Innovation drives change: “The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production and transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates” (Schumpeter 1950, p. 83). And, change leads to creative destruction through a process “. . . of industrial mutation . . . that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism” (Schumpeter 1950, p. 83).

Schumpeter continues in Chapter 7 by arguing important implications for thinking about capitalism follow after recognizing the role played by creative destruction. Creative destruction takes time to unfold, which means capitalism should not be judged at a particular point in

⁴*CSD* went through three editions, the last appearing in 1950.

⁵Indeed, in the course on Schumpeter described in Dalton and Logan (2019), this last part was the only part of *CSD* not taught to students.

time but rather over time. Said differently, “All hail economic growth!” Capitalism’s ability to deliver economic growth and, thus, improve standards of living over time should be the basis on which to judge it. Likewise, Schumpeter cautions to not judge capitalism based on the misdeeds of individuals or individual firms but rather the entire system. Deirdre McCloskey formulates this idea as her “Bourgeois Deal,” which goes something like this: “Let people have a go. Let them innovate. Let them reap the rewards of their innovation. In the meantime, they will become fabulously rich and inequality will emerge. But, over time, we will all be fabulously rich as innovation fuels economic growth.” “Fabulously” is not hyperbole, as the magnitude in the change in real GDP per capita wherever capitalism prevails clearly attests (McCloskey 2006, McCloskey 2010, McCloskey 2016). And, it matters beyond national income statistics, morally so, because creative destruction and its accompanying economic growth allow people to lead healthier, longer, and more fulfilling lives.⁶ Indeed, Robert Lucas famously wrote “The consequences for human welfare involved in questions like these [on the causes of economic growth] are simply staggering: Once one starts to think about them, it is hard to think about anything else” (Lucas 1988, p. 5).

Schumpeter further describes how recognizing creative destruction as the essential fact of capitalism changes how we should think about it. For example, he argues people typically think about how capitalism administers existing economic and social structures. The relevant problem, however, is how capitalism creates and destroys them. An example might be the income distribution. Whereas a typical policy response focuses on redistribution, Schumpeter seems to suggest our focus should be on mobility within the distribution instead, as mobility is more closely related to creative destruction. If creative destruction can take place, as opposed to barriers to entry protecting those at the top, for example, then people will rise and fall along the income distribution.

The last implication Schumpeter describes in Chapter 7 relates to competition. Economists typically focus on price competition. But, if creative destruction is the essential fact of capitalism, then price competition is of second order importance. Competition from innovation is what really matters. Firms lose profits from price competition; they go bankrupt from competition from innovation. The stakes in the two types of competition are a difference of kind. In

⁶Cowen (2018) presents a recent moral case for more economic growth.

today's world, consider competition between Walmart and Target versus Walmart and Amazon.com. Amazon.com is the existential threat to Walmart. Target is not. Schumpeter's point was recognized by George Stigler:

...Schumpeter painted an unconventional picture of the capitalistic process. The competition between the Pennsylvania and New York Central Railroads, he argued, might be sporadic and even trifling, but the competition to railroads provided by new transportation media such as trucks, automobiles, and airplanes really mattered...We economists mostly rebelled against such heresy, but it left its mark (Stigler 1985, p. 101).

Stigler may have acknowledged economists value Schumpeter's point about competition, but evidence suggests innovation, entrepreneurship, and creative destruction remain undertaught (Diamond 2007, Gwartney 2012, Phipps, Strom, and Baumol 2012). The two cases of creative destruction we consider highlight the importance of competition from innovation in upending existing economic and social structures.

We first consider Blockbuster/Netflix and then Uber/taxicabs.⁷ The case of Blockbuster/Netflix is as perfect a case of creative destruction one could observe to illustrate Schumpeter's idea playing out in the real world: a firm with a new way of doing business enters an industry, an incumbent firm fails to respond quickly enough, and the new firm sweeps the old firm from the market. In this industry, the movie rental business, Blockbuster was the incumbent firm with a network of physical stores stretching across the United States and other countries. The technology Blockbuster employed was simple. To rent a movie, first VHS tapes and then later DVDs, you visited a store, chose any movie in stock, and returned the movie to the store before a designated time to avoid late fees. Netflix's innovation was also relatively simple and consisted of two main changes to Blockbuster's business model—mail-shipped DVDs and a subscription-based service without late fees. The mail-shipped DVDs cut out the necessity of visiting a

⁷The two cases we consider have been widely reported on, and many references could be cited to support our discussion. Schmidt (2017) is representative of articles in the popular press reporting on Blockbuster's collapse. Antioco (2011) provides a fascinating perspective from a former Blockbuster CEO. Birkinshaw (2017) provides an overview of Uber/taxicabs and has the added benefit of giving Schumpeter a nod with its title. Editorial Board (2018) is a good example of the ongoing debate in particular locales for how to deal with the "Uber problem."

store, which consumers valued, and the subscription-based service allowed consumers to watch as many movies as could be mailed back and forth with Netflix during a month. It was the removal of late fees, however, which made Netflix so dangerous to Blockbuster, as late fees were a significant source of customer complaints. Once Netflix opened for business and word-of-mouth spread about the service, customers began to leave Blockbuster. Leadership disagreements at Blockbuster prevented an effective response to the competition from Netflix and over the course of the 2000s Blockbuster slowly wasted away.

The case of Blockbuster/Netflix illustrates not only how creative destruction affects the firms involved but how creative destruction affects the entire economic and social structure, a point stressed by Schumpeter. The creative destruction unleashed by Netflix did not just change which firm consumers rented movies from but contributed to deeper changes as well. Instead of searching for movies in physical stores, consumers searched online. This likely led to changes including time savings; searches and, thus, search results driven by Netflix's algorithm instead of browsing in a store, which could have changed the types of movies viewed by consumers with unknown cultural consequences; and the closing down of community centers, which is often how Blockbuster stores were described, especially those in smaller communities. The point Schumpeter would want us to recognize is that creative destruction has far reaching consequences.

Whereas Blockbuster/Netflix is representative of a pure theoretical case of creative destruction, the case of Uber/taxicabs demonstrates the logical creative destruction outcome can be far from certain. Taxicabs operate under government licenses, and those licenses are often in short supply. Barriers to entry remain high for taxicabs in many markets. As a result, inefficiencies in the taxi industry abound, and consumer dissatisfaction is widespread. Uber's innovation was to develop a software tool to connect private owners of cars with consumers seeking transportation. User reviews help to decrease the information asymmetries between Uber drivers and consumers, e.g. does this Uber driver have a safe driving record. The power of Uber's innovation lies in the fact that it drastically reduces the transaction costs of getting a ride. From a Schumpeterian perspective, once Uber entered the market, what happened next was inevitable. Consumers began to flock to Uber, and the taxi industry faced intense competition worldwide. In New York City, for example, the value of a taxi medallion, the required license by the government to

operate a taxi, plummeted. Another Blockbuster? Not yet.

In many locales, taxicab companies have slowed down or stopped creative destruction by successfully lobbying for government protection. This protection ranges from taxes on Uber to outright bans. Taxicab companies, as opposed to Blockbuster, are already in a strong position to lobby for further government protection from their participation in existing licensing schemes. The costs from preventing the creative destruction from occurring are severe. The direct costs hit consumers, as prices increase or Uber becomes unavailable, and producers, as innovation becomes more expensive. The indirect costs come from governments signaling the costs of innovation will increase or be prohibitive. Entrepreneurs may be reluctant to undertake new projects or move to more innovation friendly locales.

If creative destruction is the essential fact about capitalism and a main driver of economic growth, then slowing down or stopping creative destruction from occurring prevents us from achieving our highest levels of human welfare. The case of Uber/taxicabs is a cautionary tale. By revealed preferences, most consumers clearly prefer Uber to taxicabs. Yet the policies suppressing Uber prevail in many locales because of collective action problems. Societies limit creative destruction at their peril.

5 Conclusion

In the decades since its publication, *CSD*'s influence has steadily grown in economics and many other fields. And, it is no wonder. From a macro-level perspective, the book contains four major achievements, any one of which would be highly influential. These four major achievements include the following: 1) one of the most balanced and comprehensive critiques of Marx's thought ever written; 2) one of the most perceptive descriptions of capitalism ever written, including the introduction of the concept of creative destruction; 3) an ironic and satirical description of socialism which calls its feasibility into question; and 4) a theory of democracy with much explanatory power.

Citation data provide some quantitative evidence about *CSD*'s influence. Using Web of Science data, Diamond (2009) and Dalton and Gaeto (2019) show annual citations to *CSD* have steadily increased over time. This is true when looking at all publications or economics

publications only. By way of comparison, *CSD* has received slightly more annual citations since 2002 than John Maynard Keynes's *The General Theory of Employment, Interest, and Money* (*GT*) when considering economics publications only.⁸ When expanded to include all publications, which shows influence beyond economics, then *CSD* has received more annual citations than *GT* since 1992, reaching nearly twice as many in the years leading up to the Great Recession. The citation data support our argument in this essay, which is to highlight the continuing relevance of *CSD* for understanding the world today.

So, convinced by our argument and eager to read *CSD* themselves, how should readers approach the book today? Access is fortunately not a problem. *CSD* remains in print in cheap paperback form. The two biggest obstacles to reading *CSD* today are the difficulty of getting through the beginning part on Marx and the density of Schumpeter's prose. As to the Marx part, this section is the most difficult, as most readers today, not just intelligent laymen but trained social scientists, are not as steeped in Marx's theories as they were in Schumpeter's time. Since the book opens with Marx, we suspect many readers give up on *CSD* soon after beginning. Readers will, therefore, get the most out of the first part if they have some familiarity with Marx's theories, understanding concepts such as the labor theory of value, falling rate of profit, industrial reserve army, etc. As to the density of the prose, we remind readers of Francis Bacon's advice: "Some books are to be tasted, others to be swallowed, and some few to be chewed and digested . . ." *CSD* requires much chewing and digesting. Dalton and Logan (2019) provides a description of a course on Schumpeter in the form of a dialogue between professor and student. The dialogue can be read to get an overview of Schumpeter's thought, including *CSD*. More importantly, the appendix in Dalton and Logan (2019) contains twenty-five discussion questions which can be used to guide the reader through the main arguments in *CSD*.

Although certainly a product of its time and its author, the vision Schumpeter lays out for our dynamic world in *CSD* contains many ideas which remain relevant for understanding the world and designing policies to support human flourishing. We envy new readers as they discover Schumpeter's insights for the first time, but we take comfort in knowing *CSD*, like other truly great books of non-fiction and fiction alike, should be read and reread many times, chewed and

⁸Diamond (2009) and Dalton and Gaeto (2019) provide a motivation for comparing Schumpeter and Keynes independent of the context of this essay. We point out the comparison here because we think many readers will find these facts surprising given the popularity of Keynes.

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