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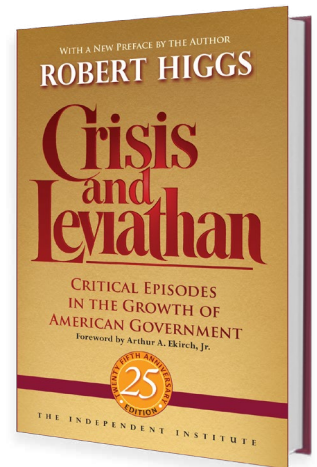
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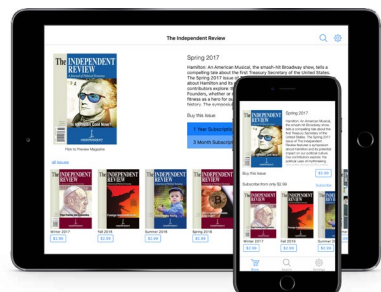
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A Vision for a Dynamic World

Reading Capitalism, Socialism and Democracy for Today

— ◆ —

JOHN T. DALTON AND ANDREW J. LOGAN

Published in 1942, *Capitalism, Socialism and Democracy* ([1942] 1950, hereafter *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 offering 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

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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 that reading *CSD* remains essential for understanding the world.

Background and Context of the Book

By the time Schumpeter began writing *CSD* in 1939, he 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 *Theorie der wirtschaftlichen Entwicklung* in 1911, which was translated into English as *The Theory of Economic Development* (hereafter *TED*) in 1934. 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. In Schumpeter’s theory, entrepreneurs, funded by credit from the banking sector, produce innovation, which fuels the dynamics of capitalism. *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 *TED* in terms of economic change and then later expanded in *CSD* to include not only economic but also social and political change. *TED* represented Schumpeter’s early vision of the economic world, which provided the foundation for his vision of the social world as a whole that 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 area of the Austro-Hungarian Empire that 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 that 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 the city in this period as “techno-romantic Vienna,” a phrase designed to capture the time of transformation in which Schumpeter grew up (McCraw 2007, 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, a notion he would later introduce in *CSD* to describe the incessant change taking place in the economy as old ways are 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 toward socialism, and how democracy, if at all, would fit into such a system. *CSD* would be the result of the collision of Schumpeter's vision and what was happening in the world at large. As a result of that collision, his 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 to describe the trajectory not just of the economy but of history and of the future. And so he began *CSD* by considering Karl Marx.

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 address first the inadequacies of Marx's theory in order to clear the way for his own theory. Over the course of four chapters, he 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 its followers must embrace uncompromisingly and wholeheartedly—much like the system of organized religion it seeks to replace. The chapter "Marx the Sociologist" celebrates Marx's ability to tie together sociology and economics and discusses the intellectual currents from which his theory of class warfare flowed. "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 that capitalism is not best described by capital accumulation but rather by innovation, which, when recognized, overturns many of Marx's gloomy implications about the future because innovation is 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.

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. McCloskey (2006, 2010, 2016) argues that we should drop it altogether and replace it with something such as *trade-tested betterment*. However, we use the term *capitalism* throughout this essay to be consistent with Schumpeter's terminology in *CSD*.

The capitalism section of *CSD* makes three claims: first, that capitalism is an inherently dynamic process; second, that this dynamism has brought incredible prosperity to the average citizen; and third, 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, and he notes 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 toward a few, highly concentrated monopolies. As these corporations grow in size, however, they will become increasingly bureaucratized, a phenomenon that will lead 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 anticapitalist intellectual class ushers in the socialist economic system.

As a result of this problematic process, Schumpeter begins the socialism section of *CSD* posing a question whose pithy response inevitably invites readers to debate: "Can socialism work?" (167). He answers, "Of course it can" (167), and argues that socialism is not only feasible but also 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, thus eliminating the economic downturns endemic to the capitalist system and permanently eradicating unemployment.

Schumpeter's description of the feasibility of socialism stretches credulity, however, and suggests that 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

2. "Of course it can't" comes from McCraw 2008, xxiii.

part of *CSD* is a brilliant example of satire by Schumpeter, a way to not turn off pro-socialist readers, to embed his critiques about socialism in an ironic manner, and to 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 has accomplished is to shake the reader free of the type of apathy toward anticapitalist thinking and policies that 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 that assumes that individual wills or views will align. So he instead introduces his own definition of democracy: a process by which individuals struggle for public support for their views and through which, 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. He also describes four conditions required for democracies to be a success, a list that should give even the most casual observer of democratic societies today plenty to consider: (1) high-quality individuals selecting into politics, (2) a range of political decisions that 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 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 on it any further.⁵

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. We instead discuss what

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

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

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

we think most readers would consider the most lasting idea in *CSD*: creative destruction. This key idea drives the argument in the book. In this section, we describe the term and the role the idea plays in understanding economic growth and discuss two applications of it in 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. Leading into this notion, he 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” (1950, 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” (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” (83).

Schumpeter continues in chapter 7 by arguing that important implications for thinking about capitalism follow after recognizing the role that creative destruction plays in it. Creative destruction takes time to unfold, which means capitalism should not be judged at a particular point in time but rather over time. Said differently, “All hail economic growth!” Capitalism’s ability to deliver economic growth and thus to improve standards of living over time should be the basis on which to judge it. Likewise, Schumpeter cautions that we not judge capitalism based on the misdeeds of individuals or individual firms but rather on the entire system. Deirdre McCloskey (2006, 2010, 2016) formulates this idea as the “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 attested to by the magnitude in the change in real gross domestic product per capita wherever capitalism prevails. And economic growth matters beyond national income statistics, morally so, because it allows people to lead healthier, longer, and more fulfilling lives.⁶ Indeed, Robert Lucas Jr. has famously written that “[t]he 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” (1988, 5).

Schumpeter further describes how recognizing creative destruction as the essential fact of capitalism changes how we should think about capitalism. For example, he argues that people typically think about how capitalism administers existing economic and social structures. The relevant problem, however, is how capitalism creates and destroys

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

those structures. An example might be the income distribution. Whereas a typical policy response focuses on redistribution, Schumpeter seems to suggest our focus should instead be on mobility within the distribution because mobility is more closely related to creative destruction. If creative destruction can take place, as opposed to the erection of barriers to entry to protect those at the top, for example, then people will rise and fall along the income distribution.

The last implication of creative destruction 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 the competition that comes from innovation. The stakes in the two types of competition are a difference of kind. In today's world, consider competition between Walmart and Target versus Walmart and Amazon. Amazon is the existential threat to Walmart. Target is not. George Stigler recognized Schumpeter's point:

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. (1985, 101)

Stigler may have acknowledged that economists value Schumpeter's point about competition, but evidence suggests that Schumpeter's notions of innovation, entrepreneurship, and creative destruction remain undertaught (see, e.g., Diamond 2007; Gwartney 2012; Phipps, Strom, and Baumol 2012). The two cases of creative destruction we consider here 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 Blockbuster/Netflix situation is as perfect a case of creative destruction as one can 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.

7. The two cases we consider have been widely reported on, and many references can 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."

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 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, that made Netflix so dangerous to Blockbuster because 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 also how it affects the entire economic and social structure, a point Schumpeter stresses in *CSD*. The creative destruction unleashed by Netflix not only changed 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 type of search likely led to other changes, including time savings; searches and thus search results driven by Netflix's online 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 how the logical outcome of creative destruction 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—for example, 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 because of their participation in existing licensing schemes. The costs of preventing the creative destruction from occurring are severe. The direct costs hit both consumers as prices increase or Uber becomes unavailable and producers as innovation becomes more expensive. The indirect costs come from governments signaling to entrepreneurs that the costs of innovation will increase or be prohibitive. Entrepreneurs may be reluctant to undertake new projects or may 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. As revealed in the data, 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.

Conclusion

In the decades since the publication of *Capitalism, Socialism and Democracy*, its influence has steadily grown in economics and many other fields. No wonder. From a macrolevel perspective, the book contains four major achievements, any of which would be highly influential: (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 that calls its feasibility into question; and (4) a theory of democracy with much explanatory power.

Citation data provide some quantitative evidence of *CSD*'s influence. Using data provided by Web of Science, two studies (Diamond 2009; Dalton and Gaeto 2019) show that annual citations to *CSD* have steadily increased over time. This is true when looking either at all publications or at 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* (1936) in the case of economics publications only.⁸ When the analysis is expanded to include all publications, which shows influence beyond economics, then *CSD* has received more annual citations than *General Theory* since 1992, the number 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 *CSD*'s continuing relevance for understanding the world today.

So, convinced by our argument and now eager to read *CSD*, how should readers approach the book today? Access is fortunately not a problem. *CSD* remains in print in

8. Diamond 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 Keynes's popularity.

inexpensive 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. The Marx part is the most difficult because most readers today, not just intelligent laypersons but also trained social scientists, are not as steeped in Marx's theories as readers were in Schumpeter's time. Because the book opens with Marx, we suspect many readers give up on *CSD* soon after beginning it. Readers will therefore get the most out of the first part if they have some familiarity with Marx's theories and understand concepts such as the labor theory of value, the falling rate of profit, the industrial reserve army, and so on. As to the density of the prose, we remind readers of Francis Bacon's advice in his essay "Of Studies": "Some books are to be tasted, others to be swallowed, and some few to be chewed and digested." *CSD* requires much chewing and digesting. Our paper "Teaching and Learning Schumpeter" (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 this paper contains twenty-five discussion questions that 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 that remain relevant for understanding the world and for designing policies to support human flourishing. We envy new readers as they discover Schumpeter's insights for the first time, and we take comfort in knowing that *CSD*, like other truly great books of nonfiction and fiction alike, should be read and reread many times, chewed and digested.

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