

B.A. Part I (Economics Honours)
Paper – Ist
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Schumpeter's Innovation Theory

This theory was propounded by Schumpeter. **According to this theory profit is the reward for innovations.** Innovation refers to all those changes, in the production process with an objective of reducing the cost of commodity so as to create gap between the existing price of the commodity and its new cost.

Innovation may take any shape like introduction of a new technique or a new plant, a change in the internal structure or organisational set up of the firm or change in the quality of raw material, a new form of energy, better method of salesmanship, etc.

Schumpeter makes a distinction **between invention and innovation.** Innovation is brought about mainly for reducing the cost of production and it is cost reducing agent. Profit is the reward for this strategic role, Innovations are not possible by all entrepreneurs. Only exceptional entrepreneurs can innovate. They are capable of tapping new resources, technical knowledge and reduce the cost of production. Thus the main motive for introducing innovation is the desire to earn profit. Profit is therefore the cause of innovation. Profits are of temporary nature. The pioneer who innovates earns abnormal profit for a short period. Soon other entrepreneurs, “swarm in clusters”, compete for profit in the same manner. The pioneer will make another innovation. In a dynamic world innovation in one field

may induce other innovations in related fields. The emergence of motor car industry may in turn stimulate new investments in the construction of highways, rubber, tyres and petroleum products. Profits are thus causes and effects of innovation. The interest of profit leads entrepreneur to innovate and innovation leads to profit. Thus profit has a tendency to appear, disappear and reappear. Profits are caused by innovation and disappear by imitation. Innovational profit is thus, never permanent, in the opinion of Schumpeter. Therefore it is different from other incomes, such as rent, wages and interest. These are regular and permanent incomes arising under all circumstances. Profit on the other hand is a temporary surplus resulting from innovation. Prof. Schumpeter also explained his views on the functions of the entrepreneur. The entrepreneur organises the business and combines the various factors of production. But this is not his real function and this will not yield him profit. The real function of the entrepreneur is to introduce innovations in business. It is innovations which yield him profit.

Criticisms:

1. This theory concentrates only on innovation, which is only one of the many functions of the entrepreneur and not the only factor.
2. This theory does not consider profit as the reward for risk-taking. According to Schumpeter it is the capitalist not the entrepreneur who undertakes risk.
3. This theory has ignored the importance of uncertainty bearing which is one of the factors that determines profit.
4. This theory attributes profit only to innovation ignoring other functions of entrepreneur.
5. Monopoly profits are permanent in nature while Schumpeter says that innovate profits occur temporarily.

6. This theory has presented a very narrow view of the function of the entrepreneur. He not only introduces innovation but he is equally responsible for proper organisation of the business. As such profit is not merely due to innovation. It is also due to organisational work performed by the entrepreneur. As it is well known, every entrepreneur does not innovate and yet he must earn profit if he is to stay in business.

7. It is an incomplete theory because it has failed to explain all other factors that influence profit.