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Topic : Schumpeter's Innovation Theory of Profit

Schumpeter's Innovation theory of Profit

The Innovation Theory of Profit was proposed by Joseph. A. Schumpeter, who believed that an entrepreneur can earn economic profits by introducing successful innovations.In other words, innovation theory of profit posits that the main function of an entrepreneur is to introduce innovations and the profit in the form of reward is given for his performance.

According to Schumpeter, innovation refers to any new policy that an entrepreneur undertakes to reduce the overall cost of production or increase the demand for his products.

Thus, innovation can be classified into two categories;

The first category includes all those activities which reduce the overall cost of production such as the introduction of a new method or technique of production, the introduction of new machinery, innovative methods of organizing the industry, etc.

The second category of innovation includes all such activities which increase the demand for a product. Such as the introduction of a new commodity or new quality goods, the emergence or opening of a new market, finding new sources of raw material, a new variety or a design of the product, etc.

Innovation may take any shape like introduction of a new technique or a new plant, a change in the internal structure or organizational 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, tyresm 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 organizes 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.