

Quadrant II – NOTES

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Module name: **Schumpeter Theory of Profits and innovation**

Module No: 59

Schumpeter Theory of Profits and innovation

- Joseph Schumpeter says that the main function of the entrepreneurs is to introduce innovations in the economy and profits are reward for his performing his function.
- Innovation means any new measure or policy adopted by an entrepreneur to reduce his cost of production or to increase the demand for his product.
- Thus innovations can be divided into two categories.
- 1st type of innovation are those which reduce cost of production or in other words which change the production functions.
- Which includes introduction of new machinery, a new and cheaper technique or process of production, exploitation of new source of raw material, a new and better method of organizing the firm.
- Second type of innovations are those which increase the demand for the product or in other words which change the demand or utility function.
- This includes the introduction of new product, a new variety or design of product, a new and superior method of advertisement, discovery of new market etc.
- If innovations are successful or if it achieves it's aim of either reducing the cost of production or enhancing the demand for the product, it will give rise to profit.
- Profits emerge due to successful and innovation either cost falls below the prevailing price of the product or the entrepreneur is able to sell more and at a better price than before
- Profits caused by particular innovation are only temporary and tends to be completed away as others imitate and adopt it.
- An innovation ceases to be new when others also come to know of it and adopt it.
- When entrepreneurs introduce a new innovation he is first in a monopoly position and earns huge profit.
- After some time when others adopt it in order to get share, Profits disappears.
- If the law allows and entrepreneur is able to get his new innovation e.g. new product patent, then he will continue to earn profits.
- But in an competitive economy and without patent laws, the existing competitors or the new firm will soon adopt any successful innovation and profits would be eliminated

- But in competition and progressive economy entrepreneurs always introduces new innovation and thus profits continue emerging out of them.
- Prof. Stigler says that such kinds of profits are temporary and will be eliminated by the attempts of other firms to share them. But this profits may exist for a long time because of ignorance of firm.
- The successful innovator can continuously seek new profit since horizon of innovations is unlimited.
- Thus innovations are important source of profits.
- Obtaining profit is necessary incentive for the entrepreneurs as they introduce innovations and helps in economic development of the country.
- Since innovations, if successful, yields profits and profit is also the motive to introduce innovations, Profits are both cause and effect of innovations.