

MICROCREDIT AND MICROENTREPRENEURSHIP: AN EXTENSION OF SCHUMPETER'S FIVE-FACTOR MODEL

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INTRODUCTION

The concept of collateral free microcredit originated in Bangladesh around the beginning of the 20th century when Rabindranath Tagore founded the Kaligram Krishi¹ Bank in Patishar village in the district of Naogaon in 1905 (Mondal, 2002). The essence of microcredit program, as envisioned by Tagore, is the absence of physical collateral. Microcredit is defined as a system of credit delivery and savings mobilizing scheme especially designed to meet the unique financial requirement of the poor. The financing scheme allows the recipients to improve the status of their living through access to additional capital without collateral. A borrower of microcredit must belong to a group to qualify for a loan. The original microcredit model required that a group of five individuals guarantee repayment of a loan offered to one member at a time. Once a group member has paid off a loan, another member of the group may qualify for a new loan or a repeat loan may be granted to a non-defaulting client. The original model has gone through many transformations. In Bangladesh, microfinance clients are typically self-employed, low-income entrepreneurs in both urban and rural areas. A typical microloan ranges from Taka 4,000 to Taka 50,000 (U.S. \$ 70 - \$865). Clients are often traders, street vendors, small farmers, service providers (hairdressers, rickshaw pullers), artisans and small producers, such as blacksmiths and seamstresses. Usually their activities provide a stable source of income (often from more than one activity). In addition to financial intermediation, many MFIs provide social intermediation services such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group. Thus the definition of microfinance often includes both financial intermediation and social intermediation. The size of an initial loan or the microcredit varies from MFI to MFI. A variety of loan products is available and more are being developed for individuals and businesses. The purpose of this paper is to analyze the microcredit program of Bangladesh with a view to depict the growth of the microentrepreneur class. In doing so, the paper uses the elements of entrepreneurship developed by Schumpeter (1950) and extends his model of microentrepreneurship in Bangladesh. The paper concludes with two cases of successful microentrepreneurship in Bangladesh.

The microfinancing approach has evolved as an economic development tool intended to benefit low-income women and men including the self-employed. MFIs can be non-governmental organizations (NGOs), savings and loan cooperatives, credit unions, government bank, commercial banks, or non-bank financial institutions. Today, in addition to group based lending, microcredit is offered to individual borrowers with or without collateral. There are an estimated 7,000 microlenders or Microfinance Institutes (MFIs) with 25 million poor clients worldwide (www.gdrc.org). Various models of microcredit with or without collateral exist in 60 countries². Although the primary goal of microcredit operation is poverty alleviation, providing assistance to an existing microenterprise and developing the microentrepreneur class is seen as a secondary goal in many countries. The recovery rate of microcredit in Bangladesh is 96 percent which compares to a recovery rate of 63 percent for conventional loans. The recovery rate of microcredit in other countries is as impressive as that of Bangladesh. For example, China faces

¹ “Krishi” is a Bengali word meaning “agricultural” in this context.

² The number of MFIs and borrowers as well as countries adapting various models of microcredit operation are growing continually. Updates are available at *The Virtual Library of Microcredit*, a site of Global Development Research Center (www.gdrc.org).

a serious problem of nonperforming loans (NPL). Most estimates suggest that the NPL in China is around 50 per cent. By contrast, the recovery rate of the microcredit operation in China (although operating on a limited scale) is 95 percent or a NPL of 5 percent.

MICROCREDIT OPERATION IN BANGLADESH

The decade of 1990s has seen a rapid growth of MFIs in Bangladesh. At the present time, there are more than 1200 NGOs working in Bangladesh on various aspects of economic development. More than 800 of these NGOs are engaged in providing microcredit through their MFI wings to a variety of borrowers throughout the country. Credit and Development Forum (CDF) statistics covered the microfinance programs of 601 MFIs which reported lending activities in 2001. Historical reports of CDF indicate only a handful of NGOs providing collateral free microcredit to rural borrowers until the mid-eighties. The popularity of Grameen Bank attracted others into the field and many NGOs started collateral free microfinance programs in late 80s and 90s.

The rapid growth of MFIs coupled with a near perfect loan recovery rate has been accompanied by development of a variety of loan products. The number of borrowers increased manifold. All borrowers do not fall into the same category. In most instances, MFIs make a distinction of borrowers and offer differentiated loan products to different groups. ASA (pronounced "Asha") for example, is one of the largest MFIs and offers two types of loans: *small loan* and *small business loan*. The size of the initial small loan (Tk 4,000-6,000) is comparable to similar microloans offered by other MFIs. It is offered to landless and assetless women whose monthly income does not exceed Tk 2,000 and who own less than 50 decimals of cultivable land. This loan may be increased by Tk 1,000 to Tk 2,000 depending on the clients who qualify for a repeat loan. On the other hand, the small business loan is significantly larger in size. The initial small business loan amount is Tk 15,000, which may be increased annually by Tk 4,000 to Tk 6,000. This loan is offered to an existing business. The existing business may need the additional capital to either expand its operation or to buy equipment for modernizing its product or to explore new markets for an existing product. Other resourceful MFIs also differentiate between borrowers along the same general line as ASA. The borrowers of MFIs, therefore, may be classified as:

- Microborrowers
- Microentrepreneurs

The microborrowers fall in the class of capitalists whose goal is to generate increasing income opportunities. These are borrowers who demonstrate the willingness and ability to generate a steady flow of income through conventional sources such as trading or paddy husking. There is no significant risk involved in the income generating activities of the microborrowers. Their labor is the predominant input, which is supplemented by a stock of capital in the form of a microcredit. The microborrower's ability to repay the loan is evaluated jointly with other members of the group.

A microentrepreneur usually owns a microenterprise and is engaged in innovating new ways of doing business or initiating changes in the production function, exploring market opportunities for his product and, ultimately changing the *culture* of doing business.

The operation of microfinance industry in Bangladesh is a distinct blend of normative and positive economics. As Friedman (1935) suggests, normative economics uses value judgments in evaluating an economic outcome. In other words, normative economics often interprets an economic problem and its solution using such terms as "ought to be". Positive economics, on

the other hand, is free of value judgments³. The positive economics methodology requires that an economic problem and its solution be stated in terms of efficiency, that is, obtaining maximum output per unit of input. Such standards as “women whose monthly income does not exceed Tk 2000” represent a norm established by an individual MFI or the MFI industry. Standards for microentrepreneurs, on the other hand, are established on the basis of efficiency. These standards represent methodologies of positive economics.

A significant aspect of the operation of microcredit in Bangladesh is the emergence of the microentrepreneur class. A big portion of microcredit goes to microborrowers. Through their operation, the microborrowers have not only done well for themselves, but also have contributed to the sustained growth of the economy of Bangladesh and helped alleviate poverty. The contributions of the microentrepreneurs go far beyond generating a steady flow of income. They work as agents of change. They innovate and open up new opportunities for others. In order to understand how the microentrepreneurs work as agents of change in a developing economy, a brief overview of the Schumpeterian entrepreneurial class is presented below.

AN OVERVIEW OF ENTREPRENEURSHIP

Private means of production in a growing economy leads to innovation and assumption of risk. These two phenomena, innovation and risk-taking are associated with entrepreneurship. The term “entrepreneur” was first introduced in the Mercantilist age by Richard Cantillon (1680-1734). Schumpeter (1950) notes “Cantillon’s work, which is usually, though not quite correctly described as the first systematic treatise on economics, then introduced the term “entrepreneur”. It is worth our while to note that Cantillon defined this entrepreneur as the agent who buys means of production at certain prices in order to combine them into a product that he is going to sell at prices that are uncertain at the moment at which he commits himself to his costs”. (pp 253-54). The idea thus developed by Cantillon was incorporated into Say’s *Treatise on Political Economy* (1821).

Say defined an entrepreneur as an agent who combines other resources into a productive organism. He also used the term to indicate shifting of resources from a lower productive state to a higher productive state. It is important to note that Say did not incorporate the element of risk in his analysis of entrepreneurship although Cantillon alluded to it. Later, John Stuart Mill developed the concept further and associated entrepreneurship with activities involving risk and profit (Mill, 1871).

Although Mill incorporated risk in his analysis of profit and linked it to entrepreneurship, he, in fact was using the terms “entrepreneur” and “capitalist” synonymously. It appears that during most of the later nineteenth century, the two terms were used synonymously. Joseph Schumpeter is the first economist who distinguished between an entrepreneur and a capitalist (Schumpeter, 1939, 1950). According to him, assumption of risk involving innovation is the role of the entrepreneur, while assumption of risk involving potential for profit is the role of a capitalist. Both an entrepreneur and a capitalist undertake risk; but their *domains* are separate. Individuals who own business and take risk with their capital in pursuit of profit, but do not innovate, are capitalists. There are individuals who take risk by introducing a new product,

³ Friedman, in his essay *The Methodology of Positive Economics* quotes from the 1891 book of John Neville Keynes titled *The Scope and Method of Political Economy*. According to Friedman, Keynes makes a distinction among “a *positive science* ...[,] a body of systematized knowledge concerning what is; a *normative or regulative science* ...[,] a body of systematized knowledge discussing criteria of what ought to be; an *art* ...[,] a system of rules for the attainment of a given end”.

adopting a new production process, creating new markets, introducing new technology or creating a new economic organization. Schumpeter referred to these individuals as “entrepreneurs” who belong to a “distinct sociological class”. According to him, the process of discovery and innovation modifies the past and creates new opportunities for the creation of wealth in the future. This is what Schumpeter described as the process of “creative destruction”.

According to Schumpeter, “the function of entrepreneur is to reform or revolutionize the pattern of production by exploiting an innovation or, more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way, by opening up a new source of supply of materials or a new outlet for products, by reorganizing an industry...” He went on to attribute innovation as the business activity that brings about a new production function as a result of one or more of the following five economic activities:

1. introduction of a new good
2. adoption of new inputs to produce a new good or the previously produced good
3. introduction of new technology
4. opening of a new market; and
5. creating a new economic organization.

According to Schumpeter, the above five elements of innovation translate to the domain of activities of an entrepreneur. Figure 1 links innovation to Schumpeter’s five elements of entrepreneurship.

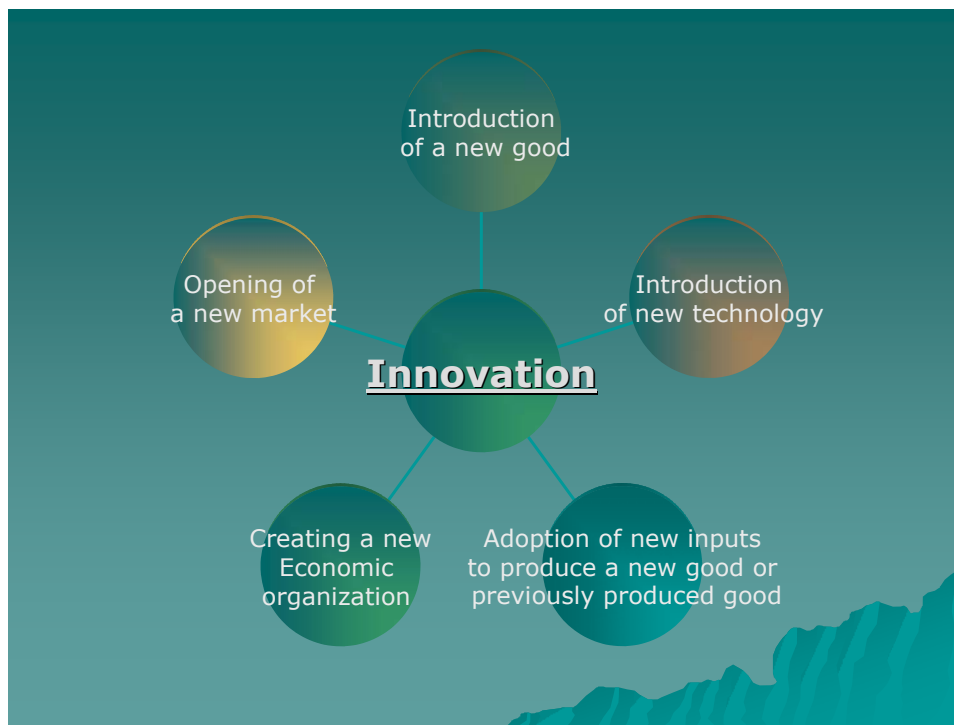


Figure 1: Innovation and Entrepreneurship

A brief description of entrepreneurial activities related to the Schumpeterian model is presented below.

The introduction of a new good: Arguably this is the most important activity of an entrepreneur pertaining to the change in a production function. An entrepreneur seizes the opportunity to

introduce a new product in the market that is currently not available to the consumer. In the context of Bangladesh, particularly in a new and emerging market, introduction of a new good has the prospect of maximum return to an entrepreneur.

The introduction of a new method of production: This refers to changing technological relationship or the existing production function. In order to lower the per unit cost of production, an entrepreneur may introduce a new method of production or substitute new and cheaper inputs in place of existing inputs. If an entrepreneur is successful in doing this, she or he will ensure the maximum profit from the sale of a new product. In the context of Bangladesh, where labor is abundant and cheap, microentrepreneurs typically look for substituting more labor for capital in devising newer methods of production.

The opening of a new market: This is one of the two functions of innovation. Once a product has been developed with the least cost method of production, an entrepreneur looks for a new market. In the context of Bangladesh, with an ever-growing population leading to unmet demands, finding a market does not seem to be a problem for an entrepreneur.

The conquest of a new source of supply of a raw material: This is the second function of innovation. Because resources are scarce, new source of supply of raw materials is an important factor in ensuring continuous supply of a newly developed product. In the context of Bangladesh, particularly where capital is scarce, a microentrepreneur has to continually search for new sources of supply of raw materials.

The carrying out of a new organization of an industry: In describing the innovation as the final process of changing a production function, Schumpeter related this process of innovation to breaking into a monopoly market. The microfinance industry of Bangladesh is an example of a new organization of an industry. A number of commercial banks of Bangladesh have opened up new departments for microcredit to the MFIs.

Schumpeter described two different patterns of industrial innovation linked to entrepreneurship. One form of industrial innovation described by Schumpeter in *The Theory of Economic Development* (1934) is small firms operating in highly competitive industries, while in *Capitalism, Socialism and Democracy* (1942), this role is played by large firms operating in oligopolistic industries. Studies suggest that both Schumpeterian patterns of innovation can co-exist in an economy in different industries (Arrow, 1962; Herbert and Link, 1982). Interestingly, the microfinance market in Bangladesh consists of a regulated monopoly, an oligopoly of three big MFIs and a large number of MFIs forming a monopolistically competitive market. Schumpeter's model fits well in analyzing the microfinance market in Bangladesh.

Schumpeter's theory of entrepreneurship stimulated extensive writing on the subject. Numerous studies have supported various sets of personality characteristics based on certain assumptions about behavior where sets of criteria, traits and personal principles and characteristics provide different types of insight. An approach now gaining more popularity explains entrepreneurship by combining economic, personal, and sociological variables. Personal characteristics, such as the need for achievement, risk-taking propensity, locus of control, beliefs about wealth and material gain, and business growth are related to a person's predisposition toward business leadership (Gartner, 1990, McDaniel, 2002). A belief that a person can influence his personal destiny and locus of control distinguishes entrepreneurs from the general population. The microentrepreneurs of Bangladesh possess the traits and characteristics of the "distinct sociological class" described by Schumpeter.

In reality, Schumpeter's model works through the transformation of a production function. A production function is the technological relationship between inputs and outputs. In other words, a production function refers to the methods and processes by which the factors of production namely land, capital and labor are combined by an entrepreneur for tangible output. This is where Schumpeter made a distinction between the terms invention and innovation. According to him, invention is discovery of new ideas, concepts, or material items that are normally confined to speculative reasoning. Such reasoning can be abstract and may remain uninvestigated in a scientific laboratory; however, if an invention in the form of an idea or a material item is transferred to the business sector with a view to changing the production function, then it becomes innovation.

There have been much discussions on the role of an entrepreneur in developed and developing economies after the work of Schumpeter, particularly by Sweezy (1943), Leontief (1937), Angell (1941), Wright (1947), Lange (1943), Rostow (1948) and McDaniel (2002). The debate usually centered on the role of entrepreneurship in invention and innovation. More importantly not much has been done in relation to a developing economy. Although Rostow provided the theory of stages of economic growth, much of his theory came under close scrutiny in the later half of the twentieth century particularly with the onset of a service economy. Many developing economies showed signs of prosperity through proper planning of their manpower and surplus labor. The globalization of the world economy speeded up the process of integration of both developed and developing economies. Bangladesh planned for the utilization of its surplus labor through significant investment in labor-intensive industries such as garments and apparels, food processing and handicrafts.

RECIPIENTS OF MICROCREDIT

The modern era microcredit loans are largely used as a means of boosting income of the recipients. In most cases, a borrower must belong to a group in order to qualify for a loan. Organizing groups is a big part of the operating expenses of MFIs. While many MFIs monitor their portfolio with respect to the type of loan disbursements and provide training to borrowers regarding the opportunity cost of fund, it appears that the bulk of microloans go to retailing followed by livestock. Examples of retailing include trading in food grains and vegetables and proprietorship of small shops and stalls. Livestock includes milk cows and poultry rearing.

Sector	Disbursement June 2000 (%)	Disbursement June 2001 (%)
Agriculture	12.63	12.23
Fisheries	4.74	4.91
Food Processing	6.99	3.78
Retail Trade	41.31	43.02
Cottage industries	3.03	3.03
Transport	3.42	2.78
Housing	1.28	1.16
Health	0.39	0.45
Education	0.02	0.08
Livestock	20.91	18.11
Others	5.28	10.45
Total	100.00	100.00

Table 1: Disbursement of Microcredit by Sectors

Source: CDF Statistics, Vol- 10, 11 & 12 CDF, Dhaka

Table 1 provides a sector-wise breakdown of microcredit disbursements in 2000 and 2001. The table demonstrates a downward trend of loan disbursements in such high-return activities as food processing, transport, and housing. Efficient MFIs like ASA and BORO, Tangail evaluate their portfolios and promote lending in these high return sectors. They have developed new loan products that are significantly bigger than the industry average and cater to the needs of individual microentrepreneurs.

MICROENTREPRENEURS OF BANGLADESH: SUCCESS STORIES OF TWO WOMEN

Microcredit has created a class of microentrepreneurs in Bangladesh, composed mostly of women. Throughout the country, there are many successful shops and firms owned and managed by women. Some launch a business project to uplift their economic status, while others venture into the business arena to do 'something different' or 'something differently' and, importantly, worthwhile for society. Women entrepreneurs are making their presence felt in rural areas too. Village women mainly start business in the struggle for survival, but with a little support from microfinance institutions supported by their NGOs and social welfare organizations, they can go beyond the subsistence level and make healthy profits from their thriving business activities. These women innovate and change the production function – the fundamental attributes of an entrepreneur. Because they have modest resources, they are known as microentrepreneurs; however, they discover new sources of supply of inputs and new markets, just like any other entrepreneur.

In 2002 the Women Entrepreneurs Association, Bangladesh (WEA) decided to recognize and honor six women microentrepreneurs for the first time. The recipients of the WEA crests included three from the rural areas and three from the urban areas. These microentrepreneurs represent a wide array of entrepreneurial endeavors. In the rural division, recipients included Minu Begum (unique tea stall), Majeda Khatun (variety store) and Dr. Sandhya Roy (health food). In the urban area, awardees included Dil Rowshan Akthery, (flower club and cottage industry), Ruby Ghuznavi (natural dye), and Rahima Mahmud (dairy and agriculture). Profiles of two women microentrepreneurs, one from the rural area and one from the urban area, are presented below.

Minu Begum: Diversified Portfolio

Minu Begum would qualify to be an entrepreneur by Schumpeter's criteria. She grew up in abject poverty. After being abandoned by her husband, Minu Begum started to sell tea and bhapa pithas (rice cake baked in indigenous oven) to make a living and has established herself as an entrepreneur with diversified investments. She fulfills all of Schumpeter's five entrepreneurial criteria:

- introduction of a new good
- adoption of new inputs to produce a new good or the previously produced good
- introduction of new technology
- opening of a new market; and
- creating a new economic organization

Introduction of a new good: The combination of bhapa pitha and tea is unique and would be equivalent to introduction of a new good. In rural Bangladesh, tea stalls are common; however, tea is usually consumed with certain types of biscuits made of dough. Minu Begum's idea of

combining tea and bhapa pitha in her tea stall introduced bhapa pitha as a substitute good for biscuits and a complementary good for tea.

Adoption of new inputs to produce a new good or the previously produced good: As a microentrepreneur, Minu Begum adopted new inputs, namely rice powder and salt to produce a new good. Although bhapa pitha is sold in rural and urban areas of Bangladesh, it was not packaged with tea until Minu Begum did so in her stall.

Introduction of new technology: After opening her stall, Minu Begum found that her entrepreneurial idea of selling tea with bhapa pitha was a successful business venture. In 1990 she heard about Grameen Bank's microfinancing and took a loan of Tk. 3,000 to build a tea stall. This allowed her to experiment with new technology in order to install new hearths to bake bhapa pitha on a large scale. As her business grew, she designed additional hearths to bake the bhapa pitha more efficiently.

Opening of a new market: A tea stall run by a woman in Bangladesh is an act of bravery. Minu understood that but she decided to be a "front-runner", because, "someday in future, women would be managing all kinds of business". She made innovative and attractive designs around her tea stall which attracted additional customers and enabled her to expand the market.

Creating a new economic organization: After one year of operation, Minu Begum took a second loan of Tk. 5,000 to expand her quite successful tea stall business. With further loans and by diversifying investment in other income generation activities, she became self-sufficient and diversified her business. She lives alone and has taken the responsibility of educating the seven children of her sister. She now owns a plot of land with two houses on it. Her enterprises extend beyond the tea stall with many employees and include a cow shed, ten cows, 52 chickens and ducks, and cash capital. After 12 years in business, her total assets are valued at Tk. 700,000, which is a remarkable achievement considering she started off with an initial investment which included a tea stall and a loan of Tk. 3,000.

Syeda Ruby Ghuznavy: Entrepreneurship begins in laboratory

Syeda Ghuznavi began her career in natural dye in 1982 as a research and development specialist in a project funded by the Bangladesh government. In the process, she developed thirty colorfast dyes and trained hundreds of individuals. Then to prove wrong the widespread belief that natural dyes were not cost-effective, Ghuznavi founded *Aranya*, a microenterprise of natural dyes. What followed after that was a sequence of Schumpeter's five criteria of entrepreneurship: introduction of a new good, adoption of new inputs, introduction of new technology, opening of new market, and creation of a new economic organization. Very soon, *Aranya* became a commercially viable project of natural dye. In addition to finding a market in Bangladesh, *Aranya* started exporting to Europe, Japan and the USA. It is one of the few enterprises in the region working with pure natural dyes which are non-pollutant and non-carcinogenic.

Aranya works with thousands of craftspeople across the country and generates increased employment, particularly for rural women. Talking about the challenges she faces as a woman entrepreneur, Ghuznavi says the biggest challenge she has encountered was the inability to get bank loans without 100 percent collateral. "Obviously the many male loan defaulters of our country did not have to fulfill this requirement." She further states that women lack the network that men have in official circles, and that unlike men, women have to establish their credibility time and again. Ghuznavi is of the opinion that it is about time, banks reversed their policies of

credit for young business women. She advises potential entrepreneurs to plan their projects meticulously before launching them.

SUMMARY AND CONCLUSIONS

Although group-based and collateral free microcredit has been in existence in Bangladesh since 1905, it was popularized in the 1980s when a large number of non-governmental organizations adopted the model. Today there are more than 7,000 microfinance institutes in 60 countries serving over 25 million poor clients. These MFIs offer both group-based and individual loans to microentrepreneurs. Microcredit has reached 12 million households in Bangladesh and is being used both as a tool of poverty alleviation and growth of microentrepreneurship. Analyzing the profiles of microcredit recipients, the paper, for the first time, identified two groups: microborrowers and microentrepreneurs. Microborrowers are identified as loan recipients who do not engage in any risky investment and whose primary goal is to generate a steady flow of income through such conventional means as setting up a retail store or rearing one or more milk cows. Microentrepreneurs, on the other hand, assume risk with a small amount of the loan and bring about changes in the production function through innovation.

Using the definition provided by Schumpeter, the paper developed a model of entrepreneurship which emphasizes innovation and identifies five economic activities. For the first time, this model of entrepreneurship is extended to include microentrepreneurs of Bangladesh. The Schumpeterian model of microentrepreneurship was used to analyze two women entrepreneurs identified by the Women Entrepreneurs Association, Bangladesh (WEA). Analysis shows that microcredit leads to the growth of microentrepreneurship in a developing country like Bangladesh allowing the microentrepreneurs opportunities of innovation and social advancements which otherwise would not have existed.

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