The Soul of the German Historical School

Methodological Essays on Schmoller, Weber, and Schumpeter

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Contents

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Chapter 1. 'Rational Reconstruction of the German Historical School: An Overview,' from Yuichi Shionoya (ed.), *The German Historical School: The Historical and Ethical Approach to Economics,* Routledge, 2001, pp. 7–18.

Chapter 2. 'A Methodological Appraisal of Schmoller's Research Program,' from Peter Koslowski (ed.), *The Theory of Ethical Economy in the Historical School,* Springer, 1995, pp. 57–78.

Chapter 3. 'Getting Back Max Weber from Sociology to Economics,' from Heinz Rieter (ed.), *Studien zur Entwicklung der ökonomischen Theorie XV: Wege und Ziele der Forschung,* Dunker & Humblot, 1996, pp. 47–66.

Chapter 4. 'Joseph Schumpeter and the German Historical School,' from Peter Koslowski (ed.), *The Theory of Capitalism in the German Economic Tradition,* Springer, 2000, pp. 3–23.

Chapter 5. 'Instrumentalism in Schumpeter's Economic Methodology,' from *History of Political Economy,* Summer 1990, pp. 187–222.

Chapter 6. 'Schumpeter on Schmoller and Weber: A Methodology of Economic Sociology,' from *History of Political Economy,* Summer 1991, pp. 193–219.

Chapter 7. 'The Origin of the Schumpeterian Research Program: A Chapter Omitted from Schumpeter's *Theory of Economic Developmen,'* from *Journal of Institutional and Theoretical Economics,* June 1990, pp. 314–27.

Chapter 8. 'The Science and Ideology of Schumpeter,' from *Rivista Internazionale di Scienze Economiche e Commerciali,* August 1986, pp. 729–62.

Chapter 9. 'Joseph Schumpeter on the Relationship between Economics and Sociology from the Perspective of Doctrinal History,' from Yuichi Shionoya (ed.), *The German Historical School: The Historical and Ethical Approach to Economics,* Routledge, 2001, pp. 138–54.

Chapter 10. 'Schumpeter's Preface to the Fourth German Edition of *The Theory of Economic Development,'* from *Journal of Evolutionary Economics,* May 2004, pp. 131–42.

Chapter 11. 'The Schumpeter Family in Třešt',' from *Hitotsubashi Journal of Economics,* December 1989, pp. 157–71.

Introduction

This volume is a collection of my essays on Gustav von Schmoller (1838–1917), Max Weber (1864–1920), and Joseph Alois Schumpeter (1883–1950), published during the past fifteen years. These three intellectual giants are connected with the German Historical School of Economics in different ways. In the history of economics, the German Historical School has been described as a heterodox group of economic researchers who flourished in the German-speaking world throughout the nineteenth century. The definition of a "school" is always problematic. Even if the core of a certain idea were identified in the continuous and discontinuous process of the filiation and ramification of thought, it is still possible to trace its predecessors, successors, and sympathizers in different directions, creating an amorphous entity of a school. It is beyond question, however, that Schmoller was the leader of the younger German Historical School, the genuine school with a sociological reality.[1] Schmoller was indeed the towering figure of the Historical School at its zenith.

Although Weber and Schumpeter were both brought up in the German-speaking world under the influence of historical economics, their works are appreciated independently of the German Historical School, for they established their own system of thought that can be understood without reference to that school. Whereas Weber was sometimes counted as one of the members of the youngest Historical School (or its third generation) and declared himself repeatedly to be a student of the school, Schumpeter was never considered even as working on its periphery because he was in the vanguard of theoretical economists. However, Schumpeter's aspiration to a universal social science was informed by the German Historical School, although he seldom revealed it when he addressed his Anglo-American audience after he left Germany for the United States in 1932. This collection treats Schumpeter, the apparent outsider of the German Historical School, as its key associate among the three addressed and approaches Schmoller and Weber through Schumpeter's looking glass.

The unifying idea of the Schmoller-Weber-Schumpeter nexus in this book is to rationally reconstruct the methodological essence of the German Historical School led by Schmoller on the basis of Weber's and Schumpeter's works. Whereas Schmoller had devised a distinctive research program of economics as well as massive historical research that relied on a deep belief in historical economics, both Weber and Schumpeter, as the creative successors of the German Historical School, developed a characteristic methodology that contributed to the theoretical, if not actual, resolution of the *Methodenstreit* (the controversy on method between Schmoller and Carl Menger, or between

history and theory), and explored the unique field of economic sociology or *Sozialökonomik* that was methodologically designed for the synthesis of history and theory. By the synthesis of history and theory I mean the theoretical formulation of history, or "reasoned history" *(histoire raisonnée)*—to use Schumpeter's favorite term—, or the "ideal-type construction of history"—to use Weber's formula—, both of which are different from the mere collection, classification, summarization, and ad hoc explanation of historical data.

According to Weber and Schumpeter, the real challenge of the German Historical School to mainstream economics was not the dichotomy between theory and history, between nomothesis and idiography, between generality and specificity, between universality and individuality, between deductivism and inductivism, and so on. Rather, it was the need to analyze the overall picture of society, based on the conception of the whole man, from evolutionary and comparative perspectives. From these perspectives, other crucial concepts such as history, ethics, and institutions will follow.

This book focuses on the methodological aspects of the German Historical School because whereas its historical and theoretical work on economic institutions and its political and social advocacy were inevitably constrained by the historical context, its methodological contributions to the social sciences have been general and universal. Schmoller's research program had proposed the methods and procedures by which a "historical-ethical approach" to economics could be substantiated in economic sociology. Schmoller's defects, however, lay in the methodology for establishing a foundation of economic sociology. The contributions of Weber and Schumpeter in exploiting the potentialities of the German Historical School are found in their construction of the methodological foundation of economic sociology, which I contend could serve as the source of a future research paradigm in economics across time and space.

It is remarkable that the neo-Kantian philosophy (represented by Heinrich Rickert) as the basis of Weber's methodology, on the one hand, and the early positivist philosophy (represented by Ernst Mach) as the basis of Schumpeter's methodology, on the other, converged into similar methodological thought through their conscious orientation toward economic sociology. This methodological idea, combined with the scope and method of a universal social science, is called here the "soul of the German Historical School." By the soul I refer to the Greek *psyche,* meaning the breath of life, which differs not only from the *nous* embodied in intellectual achievements but also from the *mind* embedded in the body or society. As, according to the Platonic conception, the soul is related to the general ideas and rational reconstruction of thought, it can transmigrate between bodies or societies. This book describes how the soul of the German Historical School was succeeded, reconstructed, and developed by Weber and Schumpeter at the peak of the school so as to crystallize the use of teleological holism and instrumentalist methodology as the tools needed to arrive at the big picture of society.

Why can Schumpeter be regarded as the key contributor to this project? Indeed, my knowledge of Schmoller and Weber is relatively limited compared to that of Schumpeter. But I find in Schumpeter's work three useful organizing ideas to reconstruct the soul of the German Historical School, the ideas that I suspect have been little known to both contemporary Anglo-American theoretical and historical economists.

The *first* idea is Schumpeter's interpretation of Schmoller's historical-ethical approach as the prototype of economic sociology in his article, "Gustav v. Schmoller und die Probleme von heute" (1926). This proved to be a noticeable declaration of the "first Schmoller renaissance" in the midst of the dismissive academic atmosphere of the inter-war period following the defeat of Germany and the demise of the German Historical School. Schumpeter was concerned with *"living* Schmoller and his *influential* message, not with what is combined with his rich personality and is today nothing more than a memory and monument."[2]

The *second* idea is his formulation of economic methodology as instrumentalism in his first book, *Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie* (1908), which is meaningfully compared to Weber's methodology of *verstehende* (interpretive) sociology. Schumpeter's instrumentalism is different from the caricatured notion of instrumentalism, which is the way most economists understand the term today. It is expected to apply to much broader fields of the social sciences.

The *third* is his idea of a universal social science in the last (seventh) chapter of his *Theorie der wirtschaftlichen Entwicklung* (1912), which was entitled *"Das Gesamtbild der Volkswirtschaft"* (The Overall Picture of the Economy). Since he deleted this chapter from the second and subsequent (including English) editions of *Entwicklung,* that idea has long remained unnoticed. This chapter, revealing for the first time the idea of Schumpeter's research program for a universal social science, presents not only a useful clue to understanding his wide-ranging work but also his alternative to the past major attempts to construct a universal social science. Incidentally, the chapter can be seen to compete with the last (fourth) book entitled *"Die Entwickelung des volkswirtschaftlichen Lebens im ganzen"* (The Development of Economic Life as a Whole) in Schmoller's *Grundriss der allgemeinen Volkswirtschaftslehre* (1900–1904).

Although these three critical works of Schumpeter's (1908, 1912, and 1926) had long been available only in German, it is a welcome development that one of them, the seventh chapter of the first edition of *Entwicklung,* was recently translated into English in the first volume of the series, "The European Heritage in Economics and the Social Sciences."[3]

I discuss each of the three ideas, which constitute the core blocks of this book, in Chapters 2, 5, and 7. Schumpeter also displayed a masterly skill in writing the history of economics; his penetrating analysis of the doctrine and method of the German Historical School is also utilized as the basis of this book.

Let me explain briefly the content of each chapter. Chapter 1 describes the nature of the approach taken in this book as the rational reconstruction, rather than the historical reconstruction, of the German Historical School and Schmoller.[4] I do not contend that the German Historical School had a single overarching vision of historical economics, but that one aspect of its scholarship can be reconstructed through artificial efforts of the human mind to mine the valuable groundwork for evolutionary and institutional thinking from its quarry. Of course, such a reconstruction must contribute to an understanding of the German Historical School as well as to the orientation of our contemporary research that must extend beyond the scope and method of mainstream economics.

Schmoller's idea of economic research originated from a simple notion, inherited from the older Historical School, that the economic process consists of the interactions between the natural-technical and the psychological-ethical factors of society, and proceeded to the formulation of the historical-ethical approach. However, his historical-ethical approach was diametrically opposed to the theoretical-economic approach of mainstream economics. A more balanced view might be that the relationship between natural-technical and psychological-ethical factors was the quintessence of the moral sciences in the eighteenth century, which I formulate as the evolutionary approach to the interaction between the "mind and society," and that the German Historical School is logically located within the framework of this approach.

Chapter 2, on a methodological evaluation of Schmoller's economic research program, analyzes the structure of his historical-ethical approach in terms of two axes: history versus theory and ethics versus economy. Schmoller's vision of economic research was concerned with the whole range of these controversial issues. According to Schumpeter, the combined vision of the development and unity of social life was the essence of the German Historical School. I suggest the use of instrumentalism and teleology to sustain the structure of Schmoller's historical economics or economic sociology.

Chapter 3 is intended to interpret Weber's methodological work for sociology as essentially equivalent to instrumentalism and to remove the barrier between sociology and economics. Importantly, Schumpeter's approach to economic sociology, starting from theoretical economics, differed from Weber's, which started from the overarching tool of sociology. The goal of my methodological investigation of the German Historical School is to help to discover, understand, and justify the approaches to economic institutions and their changes from the standpoint of Schumpeter and Weber.

Chapter 4 presents a summary view of Schumpeter's relationship with the German Historical School, covering the reconstruction of Schmoller's research program and Schumpeter's conception of economic sociology. Schumpeter's *Capitalism, Socialism and Democracy* (1942) was not a "pot-boiler," as he often called it, but a serious work of economic sociology focused on the evolution of institutions in terms of the consistency (or inconsistency) between economic machinery and value schemes, or the interactions between economic factors and noneconomic factors.

Chapter 5 is an interpretation of Schumpeter's *Wesen* as the application of Ernst Mach's philosophy of science to economics. If it is admitted that neoclassical economics emerged from the metaphor of mechanics, Schumpeter put the final touches on its system, laying the groundwork for its paradigm by ingeniously adapting the methodology of natural science to economics.

For Schumpeter, however, instrumentalist methodology was not confined to abstract economic theory. Insofar as economic sociology is also a theory, the same methodology can be applied to a broader perspective of economic and social change. I have examined the applicability of instrumentalism with regard to Schmoller and Weber in Chapters 2 and 3, respectively. Chapter 6 further explores the methodology of economic sociology in reforming the methodological foundation of the German Historical School.

Chapter 7 describes Schumpeter's research program for a universal social science or a comprehensive sociology, relying on the missing seventh chapter of the first edition of his *Entwicklung.* His program consists of three layers of economic research: economic statics, economic dynamics, and economic sociology. This represents half of the system of the moral sciences; in other words, it is a system of substantive theory that is distinct from a system of metatheory. Schumpeter the polymath also worked in the area of metatheory that includes the philosophy of science, the history of science, and the sociology of science; thus what he delivered throughout his life was much broader than what he planned in his missing seventh chapter. I call his broader system a "two structure approach to the evolution of the mind and society," as referred to in Chapter 1 of this book.

Although this book addresses the German Historical School through the looking glass of Schumpeter, it is untrue that he was concerned only with the tradition of that school. His intellectual background was influenced primarily by Léon Walras, Karl Marx, and Schmoller. In his preface to the Japanese translation of *Entwicklung,* he explained the aim of the book with special reference to Walras and Marx.[5] Chapter 8 examines how Walras and Marx could coexist coherently within Schumpeter's thought; this is the question that has confounded Schumpeter scholars who have sometimes regarded him as somewhat schizophrenic. Whereas Schumpeter's conception of economic sociology that was inspired by Schmoller relates to the formal framework of socio-cultural development, his theoretical analysis based on the presumption of Walrasian and Marxian visions provides the substantive content for the workings of the economy and society.

Chapter 9 focuses on Schumpeter the historian of economic thought. Contrary to a commonplace view that he pursued the development of analytical economics along Walrasian lines, I elucidate how he assessed the attempts of economic sociology as they appeared in the historical literature in light of his research program for a universal social science. Whereas Chapters 2, 3, and 6 consider the relationship between economics and sociology from the methodological viewpoint, Chapter 9 examines that relationship from the perspective of the history of thought, covering Comte, Marx, Pareto, and Weber.

In Chapter 10 I discuss the supporting evidence on the role of instrumentalist methodology in Schumpeter's concrete work on business cycles, another example of his synthesis of theory and history. The evidence is his preface to the fourth German edition (1935) of *Entwicklung,* which supplements the previous chapters (Chapters 2, 3, and 6) on instrumentalism. It might be argued that the disagreement between Schumpeter and Simon Kuznets (a Schumpeter critic) on his work on business cycles is reminiscent of the *Methodenstreit.*

The genealogy of the Schumpeter family is appended as Chapter 11. When I visited Schumpeter's birthplace, Třešt', Czechoslovakia, in August 1989, this small town was governed by the communist regime just before its fall. I found that although Schumpeter himself was despised there as the puppet of capitalists, the history of his family had been indispensable to the town of Třešt' for four hundred years even without Schumpeter the economist. I am deeply indebted to the staff of the town office and regional historians for decoding the historical record.

With the increasing acceptance of evolutionary and institutional thinking among contemporary economists, general interest in the German Historical School and Gustav von Schmoller in particular has risen steadily during the past decade.[6] This can be called the "second Schmoller renaissance." Isaiah Berlin characterized the rise of German romanticism as a great turning point in the history of Western thought.[7] The German Historical School, belonging to the tradition of historicism as part of German romanticism and idealism, wrought a radical transformation in the outlook of economics. Yet mainstream economics has never taken the impact of the romantic revolution on economics seriously; it is only in recent decades that economic thinking in the form of evolutionism and institutionalism is gradually returning to it. However, because the so-called neo-Schumpeterian evolutionary economics is largely confined to the problems of technological innovation, it cannot cope with the challenge of Schumpeter's socio-cultural development. Similarly, the so-called new institutional economics is an extension of neoclassical economic theory and thus unable to cover the subject matter of Schmoller's historical-ethical approach. I cannot but suspect that there is a strong divide between the Continental and the Anglo-American perspectives on the social sciences.

In editing the articles for this volume, I have not changed their content in principle. Rather, my revisions involved three nonsubstantive areas. First, as the original articles inevitably overlap somewhat, I tried to eliminate duplication as much as possible. Second, I used a consistent style for the text, notes, and references. Third, I tried to reduce grammatical shortcomings contained in the original articles.

Notes

1 J. A. Schumpeter, *History of Economic Analysis,* New York: Oxford University Press, 1954, p. 809.
2 J. A. Schumpeter, 'Gustav v. Schmoller und die Probleme von heute,' *Schmollers Jahrbuch für Gesetzgebung, Verwaltung und Volkswirtschaft,* 1926, p. 339.
3 Ursula Backhaus, 'The Theory of Economic Development,' in Jürgen Backhaus (ed.), *Joseph Alois Schumpeter: Entrepreneursip, Style and Vision,* Boston: Kluwer Academic Publishers, 2003.
4 For a recent work of the historical reconstruction of Schmoller, see Erik Grimmer-Solem, *The Rise of Historical Economics and Social Reform in Germany 1864–1894,* Oxford: Clarendon Press, 2003.
5 J. A. Schumpeter, 'Preface to the Japanese Edition of *Theorie der wirtschaftlichen Entwicklung,'* 1937, reprinted in R.V. Clemence (ed.), *Essays of J. A. Schumpeter,* Cambridge, Mass.: Addison-Wesley, 1951.
6 Helge Peukert, 'The Schmoller Renaissance,' *History of Political Economy,* Spring 2001.
7 Isaiah Berlin, 'The Romantic Revolution: A Crisis in the History of Modern Thought,' in *The Sense of Reality,* New York: Farrar, Straus and Giroux, 1996, pp. 168–70.

1. Rational Reconstruction of the German Historical School: An Overview

Historicism in economics originated in Germany in the latter half of the nineteenth century. According to the accepted view in the history of economic thought, the German Historical School had three generations: the Older Historical School (Wilhelm Roscher, Karl Knies, Bruno Hildebrand); the Younger Historical School (Gustav von Schmoller, Lujo Brentano, Karl Bücher, Friedrich Knapp, Adolph Wagner); and the Youngest Historical School (Arthur Spiethoff, Werner Sombart, Max Weber) (Schumpeter, 1954, 807–820). Can one develop a unified picture of the German Historical School from these diversities? If so, in what sense and how?

I. Introduction

The German Historical School has been described as a criticism of British classical economics. In opposition to the universally valid economic theory, it asserted that economic principles should be inductively derived through the study of historical facts of different countries. However, that was an immediate moment; the root of the Historical School must be found in German romanticist, idealist, and nationalistic ideology that was a reaction to rationalism and enlightenment, of which classical economics was one of the products. Therefore, it is understandable that German thinkers such as Johann Gottfried Herder, Adam Müller, and Friedrich List are sometimes regarded as the forerunners of the Historical School.

Quentin Skinner (1969) discussed two approaches to interpreting texts in the history of ideas: one is to emphasize the total historical context in which any text is located; the other is to derive from the text universal propositions apart from the context of history. The two approaches may be called contextualism and textualism. In the same sense, Richard Rorty (1984) distinguished the methods of description in the history of philosophy as historical reconstruction and rational reconstruction: the former places the text in question in the context of the past and identifies what it wanted to say; the latter interprets the text from the standpoint of the present and specifies what it could have said in terms of ideas unknown to the original authors. The distinction between 'meaning' and 'significance' may also be attributed to the goals of the two methods of reconstruction, respectively.

The German Historical School can be reconstructed in terms of a historical as well as a rational context. According to the German perspective, the

organicist *Weltanschauung* was politically oriented toward industrialization of less-developed Germany and concerned with the building of an institutional framework on a national basis and thus could not accept British *laissez-faire* economics. But the importance of the German Historical School cannot be overemphasized in its historical role alone. The fact that its thought was partly implanted in other countries—e.g., England, the United States, and Japan—in its heyday and that some of its influence was revived in Germany after its decline reflects its universalizable elements. Despite divergences among the members of the school, its intellectual project can be generalized through an interpretation and reconstruction of the scope and method of economics; this suggests a new perspective that may provide an alternative to present-day mainstream economics. This chapter presents the framework for a rational reconstruction of the German Historical School, and explores the relevance of its thought to current evolutionary and institutional thinking.

II. Evolution of the Mind and Society

Social science observes social reality and constructs theory, which, in turn, becomes an object of observation. Social science is thus characterized by its duality: it addresses social reality and its achievement becomes an object of social science. These dual aspects of social science can be represented by the notion that the mind and society interact in a historical process.

In this sense, suppose that there are two objects of study in social science: society and the mind, or economy and economics, as far as economic science is concerned. The former relates to a whole group of real and organizational factors of society and the latter to spiritual and ideational factors of society. We will assume that the system of theory addresses society and that the system of metatheory addresses the mind. Theory in economics comprises economic statics, economic dynamics, and economic sociology, which differ in scope and method as they relate to an economic society. Metatheory, which considers the mind or thought, is a theory about theory and consists of the philosophy of science, the history of science, and the sociology of science. Thus the structures of theory and metatheory are parallel in the sense that in social science both society and the mind are analyzed at three levels: the static, the dynamic, and the social. The two structures can be interpreted as the system of theories for two different social areas: the mind and society. I call this concept of social science a two-structure approach to the mind and society (Shionoya, 1997, 262–65).

From this observation it can be inferred that just as a social study, whether historical or theoretical, focuses on social reality and attempts to make a subjective construction of the reality, so a study of theories is merely a subjective construction of those theories because they are part of social reality. Studies conducted in the past, which may be classified as culture, science, thought, or whatever, are now part of the social reality. An approach to

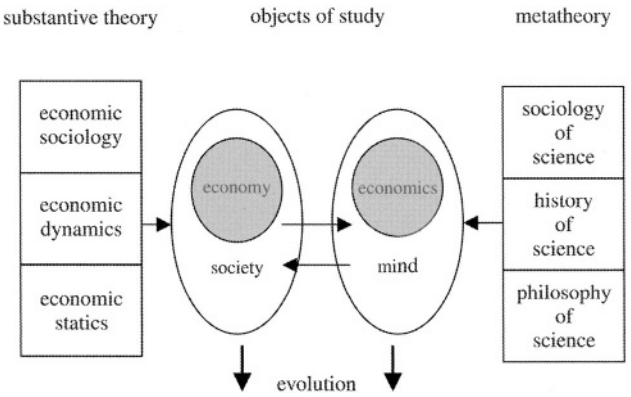

Figure 1. Two-structure approach to the mind and society (Source: Yuichi Shionoya, *Schumpeter and the Idea of Social Science: A Metatheoretical Study,* Cambridge University Press, 1997, p. 265.)

previous studies, whether an interpretation or a critique, is also either historical or theoretical.

Figure 1 summarizes the two-structure approach to the mind and society, which I developed through an inquiry into the work of Joseph Schumpeter. Contrary to the conventional view, I believe that Schumpeter should be regarded as one of the successors of the German Historical School because he attempted a rational reconstruction of that school, especially Schmoller's research program, in terms of economic sociology and made his own contribution from this perspective (Schumpeter, 1926). The framework of his approach thus will be useful in reconstructing the Historical School.

The left part of Figure 1 shows that substantive theory addresses social reality or the real aspects of society and attempts to subjectively construct the reality, where three levels are distinguished in theoretical or historical investigation. When the focus is on the economy, the levels of economics include economic statics, economic dynamics, and economic sociology. The right part of figure shows that metatheory is merely a subjective reconstruction of mind products or scientific theories, which consist of the philosophical, historical, and sociological investigation of thought and science. Rorty's distinction between historical and rational reconstruction is the first approximation that does not distinguish between types of metatheories.

The important conception underlying the two-structure approach is that interactions between the mind and society shape historical evolution and that the mind and society are two aspects of the same evolutionary process. In Schumpeter's view (1954, p. 137), this recognition is attributable to Giambattista Vico, the eighteenth-century Italian thinker. Because Vico is regarded as the first serious critic of Cartesian rationalism and the founder of nineteenth-century historicism, I argue that the evolution of the mind and society is key to understanding the German Historical School, which took ethics seriously as a determinant of social schemes in an evolving process.

Attempts to explore the interactions between the mind and society are illustrated, among others, by Karl Marx's distinction between the substructure and superstructure of society, Weber's association between the Protestant ethic and capitalism, and Schumpeter's thesis that capitalism will fall because of its moral failure resulting from its economic success. These attempts are understood in light of the two-structure approach that models the research program of the German Historical School.

Schumpeter summarized six basic perspectives of the German Historical School: (1) the unity of social life, (2) a concern for development, (3) the organic nature of society, (4) the plurality of human motives, (5) individuality rather than generality, and (6) historical relativity rather than universality (Schumpeter 1914, 110–13). Of these perspectives, Schumpeter attached much importance to the combination of (1) and (2), contrary to the standard view of historicism, which emphasized the combination of (2) and (5), as was evident in the work of Ernst Troeltsch and Friedrich Meinecke. In a historical process, according to my interpretation of Schumpeter, all aspects of society change through multifarious interactions; this entails endogenous development or evolution because all social factors are included in the process. Interrelationships between the mind and society represent a simplified model of this process and are the object of economic sociology, in which historical individuality is incorporated into an appropriate theoretical schema such as typology or stage theory. I will now discuss how the German Historical School is restructured as a theoretical scheme that deals with an evolutionary process by means of the historical-ethical method.

III. Historical-Ethical Method

Schumpeter argued that the German Historical School was developed as a genuine school under Schmoller's leadership (Schumpeter 1914, 100–101; 1954, 809–14). This is how Schumpeter interpreted the rational reconstruction of the Historical School. Schmoller called his method 'historical-ethical' (Schmoller 1897, 26): this sloganistic advocacy of method is merely a rational reconstruction of the school that would serve as a strategy for its integration and development in the future. Elsewhere I have examined Schmoller's research program in greater detail and argued that much of his program should be revised from the viewpoint of rational reconstruction (Shionoya, 1995).

On the basis of this dual method, the Historical School opposed not only British classical economics but also contemporary German and Austrian neoclassical economics. The latter confrontation included the *Methodenstreit* between Schmoller and Carl Menger and the *Werturteilstreit* between Schmoller and Max Weber. Although it is commonly believed that Schmoller lost both battles, such an outcome was not necessarily the result of rational investigation. To discover clues to a rational reconstruction of the German

Historical School, let us analyze the meaning and significance of the historical-ethical method in economics separately.

1. Empiricism versus rationalism

In the *Methodenstreit* the historical method, or empirical and inductive method, was diametrically opposed to the abstract, theoretical, and deductive method, and the relative superiority of the two methods was the bone of contention. But even for Schmoller the historical method was not simply directed to the accumulation of historiography and historical monographs; rather, it aimed to gather materials to ultimately build a broader theory for the institutional framework of the economy and its historical changes.

In hindsight it is pointed out that the real issue in the *Methodenstreit* was not methods as such but problems to be pursued: *utility and price* or *institution and evolution.* Neoclassical economists focused on the former, whereas historical economists addressed the latter. A method's validity and effectiveness depends on the problems: for the Historical School, the method based on *history and ethics* was advocated to deal with the problem of *institution and evolution.* In later years, in recalling the *Methodenstreit,* Schmoller acknowledged the relationship between methods and problems (Schmoller 1911, 479).

Even the controversy was not inevitable. Although Schmoller's historical-ethical method mainly focused on explaining the institutional foundations of the economy, he admitted the value of the neoclassical analysis of utility and price within the framework of institutional analysis. His comprehensive, two-volume *Grundriss der allgemeinen Volkswirtschaftslehre* (1900–04) was an attempt to develop a system of economics on the basis of historical knowledge; in other words, he intended to integrate two economics. Whether he succeeded or not is another story. The study begins with the 'anatomy' of the institutional framework involving ethics, then argues the 'physiology' of economic circulation in terms of price and income, and concludes with his observations on the development of society as a whole.

Schmoller held that the development of human recognition takes place as the alternation of rationalism and empiricism (Schmoller 1888, 147); instead of making a rash generalization on a poor empirical basis, one should engage in empirical research before launching into the theoretical treatment of historical materials, insofar as the major object of economics is the evolution of economic institutions in a historical process.

The lesson of the *Methodenstreit* is the recognition that new theories would be formulated through feedback between theoretical and historical approaches. To permit continuous feedback, we should make explicit the research task for which cooperation between theory and history will be most necessary and feasible. The need for as well as the difficulty of such cooperation will increase as one goes up the layers from economic statics to economic dynamics to economic sociology (see figure 1). Schumpeter (1926)

defined Schmoller's historical method as the prototype of economic sociology, the theoretical discipline for the development of institutions in terms of interactions among individuals. Schumpeter later coined economic sociology as the generalization, typification, and stylization of history by means of institutional analysis and located it as one of the four disciplines in economics beside theory, history, and statistics (Schumpeter 1954, 20).

The fundamental defect of the historical method in the German Historical School was the methodological view that theory or law must be a summary or generalization of empirical facts. Since it is extremely difficult to acquire information about the total historical development of economic life, a theoretical formulation based on the historical method would never be attained within a finite time. The School's opposition to simple and unrealistic assumptions in theoretical economics was also derived from this naïve empiricism. When Schmoller (1911, 467–68) considered the nature of concept formulation, he argued that concepts are an auxiliary means to organized thought, not a perfect copy of reality, admitting nominalism instead of realism. But because he believed that the ultimate goal of science was still realism, he suffered from the serious contradiction between nominalism and realism.

To utilize feedback between theory and history, one should not wait until extensive data are collected in order to endow concepts with as rich an empirical content as possible. From nominalism it is only a step to instrumentalism, the view that theories are not descriptions but instruments for deriving useful results and are neither true nor false. Instrumentalism asserts that assumptions or hypotheses are arbitrary creations of the human mind and need not be justified by facts, and that theories deduced from assumptions are not descriptive statements in themselves but instruments for understanding and explaining facts. Although a collection of historical facts is welcome, economic sociology based on the historical method should be formulated on the methodology of instrumentalism.

Schumpeter, adapting instrumentalist methodology to economic sociology, carried out a wide range of investigations mainly in terms of the interactions between economic and noneconomic phenomena, treating noneconomic elements as a set of social institutions surrounding the economic area (Shionoya, 1997, 193–222). It should be noted that Max Weber also tried to develop a solid foundation for economic sociology by linking economic phenomena with political, legal, and religious phenomena (Swedberg, 1998). His methodology of ideal type was a version of instrumentalism specifically applied to the historical method (Shionoya, 1996). In addition to the work of Schumpeter and Weber, it is possible to add Werner Sombart's threefold approach of economic spirit, order, and technology to see what the rational reconstruction of the German Historical School has produced: all three scholars contributed to the development of an economic sociology that was based on the substantiation of the historical method as it applied to the interactions between economic and noneconomic areas.

2. Morality versus self-interest

The second distinctive feature of the German Historical School is its emphasis on the ethical method. Although it seems generally accepted that Schmoller was also defeated in the *Werturteilstreit,* that is not a valid interpretation. It is indeed true that ethical value judgment was denied by Weber's thesis of value freedom in science. But this means neither that social science should not deal with value judgment, nor that Schmoller's ethical method should be rejected simply because it is value laden.

To avoid misunderstandings about the German Historical School and to attempt its rational reconstruction, it should be noted that the ethical method as a scientific method implies a hypothetical assumption in economic theorizing. It assumes that human behavior is motivated by various considerations other than self-interest, including morality, law, and customs. If this were the expression of value judgment, the assumption of the self-interested man in mainstream economics, which was ridiculed by Thorstein Veblen as a 'lightning calculator of pleasures and pains' (Veblen 1919, 73) and by Amartya Sen as a 'rational fool' (Sen 1977), would have been condemned as a sort of value judgment commending egoism. In fact, Schmoller did not advocate any subjective value judgments, but dealt with the evolution of the historical process in which ethical values are developed as a matter of facts and tried to explain the reality in terms of broader human motives. In his view, values in the form of law, morality, and custom are embedded in institutions and play a leading role as the determinants of evolving institutions and of consequent economic performance.

Schmoller asserted that the ethical approach not only aims at the recognition of moral facts that are embedded in social institutions but also is conceived in a teleological form (Schmoller 1911, 437). The nature of teleology in Schmoller is quite important in appraising his ethical method but has been little noticed. From the Kantian teleological perspective, society is assumed to have certain ends that are explained as if human actions and social systems might work spontaneously and reciprocally to achieve those ends based on the teleological relationship between ends and means. If a society can be regarded as a unified entity with its own ends—in other words, if holism can be assumed—, a teleological inquiry is useful to make an estimate of the world about us in terms of the relationship between ends and means. Since moral values are to govern society as a whole, teleology is effective in the study of institutional organizations embodying ethics.

The principle of teleology cannot be used for cognitive purposes in the strict sense; it can be employed only by reflective judgment to guide an investigation of an organic entity. Schmoller regarded teleology as a heuristic device that supplements an empirical study when historical knowledge is insufficient. Teleology assumes that individuals behave as if they would purposefully serve the ends of the whole. For Schmoller, the leverage for this purpose was ethics of justice. The teleological ends would be realized in an evolutionary process based on interactions between ethics and institutions. Schmoller's teleology

relates to methodological holism and has nothing to do with the justification of a specific ideology.

The ethical method thus has two functions in historical economics: first, ethics is understood empirically as a determinant of human behavior and social systems; second, it is assumed methodologically as a teleological principle of social inquiry. In restructuring the German Historical School, the combination of teleological holism and instrumentalist methodology will provide the historical-ethical approach with a legitimate foundation. In other words, the status of ethics in the Historical School should be interpreted as a value premise, not as a value judgment.

IV. Institution and Evolution

The German Historical School is characterized by the unique attempts of the stage theory of economic development. Schmoller in particular tried to formulate a stage theory of institutions in terms of the interactions between economy and ethics (Schmoller 1900–04, vol. 1, 53–57). He distinguished social systems in the family, the regional community (village, city, and state), and the business firm. Each system is based on a different organizational principle: sympathy, kinship, and love for the family; neighborhood, nationalism, law, and coercion for the regional community; contract for the firm. What Schmoller meant by the ethical determinants of institutions relates to these principles. Contrary to a self-interest model of economy, historical economics pays attention to a community in which individuals share common values and the public interest in pursuing economic activities on the basis of their culture, history, and traditions.

From autarkic family economy or tribal economy there developed two types of organizations. On the one hand, organizations of the regional community such as village economy, city economy, territorial economy, and national economy were formed for the purpose of controlling economic life and serving the public interest at different levels of the regional economy. On the other hand, business firms were developed as organizations to pursue profits, and the private enterprise system entailed various institutional arrangements such as the division of labor, markets, social classes, property ownership, and so on.

Schmoller's scheme of development in stages from village economy to city economy to territorial economy to national economy was based on the idea that the institutions of community are the carriers of social policy to control the free play of firms in the marketplace. His stage theory was concerned with the evolution of institutions brought about by the interactions between ethics and economy, between spiritual-social and natural-technical factors. It basically differed from the notions of the Older Historical School that relate to the natural-technical aspects of the economy.

1. Economics of latecomers

The idea of institutional evolution stressed by the German Historical School has relevance to contemporary thinking in economics and ethics. Several factors are involved in the idea of institutional evolution: first, Germany was a latecomer to the process of industrialization inaugurated by Great Britain; second, the industrialization process is quite diverse across countries; third, a latecomer depends on institutional factors rather than on *laissez-faire* to catch up advanced countries; fourth, institutional development is explained not so much by the free choice of autonomous individuals in markets as by the sense of community and coordinated actions based on shared values.

These themes are integrated in Alexander Gerschenkron's thesis of economic backwardness, which denies the uniformity of economic development among countries and recognizes a differentiated pattern of development that is systematically accounted for by relative degrees of backwardness (Gerschenkron 1962). Gerschenkron's thesis represents neither a universal proposition nor a descriptive, unique history of economic development but rather an intermediate schema, i.e., a typology. If all economic phenomena were characterized by perfect uniformity, there would be no reason to talk about institutions for which certain economic phenomena were typified; only one meaningful institution would exist. On the other hand, if all economic phenomena were *sui generis,* one could not categorize them according to a particular type or group; there would be such an infinite variety of behavioral patterns that it would be useless to consider types.

The concept of institution is essential to historical research in two senses: first, in the cognitive sense, institution makes a typological observation possible despite the seemingly infinite complexity of history; second, in the practical sense, institution is a strategic device of latecomers for catching up to advanced countries through a differentiated growth path based on the degree of economic backwardness. Thus the institutional approach of the German Historical School is not a uniquely historical product but is generalized in the economics of latecomers. Furthermore, to meet the demands of the German Historical School their stage theories should be replaced with typological theories that admit a differentiated growth path instead of maintaining a standard stage sequence.

2. Communitarian ethics

What constitutes the strategy of latecomers in terms of institutional devices is communitarian ethics. The current debate in ethics and political philosophy between liberalism and communitarianism is, I argue, a reproduction of British classical economics and German historical economics (Shionoya, 2004). Community is characterized by common social practices, cultural traditions, and shared values; it is something more than a society of free and autonomous individuals. Communitarians emphasize the social