

As We See It

In capitalist reality as distinguished from its textbook picture, it is not [static] competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization—competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their very lives. . . . This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in.— Joseph A. Schumpeter

Capitalism, Socialism and Democracy

Every day there are new developments reminding us of the profound impact the Internet is having on the economy. This topic was addressed in a May 9, 1999, Paine Webber investment policy publication authored by Edward M. Kerschner, Thomas M. Doerflinger, and Michael Geraghty entitled *The Information Revolution Wars*. To illustrate how the Internet might impact the economy, the authors reviewed how several past Industrial Revolutions such as development of the railroad and automobile industries altered the economic landscape. In their publication they stated: “To anyone interested in the economic impact of the Internet, the Railroad Revolution deserves close attention, because railroads did to America’s *industrial sector* what the Internet is doing to the *service sector*.”

The railroads dramatically changed and even destroyed many traditional industries while creating entirely new ones. The Internet is likely to do the same. Some of the more interesting analogies are as follows:

- Railroads shortened shipping time, reduced transportation costs, expanded markets, and reduced the price differentials between local and distant markets for products such as wheat. Similarly, shopping on the Internet can dramatically shorten the time it takes to comparison shop and greatly empowers the buyer. If the desired product is unavailable locally, one can order on the Internet and get one-day service via FedEx.
- Railroads not only affected the price of grain, they transformed the entire marketing process. Before railroads were established, grain was sacked and taken to the local mill for processing. Now grain could be hauled in bulk to that new business—grain elevators—where it was loaded on rail cars for processing elsewhere. Although each industry is different, it is broadly true that the Internet increases the power of producers relative to distributors. Some middlemen will lose as producers communicate with customers over the Web and, in some industries, deliver product as well.
- Railroads accelerated economic activity while making it less volatile. Since transit time for goods was reduced considerably, the inventory required to support a given level of sales was reduced thereby raising return on investment. Moreover, the shorter transit time reduced the risk of loss from price movements and encouraged shipping, which increased economic activity. The Internet is having a similar impact. As consumers buy directly from producers or Web retailers inventory requirements are reduced. For example, Amazon.com inventories books in a few large warehouses rather than hundreds of stores as is the case with Barnes & Noble.
- Before establishment of the railroads, each town set its own clock with, understandably, considerable variance. Railroads could not operate efficiently in this environment. So, in 1883 the railroads divided the U.S. into four *time zones* within which all timepieces were to be synchronized. We are now on *Internet Time*. Shopping is no longer restricted to *store* hours, or research conducted only when the library is open.
- As the railroad consumed high quantities of various products, it hastened economic development. For example, wrought iron rails wore out rapidly and were replaced by steel rails. Naturally, the steel industry thrived. In contrast, Internet commerce actually reduces the need for many materials. Since they are now available on a CD, few of us would purchase the 32-volume printed version of the Encyclopedia Britannica today. This reduction in demand for basic materials has altered the characteristics of inflation.

These are but a few examples of the railroad’s and the Internet’s impact on the economy. In the end, few industries were unaffected by the revolution in transportation. Likewise, few industries will be unaffected by today’s Information Revolution. As was the case with the railroads, the economy will be transformed in many as yet unforeseen ways and many traditional businesses will be destroyed while new ones are created. It is what economist Joseph A. Schumpeter called, *Creative Destruction*.

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