Condensed Version

CORPORATE POWER IN THE MARKETPLACE

by

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I have been asked to give you my present perception of the issues raised in our book on The Modern Corporation and, as an economist, I will focus on the second theme of this conference, the power of corporations. At the same time I will keep in mind the extent to which the separation of ownership and control increases that power. Also in speaking of corporate power in the marketplace, I want to make it clear that I am not concerned with monopoly power. Our book does not even list monopoly in the index. Rather I am concerned with the market power which arises naturally when there is active competition among a few large independent corporations and is reflected in the pricing discretion in the hands of individual competing enterprises.

Part I

The Basic Change in the Structure of the Free Market System

As you know, the central aim of our book was not to give answers to the basic issues we raised but to present a realistic framework to replace the framework of the conventional picture of economic life so skillfully painted by Adam Smith in 1776, and which still provided the basic framework for the conventional wisdom fifty years ago.

At the time Adam Smith wrote he was well justified in championing competition among the many small producers of his day as the great coordinator of production and distribution. The individual small producer tended to have no significant market power over the pricing of his product; prices were determined by the invisible hand of market forces; and the free market system not only tended to direct resources into optimum uses in the long run but, more important for present purposes, it provided an automatic mechanism tending to maintain full employment through the flexible adjustment of prices. If general demand fell and the total money stock remained constant, a fall in the price level would automatically increase the real buying power of the money stock, thereby stimulating real demand and restoring full employment at a lower level of prices.

Then the Industrial and Corporate Revolutions gradually altered the structure of the free market system by transferring much of the task of coordinating productive activity from the marketplace to the administrative actions of the managers of corporations.

This gradual shift from market to administrative coordination had two profound effects. First, it gradually increased the productivity of both labor and capital so that the average level of living rose greatly over the years.

Second, it undermined the ability of the free market system to maintain economic stability. It gradually substituted a radically different kind of competition for that relied on by Adam Smith. So long as prices were set by the market, they were highly flexible since no one producer could expect to influence a market price ruled by the equating of supply and demand. But as corporate production increased, this had the natural and legitimate effect of increasing the role of markets in which competition was between a few independent competitors who thereby obtained some degree of pricing discretion. An individual management could estimate its costs and the probable demand for each of its specific products and then set its price in the light of what it thought its few competitors would do if it set one price rather than another. Or it would adopt the price set by a price leader. In either case, the price would usually be set by the seller so that it would tend to be held constant for a period of time and a series of transactions. Under this different kind of competition, prices were set by the visible hands of competing managements and could only perform the function of directing a nation's resources of labor and capital into optimum uses <u>if close to full employment could be maintained for the economy as a whole.</u> But this is what the free market system cannot do if too large a proportion of prices behave in a non-classical fashion.

By the time our book was published, the conventional wisdom had registered the great increase in potential productivity due to the corporation but it still clung to the view that the free market system would operate automatically to eliminate excessive unemployment of labor and capital. Yet at that time a significant part of the country's industrial plant was idle and a quarter of its labor force was unemployed. Clearly a new framework was needed within which to work out the economic issues and policies for that day.

<u>Market Power in the New Framework</u>

As I now read what we said at that time, I continue to believe that the most important <u>economic</u> conclusion we reached is in the chapter on <u>Concentration of Economic Power</u> where we said in our fifth and final conclusion on "economic power":

> Competition has changed in character and the principles applicable to present conditions are radically different from those which apply when the dominant competing units are

smaller and more numerous. (p. 45)

And I fully agree with our final conclusion that the Modern Corporation has wrought such a change in the free market system that:

> New concepts must be forged and a new picture of economic relationships created. (p. 351)

In our book we provided the new framework when we showed that by 1930 roughly three quarters of the business wealth of this country was held by corporations; that practically half of this corporate wealth was controlled by the two hundred largest; that a substantial part of this wealth involved a separation between ownership and control; and that the free market system had shifted from one dominated by markets in which competition was among the many to a system compounded of such markets and markets in which competition was among the few, with significant market power in the hands of management.

But we did not go much beyond these concepts to answer the basic question of how such an economy, with a significant part of its industrial plant and manpower already idle, could be returned to health. What could take the place of the classical automatic corrective of free-falling prices as the mechanism to maintain high employment of resources?

Part II

<u>New Market Concepts for the Pre-War Period</u>

When I turn from my present perception of what we said with respect to market power and consider the new concepts which grew directly out of this new framework, I have no hesitation in saying that far and away the most important new economic market concepts were the concept~~s~~ of an

Hoover Error

"Administered Price" and the concept of "Administrative Competition." The first can be defined as a price set for a period of time and a series of transactions. The second is a non-classical form of competition in which there are so few independent competitors that individual competitors have a significant degree of pricing discretion so that setting prices becomes an active function of business administration.

The difference between classical and administrative competition can easily be seen in the difference between the markets for farm products and farm implements.

What makes these two new concepts important is that they alone are sufficient to explain not only why, in the 1930s, the automatic corrective of Classical Competition could not work, but also provided an alternative mechanism which could maintain high employment in a way consistent with the free market system.

This problem and a solution were clearly brought out in a 1934 paper on "Price Inflexibility and the Requirements of a Stabilizing Monetary Policy," which I gave before a joint session of the American Statistical Association and the Econometric Society.[1] There I first publicly introduced the concept of an administered price and gave extensive statistical evidence that there were two quite different types of competitive market, Hosier Firor
one in which prices changed frequently and were highly flexible and one in

which prices changed infrequently and tended to be inflexible. This can also be seen in Chart I.

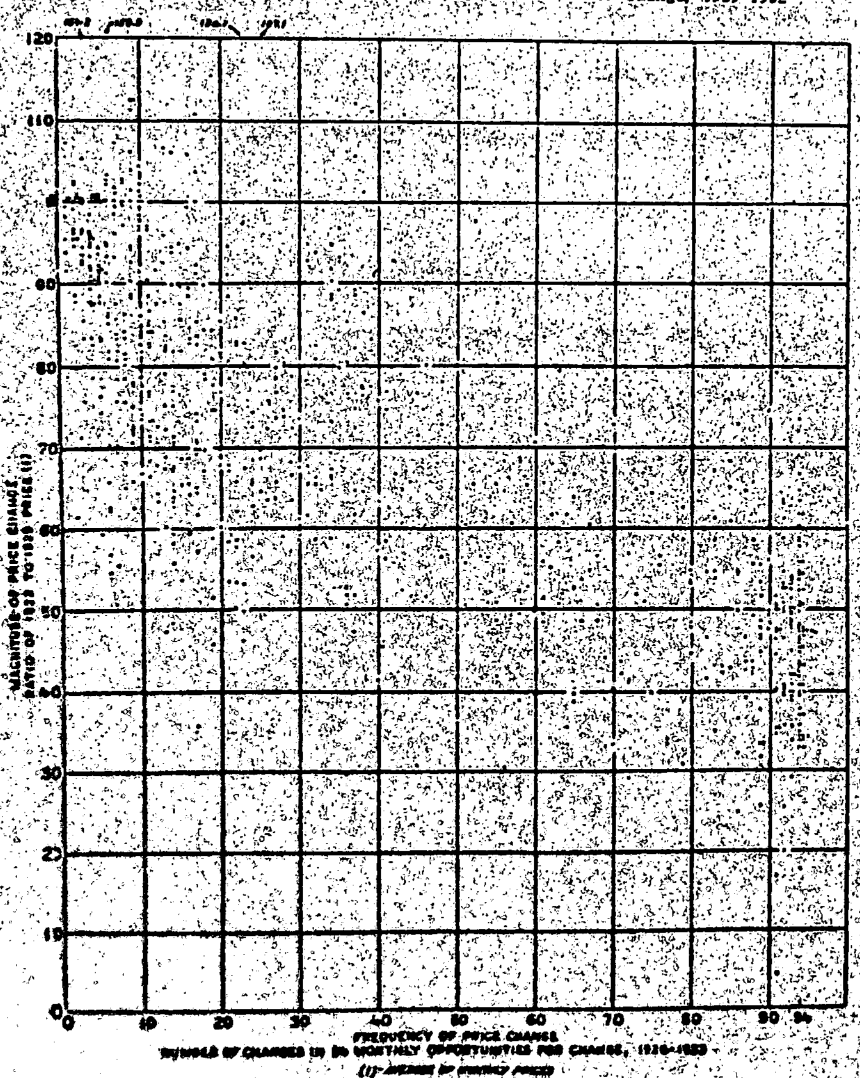
Basically the paper said that if you have a national economy in which all production is sold in classically competitive markets, the classical automatic can operate when demand falls. But in an economy in which roughly half of production is sold in administratively competitive markets, there is no automatic corrective because only half of prices will fall in a classical fashion

while half will drop insufficiently to correct the fall in real demand, thereby creating persistent unemployment and a distorted price structure. However, in these circumstances, an expansion in real aggregate demand by other means would operate to raise classically competitive prices, raise production and employment in administratively competitive markets and, if sufficient, lead to a restoration of full employment.

Chart I

RELATION BETWEEN FREQUENCY OF PRICE CHANGE AND MAGNITUDE OF PRICE CHANGE DURING DEPRESSION. DISTRIBUTION OF 750 PRICE SERIES INCLUDED IN B.L.S. WHOLESALE PRICE INDEX

By Frequency of Price Change and Magnitude of Price Change, 1929–1932



From: Journal of the American Statistical Association, 1935, p. 404

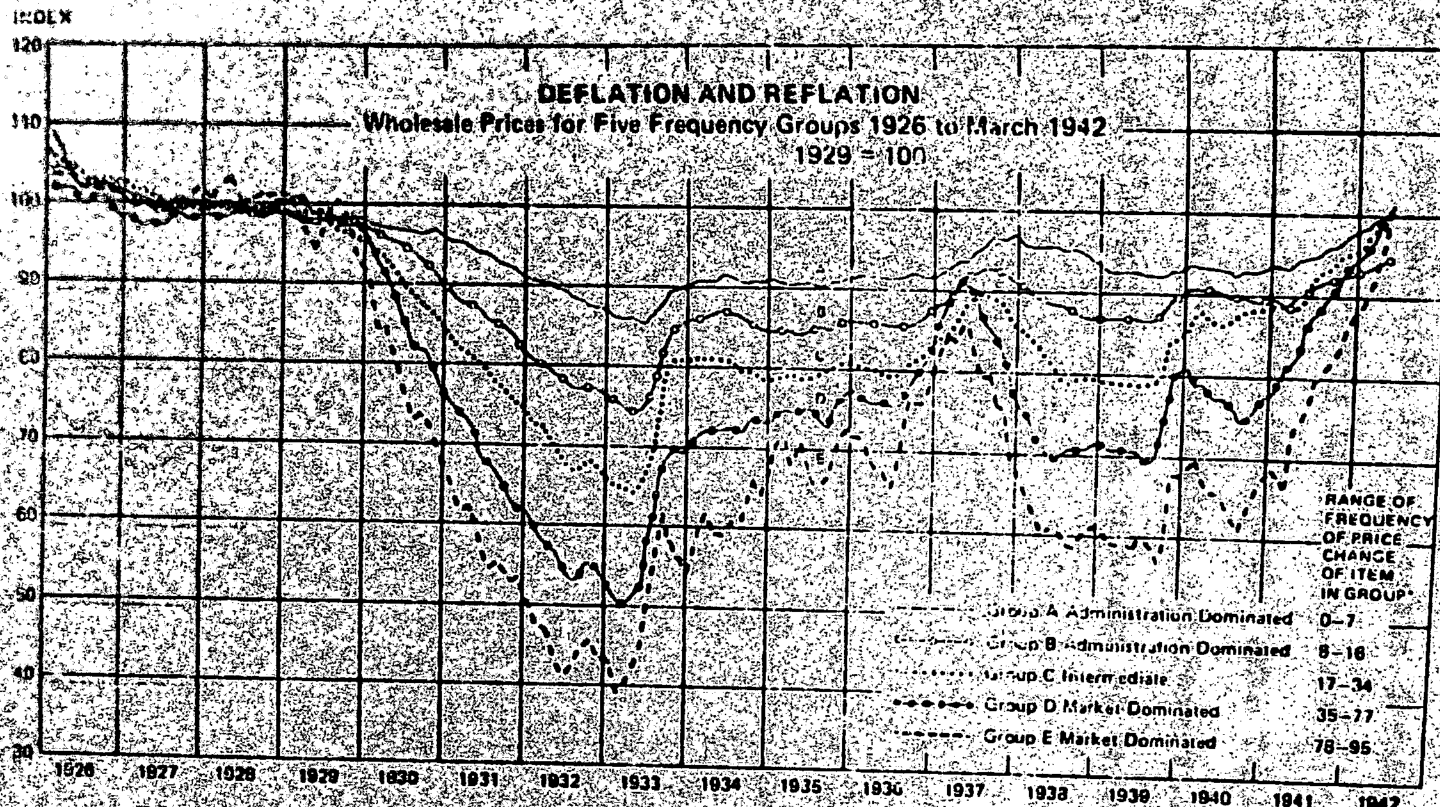
As I look back on this 1934 analysis, I would now modify it in only two important respects. First, I would add Keynes's deficit spending to my monetary expansion as a possible but not a necessary way for government to expand aggregate demand when there is excessive unemployment. Second, I would point out the new kind of inflation which we have been experiencing over most of the period since 1955 and say that the 1934 analysis does not cover this new phenomenon.

Here I will discuss the role of market power, first in the recession and recovery from 1929 to 1942 and then in the more recent experience with the new phenomenon of inflation and recession at the same time.

The Recovery from the Great Depression

In the long period of recovery from the great depression, the basic analysis of the 1934 paper receives a remarkable confirmation. By 1942 not only did the substantial unbalance between classically competitive and administratively competitive prices disappear, but also the wholesale price level at full employment in 1942 was almost exactly the same as at full employment in 1929. This is shown in Chart II.

Chart II



*Price indexes are for 731 items included in the B.L.S. wholesale price index grouped according to frequency of price change in the months of the period 1926-1933.

From: Roots of Inflation, by Gardi er C. Means, et al., New York, 1975, p. 9.

During this period there was great confusion as to recovery policy. This confusion in policy was finally resolved. In place of the classical automatic corrective of a general fall in price level, an increase in aggregate demand was generated by a combination of monetary and fiscal measures stimulated in part by war demand. This produced the same full-employment price level as before the recession and reversed the distorting decline in flexible prices. The success of this basic shift in policy lead to the enactment of the Employment Act of 1946.

Part III

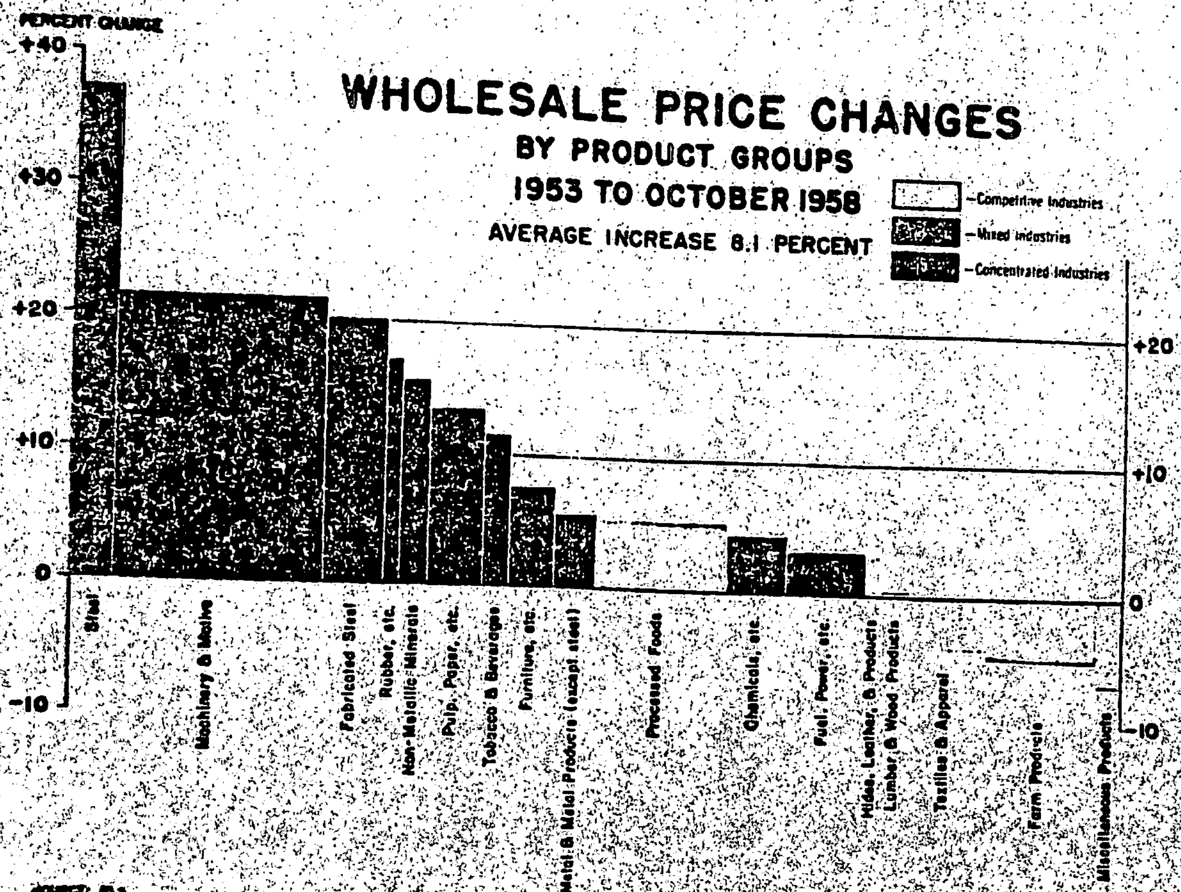
<u>Structural Change and the New Type of Inflation</u>

When I turn to the role of Corporate Power in the Marketplace during recent years, I find that the creeping increase in the role of Administrative Competition has passed a critical point in changing the structure of the free market system and suddenly brought us a new type of inflation with prices rising sharply in recession.

The conventional wisdom holds that any sustained inflation "always and everywhere comes from too much money chasing too few goods." Yet, if this were true it would mean that simultaneous inflation and recession would be impossible. One could not have too much demand for goods in general and too little demand for goods in general at the same time.

Yet in each of the four substantial recessions in the last dozen years, <u>prices rose substantially while demand fell</u> substantially. Most of the inflation in these four recessions represented not "too much money chasing too few goods" but "too little money chasing goods on well stocked shelves." Obviously, in these recessions, more prices by weight, were rising than falling. I have called this new type of inflation "Administrative Inflation" because it arises from the behavior of administered prices.

Chart III



From: Administrative Inflation and Public Policy, Gardiner C. Means, Washington, 1959.