Important Problems in the Economics of the Firm.

By Melvin G. de Chazeau*

Since economic theory broke the chrysalis of its traditional absorption with the conception and assumption of a tendency toward a full employment equilibrium under such competitive conditions, considerable progress has been made in the accounting and the analysis of aggregate national behavior. Within the framework of national income accounting, aided by the use of economic models, we have done much in research, in clearer definition of variables, and in the analysis of reciprocal relations among such variables, to derive a clearer picture of the flow of income through the economic system and a practical understanding of what is required in government and in private policies if we would succeed in maintaining a high level of productive employment. Here, theory and its practical application merge in a fruitful purpose which has been realized to an important degree in the work of the President's Council of Economic Advisers in the United States.

The theory of the firm has not progressed in anything like the same degree. Since Edward Chamberlin's *Theory of Monopolistic Competition* and Joan Robinson's *Imperfect Competition*, at least, we are aware that product differentiation and fewness of sellers have consequences for management behavior other than those contemplated either in the theory of pure competition or the theory of monopoly. To allow for the alternatives that real markets provide, we have drawn an artificial, and largely fallacious, distinction between "price" and "non-price" competition and policy. And we continue to construct our geometrical exercises and to premise our reasoning on an assumption of profit maximization that is widely belied in short-run markets and baffles all concrete, useful formulation as a long-run concept.

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Meanwhile, in the United States at least, private management has developed an intense interest in economics and economic analysis since World War II. This is especially true of the management of our larger firms. One reason for this concern is the growing sense of "social responsibility" which develops with the general recognition that business fluctuations, inflation og deflation, are not inevitable but are at least partially attributable to short-sighted private action. In this context, there is a new note of justification of management policies not only to buyers and suppliers but also to organized labor, to government, and to the general public. Both the policy itself and its justification tend to rest more heavily on an economic analysis of trends in the economy and of costs within the firm.

A second reason for the new attitude is found in the increasing size and complexity of firms serving mass markets. Decentralization of management responsibility on a product-line basis has often become essential to efficiency. The separate divisions of many large firms are to all intents and purposes separate business enterprises with a common financial leadership, centralized staff and general policy-making functions. Such an organization must establish standards of performance for control purposes and for efficient operation. These (short- and long-run) and of market potentials as well as a detailed analysis of costs. Economic analysis becomes a central staff function for appraisal, for planning, and for policy making.

Many other pressures are forcing management to give increasing attention to economic considerations, especially to the long-run impact of its decisions. Among them, the more prominent are the upward leverage that organized labor in a full-employment economy can give to wages and especially to so-called "fringe" benefits, to private retirement pensions, and, more recently, to the guaranteed annual wage; the squeeze that can be imposed in the light of such partially fixed cost increases through active government pressure on firms to hold their prices well below the market-clearing level as a defense against inflation; the adverse discrimination that could result from depreciation allowances or inventory valuation methods that fail to reflect replacement costs and the lower value of money in the face of high corporation income taxes; the rising level of fixed costs as automation becomes a necessary method of production if competitive position is to be maintained or improved. These and similar forces have compelled management to extend its planning outlays, and to rationalize (usually by way of the firm's Annual Report to its stockholders) these considerations in a manner designed to con-

vince its own labor and the general public that a reasonable profit is essential in order to maintain and to improve productive efficiency and real standards of living.

It is of great social importance that this emphasis on economic analysis should continue, primarily because it makes for a possible acceleration and a surer and smoother rate of change in the dynamics of a private enterprise system. We are accustomed to measure economic progress and the conditions of economic progress in physical terms: in the amount of capital or the aggregate horsepower per worker, in the volume of savings, in the output per unit of input, etc. Still, we are all aware that the most valuable assets of a firm seldom appear in its balance sheet. Physical assets have a value greater than scrap because of intangibles like executive organization, technical "know-how", consumers' acceptance of a brand or trade name or manufacturer's label, and an efficient working team. In the same way, the crucial resource for economic progress is creative thinking at all levels of a productive organization. Managerial economics, by clarifying and quantifying relevant considerations and relevant alternatives in business decisions, may stimulate and assist in more effective creative thinking.

But those who use, and more particularly those who teach, managerial economics are continually faced with problems of interpretation and of concept where the theory of the economics of the firm seems either inconsistent or inapplicable to the situation with which they must deal. In bringing some of these to your attention, I will not comment on the very real difficulties in marshalling pertinent economic information for the guidance of business decisions. Management must be oriented toward a future of substantial uncertainty. The truly relevant considerations are, of course, future prices, future costs, and future markets and there is no economic or statistical device that can penetrate with certainty the veil of the future. There are better and poorer ways of forecasting pertinent trends; but this common problem for all economic analysis in the business field is not at issue here. Nor do I want to spend any time on the old fallacious bromide that "it may be true in theory but it isn't true in practice." Our real problems derive less from the complexity of individual behavior than from the inapplicability or the basic limitations of the premises on which our theories are based. It is to this failure of our premises to approximate actual market situations that I would focus attention.

Among the problem areas that might have been selected, I have chosen three fairly broad ones for comment. First, I shall consider the

motivations of management in the large private corporation. In the light of this discussion I shall want to comment on the meaning and significance of business policy decisions. Second, I shall take up some of the questions raised by attempt to analyze demand, especially in high employment and high standard of living economies. Finally, I want to say a few words about the practicability and usefulness of cost analyses in the presence of a growing weight of common and of fixed costs. I do not have the solutions for the problems raised–some may not be amenable to solution in the ordinary sense of that term; I seek rather to promote a wider and more critical study of these matters.

A. Motivation of Management and the Nature of Policy.

The major trouble with our theory in this area is its gross oversimplification (to the point of falsification) of what goes on in actual market situations. This is bad enough when it takes the form of an alleged analysis of price-making forces in terms of the geometry of monopolistic competition, oligopoly or monopoly in the presence of the pervasive theory of profit maximization. There is at least meaning in a elasticity of demand in a market situation. But in the personal context of markets dominated by administered prices–the only situation where motivation is relevant–the operator who gives no thought to the future is hard to find and the large firm that rations its output rather than let price reach its full marketclearing height is almost typical.

Profit maximization cannot be made an effective analytical tool if, even in the short run, its application must be hedged by reservations that cannot be weighted. And as a longrun principle of motivation, it loses definable analytical content and becomes a specious tent to cover our ignorance of an indefinite number of contradictory ideas. If the profit motive means that we will choose the greater rather than the lesser good after weighing all the alternatives we are acute enough to recognize and all the time periods we are wise enough to envision, it may be true; but it is a principle of no analytical value.

There is a more subtle (and dangerous) impact of oversimplification of the decision-making process which stems from our traditional emphasis on price (a natural focus of pure competition) and our carry-over of this emphasis into areas of so-called administered price determination and price policy. Many of us, who have tried to find out what businessmen actually do in this area, find ourselves at odds with reality because

of an arbitrary distinction between price and non-price methods of competition. And by trying to probe price policy in isolation, we may inadvertently put into the mouths of our respondents "explanations" which are little more than reasonable rationalizations of a process much more complicated than our simple questions can probe. This may be an important reason why surveys of business practices in setting prices so often indicate that the most pervasive method is to add a margin for profit on a cost estimate–so-called "cost-plus" pricing. Such pricing "methods" may be less a description of the process than a reflection of a common standard of "fairness" which calls for justification in terms of cost. As often as not, the price may determine the permissible cost (including product design, materials, manufacturing methods, distribution, sales terms, and a host of other concommittant variables) rather than actual cost setting the price. In practice, the cost-plus formula may be no more than a rough guide to transfer prices among divisions of the firm and to responsibility and performance of such divisions.

We sometimes forget that, when there are alternative ways of increasing sales or improving competitive position, price is but one, and not necessarily the most effective, may to realize the purposes of the firm. Such alternatives are always at hand in the area of administered prices with which alone we are concerned here. Indeed, the important point here is that there probably is no such thing as a price policy apart from things like sales promotion, distribution, quality improvement, manufacturing design, terms and guarantees, etc. that make up the bundle of services called the "product."

If pricing decisions are difficult to fathom, the essence of what we call "policy" is even more baffling. Here it is possible that we may be seeking from businessmen something that does not exist in their minds in a form that can be specified or quantified. Policy may be a vital force in the conduct of the firm even where the firm's objectives have not been reduced to words. Procedure for the guidance of staff will often reflect an aspect of policy; but the objectives of the firm–the status it would achieve in its industry, the satisfactions it may permit as a field of endeavor, the prestige and power that it is expected to bestow–are likely to be largely intangible and inchoate. Where this is indeed the case, the researcher's attempt to force management to formulate a policy may produce no more than an acceptable though honest rationalization. We seldom know our own motives in anything like the specifics in which we are prone to explore business policy.

In the circumstances I have described, price resarch and price analy-

sis become heavily weighted with qualitative judgments. Results are not only less definitive but their significance for public policy is also clouded. The analyst of markets governed by pure competition among standardized products seldom suffered such qualms. Price changes could be assumed to reflect public interest; indeed, it was through the price mechanism that a private enterprise economy distributed equitably the benefits of human ingenuity in lower cost and better quality. When competitive forces are diverted via product differentiation into other services, there is no such assurance. The services added to the product may or may not constitute a real price reduction for the buyer. True, there is often a limit to any loading of services beyond which price competition again breaks out: there are recurrent "price wars" in the sale of gasoline at service stations; resale price maintenance tactics in the sale of consumer durable goods is undermined through cut-price supply houses; the negotiation of a "turn-in value" for second-hand automobiles against the purchase of a new car or even of old automobile tires against the price of new tires may upset or revolutionize the price structure. But such sporadic or undercover competitive tactics have dubious social consequences. Advantages of purchase may be inequitably distributed in response to the power or the special "know-how" of buyers. Private power, not policed by the objective forces of market competition, undermines our faith in the healthy functioning of private capitalism.

On the other hand, the development of mass markets in the United States has evolved an organization that approaches the effective socialization of the large, privately owned corporation. As early as the Twenties, the expanding demands of American markets had already begun to exceed the ability of wealthy families to provide the necessary capital or the specialized leadership. To meet the first need, there developed the broadly based corporation dependent on the general public for equity funds; to meet the second, a new professional management was trained to supplant the traditional owner-entrepreneur. Many profound effects stem from this new direction of growth. Most obviously, the firm that must look to a wide public for investment support will need to list its securities on important stock exchanges. This alone imposed a need for more information about company operations, required first by the Stock Exchange itself as an incident of listing the stock and subsequently in much greater volume and detail by the Securities and Exchange Commission as a condition of the issue of new securities.

The full impact of professionalized management on the policies and practices of corporations which are widely owned, has not yet been

adequately analyzed and, indeed, has not yet fully developed. Certainly, in many ways, the results, or probable results, are debatable. I will confine my own suggestions to those trends that have struck me most forcefully in my studies of business practices and business organization. The comparative frankness of American management with regard to the operations of the firm owes much to the growth of professional management. It is not just that such managers have been more broadly trained in the reciprocal values of better industrial data. It is also important that an employee management must justify its plans and its operations in a sense never contemplated by owner-operators of earlier years. And especially as the firm grows in size and in complexity, a hired professional management must become increasingly the arbiter among a wide scope of interest groups that have important but conflicting claims on the firm. These comprise not merely the various divisions within the firm itself; they also include the interests of shareholders as compared with consumers, with suppliers and distributors, with workers, and especially organized workers, with the community in which the firm operates, with goverenment authorities, and with the general public where its actual and potential "owners" are to be found. This complex of pressures has done much to enlarge and to improve information available with respect to the operations of the firm. Much attention has been given by many corporations, for example, to a recast of the firm's Annual Report to Stockholders and especially to simplification of its terminology. It is not merely that stockholders include a growing proportion of American workers; it is rather that the Annual Report, widely distributed to interested parties, has become a strategic policy for the formulation and rationalization of the objectives and practices of the firm.

These tendencies are reinforced by the growing complexity of the large firm producing highly differentiated products in many markets. As we shall see, enlarged investment in durable equipment and a growing proportion of costs that are relatively fixed (in part by investment decisions like those involving automation, in part by labor contracts imposing enlarged fringe benefits and guaranteed annual wages, in part by expectations of the community that may be dependent on the firm for its livelihood), force management to weigh many factors other than immediate profits and to extend the perspective of its decisions over a longer period of time. In the multiproduct firm, the profit or loss of a single product operation, even more that of some aspect of a single product operation, tends to become submerged in the averages of the firms' total results. Management, therefore, is largely freed from the

leverage of short-run specific results. It can focus its energies and its creative imagination on the longer range and wider angle impacts of company policy. For an employee management, compensated primarily from salary, these broader concerns are most compatible with its position as arbiter of conflicting interests. Its situation, therefore, makes it more sensitive to, and more able to heed the dictates of, those "social responsibilities" which changing standards of social performance impose on the behavior of private capitalism.

What is the net result of all this? I have tried to show how the development of administrative pricing in the modern corporation has destroyed the value of the theoretical assumption of profit maximization and the isolation of price policy from the viewpoint either of analysis or of understanding. Indeed, I suggested some forces which seemed to be in process of submerging the profit motive beneath the implications of a broad band of considerations that might be summed under the phrase "social responsibilities." But at the same time I stressed the qualitative uncertainty in which this new competition leaves the subject, more especially with regard to its public statesmanship, no matter how beneficently motivated it may be, as a substitute for objective competition. It is the power which the firm can exercise, or is suspected of being able to exercise, that taints the significance of its behavior. In this situation, I suggest that we are not really concerned with motivation at all: we can certainly assume that the great majority of mankind has a healthy regard for its own self-interest. But we are very much concerned with power, with the exercise of that power, and with the forces that forbid or modify the exercise of that power. And here, perhaps, is a unifying approach to the study of the firm. Empirical analyses of the limitations on the freedom of management decisions, which are only partially economic in character, could contribute importantly to our knowledge of the competitive process, whether or not they also permitted a reformulation of the economic theory of the firm.

B. The Analysis of Market Demand.

Most businessmen, as you problably know, think of the aggregate market demand for their class of products as probably price-inelastic in the short run. Where products are durable as well as being differentiated, the apparent impact of price on sales may be completely submerged in the dynamic forces of change that do appear to govern sales, like expectations regarding employment, income, or prices. These

factors are difficult enough to isolate under any circumstances, but they become most unmanageable where purchase is complicated by replacement. The automobile is the well-known illustration: a necessity for modern living although the purchase of a new car remains very much a luxury. C. F. Roos and Victor von Szeliski made the classic study of the "Dynamics of Automobile Demand" for the General Motors Corporation in 1938. They found some twenty-eight important variables that affected the sales of new automobiles. But even if we ignore all but the seven or so which were considered most important and which were through graphic correlation to quantify their relative importance in sales, so many determinants would be of practically no value for the projection of company sales and for the formulation of company policies. Dynamic factors which could change their relative weights in accounting for future sales; and the successful application of the demand formula to the projection of demand for sales would require a perfect projection of each of these independent variables. Such complexity is usually out of the question for a private company: the cost, the time, and the basic inadequacy of data all require some more simple, if less accurate, approach.

This instability in demand associated with the inventory af services represented in the durable good, has become a major concern for stabilization policy since the war. In the prewar, the relation of consumers' expenditures to disposable income was sufficiently stable to be used with confidense in estimating consumer savings and the gross national product. In the high income, high employment market of the post war, perhaps as a reflection of the growing proportion of durable goods in consumer hands, changes in the rate of saving and thus in the volume of consumers expenditures have shown considerable independence of the relative size of disposable income. In short, here as in the case of private capital outlays, it has been necessary to supplement other sources of information with an attempt to discover how consumers plan to spend their incomes or their liquid resources on important classes of consumers durable goods.

At one time we thought we found significant meaning in Joan Robinson's definition of a product as "a break in the chain of substitutes." But with the growth of mass markets and more particularly with high employment income, it becomes increasingly difficult to determine what is a "product" and what is therefore the "market" in which competition of substitutes will help to determine price.

In the competition for this new purchasing power in the hands of

consumers, who in aggregate hold so large a proportion of durable goods that it has been estimated that new purchases of newly produced goods could be reduced 40 per cent without any real reduction in the income of services, the practical significance of a break in the chain of substitution is being gradually effaced. Again, the development of the modern automobile in the United States illustrates this trend. In the prewar period, it was probably correct to say that there was less competition between certain makes of automobiles (more particularly between Ford, Chevrolet, and Plymouth as a group and luxury cars like Lincoln, Cadillac, and even Buick) than existed between automobiles and some other kinds of durable goods. But the trend since the war has been to increase the size and power and luxury characteristics of the former group and to adjust toward the same norm the characteristics of the latter group until they can all appeal in an overlapping market sense to the same mass market at a higher price level.

When this trend is combined with the characteristic chain-linking of demand for different types of goods which together contribute some distinctive service characteristic, like the component parts of milady's wardrobe or the composite of products which cater to a leisure-time bias toward fishing, the classification of products, which are in close competition with each other for the consumer's dollar, is expanded in many ill-defined directions with substantial overlaps at innumerable points in the various groupings. Of similar importance in the field of basic materials in the scientific development of alternative processes and alternative materials for the satisfaction of the same type of end product. Here again the area of competitive substitution expands indefinitely from a given "industry" to a combination of industries. In each case, the determination of market area, of competitive forces in the market area, and for the factors governing demand and sales characteristics for a given product is made much more difficult.

In these circumstances, the scope for useful application of refined techniques designed to measure the price elasticity of demand is greatly narrowed. Other things are never equal, and the impact of such price elasticity as may exist is often engulfed in the surge of dynamic forces. Even consciously to set up a controlled experiment that would approximate price elasticity is an undertaking that is both costly and likely to prove inconclusive indeterminate. It is necessary in this area that we try to ascertain a more significant grouping of the major variables that affect sales and from these seek a means of selection and weighting that will permit more effective guidance for business policy.

C. The Analysis of Costs.

American management, like management everywhere I suppose, has only gradually been forced by the pressure of circumstances to discover the nature of costs and the uses of cost analyses for the purposes of control, of operating performance, and of business policy decisions in addition to the traditional accounting of income and outlays for bookkeeping and fiduciary purposes. American firms have made substantial progress in the assembly and analysis of significant costs: the derivation and determination of those costs that do not vary with output at all; those that can be made to vary but not in proportion with output, over significant operating ranges; and those that tend to vary in proportion to output. I do not propose to discuss or to appraise this trend in American industry. Suffice it is to say that we have not yet approached a level of performance in this area that approximates achievements in engineering or in technical operations.

I am concerned about certain trends that seem to threaten the applicability of cost analyses and thus to undermine much of what has already been accomplished. Important among these is the growth of common costs in the firm that produces many products in many markets. I refer to common costs rather than to strictly joint costs because it helps very little that common costs are theoretically subject to scientific allocation by varying the proportions in which products are produced. In most cases, and especially under dynamic conditions, it will usually cost the firm more than it is worth to make such experimental changes in the pattern of its output. Common costs are spread throughout a large organization. They are found in physical equipment which can be used for the production of common components or for different products, but they are most importantly found in technical "know-how", in business organization, in research and development, in advertising, selling and distribution, and in similar functions. One of the best illustrations of common cost is the development of consumers' acceptance for the products of a firm and the carry-over of that acceptance to new products and functions that may be undertaken. The ready transferability of productive capacity from one product or product line to another and from one period of time to another, means that the cost allocated to one product or to one time period rather than to another depends principally on judgment. The expansion or contraction of these common costs has little direct or definable relation to the output of a given product.

The second trend, in many ways similar to the first, is the growth of overhead costs which are relatively fixed over time periods. While it is true that the ration of capital and of overhead costs to labor and materials is not overwhelming, even in basic industry today, the spread of automation cannot help but increase the weight of the fixed component in manufacturing costs. Possibly even more important has been the trend toward greater labor security. The demand for private pensions, for various "fringe benefits," for larger severence pay, and more recently for the guaranteed annual wage reflect this demand. That the recent AFL-CIO amalgamation, with the voting of a war chest of $25 million to fight for the guaranteed annual wage, is not a mere jockeging for an advantageous bargaining position, is suggested in the most recent contract negotiated with General Motors. which includes a first approximation to a realization of this purpose. The requirement of increasing security converts former variable costs, that is labor costs, into quasi-fixed costs.

Of similar nature, even though it is not based on contract, is the implicit commitment to communities by the large corporation whose decentralized facilities may be the sole or primary source of income for such regions. This movement, originally initiated to avoid traffic congestion in large cities and perhaps to secure a more docile, less organized, lower paid work force, and possibly to take advantage of lower taxes or other inducements, has boomeranged in the creation of new quasi-fixed costs. With higher standards of reasonable social performance in maintaining high employment, sometimes reinforced by unemployment insurance rates, it is likely to prove extremely difficult to cut back production in such communities in preference to cutting back plants in large cities even where the latter are more efficient. Forces of this kind are restrictive for the policies of a professional, nonowning management than they would be for ownermanagers. The professional employee has no important defense against them. His own self-interest in the development of the firm leads him to weigh the morale of his work force and the reputation of the firm with the general public more heavily than a small increase in short-run profits in which he would share only minimally.

Finally, in the United States, there is a special factor which tends to reduce the applicability of "scientific" cost analysis. I do not refer to dynamic change in technology markets, although this too is a factor in cutting down the fruitfulness of extensive analyses of cost functions that may be rendered rapidly obsolete. I refer rather to the defensive

position in which the large, and especially the large integrated, firm finds itself in view of the antitrust laws. The integrated firm that overlaps several different markets or stages of operation can hardly neglect the profits it may derive from other stages or orther markets while meeting the price established by nonintegrated firms in a given market. Its ability to compete in this given market, therefore, is hardly incontrovertible evidence of its efficiency in that market. Its competitive position, derived partially from its protected position elsewhere, thus rests in part on potential discrimination. Since there is no objective way in which the efficiency of the integratede firm can be differentiated from its strategic (that is, its monopoly) power, there is a tendency for government regulatory authorities to require adherence of policy, especially of price policy, to minimum total costing standards based on some arbitrary allocation of overhead. These standards of "fair price" based on some arbitrary allocation of total costs threaten to supplant standards of comparative contribution over variable costs, based on a more scientific cost analysis, as a guide to policy.

D. Conclusions.

I have tried to show that in his approach to planning and to decision-making, the professional manager of a modern, widely owned corporation in the United States is not too differently placed from the economist or the government administrator. Circumstances are forcing business executives of the large corporation to be increasingly concerned with the long-run implications of their current decisions and with the long-run status of their firm within the economy. Even production decisions, while more closely oriented to short-run market prospects, impose commitments which force a longer perspective. Increasingly the manager is forced by the nature of his costs, more particularly the growth of quasi-fixed costs which are not proportional to output, to determine issues and form policies which can be only generally related either to costs or to demand analyses. Increasingly, he is driven by considerations that are only indirectly related to any meaningful concept of maximization of profits. More generally, the crucial area of business decision and business planning takes on the characteristics, like those of investment programming. There is need here for a fresh viewpoint to comprehend the new forces which condition investment planning and investment decision in the post-war economy.

If economics is to be effective in directing or in interpreting the

forces which are at work in modern markets, it must approach the problem of competitive behavior from a more realistic viewpoint. A study of market structure cannot be avoided but the categorization of market structures in the well-worn niches of pure competition, monopolistic competition, oligopoly and monopoly must be recognized as no more than a theoretical hunting ground for questions which need to be answered in the real world. Analysis of such type situations will not and cannot give answers to real economic problems since it is doubtful that they represent to a significant degree the operation of real markets. Real markets are more likely to constitute a spectrum of situations in which the economics of production and distribution and the impact of social and economic standards (reflected in pressures from organized labor, from government, from community, and even from public opinion), constitute varying limitations on the exercise of power attributed to the corporation. We must enlarge our concept of competition to include not only the alternatives to price change which the producer of a differentiated product enjoys but also the alternatives to self-serving action which the institutional framework of modern business behavior may impose.

To me, these considerations are both encouraging and discouraging. They are encouraging in the sense that they imply that the large firm will not and cannot afford to exploit the full potential of its market position. This is what I implied by the socialization of the large private corporation. They are discouraging in that they suggest that the impact of market forces on business decision is dulled and the actions of business executives tend to be governed by other than measurable economic forces–call them strategic or social or "business statesmanship." Society has not yet developed an effective mechanism for the guidance of such private governments nor an accepted theoretical framework within to appraise their social contribution. To do so, as I see it, is the real task for economists in the future.