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Economics and the public purpose: Some discussion points related to chapter three of John K. Galbraith's homonymous book

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"ECONOMICS AND THE PUBLIC PURPOSE"

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Some Discussion Points Related to Chapter
Three of John K. Galbraith's Homonymous Book

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Hans G. Monissen

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"Economics and the Public Purpose"

- Some Discussion Points Related to Chapter Three of

John K. Galbraith's Homonymous Book - ⁺

by Hans G. Monissen, University of Konstanz

The Issue

When Harold Demsetz reviewed Galbraith's The New Industrial State, he stressed the author's remarkable talent "to rally popular support for ideas not now popular" (Demsetz, 1968, p. 802). Without questioning this view by entering into a detailed analysis of the characteristic features of the demand and supply conditions of the competitive market for ideas and beliefs, we suspect that Demsetz laid too much stress on Galbraith's powers of persuasion and thereby strongly underrated Galbraith's superior ability to know the market conditions for his products and to react to the demand functions of his consumers. We think it is not too far-fetched to classify The New Industrial State as a major reference handbook which articulates, supports and manifests the otherwise unstructured cultural uneasiness of his typical reader. This view in fact helps to explain how Galbraith can afford to reserve almost one third of his new book Economics and the Public Purpose for summarizing with only minor modifications and ramifications his main views expressed earlier in

⁺ Paper presented at the "Analysis and Ideology" Conference at Interlaken, June 1974. This paper and an accompanying paper by Gérard Gäfgen, University of Konstanz, dealt with some major economical and political issues raised by John K. Galbraith latest book. The paper by Gérard Gäfgen "On the Methodology and Political Economy of Galbraithian Economics" is scheduled for publication in *Kyklos*.

The New Industrial State (cf. Galbraith, 1973, pp. 81 - 175).

This section is entitled "The Planning System". In our opinion, this is the most important part of Galbraith's latest treatise on problems of our time. Understanding the Galbraithian notion of the workings of the planning system is a proper starting point for a more general assessment of his broader vision of the workings of the capitalistic industrial society and his proposals for socio-economic reform. There is another reason for concentration on one particular part of Galbraith's book. Because his literary sphere of activity spans more economical and political issues than an average social science faculty could handle, a discussant has no other choice than to comply with his intellectual idiosyncrasy by being selective.

Our discussion relies on the thematic structure of Galbraith's book but we have chosen headings suited more for a general summing-up. . Even at the risk of being repetitive, we thought it worthwhile to summarize the major ideas presented before taking up some specific points.

The Structure of the Industrial Economy: An Overview

(Galbraith, chap. three, IX)

As Galbraith diagnoses, our modern economy is shaped and structured according to the interests of a small group of giant corporations - "the world of the few hundred technically dynamic, massively capitalized and highly organized corporations" (Galbraith, 1971, p. 28) - which perform society's planning function. For

¹⁾ For these and related issues compare G. Gäfgen, op. cit.

obvious reasons, Galbraith calls this sector the planning system which should be contrasted with the market system ¹⁾ - a minor subdivision of the whole economy with some performance characteristics as described by neoclassical economic theory. This state of affairs may be regrettable but Galbraith reminds us not to overlook that this situation is by no means a mere historical accident. Technological imperatives dictate the growth into increasing plant and firm size and industrial concentration. In addition to the "eigendynamik" of modern technology, organizational advantages push the firm size over the level determined by least-cost considerations because ever increasing firm size allows an almost complete control of all environmental variables which includes the firm's costs conditions, technology, output prices, the response of consumers and the possible interventions of the central government agencies. "When the task lends itself to organization, there is no upper limit to the size of the market". (Galbraith, 1973, p. 82).

Borrowing from the work of Berle-Means (Berle and Means, 1933) and Veblen (Veblen, 1921), Galbraith states that the owners of the modern firm - for all practical purposes the stockholders - have lost control over the activities of the management. Group decision-making has replaced the classical Schumpeterian entrepreneur. The effective power is transferred to the whole anonymous body of the executive salaried planning staff - the technostructure

¹⁾ The world of smaller sized firms acting mainly as price takers. Galbraith's definition lacks operational meaning because, at the same time, he admits some monopoly elements guiding their behavior.

as Galbraith christened this group in The New Industrial State by constructing an odd but suggestive neologism. It is interesting to note that top management is completely adjusted to the interest of the lower levels of the hierarchical control pyramid and has confined itself to a mere ritualistic approval of the decisions of the lower ranking specialists.

Galbraith follows his previous efforts in The New Industrial State when he starts by constructing a model describing the development of "the corporate sector" of the economy. The corporate sector is the focal point for a visualized larger model - the dual economy - the characteristic features of our mature capitalistic society. As a pure descriptive starting point it is certainly appropriate to remind the reader that the bulk of our gross national product originates in a few hundred giant corporations. But to "infer" from this a quasi deterministic tendency towards "Brobdingnagian size", as one critic aptly has described it (Adams, 1967 a), and the necessity of a large firm size as a prerequisite for technical progress and efficient production is much too superficial, for it fails to show both analytically and empirically the relevance of the described linkage and, in addition, it ignores the favorable policy climate given by the permissive and accomodating government behavior in the past. Criticism along this line was especially raised by Walter Adams (Adams, 1967 b) and there is no reason to cover these issues once more. But it is interesting to note that Galbraith modifies this historicistic approach

somewhat when he includes in Economics and the Public Purpose a chapter on socio-economic reform ¹⁾.

When Solow charged Galbraith with "big-thinking" (Solow, 1967, p. 1), he certainly had in mind Galbraith's preference for casting his arguments in extremely simple forms by neglecting all structural and institutional details. The actors on Galbraith's economic scene are either aggregated sectors or monolithic management groups tied together in stable intra- and interindustry relations to pursue what he calls their "common protective and affirmative purposes". The reader very often gets the impression that the "planning system" consists of a single giant completely vertically and horizontally integrated firm with a homogenous executive body. This approach is very convenient for it allows a complete discarding of the intricacies of modern relative price theory. In both The New Industrial State and Economics and the Public Purpose Galbraith contests the coordinate function of the market and rejects the working of the price mechanism. ²⁾ In his prior work Galbraith failed to develop a theoretical model explaining the organization of the economic system (Gordon, 1968; Meade, 1968; Sharpe, 1973, p. 45). Galbraith tries to fill this gap in his latest book by referring to a "deus ex machina", the interfirm contract. Lacking any price theoretical foundation, this device, as we will see, is nothing more than a descriptive adhocery.

1) For reasons of the history of economic ideas we should note that Economics and the Public Purpose is not only Galbraith's "summa theologica" but also the direct intellectual linkage to his first major work, his monograph A Theory of Price Control (Galbraith, 1951).

2) It is certainly correct to observe that the institutional framework included in our standard textbooks on price theory - the narrow private property budget constraint - is inadequate for dealing with problems of our mixed economy. But it is certainly strange to conclude from this, as Galbraith does, that price theory per se is useless.

Similar price theoretical difficulties arise with regard to the behavior of the "technostructure". Comprising the executive body of the corporate firm to a monolithic group is the major ingredient for the Berle-Means-theme of separation of stockholders from corporate control. But we should note that neither economic theory nor empirical evidence validates such a procedure (see especially Alchian, 1969). In Galbraith's analysis, the members of the technostructure play their role dictated by their common interests which derive from "their common protective and affirmative purposes". But there is no mechanism defined which could account for deviating (individual?) behavior which, from a strict methodological point of view, means that their behavior remains largely unexplained.

The discussion of the technostructure demonstrates in a striking way that Galbraith adheres to a methodological collectivism, popular for instance in contemporary sociology, which should be contrasted with the methodological individualism as practised by the majority of the economic profession. Our aim is certainly not to degrade the methodological collectivism by drawing a sample of possibly atypical examples from one single written source but to point at an inherent danger of this approach, namely to neglect structural details and to slight individual behavior differences. The issue under discussion is not that technostructures pursue their own interests but that they do this in different ways and in varying degrees. Recent work in economics have taught us that different modes and degrees of discretionary managerial behavior can be systematically and coherently explained by reference to different socio-economic penalty-reward structures or different assignments of property

rights or entitlement rights structures (Alchian and Demsetz, 1973). Whatever the consequences of different institutional arrangements on the allocative efficiency of the economy may be, there is little or at least inconclusive empirical evidence that separation of management from control (whatever this catch phrase may mean) implies that the market value of the total compensation in terms of pecuniary plus nonpecuniary rewards of management in technostucture oriented firms with large stock ownership dispersion is comparatively higher or that the wealth of the stockholder is less guarded (compare Alchian, 1969). This conclusion could be modified if we consider so-called regulated industries and it may well be the case that Galbraith's analysis is strongly influenced by observation stemming from these industries. The above mentioned result is the implication we derive from economic theory if we assume a competitive market for labor (management) inside and outside the firm and a competitive market for corporate control.¹⁾ We exclude the market conditions of the product market from this list because product market competition is a neither necessary nor sufficient condition. It is not necessary, because the issue is the optimal exploitation of a given market position on which both management and/or stockholders may capitalize. It is not sufficient, because a given degree of managerial discretion may be typical for a whole industry.

As a marginal note we should emphasize that Galbraith excludes top management from the actual decision process. The function of the directors is confined to a mere ritualistic ratification of the

¹⁾ This latter control mechanism is discussed in Manne (Manne, 1965).

decisions of the subordinate staff members. Taken to its logical consequence, the argumentation could be applied to any position in the organizational decision pyramid with the surprising result that the lowest level of hierarchical order has the actual power and any higher level has only a ritualistic function. Similar arguments were submitted in Galbraith's earlier book The New Industrial State. But in the same context - and there is no textual evidence that he changed his position in his later writings - he assigns a very crucial and decisive role to the top management group which cannot be reconciled with the above mentioned mere ceremonial function. "... it selects the men who comprise the group that make decisions, and it constitutes and reconstitutes these groups in accordance with changing needs"(Galbraith, 1971, p. 83, italics added). Sharpe is correct when he set forth the inherent contradiction of the dual management role (Sharpe, 1973, p. 50). The very fact of selecting the decision-making body means selecting his own preferred decisions which means that Galbraith's position is reduced to a mere camouflage for an otherwise untenable hypothesis. With regard to the empirical foundation, there is now overwhelming evidence for industries in different countries that a change in top management positions may have a decisive effect on the behavior of the corporation. ¹⁾

Managerial Discretion

(Galbraith, chap. three, X and XI)

According to Galbraith, the modern corporate management pursues its own pecuniary and nonpecuniary interests and not those of its

¹⁾ For a short sample of more dramatic examples for the US compare Sharpe (Sharpe, 1973, pp. 51 - 53).

legitimatizing owners. Given the near omnipotence of the technostructure, it is not difficult to fulfil its major protective interest, namely to secure its own existence. The main possible sources of interventional influence - owners and creditors - are excluded from any discretionary activity by the provision of an uninterrupted level of earnings. A plurality of other instruments is available to exclude also the other major groups challenging the autonomy of the incumbent management. This we will discuss below. Given the guarantee of its protective purposes, the corporate firm can be directed towards the fulfilment of the intrinsic interest of the technostructure, which is the realization of a growth rate as large as possible. Growth serves the direct non-pecuniary and indirectly also the pecuniary purposes of all members of the technostructure. The first strategy for growth is the largest possible expansion of production and sales given the existing plant and firm size, the second strategy is the quite obvious effort to take over existing smaller sized firms.

In Galbraith's theory of the firm model, corporate management seeks to pursue a "panoply of organizational interests" (Galbraith, 1970, p. 473). But these pecuniary and nonpecuniary interests can all be substituted under the most important goal which is to obtain the greatest possible rate of growth of the firm. Galbraith borrows from the work of Baumol and others when he maintains that after earning a minimum rate of profit the firm proceeds to trade off higher profit rates for the prospect of increasing the growth rate of the firm. Galbraith - as Baumol - is mistaken when he thinks that growth rate maximization is the dynamic counterpart of the static model of sales revenue maximization. It is the

latter model to which he refers several times when comparing his analysis with the "old-fashioned" model of profit maximization. The following discussion is addressed to the evaluation of some analytical aspects of the two models referred to by Galbraith: growth rate maximization and sales revenue maximization.

Given any initial state of the firm, growth rate maximization - and this may be, at first sight at least, surprising - requires intra-period profit maximization, i. e. profit maximization in every current and future period given the inherited stock of capital. Contrasted with a firm maximizing profit, a firm striving for growth rate maximization will permanently overinvest - at least under steady state conditions, for which almost all models are constructed. There is a straightforward analogy to the neoclassical growth model which might deviate from the golden rule path because the investment rate is too high. For his own hypothesis Galbraith states an important proviso, namely a necessary minimum rate of profits must be secured. Without any further information about the workings of the capital market, it may well happen that the desired rate is exactly equal to the rate which maximizes the present value of the firm. Galbraith does not specify the mechanism determining the required minimum rate, which means that the reader has to invent his own discriminating test implications.

Recently, Harold Demsetz has designed such a test (Demsetz, unpublished). The result was unambiguous: There is no empirical evidence that there is any relationship between any of several indices of a firm's technostucture orientation to a measure of the trade-off between the average annual growth rate of sales

and the average annual rate of return on equity over the analyzed period from 1958 to 1970. Perhaps Demsetz' analysis includes the wrong test variables. But in this case the real Galbraith should stand up and formulate the adequate test environment. ¹⁾

Almost all models emphasizing growth rate maximization are formulated under steady state conditions, which means that there is no ambiguity with regard to the maximand variable. Under non-steady state conditions there is a whole range of variables offering a choice for the best target. Non-steady state conditions raise another familiar problem. We recall from capital theory that maximizing the internal rate of return on investment leaves the scale of the operation completely unspecified. The same is valid for Galbraith's proposal to maximize "the" growth rate of the firm.

More important, growth rate maximization has no static counterpart. Or, if we state it otherwise, the dynamic counterpart of the static model of sales revenue maximization is not maximization of the growth rate of the firm but maximization of the present value of discounted future sales revenue (see Williamson, John H., 1966). The applied discount rate is a subjective magnitude and not market-determined. This fact does not offer a direct and simple operational test implication. But without entering into the particulars of this model, it is sufficient to note that this model has nothing in common with a model emphasizing maximization of a growth rate. For the most general case, static sales revenue maximization - usually stated under the proviso of a given minimum

¹⁾ There is a theoretical ambiguity in the procedure of Demsetz, for he thinks incorrectly that growth rate maximization is the dynamic counterpart of sales revenue maximization. And it may well be that the latter model does better.

profit restraint ¹⁾ - yields a revenue level and therefore an output level larger than the one forthcoming under conditions of pure profit maximization. And it should be obvious that a model leading to overproduction must be based on different behavior assumptions than a model leading to overcapitalization. It is now up to Galbraith to resolve the contradictions caused by the use of two different models of the behavior of the capitalistic firm.

Sales revenue maximization tries to evade the index number problems associated with defining the output of a multi-product firm, and if we judge from the underlying behavioral motivation of the somewhat technically specified hypothesis of the sales revenue model, i. e. maximizing sales revenue will enhance the power of the technostructure and enlarge the spectrum of pecuniary and nonpecuniary advantages given by an increased capital basis, increased firm size, extended market share etc., we are inclined to assume that the inventors of such models are virtually interested in maximizing "output" subject to a given minimum profit level. We know from introductory price theory that sales revenue and production are usually positively related only up to a certain output level. An output maximizer subject to a minimum profit constraint may push production over the maximum value of sales revenue. But then we have to admit that management relies basically on two different utility functions, one for each branch of the total revenue curve.

¹⁾ An economically somewhat strange hypothesis, because in fact it implies that management is not willing to trade-off a small amount of sales revenue for whatever large amount of current profits offered as a compensation.

Sellers' Pricing Behavior

(Galbraith, chap. three, XII)

In order to avoid the risks and hazards of the market, which is the prerequisite for rational and efficient planning, the Galbraithian firm must be able to control at least the prices of its final products. To fulfil this is not difficult because the size of the corporate firm in its given industry allows monopolistic price fixing. Given the controllability of product prices "their safest recourse is to exercise the initial control not over production with its uncertain effects on price but to fix the price. Production is then accommodated to what can be sold at that price" (Galbraith, 1973, p. 114). It follows from the affirmative purposes of the technostucture that the prices set to foster growth are necessarily lower than the prices set by a wealth or profit maximizing firm. The oligopolistic structure of the typical capitalistic industry requires price-leadership by a dominant firm, for otherwise the uncoordinated activities would be self-destructive. Once more the common protective purposes of all technostuctures involved guarantee a quasi automatic coordination of all major firms to their mutual advantage.

The actors in the Galbraithian world are all price searchers. Of course, Galbraith does not use this term which has some implicit connotations referring to information and adjustment costs. A systematic analysis of these cost items is completely lacking in his writings. ¹⁾ Recognition of

¹⁾ Arbitrary implicit assumptions about the magnitude of information costs, either zero or infinite, are to a large degree responsible for a faithful adherence to the market classification scheme of standard neoclassical price theory.

the existence of these costs would prevent him from reproducing the familiar but definitely wrong clichés derivable from standard static price theory, namely attributing to the activities of so-called "imperfect competitors" the undesirable consequences of too small an output level at too high prices with the result of excessive profit rates and inefficient allocation of the social product. According to Galbraith, technostructure oriented firms modify somewhat this "neoclassical" result because they strive for sales revenues maximization.

Whatever the goal function may be, the decisive factor is that these imperfect competitors control prices. Here Galbraith's position is most confusing: Setting prices says nothing about the underlying search process. Changing prices has the consequence of a corresponding change in the quantity sold. This could be called the power to administer prices. But we should note that from a negatively sloped demand curve per se nothing can be inferred with regard to market power or ability to earn "excessive" profits. "A modern myth has grown up around the 'facts of life' in price-searchers' markets - the facts that their prices fluctuate less than those of price-takers' markets, the prices of the individual firms change at about the same time, and the largest firm usually is a price-leader" (Alchian and Allen, 1973, p. 343 f.). The first phenomenon disappears simply by referring to a lack of any factual evidence supporting the conjecture that price-searchers administer prices regardless of demand and supply conditions, disregarding for the moment the errors in interpreting the underlying statistical data. ¹⁾ The phenomenon that the prices charged change at

¹⁾ For a recent test of this position with regard to technostructure oriented firms compare Demsetz (Demsetz, unpublished paper)

about the same time is the result of an adaptive search process conditioned by the same environmental variables. Finally, from the fact that the largest firm usually initiates this process, it does not follow that it has the power to dictate the prices for the remaining firms in the industry.

The Effects of a Wage Increase - Some Formal Extensions

(Galbraith, chap. three, XII)

Of utmost importance is the controllability of prices because some major cost items, especially labor costs, are not fully within the control of the firm. But the firm has the compensating option that any conflict with organized labor can be resolved at the expense of the buyers of the final products in form of higher output prices. He maintains: "In the planning system... increased wage costs can readily passed on to the public". "Usually the price increase will be more than sufficient to offset the cost of the wage increase, this is because the occasion of the price following the wage increase is used also to rectify the level of earnings in favor of the firm... That price increases usually follow wage negotiations shows, more than incidentally, that profit maximization is not a purpose of the technostructure. If revenues can be increased just after a wage increase, they could, obviously, have been increased well before" (Galbraith, 1973, p. 118). It is usually a dominant firm, knowing both market and industry conditions best, which acts as a price leader and which initiates this adjustment process. We should expect that the strong ostracism of price-competition within a specific industry should open the door for different modes of non-price competitions, especially

advertising efforts. But somehow, a mechanism which Galbraith does not explain is effectively working so that the individual selling efforts will be coordinated to the mutual benefits of all firms in the industry.

The discussion in Economics and the Public Purpose repeats some ideas presented previously in The New Industrial State. Here Galbraith argues that a firm maximizing profits would have no incentive to pass on a wage increase because the wealth maximizing price is already determined. The fact that the modern corporation does pass on wage increases thus disproves - according to Galbraith - the profit maximizing hypothesis. Solow in his review of the book has charged Galbraith with committing a sophomore error: "The ideal textbook firm will indeed pass along a wage increase, to a calculable extent" (Solow, 1967, p. 107). To locate the essence of the dispute between Solow and Galbraith: Both agree about the qualitative aspects of the adjustment, but disagree apparently about the quantitative magnitude, because according to Galbraith the increase will be more than sufficient to offset the increase, a result which is hardly accommodated by any of the familiar models of the firm. ¹⁾

When Galbraith discusses the management goals, he relies on the growth rate maximization model. When he discusses pricing behavior and output decisions, he refers to sales revenue maximization. But even here - as will be clear from the quotations above - Galbraith's analysis is blurred by inconsistencies and mistakes. It is therefore worthwhile to set forth in a brief summary the characteristic

¹⁾ It may be that Galbraith intends to discuss the parallel development between wages and prices during a period of inflationary growth. Given this interpretation, the description will simply beg the question.

adjustment responses of some more familiar models of individual firm behavior, both of the entrepreneurial and managerial type, related to a general change in one of the environmental conditions, a change in the wage rate (see table 1 and 2 below). As mentioned, we reject Galbraith's model of the price-setting firm for explaining the price structure of a specific industry. But it is possible to generalize the analysis to the case of price-leadership by an appropriate reinterpretation of the revenue function and to use the results as a simple test of logical consistency.

Table 1: Some Simple Models of the Individual Firm

Entrepreneurial Models

Profit Maximization:

$$1. \pi = R(q, A) - C(q, \bar{w}) - A$$

$$R_q > 0; R_A > 0; C_q > 0; C_{\bar{w}} > 0;$$

$$R_{qq} < 0; R_{AA} < 0; C_{qq} > 0;$$

$$R_{qA} > 0; C_{q\bar{w}} > 0;$$

Sales Revenue Maximization Subject to a Minimum Profit Constraint
(Galbraith's model):

$$2. \text{Max}_{q,A} R(q, A) \text{ subject to } -R(q, A) + C(q, \bar{w}) + A \leq -\pi^0$$

Output Maximization Subject to a Minimum Profit Constraint:

$$3. \text{Max}_{q,A} q \text{ subject to } -R(q, A) + C(q, \bar{w}) + A \leq -\pi^0$$

1) To generalize the analysis to a model of price-leadership we could assume that the revenue function includes the reaction functions of the rival followers in the industry.

Managerial Models

Two Modified Versions of the Williamson Model (Williamson, Oliver E., 1964):

$$4. \text{ Max}_{q, S, A} U(S) \text{ subject to } -R(q, S, A) + C(q, \bar{w}) + S + A \leq -\pi^0$$

$$U_S > 0; R_S > 0;$$

$$5. \text{ Max}_{q, S, M, D, A} U(S, M, D) \text{ subject to } -R(q, A) + C(q, \bar{w}) + S + D + A \leq -\pi^0 \quad 1)$$

$$U_S > 0; U_M > 0; U_D > 0;$$

A Modified Version of the Ames Model (Ames, 1965):

$$6. \text{ Max}_{q, \pi, A} U(q, \pi) \text{ subject to } -R(q, A) + C(q, \bar{w}) + A + \pi \leq 0$$

$$U_q > 0; U_\pi > 0.$$

The symbols are:

A - advertising expenditure; C - total production costs;

D - discretionary profit $[R(\cdot) - C(q, \bar{w}) - A - \pi^0]$;

M - managerial emoluments; P - output price level $[R(\cdot) / q]$;

q - output; R - total sales revenue; S - staff expenditure in money terms; π - total profits $[R(\cdot) - C(q, \bar{w}) - A]$;

π^0 - minimum required profit level;

1) In order to simplify, we have excluded a revenue effect of staff expenditure.

Table 2: Comparative Static Responses of a Change in the Money

Wage Rate on Selected Endogenous Variables

variable model	A	p	q	R	π
1	-	?(+)	-(-)	-(-)	-(-)
2	?	?(+)	-(-)	-(-)	0(0,-)
3	-	?(+)	-(-)	-(-,+)	0(0)
4	-	?(+)	-(-)	-(-)	0(0)
5	-	?(+)	-(-)	-(-)	0(0)
6	?	?(?)	?(?)	?(?)	?(?)

Signs in parantheses specify model responses excluding advertising expenditure. The only information used are the signs of the first and second partial derivatives, first and second order conditions and the Kuhn-Tucker theorem.

Our sample of representative firm models includes three entrepreneurial models (the familiar profit maximization model, a model emphasizing sales revenue maximization, which could reflect Galbraith's static theory of the firm, and a model focussing on output maximization). The managerial models (4 - 6) are modified versions of some of the proposals found in the literature on managerial economics. We omit a further discussion of the first order conditions because our interest is directed on the derived comparative static responses of a change in the money wage rate on some key economic variables which is the subject-matter of the quoted Galbraithian conjectures. Ignoring for a moment the last model and abstracting from the signs in parentheses, we observe that the response pattern is quite uniform for the different models. An increase in the wage rate will depress sales revenue and decrease the output level. The effects on advertising expenditure are - with one exception ¹⁾ - negative which implies, because advertising expenditure and prices are both instruments to affect the quantity sold, that the price responses are generally undetermined. If we exclude advertising expenditure, we observe that the price effects become generally determined. But there is no basis for accommodating the Galbraithian conjecture that there is a compensation of the negative cost effect. Only two results are ambivalent. This occurs when the firm is operating to the right of maximum revenue value. In model 2 this implies

1)

Contrary to an a priori conjecture the effects on A and q in model 2 are asymmetric. This follows from the fact that a change in the wage rate has no direct effect on advertising costs, but is directly related to production costs C .

that profits will decrease (and not increase as we conclude from Galbraith's contentions) and in model 3 this means that total revenue will increase.

Until now, we have excluded model 6 from our discussion. We see that none of the response signs can be determined without adding a priori unjustified restrictions. ¹⁾ It is a good example of an instance where even an apparently simple model yields no specific information. If we would base the analysis on a linear cardinal utility function, as Ames did in his original work, the results are clear-cut. Following an increase in the wage rate, profits, revenue, advertising expenditure and output will decrease and the price level will increase.

In summary, Galbraith's contentions remain unsubstantiated. We could, of course, construct a disequilibrium model and assume that the firms are permanently off their demand curves. This model might yield the Galbraithian results, but only temporarily. Needless to say, that such a model would imply an inventory and rationing adjustment process which is not accommodated by the existing empirical information. Which firm model is the correct one? Even if we leave this basically empirical question out of consideration, we should note that the concomitance of the vague notion of a mainly unstructured firm model, of purely specified test implications and of little, if any empirical evidence is not an acceptable methodological basis for the complete rejection of the neoclassical model of wealth maximization. ²⁾

¹⁾ We could for instance specify the signs of the second direct and cross partials in order to get more direct information. This is, of course, not valid because we would assume cardinal properties for the utility function. Something like this happened in the work of Williamson (Williamson, 1964) who sometimes ignores the fact that his procedure is based on ordinal measurement assumptions.

²⁾ For a new orientation of the traditional theory of production and exchange which avoids some major shortcomings of neoclassical theory compare the literature of the new theory of property rights. See especially the review article by Furubotn and Pejovich (1972).

The Organization of the Industrial Economy

(Galbraith, chap. three, XIII)

In Galbraith's diagnosis, ability to control output prices is only one step towards a complete accommodation of major environmental variables and towards a neutralization of all major exogenous control mechanisms. The second step is to control cost items, too. Apart from labor costs which pose a special problem, the normal strategy is to try to take over the supply sources of its inputs. Another device much more important for coordinating the heterogeneous and conflicting interests of the various firms comprising the industrial system is offered by the technique of the economic contract. The contract between different firms allows the protection of prices, costs, sales and supply to the mutual benefit of all firms. "The contract can be thought of as extending the security which the large consumers' good firm has in its own markets or the large weapons firm has in its relation with the government throughout the planning system...." (Galbraith, 1973, p. 125). A complex system of interlocking contracts has filled the place of the market and price mechanism which has failed to coordinate the activities of the firms in the planning system. It is, of course, quite obvious that the stronger bargaining power of the larger firms will push the profit rates of the smaller ones to a minimum acceptable level.

We mentioned above that in The New Industrial State Galbraith was not able to give a satisfactory explanation of the coordination of the plans of one firm to those of the other firms. It seems that Galbraith himself felt the necessity of inventing a

device which should supersede the neoclassical notion of the price- and market mechanism. This device is Galbraith's theory of contracts. "The contract is central for the protection of prices and costs and of sales and supplies at these prices and costs" (Galbraith, 1973, p. 128). If we understand a contract as a specification and a characterization of the content of a bundle of property rights which are exchanged in a mutually acceptable arrangement, it is quite obvious that Galbraith's theory is nothing more than a pure description of observed economic transactions. Analytically, it is a pure description because he fails to give a proper explanation of the specific terms of the specific contracts and the coordination of the interlocking contracts in the total planning system. To give an economically meaningful explanation would mean that relative price theory would slip in. ¹⁾ But this theory is rejected by Galbraith. Thus, once more Galbraith is left without a theory of the organization of the economic system. It may be the case that our interpretation is mistaken and Galbraith thinks of the existence of an effective collusive agreement by all members of the planning system over all industries, whereby the terms and conditions for the viability of the net of interlocking contracts are stipulated, monitored and policed by a dominant firm in the planning system. We are reminded of the naive cartel theory where a group of competitors agrees to share a market. In Galbraith's theory, the different

¹⁾ If Galbraith intends to base his analysis on a theory of multi-lateral bargaining processes, we should object that these processes alone are not sufficient for explaining the workings of the adjustment mechanism of a complex economic structure (see Dahl and Lindblom, 1953).

technostructures, motivated by their "common protective and affirmative purposes", agree to share the whole economy. Not denying that effective collusive agreements exist in different forms and in different markets and professions, to use such a model as the explanation of the whole Galbraithian "planning system" of our mature capitalistic societies would mean leaving the realms of serious economic reasoning. As a marginal note we should add that Galbraith's "test implication" for his theory, namely the alleged existence of a specific pattern of profit rates, being highest in technostucture oriented firms remains uncorroborated by the result of a broad and heterogeneous body of empirical research work. ¹⁾

The Seller-Buyer Relationship

(Galbraith, chap. three, XIV) ²⁾

According to Galbraith, controlling market prices is only meaningful if the firm is also successful in controlling the response of its buyers at those prices. Advertising or general product management are the strategies which guarantee this success. Tastes

1) This conclusion follows from a cursory inspection of the literature. For a substantiation, the reader should consult the survey by Brozen (Brozen, 1970).

2) The original heading of this section in Galbraith's book is "Persuasion and Power". Galbraith and other writers, too, try consistently to convince the reader that mainstream economics disregard the power element in dealing with social processes. This is true as far as it concerns the meta-language but it is certainly not true if the argumentation implies general neglect of a class of empirical phenomena related to the object language. We can not imagine that the familiar textbook-questions in response to scarcity - what determines how much each person produces and gets of the total etc. - could be misunderstood as not pertaining to the distribution and the effects of "power" in a social system. And it is certainly questionable to assume that these questions remain completely unanswered.

and needs of the buyer fall under the authority of the producer. First impression suggests that the interests of different producers in a single market are in conflict but second thoughts explain that the common interest in growth and technical innovation resolves this conflict. If the whole system grows, partitioning of product markets and the related distribution of earnings and profits cease to be a zero sum game. Needless to emphasize that the close connection and interdependence between the technostructure of the larger corporate firms and the bureaucracies of the central government warrants that complementary action in form of assisting government expenditure flows uninterruptedly at the required level.

Denying consumers' sovereignty and emphasizing producers' sovereignty together with the assumption of an omnipotent salesman is Galbraith's favorite pet. Reviewing briefly the literature on the concept of consumers sovereignty, we have to admit that the definition and use of the concept is highly misleading which means that Galbraith is basically right in attacking this notion. Sovereignty in its strict meaning implies that the consumer (or the producer) is able to impose his will on the producer (or the consumer). But exchange of money for goods and goods for money cannot be imposed on the other contracting party without ignoring the elementary principles of demand and supply analysis "...market survival demands no more from sellers than it does from buyers. Each can spend his way into bankruptcy and each can survive bankruptcy without charity only if he remains within his budget constraint. Neither buyer nor seller is sovereign

in the economics of the market place" (Demsetz, 1970, p. 482). For example, in what sense can we infer that consumers in price searchers' markets are more sovereign than consumers in price takers' markets? Or, what meaning should we attach to the statement that a negatively sloped demand curve facing a producer will increase his producer's sovereignty? Given the state of affairs we are best advised to discard the concept of sovereignty from the list of economically meaningful terms altogether.

With regard to the effects and consequences of advertising on the current and future allocation of goods and services on the one hand and the alleged influence of advertising on the stability of prices, market shares and the degree of competitiveness of an industry, we most certainly need more detailed information. Telser's much-cited conclusion that "there is little empirical support of an inverse association between advertising and competition despite some plausible theoretical theorizing to the contrary" (Telser, 1964, p. 558) may be well suited to disappoint a popular folkloristic position but should not induce us to overlook that we still lack the theoretical apparatus which rationalizes this conclusion. Reference to an allegedly very complex process of want creation is a polite way of paraphrasing our ignorance, but at the same moment we could implicitly admit thereby that few of man's wants are of biological or genetic origin. We simply have to face the fact, as Demsetz emphasizes (Demsetz 1971), that social scientists have not yet developed a general theory of want creation. ¹⁾ But insufficient knowledge

¹⁾ We should warn the reader that this notion although commonly referred to is somewhat misleading. Specifying the appropriate utility function is mainly an empirical question. All utility functions which we are familiar with are necessarily subjected to a certain degree of semi-reduciveness with respect to the social system involved. But from this does not follow that the effects of advertising should be analyzed as operating on the preference function. The alternative, which may be more promising, is to rely on a more general, socially bounded budget restraint.

about the allocative, aggregative, and welfare theoretical consequences of advertising should at least make us aware of jumping to the either wrong or trivial Galbraithian conclusion that "manipulation" is all pervasive and, in addition to this, a one-sided market phenomenon. Manipulation is costly, which means that producers are prevented from hypnotizing the consumers into any desired price-quantity combination in the price-quantity-orthant.

A few points which seem to characterize Galbraith's position could be summarized as follows: (1) There is a danger of confusing the process of want creation with the formal problem of expanding or contracting the available choice set. (2) There is textual evidence that the normative, empirical and analytical aspects of the assumption "given the wants of the consumers" are misunderstood. (3) There is no rational basis for falling into precipitate ethical judgement that "inborn" or "natural" wants are superior to "manipulated" or "socially determined" wants.¹⁾ (4) A clear distinction should be made to separate the effects of advertising, the ethical basis for advertising per se and the undesirability of misleading or fraudulent advertising. (5) There is a difference between policies trying to improve the basis for better informed and more rational decision making on the one side and proposals to abolish the freedom of consumers' choice in the market place with the aftermath of accepting or tolerating the negative consequences of uninformed or risky decisions which are later regretted on the other side.

¹⁾ Ignoring for the moment Galbraith's untenable position that there is a systematic causal relationship between the degree of affluence in a society and the relative dominance of "socially determined" wants. But we should mention that the reservation stated in footnote 1) on page 26 applies here, too.

The Role of Technical Innovation

(Galbraith, chap. three, XV)

Given the interests of the technostructure, technical innovation will be organized in such a way as to serve their protective and affirmative purposes. It is interesting to note that the labor saving effects of innovation will be utilized over and above the margins set by least-cost considerations. Capital intensive methods enhance the security and power of the technostructure and assist, combined with its senior partner advertising, in stimulating the psychic obsolescence of consumers' goods. The highest degree of technical obsolescence is of course realized in the military-industrial complex where the replacement rates are most dramatic.

A general discussion of Galbraith's "Revised Economics of Technical Innovation" can be subsumed under our previous discussion. Once more, the arguments are blurred by price-theoretical inconsistencies and a lack of a specific characterization of the underlying managerial motivational structure. Concerning the allegedly planned obsolescence, we should urge Galbraith to do serious empirical research so as to corroborate this speculative conjecture.

Public Policy in the Industrial Society

(Galbraith, chap. three, XVI)

It is not surprising that public policy is strongly determined by the common interests of the planning system. "The planning system having prestige as a source of goods and services and thus as a source of public happiness, will have influence as a source

of political suggestion" (Galbraith, 1973, p. 157). In addition to this, a "bureaucratic symbiosis" makes it possible for the planning system to approach the government directly through its relationship with the public officials. Furthermore, the ability of the planning system to pass on a wage increase in the prices of its final products resolves the basic conflict between capital and labor and, as a consequence, allows an endorsement of corporate needs as public needs.

The "bureaucratic symbiosis" ¹⁾ allegedly unifies the interests of the technostructure of the major corporations - and especially those working for the defense department - with the interests of the leaders of the political scene. If Galbraith's analytical description is correct, we should be able to observe a stable and riskless performance environment for the large defense contractors under this symbiosis. Again, this speculation is not substantiated by empirical evidence. As a simple test, Demsetz has analyzed the behavior of a sample of thirteen stocks of prime defense contractors. The results he found are rather plain: "These stocks over the period 1949 - 64 offered to investors about 21 percent more risk, measured by the mean deviation of the year-to-year rates of return, than did thirteen stock randomly selected portfolios" (Demsetz, 1970, p. 483A).

There is another strand of more indirect governmental promotion to secure a riskless operation of the modern corporate firm, because fiscal policy is always able to provide the suitable set of

¹⁾ The polit-economical aspects of this popular theme are extensively discussed in the above mentioned paper by G. Gäfgen, op. cit., which makes it unnecessary to cover these issues once more. For a further discussion of some of the issues involved compare the two major interpretative treatises on Galbraithian economics by Hession (Hession, 1972) and Sharpe (Sharpe, 1973).

instruments for creating a favorable business climate. With regard to stabilization policy, we should emphasize that Galbraith is a devoted Keynesian and a strict adherent to the 45°-diagram of aggregate demand analysis. The effects of monetary policy are only unreliable concomitant phenomena impeding an effective strategy for influencing monetary and real target variables based on fiscal policy. We hesitate to draw the obvious conclusion from Galbraith's writings that he actually maintained the definitely wrong assertion that the "bureaucratic symbiosis" in fact provided the adequate environmental climate. Empirically, we have to diagnose, that the symbiosis failed, and it failed either because government was not interested in promoting the planning system in an unrestricted way by disregarding all social costs or that the central government, by relying strictly on a fiscal policy apparatus, was not able to do it at all. This latter statement is backed by referring to recent empirical work which has brought impressive evidence that the leading simple Keynesian paradigm is a most unreliable and inadequate guide to an explanation and a control of the behavior of the real world.

Some International Aspects

(Galbraith, chap. three, XVII)

The accomodation of the major influential groups to the needs of the Galbraithian planning system is not restricted to domestic markets but transcends the national territory. Galbraith claims that a multinational system of mutual interconnectives between the major corporate firms works basically in the same way as

the national planning system. Efforts to control the environment and thereby immunizing itself from the influence of all major control mechanisms are unimpeded both nationally and internationally.

Galbraith's notion of the workings of the multinational system may be thought of a revised reconstruction of the familiar theme of the conspiracy of international capital or as a bourgeois theory of economic imperialism. ¹⁾ This may be the case, but the motivation is different. The master of persuasion cannot be satisfied if he does not succeed in subsuming the interests of all technostuctures of all industrial societies under the gigantic Galbraithian vision of an economic process which accommodates their "common protective and affirmative purposes". This is big-thinking par excellence.

Instead of a Summary

The issues under discussion are all taken from chapter three, "The Planning System". According to Galbraith's own position and according to our assessment, this chapter is the most important one and, judged by standards of modern economic theory, it is one of the better parts of Galbraith's treatise. The sceptical reader may test this statement by reading for instance chapter five "A General Theory of Reform". At the least, this chapter should make it sufficiently clear that Galbraith's poor technical tools, the continual concomitance of inadequate logic, unstated assumptions, unspecified

¹⁾ We call it a bourgeois theory of imperialism because the conflicting managerial interests are apparently amalgamated into the consonant interests of the team spirit of the technostucture as contrasted with Marxian theories which allow for divergent and self-destructive behavior of the capitalist actors.

implications before the background of an obsolete economic perspective - pieces of the price theory of the early thirties and the Keynesian 45° -diagram - and the absence of any systematic factual evidence is not a reliable intellectual basis for dealing effectively with the problems of our mature industrial societies.

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