

Part V: Corporate Capitalism and Neoclassical Models

General Comments

The middle to late 1800's saw what might be described as a golden age of economic expansion in England. In fact, most of Europe grew quite rapidly between 1840 and 1873, the latter year being one of significant recession. Industrialization in the United States was also getting under way, creating new income which expanded markets for English goods and services. In fact, during this period, capital goods represented a greater and greater proportion of England's exports to the rest of the world.

Railroads, open hearth furnaces, and the Bessemer converter led to great advances in the production and shipping of steel and steel products. Production of ships, machines, and chemicals also increased at significant rates as the industrial revolution got underway.

The Concentration of Economic Power

More General Comments: With the industrial revolution came significant economies from scale. This, in turn, led to larger scales of operation for manufacturing enterprises. The larger scale firms drove out smaller firms that tried to enter the market or that were slow in adopting the new methods. Thus, fewer firms began to dominate many of the capitalist markets at the turn of the century.

In addition to larger scale firms serving local markets, improvements in transportation began to turn what were regional markets into national and international markets. A single firm might be able to produce enough of its products cheaply to compete with firms in countries far away.

Financial systems began to emerge which allowed for the funding of large scale capital accumulation. Not the least significant of these was the advent of the corporation, an entity Marx failed to see. While many individuals could invest in a corporation through the purchase of stocks, it was generally true that only a few individuals held stock in sufficient quantities to control the corporation's operations.

Oligopoly became prevalent in many industries. If you remember your oligopoly theory out of Principles, you will note that one effect of such a market organization is the absence of price competition. The exertion of monopoly power in its many forms was quite evident at the turn of the century, not just in Europe, but in the United States as well.

Marx predicted the concentration of economic power. However, he felt that the necessity to bring labor into such concentrated endeavors as the modern factory would provide the contact needed for labor to realize their exploitation and to unite against such exploitation. Obviously, that did not, and to date, has not happened.

Marx saw the early labor movement in Europe and was optimistic about its potential for fostering revolution. Toward the end of his life, Marx began to believe that the labor unions, as they were constituted, were nothing more than another capitalist institution used to control labor. They would have to go through a major transition before they could carry out the function Marx envisioned.

The English and German Cases: England had two cases relative to the concentration of wealth and property. In those areas where England competed with foreign interests, relatively little concentration took place. This is because England took Adam Smith's (and later, David Ricardo's) impassioned pleas for free trade more to heart than did some other countries. Free trade meant that competition was always present from the outside. So while local firms did concentrate, their practices tended to be competitive. In other words, they were restricted in their ability to charge a monopoly price.

Local industries were a different story, however. By local I mean industries that catered to local rather than international markets and that produced products for which there was little chance of a foreign firm to compete in the domestic market.

Railroads are probably the best example of such an industry. Railroad firms in England engaged in ruinous price competition during their development. This price competition eventually led to winners and losers.

Mergers, acquisitions, and expansions led to significant monopoly power in this very important transportation industry. Monopoly pricing was common as was predatory pricing whenever a new firm attempted to enter the industry.

Germany, as a contrast, did not begin with England's interest in unrestricted trade and the attitude of laissez-fair business practices. Germany had few restrictions on business practices. As oligopolies grew and became strong, the cartel became the principal means of doing business. Formal agreements and arrangements between firms greatly enhanced profits and the expansion of capital in the German state through the early 1900's.

The United States: It's about time we begin to analyze our own economic history. I will begin with the end of the Civil War. Industrialization was taking hold in the United States and many laws were being passed by Congress to encourage this activity. Among the more significant were various laws allowing for the establishment of corporations as a way to organize for business.

There is one most interesting set of statutes, and eventually, a constitutional amendment that had, and continues to have, tremendous implications for America's corporations. The statutes were among our country's first laws dealing with civil rights. They were intended to give the newly freed blacks full participation as citizens. Eventually, the essences of these statutes were put into the fourteenth amendment to the U.S. Constitution.

The fourteenth amendment states that no person can be deprived of liberty or property except through due process. Again, it was intended to bring all citizens into the fold as it were. The effects of this legislation/constitutional amendment are what is interesting. The position and strength of the people the amendment intended to help, the freed slaves, improved little.

However, the courts made a significant ruling. The courts argued that the corporation as an entity was an individual. This means that the corporation has all of the rights of any citizen of the United States. Due process is one of the more important of these rights.

As corporations became more powerful, several states passed laws aimed at diminishing their economic strengths or practices. The federal courts, using the fourteenth amendment, eliminated most of these attempts by declaring them to be unconstitutional. States became powerless against the rapidly emerging corporations within their borders.

Competition between corporations became intense. A reading of the popular book, *The Robber Barons*, tells of the physical and economic predatory instincts of some of our great families of wealth during this period of history. In order to get competition under control, mergers and acquisitions became the rule of the day. In fact, mergers occurred at an incredible rate toward the end of the nineteenth century. As a result, huge industrial empires were built. In fact, by 1904, three hundred large corporations controlled more than 40% of manufacturing capital and affected almost 80% of American industries. By 1913, the United States emerged as a, if not the, major player in world economic events as a result.

With the concentration in wealth came a significant concentration of income in the United States. We begin to see during this period the income concentration that has prevailed since that time. In 1929, the top 5% of income holders earned almost 40% of the nation's income. The biggest differences were due to ownership, not to differences in salaries and wages. The highest fifth of the families during this period received more than 50% of the nation's income. Of course, we have already mentioned in this class that the wealth and income distribution in the United States is still heavily skewed toward the higher income groups.

Neoclassicals and Classical Liberalism

With the obvious concentration of economic power during the early portions of the industrial revolution, and with the emergence of significantly sized corporations with the power to limit competition, did the economists abandon classic liberalism? The answer is no.

Classical theories were modified a great deal, such as combining utility analysis (Bentham) with cost analysis (Ricardo) into what is now called supply and demand. A second modification was to make the discipline of economics as mysterious as possible. This was accomplished through mathematics. Grab a copy of the *American Economic Review* and choose from the contents one or two articles that sound interesting to you. Then read the article. I will place a significant bet with you. I'll bet this "interesting" title is proven through long lists of equations, with several of the mathematical steps skipped, ending with a policy recommendation usually based on the assumption of perfect competition.

It is in this way that economists have made the basis for their policy recommendations hidden from the general public. Since perfect competition is the easiest form of competition to model mathematically, the modern theory, which holds markets to be sacrosanct, depends on this model almost to the exclusion of all others. Obviously, the markets where the largest firms reside are generally ignored in the literature, with the possible exception of Industrial Organization literature.

Neoclassical Theory — Consumption: We all know from principles that the consumer's motivation assumption of neoclassical economics is utility maximization under an income constraint. The consumer will allocate her/his income until the marginal utilities per dollar spent across all commodities are equal.

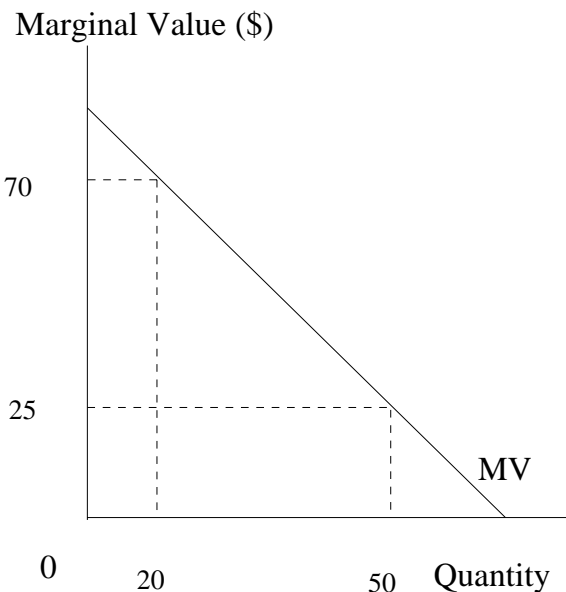
That is, until:

$$MU_A/P_A = MU_B/P_B = \dots = MU_N/P_N$$

Other assumptions include that there are a large number of producers in the market such that no one could alter price through the utilization of monopoly power. Consumers are so plentiful that no one consumer can influence price through monopsony power. Firms are assumed to want to maximize profits *given* the prices they face in the market. Further, the law of diminishing marginal utility was assumed to apply to all consumers.

Now, if satisfaction is the end goal of all consumption, and if all individuals were to maximize their own level of utility out of income by applying the formula given above, then material welfare *out of a given income distribution* will be maximized for all of society.

All this really began in the late 1800's when people like Jevons, Menger, and Walras. They all struggled with utility as a measurement of satisfaction since it is obvious that satisfaction would be impossible to numerically measure in a direct way.



Walras had a suggestion. His analysis of the demand function was to explain it as a marginal value curve. Looking at the diagram to the left, this particular individual might be willing and able to pay 70 for the 25th unit of this commodity consumed. He/she might be willing and able to pay 25 for the 50th unit consumed.

Now why would a person be willing and able to pay less for the 50th unit than for the 25th unit? Because, when you have more of something, the last unit is worth less to you. This is what the law of diminishing marginal utility is all about. So, Walras argued that the demand curve itself is a useful surrogate for the less measurable utility.

I can't emphasize enough that any one demand curve assumes several things to be constant, among them income. If this person earned more income, she/he might be willing and able to

purchase additional quantities at every price, or, in Walras's terms, might be willing and able to pay more for each unit consumed. The marginal value curve would shift to the right. The opposite holds true for a decrease in income.

If there is any redistribution of income from one person to another, the person losing income would lose utility since he/she could afford to consume less. The person gaining income would gain utility since she/he could afford to consume more. But there is not a direct way to compare the loss with the gain. Therefore, there is not way to tell whether or not society's welfare was enhanced by such a transfer. The maximum material welfare criterion discussed above must therefore assumes income distribution to be constant, i.e., incapable of objective economic analysis.

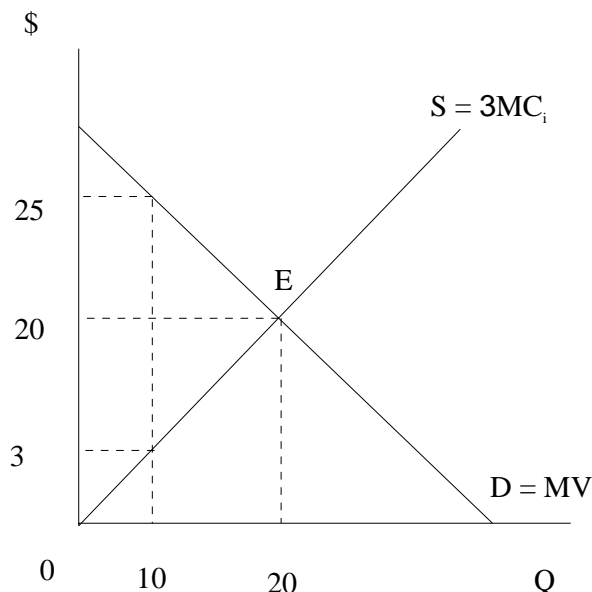
Of course, Marxists argue that it is income distribution that is one of the major weaknesses of the system we call Capitalism. In fact, income distribution is always changing. The trouble is, it is changing in such a way that income and wealth are concentrated in fewer and fewer hands. Whose hands? The professional working class, but especially, toward the owners of capital. To the Marxist, the works of Walras and his contemporaries represented a justification for these trends.

Neoclassical Theory — Production: The neoclassical theory of production was exactly analogous to the theory of consumption. The assumptions are as before. The law of diminishing returns assured that the demand for resources was downward sloping in the short-run. In the long-run, firms would hire the various resources of production (labor, land, capital, and enterprise) until the marginal product per dollar expended for each resource was equal. There would be no other distribution of the firm's money that could lead to a more efficient solution.

If all firms maximized their production, i.e., operated in long-run equilibrium, then the entire society would have to be productively efficient as well. No reallocation could bring about a more efficient solution. I'm going to depend on your memory of Principles for a bit to save some writing. The law of diminishing returns assures us that the marginal cost curve of the firm will be rising over a certain range. The firm maximizes profits when marginal revenue equals marginal cost. Because the perfectly competitive firm is a price taker, the profit maximization equilibrium is also where marginal cost equals price and is above average variable cost (I told you I was going to count on your background here). This makes the marginal cost curve the supply curve for the firm, *but only under conditions of perfect competition*. If we add all the firms' supply curves together, we get the market supply curve.

Just a quick side note might be in order. How many times have you heard the phrase, The Law of Supply and Demand? Well, since the marginal cost curve is the supply curve of the firm, and since these curves are added to obtain market supply, the law of supply applies only to perfect competition. There is no market supply when this form of competition does not exist. Think of the implications of that last statement.

Remember also that market economists look at costs as the opportunities forgone when a particular action is taken. In this case, the sum of the marginal costs of the perfectly competitive firms represents the



marginal sacrifice society makes, in terms of other goods and services, when it chooses to produce any one particular good.

Looking at the figure to the left showing the market supply and the market demand for a commodity, we can ask the question, "Should this market produce and consume the tenth unit of this commodity?" The answer is, "yes." But why?

The tenth unit nets the society \$25 worth of benefits. How do I know? Because the society has shown that it is willing and able

to pay \$25 for this tenth unit, certainly no more than \$25. On the other hand, the sacrifice society makes in producing this tenth unit is equal to only \$3. The difference of \$22 represents a net gain in net benefits (benefits minus costs) for producing the tenth unit. Net benefits could be thought of as society profit.

This will be true for the eleventh unit, the twelfth unit, and so on until the twentieth unit is produced. Adding all of these marginal net benefits would give the total net benefits society obtains by consumers buying and producers producing twenty units of the commodity. Of course, society would not want to consume and produce more than twenty units since marginal costs exceed marginal benefits. When equilibrium is achieved at point E, marginal benefits equal marginal costs and net benefits from this commodity are maximized.

Put it all together. Consumers, acting egoistically, atomistically, rationally, with each maximizing his/her own utility, will together maximize utility for the entire society. Each producer, maximizing profits, will hire resources in such a way that costs are minimized for the amount of production chosen. And, when we put the two together, society net benefits are maximized. What a system! Resources are all allocated to their highest and best uses, i.e., those uses that allow for all these efficiencies and the maximization of net benefits.

Notice that the word government did not appear in any of this discussion. Another neat thing about the market is that all these maximums are reached without any need for government interference. It accomplishes this as if led by Adam Smith's invisible hand. In fact, any government interference would lead to less than an optimal result which would, in turn, lead to a loss of societal material net benefits. Laissez-faire was the solution, at least in the vast majority of cases. All we have to do is accept whatever distribution of income existed during the period of our analysis — a moment in time.

Where is the justice in this? Each resource would be rewarded in accordance with its marginal contribution to production. The market economists called this, *distributive justice*. If you were a resource owner of labor, which we all are of course, all you had to do to increase your share of the pie was to increase your productivity. You could do this through harder work, but more likely, from training or education. You could also increase your productivity if you were lucky enough to work for a capital owner that adopted the most recent technology and gave you effective and efficient machinery with which to work.

There have been many modifications of capitalism since the originals came up with these theories. However, the worship of market efficiency still permeates the mainstream economics profession. Virtually all policy arguments from these economists begin and end with market efficiency as a goal. While problems such as externalities and income maldistribution as a result of monopoly power might be recognized, they are issues to be dealt within as near a market way as possible in order to bring about market efficiency.

You will take it from here. I want you to answer this with a discussion, to be presented in class and to be handed in, as to what came after the original notions of the neoclassicals. In other words, put yourself into the neoclassical model and try to answer what might be construed from the above discussion as obvious targets of radical thinkers.