

# Book Reviews

## 000 General Economics; Theory; History; Systems

### 020 GENERAL ECONOMIC THEORY

*The megacorp and oligopoly: Micro foundations of macro dynamics.* By ALFRED S. EICHNER. Cambridge; New York and Melbourne: Cambridge University Press, 1976. Pp. xiii, 365. \$24.95.

This book aspires "to provide a theoretical understanding of how prices are determined in the oligopolistic sector of the American economy and how these prices, so determined, affect the growth and stability of the economy as a whole" (p. 1). To these ends the author, while acknowledging much influence from previous writers, claims one new idea and two new concepts. The supposedly novel idea is that oligopolistic pricing decisions are ultimately linked to investment decisions; the novel concepts are those of the "megacorp" and of its "corporate levy." Unfortunately the oligopoly theory does not work and neither concept is really original.

The megacorp is defined as a large corporation with a degree of separation of ownership from management, a degree of multiplant operation, and "membership" (quotes added) in at least one oligopolistic industry. Since few conglomerates restrain their activities to competitive industries, we have here no more than a new name for a familiar animal. This fudge is associated with a more general tendency throughout the book to over-generalize from the case of the single-industry firm: the conglomerate case is treated quite shortly with no real understanding of the distinction between those parts of economic theory that apply properly to the subordinate divisions of a conglomerate and those appropriate to headquarters. The author completely ignores the economic significance of the multi-divisional form of organization (and thus of the distinction between "firms" and "quasi-firms," of which the latter firm is suggested by Richard B. Hefle-

rated by Oliver E. Williamson in the early 'seventies [15, 1970; 16, 1971].

The corporate levy is defined as total cash flow plus R&D expenditure plus advertising expenditures, less dividends. It is thus not uninterestingly intended to represent the corporation's grasp on all potentially growth creating resources, but is very similar to the "capitalistic surplus" of neo-Marxist writers such as Paul A. Baran and Paul M. Sweezy, whose *Monopoly Capital* [2, 1966] does not even appear in the bibliography. Eichner's version of surplus does however differ from others in being defined net of dividends, for he sees dividends as a minimum payment to the stockholder constituency, rather akin to a cost of production. However, his account of the factors determining the dividend minimum is much looser than that of some previous writers, such as my own, and he ignores theoretical arguments suggesting that stock-price, and hence take-over danger (which he buys from me as a basic constraint) may well be independent of the extent to which a given growth rate is internally or externally financed.<sup>1</sup> The substance of the oligopoly theory is located in chapter 3 called "The Pricing Decision" and is based on the case of a price-leading firm in a single industry, acting "as the surrogate for its fellow oligopolists." In several places<sup>2</sup> it is implied that this firm is assumed to practice joint profit maximization, but without any explanation of why this particular strategy will necessarily be chosen. No matter for whatever the theory that follows, it is not based on the hypothesis of joint profit maximization. It is based, implicitly, on the hypothesis that the long-run interests of

<sup>1</sup> See for example Franco Modigliani and Merton Miller [11, 1958] or Robin Marris [7, 1971, pp. 21-23]. Both these references are listed in Eichner's bibliography, but nowhere, if the index is correct, actually used or cited in the book. The author has a trick of failing to provide adequate acknowledgment where he is closely following substantial arguments of other writers, while going on to offer precise citations from the same works on relatively unimportant points.

<sup>2</sup> e.g. pages 40, 97, or 131.

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the industry are in some sense maximized, but this is by no means necessarily identical to a policy of maximizing the present value of total industry profits. In fact, it turns out that the model belongs or tries to belong to the class of theories in which prices generate profits, which generate investment funds, which generate growth—growth among other things being a possible criterion for optimization. Eichner's example begins with the logical and reasonable assumption that industry price leaders will be restrained in their behavior by industry-wide considerations, such as fear of driving customers to other products (which Eichner calls, not quite accurately, "substitution effect"), fear of new entry, or fear of government intervention. This assumption is made to generate a "supply curve" of incremental corporate funds against alternative incremental price policies reflected in an "implicit interest rate," the denominator of which is "the present value of the net gain in the corporate levy, summed up for all time periods prior to the one in which the combined substitution effect and entry factor is likely to become positive" (p. 81–82), while the numerator is "the eventual decline in the total corporate levy realized, due to both the substitution effect and the entry factor, properly discounted and averaged for all subsequent time periods" (p. 82). There follows a "demand curve" for incremental funds set against a schedule of prospective returns from the various growth creating activities to which they may be applied (including, realistically, not only conventional investment but R&D, advertising, and erecting new-entry barriers): since this conception represents only a modest extension of the conventional static marginal efficiency of capital schedule it is, in the history of the field, a distinct step backwards.<sup>3</sup>

What happens where the demand curves and supply curves intersect? Balanced growth?

<sup>3</sup> See William J. Baumol, "On the Expansion of the Firm" [3, 1962]; Marris, "A Model of the Managerial Enterprise" [6, 1963]; John H. Williamson, "Profit, Growth and Sales Maximization" [14, 1966]; Marris, "An Introduction to Theories of Corporate Growth" [7, 1971]; Robert M. Solow, "Some Implications of Alternative Criteria for the Firm" [13, 1971]; Marris, "Why Economics Needs a Theory of the Firm" [9, 1971]; and Dennis Mueller, "A Life-Cycle Theory of the Firm" [12, 1972].

Equilibrium growth? No, none of these, but optimum growth!<sup>4</sup> As the reviewer is unable to understand why the author regards this solution as an optimum, he is unable to offer any further explanation of the theory. It is possible however to sketch the elements of a theory that would follow logically from the assumptions. Let us suppose that increases in prices, while enhancing immediate profits, in the longer run affect profits adversely through loss of customers, entry, *etc.* For any time path of prices there is therefore a time path of profits. If the corporate levy is defined net of a minimum dividend, the time path of profits defines a time path of corporate levy, which, being 100 percent ploughed back, defines a time path of future levy-enhancing activities. Hence, it appears that each price-time-path policy defines a unique firm growth path. But in reality it is also necessary to ensure that the chosen policy provides for consistency between the growth path of productive capacity and the corresponding path of demands for the corporation's output. If not, capacity will be increasingly under- or over-utilized, and the profit assumptions vitiated (see Marris [6, 1963]). Hence on the author's assumptions there may be only one price-path policy that will provide the necessary balance, thus explaining the closure.

Of this theory, thus "rationalized," two comments are in order. Unlike the established theories,<sup>5</sup> Eichner's theory is not really an optimizing theory, since no well-defined corporate or even industry objective function is stated or

<sup>4</sup> This appears to be the only plausible interpretation of the relevant passage taken from page 97: "By placing the megacorp-price leader's demand curve . . . on the same set of axes as its supply curve . . . it is possible to determine what change in price, if any, will optimize the megacorp-price leader's long run market position. Assuming that the other firms in the industry will defer to the price leader's judgement . . . this will be the change in price that will then prevail until at least the next pricing period." All other difficulties apart, this actual wording suggests a clear confusion between the firm and the industry. Why, in respect of market position, should the interests of the other firms converge with that of the leader when, in fact, they are inherently opposed? Given all he has said about joint profit maximization, we must suppose that by "market position" the author in fact means something like "long run position of the industry given the leader's share in it."

<sup>5</sup> See references in fn. 3.

maximized. But even if this had not been the case, optimization would in fact have proved impossible because in fixing the minimum dividend the author has fatally reduced his degrees of freedom. The established theories by contrast treat the proportion of the current levy devoted to future levy-enhancing activities as instrumental variables and are therefore able to provide families of internally consistent size paths mapping families of dividend paths. From among these one may choose, according to taste in motivational hypotheses, paths to maximize the welfare of stockholders; paths to maximize, through growth in size, the welfare of managers subject to stockholder constraints; or paths to maximize a utility function containing as arguments both stock price and size path. Some of the established theories make no claim to also determine prices. One early model of my own claimed to determine the corporation's overall profit margin, but my later models treat the pricing decision as entirely separate from the growth decision.<sup>6</sup> Robert Solow's model first published in 1971 quite precisely determines prices, growth rates, dividends, stock prices, size, and growth-creating expenditures at all points through time [13, 1971]. In thus combining the investment decision with the pricing decision, Solow "anticipates" Eichner by some five years and provides an appropriate standard of theoretical comparison. Without a doubt, his model is more elegant, better articulated and more comprehensive than Eichner's. True, Solow's theory assumes a single-product firm operating under market conditions of monopoly or monopolistic competition; it has a determinate single-firm demand curve and makes no attempt on the problem of oligopolistic interdependence. But since Eichner makes no significant new contribution to oligopoly theory, Solow's model can hardly be rated as inferior on that score. Thus, in 1976 we are presented with a theory that is theoretically primitive compared to one comprehensive theory published in 1971 and another that is at least comparable published in 1963.

The second comment is, if anything, worse. In the chapter following the pricing decision, Eichner attempts to combine the pricing

conglomerate case and in the process becomes, if possible, even more confused. Two quotations should suffice to convince; "for the megacorp-price leader that is a member of more than one industry, the task is more complicated. Setting a price and allocating investment funds so as to optimize the the market share<sup>7</sup> in one industry may make it impossible to optimize the market share in another" (p. 117; why, incidentally, should this be impossible? The answer is that it is impossible in the author's theory because he is falsely trying to integrate individual market decisions with the overall corporate growth decision.) And on page 122; "... the amount of investment undertaken in any one of the . . . industries need not be exactly equal to the amount of corporate levy derived from that industry." Of course not! The very essence of conglomerate organization lies in the ability of headquarters to appropriate the profits of subsidiaries for purposes of the corporation as a whole. Eichner, as indicated, has tried to integrate and as it were to centralize (to "simultaneousize"?) the whole decision set. Solow was more modest. And whatever ambitions I may have nursed in the past, I am now convinced that such attempts are probably both unnecessary and misguided.

Your typical conglomerate delegates pricing decisions to its product-organized operating divisions. These "quasi-firms" are instructed to earn as much quasi-rent (operating profit) as they can, given the corporate resources that they have been allocated and the market structure and other features of the environment in which they happen to operate. To that end they must play games of monopoly, polipoly, or oligopoly against single-product firms or against other quasi-firms of other conglomerates. To understand these games we need the best quality oligopoly theory we can find, which must inevitably be game-theoretic; non-zero-sum, with strong elements of bargaining and threat theory and considerably empirical indeterminacy (see Marris [8, 1971, pp. 283-302]). The better an individual quasi-firm succeeds in its games, the better its executives will be rewarded by headquarters with salary in-

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The profits thus earned and remitted to headquarters are re-allocated according to a theory that is distinct, clearly intelligible, and easily interpretable in either the maximizing tradition of mainstream economics or in the satisficing tradition of the behavioural school. I surveyed these kinds of theories generally in the Introduction to *The Corporate Economy* [7, 1971]. The truth is that we still have no well-established general theory of the pricing behavior of oligopolistic giants. Kenneth Arrow has given us a general-equilibrium study of a world of monopolies, but he was forced to rule out oligopoly and even so, he finds that the solution is an area, not a fixed point [1, 1971, pp. 151-68]. If and when we do make more progress with oligopoly, I see no clear reason why the solution should be inherently linked with the theory of growth, however intellectually attractive such an outcome might be.

In his later chapters the author attempts to develop macroeconomic theories of distribution and employment founded on his micro chapters. The microeconomic minimum dividend acquires a macro-socioeconomic interpretation. The resulting macro distribution theory is however considerably less rigorous and/or convincing than Adrian Wood's theory of the same vintage [17, 1975]. The final chapter develops policy implications. Space forbids their detailed discussion, but the reader will not be surprised to learn that the reviewer finds these also to be naive and confused. A final quotation may provide some support for the otherwise bare assertion: "How to give the trade unions, as well as other groups in society, a greater voice in determining the secular growth rate is easy to say—though perhaps difficult to implement. . . . The inescapable economic fact is that, once the existing productive resources are fully utilized, progressively higher rates of growth of aggregate output . . . can be achieved only at the expense of progressively lower rates of growth of disposable income. . . ." (Two separated but closely related passages from page 278.) Completely wrong! If an increased share of social resources is devoted to research, development, investment, and other factors for growth, certainly the level

creased. At some point in the future the new path overtakes the old path; the hot political question is *when*.

One has the impression, confirmed by some remarks in the preface, that the author began work on this book a long time ago, perhaps as long ago as the early 'sixties. Its completion was thus overtaken by the publication of the theories of the middle and late 'sixties, which the author attempted but failed to accommodate. At one point (p. 311, fn. 27) he claims that the two types of managerial models are each an elaboration, or refinement, of the other. Nothing could be further from the truth.

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