BUSINESS PRACTICES, TRADE POSITION, AND COMPETITION

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By OSWALD KNAUTH

19  56
COLUMBIA UNIVERSITY PRESS
NEW YORK

Published in Great Britain, Canada, India, and Pakistan
by Geoffrey Cumberlege: Oxford University Press,
London, Toronto, Bombay, and Karachi

Library of Congress Catalog Card Number: 56-8555

MANUFACTURED IN THE UNITED STATES OF AMERICA

ACKNOWLEDGMENTS

MY GRATITUDE is due many people who have kindly given of their time and advice. George Soule advised in the original layout of the chapters and brought order out of confusion. William Bridgwater contributed of his skill in clarifying some obscure passages. Miss Lynette Jones and Miss Vergene Leverenz edited the entire manuscript. Those who contributed of their knowledge in their special fields are: Wroe Alderson, C. Canby Balderston, Solomon Barkin, Murray Benedict, Percival R. Brundage, Randolph Burgess, Arthur F. Burns, William H. Davis, Joel Dean, Thurlow M. Gordon, Dexter Keezer, Arnold W. Knauth, Robert Lynd, George O. May, Barbara S. Morgan, Shepard Morgan, Boris Shishkin, John Traphagen, Gordon Wasson, and Leo Wolman. To all of them my thanks. I hasten to say they are in no way responsible for the interpretation, and I suspect that individually they would disagree with parts of it.

OSWALD KNAUTH

March, 1956

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1

THE GREAT CHANGE IN BUSINESS PRACTICES

AMERICAN BUSINESS PRACTICE in its present state is the result of many decisions made by many men in solving the problems immediately confronting them, created by ever changing conditions. There is no master plan behind these decisions. All are made by individuals, in the light of their experience of the past and their judgment of the future.

This system has grown spontaneously, without the theoretical background expounded by the classical economists. It is an economy of balance and innovation, managed through the foresight of administrators in industry, in finance, in labor, and in government, each adjusting as best he can to his particular circumstances. This is no perfect or self-adjusting economy. The roles that are played by the different sections of the whole may be at times contradictory, even antagonistic, yet in the end constructive.

The classical theory of economy as developed by Adam Smith and David Ricardo, followed by a long line of economists through Alfred Marshall and Frank W. Taussig, was built on a series of assumptions:

1. That there are many independent units in every industry, each without power to affect the total.

2. That each unit strives for the greatest profit in every separate transaction as its final goal.

3. That each unit is in active competition both in buying and selling.

4. That in this activity a natural price results from demand and supply.

5. That each unit in seeking its own interest furthers the general social interest.

6. That there is nearly complete mobility of capital and labor, and also free entry into or exit from any industry.

7. That scarcity of goods (taken as a whole) is normal and hence an increase in production is the goal of industry.

On these assumptions, economists erected a theoretical logical structure which indicated that a free market would allocate resources to fill the needs of consumers in the order of their preference. An equilibrium or a natural price would exist about which actual market prices would fluctuate closely. At the natural price, demand at any given time would approximately equal supply for each article. Furthermore, any change in demand or supply would be reflected in a new price which would mark a new equilibrium.

The theory of consumption showed how the demand for each kind of article would be registered in the market in the order of consumer preferences. The theory demonstrated how the desire of businessmen to make the maximum profit on each article would lead to supplying at the lowest possible price the quantity demanded of that article. As a consequence, economic resources would be harnessed to the needs of consumers. Scarce resources would be rationed through high prices.

The classical theory further showed how an economy based on these assumptions would stimulate growth. The more successful businessmen would be those more alert in satisfying wants of consumers. They would seek to reduce

prices through cutting their costs; therefore they would search out the best sources of supply, install more efficient methods of production, exercise better management. This would lead to economic progress registered in a rise of real incomes.

The classical theory assumed that the economy under a free market competition would naturally approximate an equilibrium. Therefore, a lack of equilibrium at any time must be due to interference from the outside, such as a drought or other calamity, political maneuvering, or a combination creating a monopoly. The remedy was to restore and preserve free-market competition.

Even in its highest development the free enterprise system probably did not in any way approach the perfection of the theoretical analysis. Indeed Adam Smith's work was in large part inspired by a moralistic desire to point the true way in an imperfect world. In this approach he and his followers were successful, for the general judgment has long been that any deviation from this ideal concept of free competition is immoral; and, in truth, the theory was based on a solid set of facts which under then existing conditions had much to commend it. Legal theory has adopted it almost without change; but if the assumptions on which the classical theory rests are not true, the major tests which the economy must meet cannot be judged by the classical mechanisms.

Businessmen engaged in the management of large enterprises have long since rejected the classical theory as an explanation of their actions and methods. Many, though not all, economists have become increasingly restive when seeking to theorize about the free-market competitive economy. Some have looked back to that golden age with nos-

talgic eyes. Some economists, especially those connected with business, have rejected it completely. Others have attempted to reconcile it with the facts by adding prefixes and suggesting new standards.

With the advent of continuous mass production came the necessity for creating organized distribution. Sales became more important than production, for production depended on sales. A large and increasing part of the economy began to operate under new adaptations, and by the middle of the twentieth century approximately two thirds of the economy had split away from the free enterprise system and was functioning under rules and methods of its own making.

This segment of the economy is operated by public corporations (following the nomenclature adopted in England), whose shares are largely owned by persons not connected with the management, as distinguished from the private corporation, partnership, and individual business.

In this inquiry the word "corporation" will be used only with publicly owned corporations in mind. In this sense, "publicly owned" does not mean owned by government, but owned by a large number of private shareholders not as such connected with management.

A source of confusion lies in the grouping together of public and private corporations. These are essentially different. The public corporation has certain privileges, and its public responsibilities are more and more clearly defined and regulated. Roughly, it is identical with those whose shares are listed and traded on organized stock exchanges. There are about 3,000 of them.

The private corporation is created by the same law and has the same privileges, but it lacks public or social im-

portance. It is economically more closely related to a trust or partnership. The relationships are limited to the participants, who act as individuals and whose influence is limited to their own resources and personalities. They are not entitled to structural permanence and privilege, for they have no widespread functional and collective responsibility. Their term of existence should be limited.

The postulates of this large and growing segment of publicly owned corporations may be described as follows:

1. It is not uncommon in any industry for a few paramount corporations to control the major part of the production. One or another sets the price; others follow.

2. The basic struggle of each unit is to survive. To survive requires the winning of a trade position which insures continuity. Profit is necessary for continuity, but not profit on each transaction. No calculation of the flow of profit can be more than a rough approximation.

3. Each company seeks unique advantages which remove it from proximate dependence on the market place. Distribution is the keynote of the economy. The rate of production depends on the rate of distribution. Prime interest centers in maintaining a level, continuous flow of production and distribution.

4. In a concern making multiple products, costs are reckoned through arbitrary assumptions. It is impossible to arrive at any exact, indisputable cost.

5. Price is calculated and announced in advance after a study of consumer desires in regard to quantity, quality, size of package, custom, cost, and like considerations.

6. The bulk of capital is fixed, "sunk" in single-purpose devices, expensive and difficult, if not impossible, to move or change.

7. Shifts in each industry occur more frequently through infiltration from a neighbor industry than from a newcomer. Freedom of entry has inherent difficulties in contrast to the many advantages of the established, going concern.

8. Not scarcity but capacity to overproduce to the point of surplus determines values, prices, processes, and judgments.

The problems, policies, and methods of today's industrialists and businessmen have been determined by efforts to meet today's necessities. They do not correspond to present legal theory, which is based on the classic economic ideology of a century ago. This antithesis between practice and law has posed serious questions, led to confused thought, and produced stopgap, generally inadequate solutions.

The manufacturing economy of the mid-nineteenth century was essentially static; that of the mid-twentieth century is dynamic; the former could stop and start, the latter is a continuous flow; the former was based on scarcity, the latter on abundance. In the former, other things remained the same, "*ceteris paribus*" had significance; in the latter, change is likely to have far-reaching, unpredictable effects.

The first attempt to analyze a changed situation is necessarily to adopt prefixes and modifications of accepted concepts. Thus complete opposition between competition and monopoly is modified. In classical theory there was either perfect competition or monopoly: one was good, the other bad; one was white, the other black. Today economists recognize shades of gray. Thus, under changed conditions, competition becomes imperfect, semimonopolistic, workable, "more or less." Monopoly becomes duopoly or oligopoly, or even a "tendency toward." Restraint of trade

becomes either "reasonable" or collusive. Prices are differentiated as administered, discriminatory, follow-the-leader; they are arrived at through policies, custom, strategy, or ethics; not through face-to-face bargaining.

The former exactness of terminology has become relative and vague. Concepts shade into each other by imperceptible degrees. The inherent complexity of the economy is increased by a confusion of words and meanings. The addition of prefixes and modifications is the stage at which the courts and administrative commissions have arrived.

Accountants, in spite of their difficulties in portraying the exact position of a company in an industry, have gone one step further. The income statement has taken precedence over the balance sheet. The balance sheet represented a pinpoint of time: a static concept. The income statement reflects a flow over a period of time; it is dynamic. As a guide for action or judgment, this change which has taken place over the last twenty-five years is momentous.

The economists have advanced even farther. Aided by the great growth of statistics in recent years, they have delved deeply into the nature of the productive and distributive process. They have studied the flow of goods and money. They have measured the input and output of many industries. They have recognized the dynamic nature of the economy and have set up devices for measuring it.

The business administrators, who have been forced by the necessity of survival to adjust their acts and policies to the situations in which they found themselves, have gone the greatest distance. As they were driven to lower costs, they set up machinery for mass production. As their natural market (sometimes called the "core" demand as

distinguished from the "fringe" demand) became surfeited, they set about expanding it further by new inducements and by searching for new uses of their product. As an even flow of distribution became necessary, they set prices and qualities and developed a selling organization on whatever terms seemed expedient. They made contracts and arrangements to fit their practical needs. They permitted themselves the joy of self-satisfaction through their bringing of new goods and services to a hungry population. They also took pride in creating employment for an expanding number of workers. Naturally they gasp at being informed that they are illegal, immoral, antisocial, monopolistic.

Administrators of large businesses know from their own experience that they have no monopoly. While outside observers deplore the decline of competition, insiders know that competititon is keen—perhaps keener than ever before, even becoming destructive. But when administrators attempt to argue that they operate under the tenets of free enterprise they are so obviously beside the mark that a confused public accuses them of cynicism and even deceit. The system that has evolved is one of enterprise, demanding constant innovation and realignment. But, in the original sense, it is not "free." Rather it is "administered" or "managed" on a long-term basis. Moreover, as will be shown later, it is competitive and nonmonopolistic. But these words have acquired a meaning beyond and removed from their classical or legal sense.

The economy which has evolved is not neatly self-adjusting or logical as are the thought systems of free classical enterprise or socialism. On the contrary, it is a system which has grown spontaneously through the practical need

of thousands of businessmen to meet concrete problems. For purposes of evaluation there has been erected a system of business accounting, the aims of which give precision to the concepts that are useful in forming judgments. As the techniques of different businesses vary, so do the methods by which they are efficiently operated. This economy is in no sense a "perfect" economy. It is not a "natural" economy or a self-regulating economy. It is the result of many forces: choices between "more" and "less"; capital costs, labor costs, and organization costs; costs of expansion; costs of research and innovation; costs of security and of trade position. All of these costs and their probable contributions to production and distribution are carefully weighed by managements and decided according to their long-run estimates. There is no predetermined structure or set rule.

It is clear that the assumptions which fitted adequately the classical concept of a natural economy and the assumptions of a managed, mass production and mass distribution economy cannot be bridged over by interpretations, modifications, and prefixes. The assumptions and the analyses of the classical economy must be discarded as inapplicable to the economy of mass production and mass distribution.

The new economy has variously been called "organizational," "corporate," or "managerial." What is needed is a fresh start with theoretical analysis based on facts and practices. The theory should analyze and explain the underlying complexities of the economy. It should point out the difficulties of practical judgment in assessing the benefits and dangers of this economy. Much work of the highest skill has already contributed to this theory. This

work needs to be coordinated, so that it can be viewed as a pattern, in spite of its intricacies. Only then can economists with appropriate statistical material apply the tests which the economy must meet. Only then can legal forms and practices be readjusted to produce decisions concerning value that conform to social and economic welfare.

One further caution. The economy of the twentieth century is not homogeneous. It is a mixed economy. About two thirds of it falls under the general heading of mass production and distribution, continuous flow of goods and dynamic change. About one sixth is operated by the government, with methods inconsistently conforming to socialism. The rest (about one sixth) comprises roughly what is included in "small business" and more nearly conforms to the assumptions of classic analysis. These economic systems operate on different principles (side by side) touching each other at many points. We are concerned only with the first, except in so far as the intermingling of the other two adds to the complexity of the economy.