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Deficient Markets

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In this talk I am going to deal with one aspect of the work discussed in my book and one that I think has contemporary relevance. I have titled this talk "Deficient Markets" to draw a contrast to the notion of market efficiency prevalent in neoclassical economics. Institutional economists did not use the term "market failure" but they were critical of many aspects of market performance, and many of the issues they raised still remain in one form or another. Veblen critically analysed conspicuous consumption and status goods in terms that relate to modern critiques of consumerism. In the very recent past the economies of the world have been shaken by a major financial crisis and a resulting recession. Comparisons have been made to the Great Depression of the 1930s. Unemployment rates in many countries remain high and youth unemployment in Southern Europe in particular is little short of catastrophic. In addition to this we have witnessed growing inequality of incomes, to a point not seen since the 1920s, and a staggering rise in the relative incomes of the business elite. This has resulted in claims we are now in a new "Gilded Age." Fires in Bangladesh garment factories are eerily reminiscent of the New York Triangle fire of 1911, and photographs of child laborers in India indicate conditions much worse than those documented by Lewis Hine in America between 1908 and 1912 and which played such an important part in the campaign against child labor in the US. All of this has resulted in some critical analysis of the workings of our market system, but, among professional economists in the US at least, much less than might have been expected. In contrast the American economics literature from the 1890s through the 1930s contains a vast amount of critical work on the functioning of markets. This includes the work of progressive economists such as R. T. Ely and H. C. Adams, and institutionalists such as Thorstein Veblen, Walton Hamilton, and J. M. Clark. Today I want to say a few words about this literature.

The institutionalist critique of business and market institutions is spread widely over time and over the work of many different individuals, but it is true to say that the impetus behind a lot of the earlier institutionalist work was the experience of American industrialization. Veblen characterized the economic system of America in the early 1900s as a system of business or pecuniary institutions, including firms, markets, and the surrounding legal institutions of property rights. In Veblen's view the business firm had undergone significant development due to the introduction of new large scale technology, new methods of corporate finance, and the growth of salesmanship and advertising (Veblen 1904). The point that institutionalists made was that the activities of business firms were no longer adequately controlled by the existing institutions of the market. In Adam Smith's world the activities of businesses were to be channelled in the direction of the social advantage through the action of competitive markets with relatively little additional regulation. But for institutionalists businesses had developed new methods of profit making, had become of much larger scale, and could manipulate consumer wants. At best, Smith's ideas applied only to an economy of "petty trade," and could not provide an adequate foundation for the understanding and control of large scale industry and "big business." As Walton Hamilton expressed it: "the fundamental issue stands out in clear cut relief," there is a lack of harmony between the technology of industry and the form of its organization and control. "An economic order in which the productive processes belong to big business and the arrangements for its control to petty trade cannot abide." The task is to "devise a scheme adequate to the direction of great industry. In a world of change a society cannot live on a wisdom borrowed from our fathers" (Hamilton 1932: 593).

Within this general framework there are a number of specific themes that stand out. Not all of the institutionalist criticisms of business or markets will be dealt with here, but a number are worth renewed attention in the context of the recent problems mentioned above. First, there are a set of arguments that relate to the idea that economic control through business institutions can be "wasteful" in a variety of ways. Second, it is argued that under certain circumstances competition can lead to less than desirable results. More competition is not always better than less. Third, private business often succeeds through a strategy of shifting costs onto other people, workers, or whole communities. For institutionalists the solution to these problems was a greater level of "social control" of business behavior.

Problems of Waste

The concept of "waste" in the institutionalist literature stems originally from Veblen's work on conspicuous consumption and the devotion of resources to the production of status goods and to salesmanship and advertising (Veblen 1899). The concept of waste, however, has much broader uses than that. Veblen himself frequently talks of the various wastes that are created by the business control of industry. In general, these wastes arise from the fact that business is conducted for profit, and profit seeking may not be consistent with efficient production or maximizing useful output. Specifically, making money does not necessarily directly translate into making useful goods.[1]

It should be noted here that the idea of waste connected to the business control of industry was given particular impetus by the experience of production during World War I. Physical production rose sharply in the US and the standard of living for the "underlying" civilian population rose, despite the diversion of so many men into the armed forces. Stuart Chase (Chase 1925) noted the 25 to 30% increase in physical output over the pre-war level, a performance he attributed to war-time planning, standardization, and prioritization of production of necessities. Chase argued that there were four main channels of waste: 1) waste in consumption including military goods, speculation, adulteration, vice, quackery, super luxuries, fashion, and advertising; 2) waste of manpower due to unemployment, industrial disputes, preventable accident and sickness, and idleness; 3) waste in production and distribution due to a lack of co-ordination, duplication, restriction of output, and excessive selling costs; and 4) waste of natural resources, particularly in the cases of oil, timber, and soil, stemming from ignorance and a short sighted pursuit of present profit.

The main issues discussed by Veblen under the heading of waste include the "production of superfluities and spurious goods," or the production and consumption of goods for the primary purpose of signalling pecuniary status, and the costs of advertising and salesmanship (including multiplication of shops, sales agents, advertising, fancy packaging, multiplication of brands, and adulteration of goods). Veblen's leading conspicuous consumers were the "Captains of

[1] These are issues that stand apart from the usual discussions of externalities, although one can find a number of them discussed under the broader heading of "social costs," most notably by K. William Kapp (1950; 1963). In 1937 Kapp received a fellowship from the Frankfurt School, then located at Columbia University as the Institute for Social Research. While in the US, Kapp was influenced greatly by Veblen and J. M. Clark. The second edition of his book on social costs was called *Social Costs of Business Enterprise* (Kapp 1963) to indicate his debt to Veblen and to the institutionalists.

Industry" of his time, Vanderbilts and Rockefellers, but today the focus is on celebrities, and especially on their extravagant weddings.[2] Moreover, Veblen argues that the resources devoted to sales effort, such as competitive advertising, excessive packaging, and so on, represent a waste. Businesses in these fields are seen by Veblen as competitors in a closed market, "from which it follows that any device or expedient which approves itself as a practicable means of cutting into the market, on the part of any one of the competitive concerns, presently becomes a necessity to all the rest on pain of extinction" (Veblen 1923: 302-303).

In addition to this, Veblen conceives of many other aspects of business enterprise as a strategic game. A business can seek to profit by inflicting damage on a rival, possibly by building duplicate facilities, or by attempting in other ways to obstruct or interfere with a rival's normal business activity. Business strategy is commonly "a struggle between rival business men" and the outcome often depends on "which side can inflict or endure the greater pecuniary damage" (Veblen 1904: 32). Much of this relates to attempts to make or mar business coalitions and mergers. Patent wars are a more recent example.

For Veblen a serious form of business waste is what he calls business "sabotage." Sabotage involves the restriction of output in order to maintain profitable prices and is the result of monopoly power. But Veblen is not simply applying this idea to an individual firm but to the manner in which the key industries of the entire industrial system are operated through "business coalitions" and other "working arrangements" (Veblen 1904: 241). Veblen's point is that the productive capacity of industry utilizing modern technology is so large that if it were given free reign prices would fall to unprofitable levels. In order to maintain profitability output and technological innovation is restricted and industry is characterized by a normal state of excess

[2] DeBeers, as is well known, created the market for expensive diamond engagement rings. Ironically the company made great use of Veblen's analysis of status goods in designing their campaign (Epstein 1982).

capacity (both actual and potential) and unemployment (Veblen 1921: 8-9). The idea of the "capacity to produce" being significantly above actual output even in normal times became a common point of criticism of business in the 1920s and 30s (Slichter 1924: 330; Chase 1925: 189-190; Nourse 1934).[3]

The tools of corporation finance are a key element in this process of consolidation of industry, but the ready availability of equity markets and credit instruments gives rise to further opportunities for manipulation, predation, and the search for "free income" (Veblen 1904: 166-176; 1919: 63-84). Veblen was an early expositor of the problems of insider dealing, financial manipulation (manipulation of information and stock prices), conflicts of interest between the various classes of equity and bond holders, and the fact that the group of owners in control of a corporation may have only a transitory interest in the company, and not in the company as a going concern (Veblen 1904: 174-176). Veblen was reacting to the activities of people such as Jay Gould, Andrew Carnegie, and J. P. Morgan, but he clearly anticipates some of the less attractive aspects of the activities of present day finance houses and private equity firms. In the 1920s people such as Veblen (1923) and W. Z. Ripley (1926) gave a great deal of attention to conflicts of interest between ordinary shareholders and those in control of the corporation, the lack of information given to shareholders and the inadequacy of published corporate accounts, and the opportunities for speculation, insider dealing, and outright fraud. As J. M. Clark pointed out, the corporation provides many opportunities for abuse. Members of the corporation need "protection against each other," the small investor may have poor information concerning what he buying with shares of stock. The relation is one of "trusteeship," and chances to make money at the expense of the company are "varied and tempting" (Clark 1939: 154).

[3] Concerns such as this linked the work of Veblen and Chase to the various engineering movements that arose at the same time. The common theme was the waste involved in business practice.

In Veblen's view the activities of financiers are not primarily concerned with enhancing economic efficiency but with generating differential advantages and sources of income for themselves and their clients. The issues of conflict of interest, insider dealing, lack of information, and fraud were addressed in legislation during the New Deal (such as Glass-Steagall and the Securities Act in 1933). The recent deregulation together with the development of new financial instruments have brought all these issues back in force. In an address in 2013 Jeffrey Sachs described Wall Street as a "pathological" culture with rampant insider dealing and fraud (Legge 2013). There is little evidence that the resources devoted to finance are producing commensurate real returns (DeLong 2013).

It is also worth noting here that Veblen gave corporate finance a role in generating greater instability in the economy as a whole. The ready availability of both debt and equity financing together with the shift in the basis of corporate valuation from the value of tangible assets to the value of expected future earnings (intangible assets) encouraged firms to engage in high levels of leverage and to capitalize on the basis of intangibles difficult to value and subject to rapid changes (Veblen 1904).

Cycles, depressions, and unemployment also involve a waste of productive resources. Veblen's analysis of business cycles runs largely in terms of extensions of debt financing, based on expected earnings and made during an upswing, eventually becoming out of line with realized earnings, resulting in bankruptcies and liquidations (Veblen 1904: 112-114). Several aspects of Veblen's discussions of cycles were taken over by Wesley Mitchell. For Mitchell the problem of cycles emerges in the institutional context of developed business and financial institutions, hence the name "business cycle" (Mitchell 1913). Individual firms planned their own activities, but the economy as a whole was unplanned, resulting in cycles being generated from the profit seeking activities of businesses, the pro-cyclical behavior of banks, and various leads and lags in the movement of wages and prices. Later institutionalist writers adopted somewhat different views of the causes of depression, placing more emphasis on the roles of price inflexibility on the part of large corporations and shifts in the distribution of income towards profits resulting in oversaving or underconsumption. Rexford Tugwell particularly emphasized the increasing share of income accruing to profits over the 1920s, but the focus on the unplanned nature of the system of business as a whole was retained (Tugwell 1932).

Problems of Competition

Orthodox economics often seems to forget that not all types or aspects of competition are socially beneficial. After all, war is a type of competition. As noted above, Veblen's analysis of business indicates that competition can be socially wasteful (as with competitive advertising), or lead to firms seeking to inflict damage on rivals. Competition is not necessarily benign in its form. J. M. Clark discusses some aspects of this in terms of those forms of competition where the actions of different firms or individuals neutralize each other (Clark 1939: 157). Examples he gives are competitive armaments, competitive advertising, the waste of "cross freights," and the competition involved in invidious consumption (Clark 1939: 158).

Even where competition is focused on lowering production costs, strong competitive pressures on firms can lead to problems. Under certain cost conditions, such as firms having high levels of overhead and declining marginal costs, competition can lead to "cut-throat" competition and to prices below average total cost (Clark 1923). Such competition has the potential to become "ruinous" and to create "chaos" rather that stability. For Clark such conditions applied to railways, while Walton Hamilton applied similar arguments to the bituminous coal industry. Hamilton characterizes the bituminous coal industry as beset by persistent excess capacity, irregular operation, low wages, unsafe working conditions, strikes and labor unrest, a state of affairs in contrast with that suggested by the theory of competitive markets. Hamilton locates the basic problem in technological advance increasing capacity and creating a cost structure with high overheads and deceasing costs. Under these conditions competition leads to price cutting, low or even negative profits, and low wages. This is combined with uncoordinated investment decisions and bankruptcy laws that allow for reorganizations that retain the mining capacity in the industry. The industry is characterized more by "chaos" than by an orderly state of normal profits and capacity matched to demand (Hamilton and Wright 1925).[4] A more recent example could possibly be the US airline industry since deregulation; a history of new entry, followed by bankrupcies, reorganizations, and consolidations. Clark argues that in order to maintain profitability firms facing such conditions will adopt strategies such as price discrimination and will seek to develop formal or informal constraints on competitive price-cutting (Clark 1923: 23-24, 416-450). In a world of significant overhead costs, competition is "necessarily a thing of self-imposed restraints" (Clark 1923: 459-461).

Perhaps more importantly, competition can lead to a race to the bottom in terms of wages, working conditions, and product safety. This idea is very apparent in the work of progressive economists such as H. C. Adams, but can also be found in the institutionalist literature in the work of Walton Hamilton and J. M. Clark (Rutherford 2011: 58). This literature was originally developed in the context of American industrialization and open immigration resulting in low wages, child labor, long hours, sweatshops, and unsafe workplaces. The

[4] Hamilton argued for a consolidation of the coal industry under the control of workers and consumers (Hamilton and Wright 1928).

suggested solution was to provide a set of minimum standards in terms of wages, hours of work, and health and safety standards that would serve to define the minimum level or "plane" of competition. The relevance of this literature today is not difficult to see both in terms of the wages and working conditions to be found in the US in places such as Amazon and Walmart warehouses (McClelland 2012; O'Connor 2013) and, even more so, in terms of the worst forms of child labor to be found at the end of globalized supply chains in countries such as India (US Dept. of Labor 2012). The idea of the need for regulation to provide for a minimum *ethical* level for competition is clearly not outdated. There is no guarantee that market outcomes will be ethically acceptable, but this often seems to be forgotten by market advocates, as many of the critical comments on Pope Francis' recent apostolic exhortation make clear.

Shifting of Costs

As argued by K. William Kapp, who was very much influenced by Veblen and J. M. Clark: "the fact that private entrepreneurs are able to shift part of the total costs of production to other persons or to the community as a whole, points to one of the most important limitations of the scope of neoclassical value theory" (Kapp 1963:11). J. M. Clark discusses the same issue under the heading of "unpaid costs of industry" (Clark 1939: 156). Kapp was aware of the increasing mention of externalities in neoclassical economics in the 1950s and 60s but nevertheless maintained that it was still not recognized that externalities "are not isolated cases but widespread and inevitable phenomena under conditions of business enterprise (Kapp 1963: 8, n2).

Even in the first edition of his book, published in 1950, Kapp devoted whole chapters to the shifting of costs involved in environmental issues such as air and water pollution. This makes Kapp one of the first economists to give sustained treatment to such environmental externalities. Under the same heading Kapp considers the over extraction of renewable and non-renewable resources, including cases of open access and common pool resources. Also included by Kapp is the shifting of costs onto consumers in the form of goods of shoddy quality, adulteration of goods, and designed obsolescence. Further, and most significantly, both Clark and Kapp give a great deal of attention to what might be called the human costs of industry, including occupational diseases, industrial accidents, costs involved in female and child labor, and technological and cyclical unemployment (Kapp 1963).

The issue of industrial accidents was given vast importance in the earlier institutionalist literature. Institutionalists such as Ezekiel Downey and John R. Commons were closely invloved in the development and setting up of systems of workmens' compensation. The example of industrial accident raises a crucial point. In cases of damages an individual should be able to sue for compensation under common law. But, as is pointed out by Clark, the individual may not be able to translate his "technical legal protection" into actual effective protection due to lack of bargaining power (Clark 1939: 156) and the costs of court action. Moreover, the ability to sue for damages under common law has been seriously compromised by court decisions and interpretations that have shifted responsibility to the worker or consumer, or made class action suits more difficult to conduct. In the 1930s Walton Hamilton directed particualr attention to the impact of the courts adopting the doctrines of contributory negligence (in the case of industrial accidnet) and *caveat emptor* (in the case of consumer protection) (Hamiton 1931; 1937). More recently Shleifer and Glaeser have argued that these *judicial failures* were an important reason for the rise of the regulatory state (Shleifer 2012: 143-154). Exactly the same arguments can be applied to environmetal externalities and the extreme difficulty of using the courts to obtain remedy.

The cost imposed on the worker and on society at large by unemployment is also treated by J. M. Clark as a part of his broader concern with overhead costs. Clark argues that labor, and not just capital, involves an overhead cost: “There is a minimum of maintenance of the laborer’s health and working capacity which must be born by someone, whether the laborer works or not … if the maintenance is not forthcoming the community suffers a loss through the deterioration of its working power” (Clark 1923: 16). That the cost of labor is a variable cost to a business is “simply because the terms of the wage contract are drawn in that way” (Clark 1923: 16). In other words, it is an institutional arrangement and does not necessarily have to be that way. In standard theory, the overhead costs of capital are recognized as having to be met, but human overhead costs are neglected (Clark 1922: 133-134). Recognizing the overhead-cost component of labor, Clark makes a series of recommendations to help stabilize employment and provide a minimum standard of living. Clark’s suggestions include efforts by firms to regularize employment, union-management agreements to specify the minimum amount of employment to be provided, and unemployment compensation of a sort that links the employer’s premiums to “the disbursements which his own enterprise occasions” (Clark 1923: 381). The contemporary relevance of this issue is obvious in the cost of youth unemployment in Europe. Talk of a “lost generation” has not so far resulted in any major policy shift (McDonald-Gibson 2013). A generation is being sacrificed to the maintenance of a deficient monetary union. Veblen’s famous words concerning the “triumph of imbicile institutions over life and culture” would seem to apply here (Veblen 1914: 25).

Conclusion

The institutionalist view of the operation of a business economy is clearly one that provides a great deal of space for government interventions of various sorts. In this connection it is interesting to note the full extent of J. M. Clark's list of legitimate areas for government action. Under "strict individualism" Clark argues that the following can be justified: public defense; protection of person and property; regulating the appropriation of goods which are not yet private property; controlling inheritance and bequest; and the raising of public revenues. The "further grounds" for public action or "social control" Clark finds in the following: monopoly or oligopoly; maintaining the level of competition; cases where the individual is not able to make sound judgements (including cases of complex decisions, irrevocable decisions, and cases where there is a lack of reliable information); cases where issues of agency apply; cases involving the victims of natural disasters and technological change; the provision of a social minimum; economic guidance in general; ensuring equality of opportunity ; cases of unpaid costs of industry; cases of public goods or inappropriable services; cases where actions neutralize each other (arms races); unemployment of labor and capital; the interests of posterity; and any other discrepancies between private and social accounting (Clark 1939: 150-161).

The institutionalist critique of markets does not dispense with the idea that markets perform necessary and valuable functions, only with the idea that markets necessarily operate efficiently or function in an institutional or ethical vacuum. For institutionalists, a market is itself a complex of institutions and a "good market" (one that operates effectively even if it is not perfectly "efficient") is an entity that frequently has to be "made" by government interventions of various sorts. The theory of perfect competition and its associated welfare theorems do not define in any useful or practical sense what a “good” or effective real world market looks like, and clearly that is going to vary with the particular conditions surrounding any specific market.

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Institutionalism was a powerful and popular movement in the US in the 1920s and 30s. In my book I argue that what made it so appealing was that it promised to the young aspiring economist an *investigative* and *critical* approach, involving detailed empirical examination of the operation of the economy, and participation in significant but pragmatic social reform: *Investigative, critical, and engaged*. These are things that, in my own view at least, modern economics could do with a lot more of.

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