The Monopoly Basis of Success[1]

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If there were no God, it would be necessary to invent Him. *Voltaire*

With apologies to Voltaire, the discussion will concern not God but rather his more intriguing antithesis, the Devil. A long and complicated analysis of the issues concerning his existence is not contemplated. On the contrary, it is sufficient to observe that the Devil in each of his numerous manifestations is as essential a part of the history of mankind as his more revered antagonist. Indeed, it is easier to do without a "First Cause" than a Devil. Imagine a history which eschewed the fixing of responsibility–one that avoided judgment, assessed no blame and piously summarized the events of man's stay on this planet not in the dualistic terms of the struggle between the powers of light and darkness but which insipidly ascribed all the events of the great historic drama to the inscrutable workings of Jehovah.

Deceit, corruption and malevolence cannot be attributed to the God which is good. The Devil had to be invented; and his existence is inferred from his "performance". It is similar in the economic sphere where much of the bulk of the profession profoundly disturbed with the results of the profit seeking system has sought relief in the area of normative judgments. The price allocative apparatus of the classical economists has not seemed applicable to an economy characterized by striking differentials in the return on investment. High concentration, product differentiation, and advertising appeared more decisive than the "impersonal automatic market forces".

It was not surprising that when confronted with a choice between abandoning the traditional competitive analysis and altering the market structure, economists opted for the latter. It was easier and less painful to blame the market structure. The choice was not unlike that of earlier and more religious times which habitually castigated the Devil and burned witches. The economic realm presents daily evidence of the diabolic paraphernalia and personality in the form of those modern monopolies associated with the enormous and conglomerate large scale enterprise. And the economist, sometimes closer to demonology than science, views himself as a latter-day St. George determined to search out and destroy the Dragon whose claws stretch into all aspects of economic life. The recent book by Professor Bain is a worthy and weighty addition to the

[1] A review article of some of the issues raised by *Joe S. Bain's* Industrial Organization, New York (John Wiley & Sons), 1959.

endless recital of how that devious entity has apparently perverted and corrupted "some fraction of" an effectively competitive economy into one riddled with monopoly.

Alternatives to this approach are not lacking. Instead of concluding that competition has failed, it is also valid to reject as unconfirmed the initial hypothesis that competition equalizes profits between industries. The economist is no more compelled to introduce the monopoly hypothesis to explain the profit difference than is a physician required to consider the virtue of his patient prior to diagnosis or surgery[1]. It is the purpose of this paper to show that the monopoly or market structure theory in the form of excessive concentration, product differentiation and barriers to entry is both gratuitous as well as a "devil" theory designed primarily to "save" the traditional apparatus. But, in choosing the pejorative over the positivist approach, the traditional analysis has been made empirically meaningless and useless. Economists with a predilection for judgments rather than verifiable propositions have provided not a theory of resource allocation so much as a description of economic evils more appropriate to Dante's Inferno than to science.

I. Monopoly

Monopoly is restricted output; it is higher prices; it is inferior quality; it is the suppression of innovation; it is excess capacity; and it is a chronic waste of scarce resources. There can be no question that an "industrial organization" which facilitates a viable monopoly is not "efficient". The "performance" is "poor" because the alternative to monopoly is superior. It is not, therefore, remarkable that economists should be concerned with questions of the efficiency of the industrial organization. If they can identify the monopolies and show also how they can be eliminated, they have indeed demonstrated that their science is capable of making useful contributions.

What manner of being is this Devil which economists refer to as Monopoly–and at their most sophisticated label, Oligopoly? Is it merely a logical adjunct of cosmology populated with "good" and "bad" market structures; or does it embrace a set of verifiable propositions concerning the organization of resources? How are the propositions derived? How are they related to economics as an empirical science? Professor Bain's concern with the empirical study of issues raised by price theory led him to look for the association of certain structural characteristics of the market–high concentration, product differentiation and barriers to entry–with "poor" performance. The principal performance tests were: (1) the

[1] The moral issue is superbly delineated by that most delightful of Socialists George Bernard Shaw in the "Doctor's Dilemma" where the protagonist must choose which of two persons is most worthy of a potentially life-saving serum.

degree of efficiency attained coupled with the rate of utilization of facilities; (2) the extent to which the accounting rate of profits on equity over time deviated from the interest rate; (3) selling costs as a percentage of total revenue. His major thesis appears to be that industrial success as revealed by relatively larger or "excessive" profits and selling costs originate in structural characteristics, particularly product differentiation (p. 415).

II. Concentration and Competition

Since 1905 American *manufacturing* industry has shown no appreciable change in concentration. The author, in suggesting that by that date it was already sufficiently high to have reduced competition, follows the traditional view that competition is an increasing function of numbers. On the other hand, it is noted that an "over-all" increase in concentration for the American economy since 1890 need not and did no imply a decline or change in competition. The "over-all" increase is almost entirely accounted for by the increased relative importance of the public utility sector where not only does official public policy insist on monopoly or near monopoly but also on the power to determine rates.

In the manufacturing sector, size cannot be attributed exclusively to *technical* factors because both plants and firms are in varying degrees considerably larger than the minimal optimal size plant. The actual concentration is determined by the relative strength of several opposing forces. While advertising is believed to favor the growth of concentration through the development of product differentiation monopolies, the simultaneous expansion of both the market and small producers, e.g., in the steel and agricultural implement industries, has exerted a counterbalancing force. In addition and beyond the economic limitations, there are the legal restraints of the anti-trust laws.

III. Efficiency

The author in a prior study had relied upon engineering estimates for 20 manufacturing industries for ascertaining the minimal optimal size plant. He concluded that there was little evidence for the familiar *U*-shaped unit cost curve described in economic textbooks; and that in general there was no uniquely determined optimal size firm. On the contrary, beyond a certain minimal size, costs neither fell nor rose with output. This led to the important question of the extent to which concentration is unnecessary from the view of efficiency. His test was the size of one plant of minimal optimal scale expressed as a proportion of the total plant capacity needed to supply the market.

Considerable diversity was revealed for the 20 industries with respect to scale economics: in 6 industries, one plant would have to supply 10% or more–the automobile and typewriter industries requiring 20%–the other industries were fountain pens, tractors, copper and gypsum products; in 5 industries the minimal optimal scale was 5%–cigarettes, soap, rayon fibre, farm machinery and steel; and in 9 industries the minimal optimal size plant was smaller than 5% with 3 industries less than 2%. But this data has to be supplemented with additional information concerning "the degree of upward variation of costs as the plant is reduced to smaller scale" (p. 348). In a preponderant of cases, these tend to be moderately flat so that smaller firms are not at serious disadvantage.

So far as horizontal scale is concerned, the present concentration in industry must be explained by other factors than efficiency. A similar conclusion is reached for vertical integration with the suggestion that its appearance may be linked with a desire to acquire additional market power. On the final count, concerning undue excess capacity, the author feels there is no cause for alarm. In an economy given to wide cyclical variations in demand, additional capacity is required to meet the peak loads. In addition, some of the stand-by capacity is often obsolete high cost capacity only profitably used in boom times; while other may be justified for special markets where consumers are geographically dispersed (and is, therefore, only a "fictional" excess capacity).

Not only does the author say that on the grounds of technical efficiency plants and companies are more concentrated than necessary; but that an alteration of the market structure so as to reduce the concentration is distinctly possible as well as desirable. On the grounds of manufacturing efficiency, he foresees no loss in efficiency should public policy be changed so as to rectify the underlying structure rather than treating only the symptoms as revealed by seller conduct. On the other hand, of the 20 industries surveyed 80% approximated the ideal in efficiency.

IV. Excess Profits

"Chronic excess profits are at least *prima facie* suspect of resulting from simple monopolistic restriction, and if so are undesirable" (p. 378). Taking two periods, before and after World War II, the over-all average profit rate on corporate equity varied between 5% and 7% or excess profits from 2% to 3% (i.e. over the prevailing interest rates). "Good" performance for the entire economy would be indicated with the accounting rate just equal to the interest rate. The author "tentatively" concludes that "for some fraction of all industry in the American economy, market performance is poor or 'unworkable' in that substantial monopoly excess profits of the chronic sort are found. For another larger or at least equally substantial fraction of industry, however, average profit rates

in the long term come reasonably close to the normal interest return on owners' investment, and a more 'workable' performance is found" (p. 387).

Referring to the automobile industry, "we find an industry with persistently high excess profits and every evidence of monopoly output restriction leading in the direction of, though probably not reaching, joint profit maximization for the established firms. The 1936–1940 average profit rate on equity for all firms except Ford (after taxes) was 16.3 per cent—among the highest earned in important manufacturing industries" (p. 314). "These profit results were predictable in view of a market structure characterized by very high seller concentration and extreme barriers to entry. In contrast, profits in the steel industry at about 4.9 per annum were "so low as to suggest an approximately competitive adjustment of price to cost" (p. 312).

What is the significance of this substantial divergence in profits? Is the author correct in attributing it to monopoly power? If so, what hypothesis accounts for the differential result? And, finally, how adequate are the procedures for arriving at these results? The author was faithful to his original objective of testing the textbook price theory. Thus, in *static* conditions the competitive allocation of resources brings about an equality on the return from invested capital. Maintenance over time of substantially greater returns in some industries needs to be explained.

The author states that excess profits could result from one or four of the following causes: (1) Misestimation of future demand or costs or a lagging adjustment with windfalls. But they can be losses as well as profits and do not continue over the long run. (2) Risk rewards to successful risk takers. However, not all the firms in the industry should earn excess profits "for the existence of the risk which is being rewarded should be evidenced or proved by losses to other firms which have been less successful" (p. 375). When every firm in the industry earns more, the industry does not seem to be an exceptionally risky one. (3) Innovation—so long as the innovation cannot instantaneously be imitated—but these are expected to be "sporadic and intermittent in occurrence rather than persistent through time" (p. 376). (4) Monopolistic and monopsonistic restriction of output "generally based on a restriction of interfirm competition plus some impediment to entry of new competitors" (p. 373).

V. Definition of Profits[1]

Inasmuch as profits are the most important test of "performance" their definition is critical for the author's conclusions. Reference is made to both the excess

[1] I should like to express my indebtedness to my colleagues, Professors John Clendenin and Neil Jacoby, for their most constructive comments on the problems of this section.

profit rate on sales and that on owners' investment or equity with the choice in favor of the latter because it is "more easily calculated from available statistics" (p. 366). And, on this basis, the author compares "the automobile industry with a very steep excess profit rate (after taxes) in evidence, the steel industry with moderate rate, the meat packing industry with very low or negligible excess profits" (p. 385). "In such individual industries, any large deviation of the profit rate from the norm of a basic interest return on owners' equity may constitute a very significant aspect of market performance, possibly signifying the presence of large chronic excess profits which in turn reflect severe monopolistic output restriction and a consequent distortion of the allocation of resources among uses" (p. 386).

The definition of excess profits is important because of the use to which the index is put. As suggested above, excess profits are "excessive" in a relative sense, i. e. compared to the average rate of return in most industries and to the return on free capital. But how much significance can we attach to the differences between industries on the basis of the returns on owners' equity? Though the author is not unsophisticated in his discussion of the particular choice in favor of the return on equity as against that on sales, it is not clear why he considers the return on equity "more convenient". He notes that larger accounting profit rates on equity will indicate larger excesses of price over average costs only when other things are equal (p. 368). In comparing "differences in cost-price margins, allowance must be made for differences in the ratio of R to V[1], or in the rates of 'capital turnover'. Effectively, excess of rates on equity will be smaller relative to excess profit rates on sales, for those firms which have a higher ratio of owners' equity to sales ('slower capital turnover', and profit rates on equity must be interpreted accordingly" (p. 358).

This is an important qualification but there is no evidence that in subsequently interpreting the data Bain carries out the necessary adjustments. Automobiles, distilled liquor and cigarettes have extremely important "intangibles"[2] which are listed by accountants on the opposite side of the ledger from net worth. Selling costs, including advertising, and "research and development" represent costs not considered part of "equity". Yet a newcomer would have to make similar investments in order to be competitive. Accordingly, other things are not equal between automobiles and liquor on the one hand, and steel. One might change the base from owners' equity to owners' expenditure for "research and development" and find that the return to automobiles and distilled liquor is less than that for steel.

[1] The ratio of revenue to equity.

[2] "The most interesting aspect of advertising is its comulative effect: the fact that the effects of advertising persist beyond the period of expenditure and become a *valuable if intangible asset* of a firm." George *J. Stigler*, Theory of Price (Rev. Ed.), New York 1952, p. 208.

Had Bain dealt directly with the data on profits relative to sales the above difficulty would not have arisen. Though his conclusions would have been less interesting, he would have been closer to the traditional economist's concern with the margin above costs. It is only there that monopolostic restriction is indicated. As Bain is well aware of this it is surprising that he failed to heed his own cautions. Nor does he make allowance for the risk element when he compares the return on equity for different industries. He had earlier observed that for "a single industry of firms over any prolonged period of time, the risk rewards earned by successful firms should be at least roughly offset by the losses of unsuccessful firms" (p. 375). Yet in his discussion of industry profits he averages only the returns on equity for "the *principal firms* (four or less in each case)" (p. 385, his italics). A risk factor is not only included in the returns to these most successful firms, but unquestionably is responsible for the apparent differences in the returns (after making allowances for the "intangibles" as discussed above).

VI. The "Industry" Concept

The profits test of industrial performance rests on the validity and relevance of the industry concept. The latter which was an essential part of the Marshallian apparatus distinguished an industry by the independence of its supply and demand functions. The changes occurring in an industry were held to be *de minibus* so far as their impact on other industries were concerned. Whether the industry actually was "independent" of events transpiring in other industries or was assumed independent under the familiar *ceteris paribus* assumption is not quite clear. It was important as an abstraction and a useful tool for some analytical purposes. With demand given, a single seller, or group of sellers acting in concert, could adapt quantity so as to enhance monopoly profit. Such a seller would have no need for concern with the reactions of outside sellers because he would be the sole supplier within the "industry".

But the Marshallian industry with its separate demand function is not necessarily identical with the statistical industries as reported by the Bureau of Census. Classification by industries under the Census is often for different purposes: in the main, they are ways of reporting statistical data[1]. They do not inquire into

[1] Cf. the following: "The classification used for organizing the nation's principal industrial statistics was not, of course, established chiefly to measure business concentration. The study of business concentration deals with the competitive nature of products and of firms producing them. This is only one characteristic of an industry; others are method of manufacture, types of facilities, and other physical or technological factors." *Maxwell R. Conklin* and *Harold T. Goldstein*, Census Principles of Industry and Product Classification, Manufacturing Industries, in: Business Concentration and Price Policy, National Bureau for Economic Research, ed. by *George J. Stigler*, Princeton, New Jersey 1955, p. 15.

the *independence* of demand and price–which is the crux of the Marshallian industry. To illustrate, the Census reports data on glass containers, steel containers, paper containers and wood containers separately. But, insofar as consumers regard them as substitutes, the economist would place them in the same industry or market: they lack *independent* demand functions.

Accordingly, the industry concept must be handled with attention to its definition and purpose. Though competitive theory predicts long run profit equality as between industries, the latter are recognized in terms of their economic significance; and must reflect *market* elements rather than statistical classificatory schema. (Cf. p. 110.) Although the author refers to an industry as "a group of sellers potentially in more or less direct competition with each other" (pp. 6–7), there is no indication that he has adjusted his industries (p. 384) on the basis of the degree of substitution.

The arbitrariness of the industrial classificatory schema is most misleading when attempting to evaluate relative performance between different marketing approaches to the consumer. With Bain suggesting that it may "be argued that industries with the higher excess profits are essentially restricting their outputs below a competitive level" (p. 372) the source of the profits and the definition of the industry approach critical significance. For a number of increasingly important groupings there is no "given" demand such that a classical monopolist could restrict production and secure greater prices. The demand for the product has to be created and re-created because the products are "marginal" in the sense that the consumer may fill his requirements in a number of different ways (but see p. 322). To illustrate: a buyer may buy candy, ice cream, fruit, pastry, beer or whiskey. The potential market for each is infinitely large; the competition which counts is between different *types* of products creating their own demand.

With such products, profits depend on the creation of primary demand rather than output restriction along classical monopoly lines. The Model T Ford, mass production of radios and TV sets, electrical appliances and automobiles are the great profit-makers–not restriction and monopoly. Demand for these products is neither fixed nor periodic as with many staple items. Producers must *continually* seek to direct buyers towards their products and away from the innumerable other ways of spending. It follows that where one grouping such as cigarettes may gain greater profits, another grouping such as candy and sweets may lose. An economic definition of the "industry" should include along with the profits in cigarette manufacturing the losses in candy and pastry manufacturing.

VII. The Classical Adjustment

The classical model required the presence of certain conditions. At its best, it was a statement of long run competitive tendencies: with resources moving freely, profits would eventually equal the interest rate. With greater profits, additional resources would be attracted. Where this failed to occur, an impediment to entry was inferred. Bain's "devils" are absolute cost advantages of established firms relative to newcomers; large scale economies; and a product differentiation preference for the established firms over the newcomers. Their presence means excess or monopolistic profits persist over long periods, e.g., the automobile industry.

Now, this traditional theory implies that the monopoly profits would disappear should more resources be directed into the industry. Can we expect this to happen? The high attrition rate of automobile manufacturers in recent years suggest that the problem is not one of too few resources. As Bain is well aware, their failures are due to successful product improvement. Direction of more resources into this industry does not eliminate the "excess profits" along expected classical lines apparently because of a "product differentiation". Furthermore, it is impossible to divorce product differentiation from innovation. Bain asserts that innovation is "sporadic" and "intermittent". On the other hand, he also claims that product differentiation persists for long periods, and where it is "great" is linked to excess profits. The distinction here between innovation and product differentiation is gratuitous and without either analytical significance or empirical substantiation.

VIII. Product Differentiation

But product differentiation, whether it be the offering of a new, improved product or the "persuasion" of "ignorant" consumers that one vehicle is superior to another, is as much competitive as monopolistic. It is not without reason that we have a "theory of monopolistic *competition*". The classical model is not appropriately applied to markets where product differentiation is manifested because demand functions reflect *competitive* efforts at differentiation. In the classical model, relatively large profits ultimately led to additional resources being directed into the industry which in turn led to competitive price cutting with a movement down *fixed* demand functions until the excess profits were eliminated. But in imperfect markets, as revealed in unequal prices and market shares as well as the various forms of non-price competition, adjustments are on the *demand* side as well as the supply side. Accordingly, excess profits reflect the ability to influence demand as well as monopolistic restriction of output. And,

insofar as demand curves are pushed to the right for automobiles, cigarettes and liquor, they are pushed to the left for "sweets", motion pictures, books, etc. That is, product differentiation is competitive. At the same time, this competitiveness blurs the lines between "industries" so that the greater profits earned by General Motors are no different in kind from those earned by Sears Roebuck, and A & P in the very competitive retail trades.

For reasons which will be further elaborated in the next section, Professor Bain does not successfully bridge the gap between the classical mechanism for resource allocation and the emergence of particularly modern forms of product differentiation. Persistent long run profits are not uniquely related to monopolistic restriction. In an economy where demand is both variable and responsive to the various arts of "non-price competition", long run profits are the reward for successful competition; for continued innovation and demonstrated ability in persuading consumers that the new model is superior to the old or to other ways of spending their consumer dollar. That this is so is indicated in the fact that more resources in the automobile, liquor and cigarette industries would hardly eliminate the extra profits. Thus, the latter cannot be attributed to an "artificial restriction" of output along classical monopoly lines.

IX. Selling Costs

The author distinguishes between selling activity and costs for *informational* purposes and that "with a *persuasive* orientation" which reflect "a diversion to sales promotion of productive resources which could otherwise be devoted to producing and distributing a larger volume of useful goods and services" (p. 389, his italics). Sales promotion costs "probably are socially wasteful... and this wastefulness is probably acute in industries in which selling costs are relatively high in proportion to sales revenue". Where they are negligible or nonexistent, performance is deemed "good".

This view of selling costs, incurred to persuade consumers to buy one "brand" over another, as wasteful necessarily requires fulfillment of the *ceteris paribus* conditions[1]. The simple effect of the selling costs on the economy allegedly is confined to increasing prices and profits by simultaneously restricting sales and output. In other words, under *given* conditions of demand. But there is no reason why the impact of the selling costs is confined to increasing prices; selling expenditures also shift demand functions to the right, thereby attracting

[1] Cf.: "If the scientific observer, applying his own private standards, thinks certain product differentiations insignificant and hence wasteful, it does not follow that they are so from the standpoint of buyers." (*Joseph A. Schumpeter*, Business Cycles, New York, London 1939, Vol. 1.)

more resources. Nor need prices be higher: high advertising expenses may be in lieu of high margins to wholesalers and retailers. The choice is not confined to an economy without selling costs and one with high selling costs, but rather to a choice of different distribution channels.

Bain's analysis implicitly assumes that the selling costs have appeared in what would otherwise be a fairly *perfect* market. Thus the "admen" work on the "ignorant" consumers to make them prefer certain brands at premium prices. Without their activities, profits would be less and selling costs nominal or confined exclusively to providing minimal information. But, even though the final consumer may lack a degree in engineering, it does not follow that his choices, admittedly influenced by persuasive advertising, are "irrational and emotional" and ignorant. It is not irrational to prefer to rely on the "reputation" of established brands[1]: it is surely a more economical use of knowledge than acquiring the engineering data. Nor is the engineering data necessarily the crucial element; or a simple matter. First, engineering standards are arbitrary; second, they are often conflicting; third, there are other elements than the technical. Style or fashion, as in eye-catching attributes, is important to the buyer. It is one of the factors that induces a more rapid absolescence; and in the automobile industry, where the real competition is with the existing stock in the hands of consumers, is of primary importance. Nor is it less rational or more emotional than many of the factors governing "direct" purchasing by industrial firms such as reciprocal buying or responding to "wining, dining and blondes".

Bain's use of the words "irrational and emotional" in the pejorative is open to dispute. That the final consumer is susceptible to "persuasion" makes him neither one or the other. Nor does his liking for the superficial and eye-catching. A woman purchasing an expensive "creation" by a fashionable designer is no less rational than one who takes her dress from the bargain basement in a department store. In many cases, "irrational and emotional" mean only that the observer would have preferred the consumer to have bought on price alone; and too often he implicitly assumes not only that his detached judgment is *superior* but that the only difference between the two products is price.

Reduced to its simplest terms, Bain's judgments against selling costs come down to a not too subtle attack on consumer sovereignty[2]. Consumers are igno-

[1] Cf. the following: "...brand names signal the seller's reputation and buyers are often guided to the purchase of famous brands on the not indefensible belief that what is purchased by many cannot be entirely unsatisfactory." (*Lester G. Telser*, How Much Does It Pay Whom to Advertise?, American Economic Review, May 1961, p. 204.)

[2] See *N. H. Borden*, The Economic Effects of Advertising. Chicago 1942, p. xviii: "Advertising is sometimes criticised on the grounds that as part of the capitalist system of free enterprise it leads consumers to buy the wrong things and spend too much for them, whereas it would be better if they bought different things and spent their money in different ways. When this criticism implies, as it often does, that someone in authority

rant and, though the author says he believes in the competitive allocation of resources through the price system, he is not too sure that he likes the results. Yet the consumer, so ignorant and so responsive to persuasive promotion, is the same person who responding to all the arts of the politician casts his vote in democratic elections. If advertising is wasteful the free election with its campaign rhetoric is also.

The alternative to high selling costs is not a price structure reduced by their absence; but on the contrary, expenditures via different distribution channels, e.g., direct selling as used by the sugar refiners[1]. These expenditures may be higher; or they may not promote demand as well. Thus, in the absence of national advertising, manufacturers are more dependent on local distributors. Mark-ups are generally higher as are direct selling costs; prices need not be the same because the market is not necessarily perfect *ab initio*. The choice is likely to be confined to different kinds of market imperfections. Advertising is but one of the many activities characteristic of such markets; and may only be considered wasteful when its functions are more effectively performed by other techniques. But if that were the case it is difficult to see why the advertising is used. To a very great extent, the advertised product is "pre-sold" so that it represents a substitute for direct labor and a more intricate distributive setup. The relatively greater proportion of selling costs often represents nothing more than a form of vertical integration with the manufacturer assuming functions and thus costs hitherto carried out by other types of independent marketing specialists.

Though Bain comments that "*a priori* theoretical models are available to explain how and why competing firms in various structural situations may, in the interests of profit maximization, be led to produce goods of either insufficient or excessive quality (costs considered), or of inappropriate design" (p. 398), he fails to relate it to his findings on performance. Thus there is no reason to anticipate on *a priori* grounds that product performance would be more satisfactory or even as satisfactory with some other structural arrangement. The choice is between types of product differentiation; not between it and no product differentiation.

X. Advertising as "Waste"

The dismissal of advertising as persuasive and therefore exclusively competitive in its impact rests on the unverified proposition that the demand is given or "already making its way for wider social reasons"[2]. Persuasive and informative

might better decide what things should be bought and how consumers should spend their incomes, then the essential clash is between rival ideologies of individualism and authoritarianism; and the basic argument is not really about advertising at all."

[1] *Ibid.*, p. 500.

[2] The Listener, *Frank Whitehead*, Vol. LXV, No. 1668, April 4, 1961, p. 472.

advertising is alleged to have had no effect in making the public want to be cleaner or brush its teeth. But this is a most egregious assuming away of the problem. Markets are not perfect in the sense that consumers possess all the knowledge of the experts; nor is demand in the nature of an "untouchable" beyond the reach of competitive behavior. We may not find the appeals to anxiety, sex and ambition attractive, but they are not the exclusive child of advertising. Their ubiquity and intensity is attested to long before the emergence of what the sociologists have referred to as the "narcoticizing dysfunction of the mass medium".

The principal fallacies regarding the impact of advertising are twofold: first, excessive emphasis is placed on the allegedly hapless consumer victimized by the "Great Lie" concerning the product that he allegedly cannot afford to be without. It is assumed that the lie is not given to him in some other form (e.g., direct selling) were there no advertising. Second, emphasis on the costs of advertising ignore the fact that the necessary substitutes for advertising, e.g., larger dealer margins[1], eye-catching packaging and location of displays, also involve costs. Third, the competitive aspects of advertising are somehow thought to prove their wastefulness. But why advertising should be thought any more wasteful than the other forms of competition is not clear. The economically sophisticated does not deny "the wastes of competition"; he merely finds that its costs are substantially less than the wastes of a noncompetitive economy!

Bain's position on advertising is to "deny... the idea that we must have persuasive sales promotion to induce people to buy all the goods and services we are able to, or optimally should produce" (p. 389). "If persuasive promotion is not so required, then it and its costs are basically wasteful, and more so as they become larger." The advertising is judged not only detrimental to society but is "in general not even beneficial to the firms and industries undertaking them (except as a defense against the going promotional efforts of competitive firms and industries), since promotional activities tend to be largely self-canceling in their effects on sales, both as among competitive firms and among competitive industries" (p. 389).

There are a number of points on which it is possible to take issue with Professor Bain's approach. First, the fruitfulness of his distinction between "informative" and "persuasive" advertising is not apparent. Nor is it simply a matter of a "hazy" line between distribution costs and selling costs (p. 387). On the contrary, it is impossible to rationally distinguish between the "informational" and the "persuasive". Or to distinguish between advertising designed to "persuade" and product improvements with the same objective. So far as the

[1] "In the aggregate, wages of salesmen, travel and other costs attending personal selling efforts on the part of manufacturers, wholesalers, and retailers are several times as large as the outlays chargeable to advertising." *Borden*, op. cit., p. 26; cf. *Bain*, p. 393.

net effect on consumer welfare is concerned, there is no difference between an innovation in the form of a superior product and an old product, which through the media of advertising, is called for the first time to the consumer's attention; or a new way of using the old product. All competitive efforts are directed to "persuading" buyers; the "informational" aspects are secondary. Finally, the purpose of the innovation, advertising or competition is really subordinate to the question of the effect on welfare[1]. If it were otherwise, we might as well agree with the Socialists and reject the entire system because it is based on that ugliest of incentives, profits.

So far as the charge that the advertising is not even beneficial to the firms incurring its expense, Bain produces neither evidence nor argument to back up his assertion. There are, however, empirical tests, e. g., if the effects were "self-cancelling" it is to be expected that (a) each product would bear about the same advertising investment–otherwise they could hardly be "self-cancelling"; and (b) *all* products would be advertised. The presence of nonbranded and nonadvertised products and "private" brands is incompatible with the "self-cancelling" effect. Inasmuch as markets usually feature an array of products varying in advertising expenditures as well as the "private" brands and nonadvertised[2], the Bain argument must be rejected. The varying combinations of products with different proportions and types of selling costs demonstrate that competition involves an arsenal of weapons no one of which is necessarily optimal. The fact that not each competitor's product is advertised refutes the contention that the advertising was necessarily defensive. The lower priced, unadvertised products of Sears and Montgomery-Ward is compelling evidence against Bain's hypothesis.

Next, the argument that advertising involves a cost to society necessarily in the nature of a waste. That there is a cost is obvious: all products and services in the strict economic sense entail a cost–the "opportunity cost" in that the resources could have been used to produce something different. But Professor Bain's argument seems to be that had the resources used in "persuasive" advertising been in production, society would have been that much richer. He

[1] "One cannot condemn advertising and salesmanship out of hand, unless one is prepared to repudiate most of education, and of civilization in general; for most of the desires which distinguish man from the brutes are artificially created." Nor is the "economic system to be criticized because it manufactures our wants, or because it charges as much for making them as for gratifying them, or even more. That would be true in any social system and desirable. The development of wants is really more important than their satisfaction." *Frank H. Knight,* The Ethics of Competition, New York 1935, pp. 51–52, n.

[2] Cf. *Borden,* op. cit., p. 39. Also the following: "The continued availability of cheaper brands in some product classes suggests that not all consumers are convinced of the merits of the heavily advertised brands and that consumers can freely choose to pay for advertising if they buy such heavily advertised brands." (*Telser,* op. cit., p. 199.)

errs in thinking that the resources diverted from advertising would have gone into production. Even apart from whether that is desirable, there is no reason why they should have. The marketing function remains to be performed: if advertising is not to do the persuading, some other form of selling cost must be used in the "competition for the scarce shelf space"[1].

The data he provides refers to advertising costs, and that only for the manufacturing sector of the economy. He concludes that where these costs are greater than five per cent of sales, they constitute the "large wastes of excessive advertising" (p. 391). But this assumes that (a) persuasiveness is "waste"; and (b) that persuasiveness takes but one form–advertising. In view of the author's finding that diseconomies of the very large firm are not indicated (p. 353) the only limit on a firm's sales would be offered by his competition. Therefore, the firm has no choice but to "persuade" by one means or another. Bain's denial is clearly inconsistent with the implication of his finding on costs. For, given the fact that firms can be of any size, the problem facing them is not rising costs, as in the classical theory of the *U* shaped cost function, but "persuading" customers to buy their product rather than their rivals'. For Bain's strictures on selling costs to be acceptable, it would be necessary that all firms follow the competitive Rule of selling where the market price is equal to marginal costs. Only then would they not have to incur selling costs. But that is incompatible with the cost data.

Nor does Bain show that industries with smaller or no advertising have smaller total selling costs. He concedes that "we are substantially lacking in systematic evidence" (p. 393); and also that expensive distributive systems may meet a demand by consumers. Yet he goes on to conclude that "all or most of the industries with relatively high advertising costs are seriously suspect of undesirable or 'unworkable' performance in the matter of selling costs, in the sense that wasteful promotional costs have exceeded the 'limit of tolerance' or 'margin for error' which should probably be allowed in making normative evaluations" (p. 391).

But he provides no rationale for the judgment that advertising costs of 5% or more of sales revenue is excessive. Nor does he demonstrate that *total* distribution costs would be less (when allowances are made for quality as determined by buyers) under a system without advertising. As suggested above, the advertised article is "pre-sold"; and represents an alternative to direct selling. Though the advertising costs are high relative to alternative distributive systems, they are not high relative to *total* distribution costs[2]. In essence, they

[1] Federal Trade Commission, In the Matter of Pillsbury Mills, Inc., Dkt. 6000 (1953).

[2] "... advertising and personal selling services are alternative methods of persuading buyers... Thus, a more inclusive measure of selling costs would reveal less differences among commodities than a less inclusive measure such as advertising outlays." (*Telser*, op. cit., p. 194.)

represent vertically integrated distributive systems in contrast to the more archaic non-integrated systems. Therefore, the appropriate comparison is with industries with relatively high advertising costs and those in which the entire distribution system is considered.

Indeed, as Bain notes "practically all industries with very high advertising costs (costs equal to 5 percent or more of sales revenues) are industries producing consumer goods" (p. 391). The industries with low advertising ratios generally sell to industrial buyers where direct purchasing from manufacturers is the rule. The principal reasons for this relationship are that the number of customers is limited and often personal contact is necessary to meet special customer requirements. Copper, cement, rayon, steel and tin cans are articles used in producing consumer goods. Thus, other distribution costs are involved before they reach the consumer. These costs should properly be included before it is concluded that the advertising costs on cigarettes, liquor, fountain pens and soap are too high. Or, compare the textile industry where the "major part of the output is sold through selling houses"[1] with commissions ranging from two to five per cent depending on the type of cloth sold and services rendered.

XI. Impact and Objectives of Legal Restraints

American policy has had two diametrically opposed objectives; first, it has endeavored to maintain competition through outlawing certain forms of *conduct*. Second, competition has been drastically curtailed in a number of important economic sectors, e.g., agriculture, petroleum and retailing. The author demonstrates that Government policies "worsen" perfomance when they rely on *conduct* tests. Since the underlying market structure is left untouched the development of new and equally effective forms for restraining competition are thereby encouraged. Though the United States antitrust laws discouraged cartelization, further concentration resulted when business merged to bring about the same reduction of competition. What they could not do as independent units, they accomplished through the merger route—at least until the 1950 amendment to the Clayton Act.

It is believed that collusive agreements were most necessary in industries of moderate concentration. Where the industry was atomistic, agreement was all but impossible. Where concentration was high, agreement unnecessary: oligopolists could be much more subtle, and thus law-abiding, in recognition of the detrimental effects of competition on earnings. It would appear that while

[1] *E. B. Alderfer* and *H. E. Michl*, Economics of American Industry, New York 1957, p. 357.

oligopolists do not need agreement, the agreement requires oligopoly! A particularly helpful test of collusion is found in the media used for disseminating information: basing point or delivered price systems and elaborate reporting of prices and production make cartel pricing more effective. Secretiveness facilitates competitive behavior. Finally, the most important structural distinction is not between atomistic and oligopolistic industries but between highly concentrated and all others, including moderately concentrated oligopolies and atomistic industries.

The author's belief that the United States' anti-trust laws preserved the economy from a cartelization, inevitable in advanced economies, appears incompatible with his strictures on the futility of stressing market conduct when the underlying market structure is left untouched. If his rather trenchant comments in this regard are correct, the anti-trust laws can hardly be judged a success. There is some basis for concluding not only was Government intervention not necessary because of the strength of the newer forms of competition and the expansion of markets; but that on balance the most striking successes have been not in maintaining but in restraining the forces of competition. If there is a Devil, he is, as with most evils, the creation of man himself.