FROM OLSON TO VEBLEN:
THE STAGFLATIONARY RISE OF DISTRIBUTIONAL COALITIONS

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Introduction

This essay deals with the relationship between stagflation and the process of restructuring. The literature dealing with the interaction of stagnation and inflation is invariably based on some explicit or implicit assumptions about economic *structure*, but there are very few writings which concentrate specifically on the link between the macroeconomic phenomenon of stagflation and the process of *structural change*. Of the few who dealt with this issue, we have chosen to focus mainly on two important contributors – Mancur Olson and Thorstein Veblen. The first based his theory on neoclassical principles, attempting to demonstrate their universality across time and place. The second was influenced by the historical school and concentrated specifically on the institutional features of modern capitalism. Despite the fundamental differences in their respective frameworks, both writers arrive at a similar conclusion, namely, that the phenomenon of stagflation is inherent in the dynamic evolution of collective economic action, particularly in the rise and consolidation of 'distributional coalitions.'

1. Distributional Coalitions

It is perhaps convenient to begin our discussion of institutional dynamics with the general theoretical framework proposed by Olson, first in his 1965 work on *The Logic of Collective Action* and, later, in his 1982 book on *The Rise and Decline of Nations*.[1] According to Olson (1982, p. 184), all familiar macroeconomic theories abstracted from the very essence of the problem they sought to solve; while otherwise full of profound and indispensable insight, these theories were also 'fatally incomplete,' each having a 'hole at its very centre.' In the Keynesian theory, involuntary unemployment depended, at least in part, on the downward stickiness of nominal wages, but Keynes never explained why wages were sticky, the level at which they were stuck, or the duration of their invariability. The monetarist explanations avoided the pitfall of sticky wages but these theories failed altogether to explain involuntary unemployment – or, for that matter, the existence of any massive and prolonged unemployment. Cost-push theories for inflation and stagflation were important in emphasizing the potential significance of monopoly power, yet they did not clarify why monopoly power should affect the rate of inflation (as distinct from relative prices) and why the rate of inflation varied over time.

In Olson's opinion, these fundamental deficiencies arose largely because economists failed to incorporate the evolution of economic institutions and political cultures into their macroeconomic theories. Excessive emphasis on individual action served to divert attention from the activities of *dominant groups and organizations* which, in the final analysis, were the primary determinants of 'sticky prices,'

[1] Shorter statements can be found in Olson (1988 and 1989).

'involuntary unemployment,' 'government policies' and, in fact, the very 'rise and decline of nations.' The central position occupied by alliances, associations, combinations and coalitions in the course of social evolution suggests that, in order to get to the root of broad economic phenomena, we must go beyond the restricted context of individual action and incorporate into our analysis the logic and implications of *collective* action.

To do that, Olson begins with the basic rationale for collective action. Common sense suggests that rational individuals will seek to promote their own personal interest, but that does not necessarily mean they will strive to promote the collective interest of a group to which they belong. As members of a *large* group, individuals will usually prefer *not* to engage in collective action. For example, few rational consumers contribute money to consumer protection groups; most voters would not donate money to the political party for which they vote; numerous tax payers strive to minimize their tax payments the spending of which they ultimately enjoy; unemployed workers rarely attempt to organize political pressure groups; and many unionized workers would prefer not to pay their own union dues (provided most other workers do). This apparent 'paradox' between the interest of the group and the action of its members often disappears when the group is relatively *small*. For instance, General Motors may chose to unilaterally spend substantial amounts of money to promote tariff policies which are advantageous not only to itself, but also to the other two domestic automobile producers; or, Bechtel Corporation may invest in promoting an atomic energy policy which will favour not only its own interests but also those of other large firms such as Westinghouse and General Electric. According to Olson, both types of behaviour are entirely rational and the reason is very simple.

For an individual, the gross benefit from participating in collective action commonly appears in the form of a 'public good,' such as a higher wage rate for unionized workers, a higher price for the members of a cartel, or a lower corporate tax rate for members of a business lobby group. Note, however, that in order to obtain such individual benefits, the public good must be made available to *all* members of the group and this could be quite costly. In this context, rational optimizers would consider participating in collective action only if their expected net benefit is positive; in other words, only if their own contribution toward obtaining the public good is smaller than the gross benefit that contribution is expected to generate for them. Now, *ceteris paribus*, an increase in the size of the group will tend both to augment the cost of obtaining the public good and to reduce the share of the overall gain accrued to any individual member. Put somewhat differently, as the size of the group and the total cost necessary to attain a collective good grow, the effect of any individual contribution on the probability of securing that good tends to decline and thus diminishes the net benefit an individual can expect to derive from participating in such collective action. Since the incentive for group action decreases

as the size of the group increases, large groups will find it more difficult to organize and act collectively than smaller ones.

Note that the forgoing argument does not rule out the collective action of large groups. Indeed, such groups do organize and act, but the support of their members is commonly secured not with collective goods, but with so-called 'selective incentives.' In a large group, the net benefit to an individual from participating in collective action is usually negative and, in order to ensure such participation, *additional* incentives must be applied to individual members depending on whether or not they contribute toward attaining the collective good. (Selective incentives may be either negative or positive. A legal penalty imposed on those union members who fail to pay their union dues, or a jail sentence for citizens who evade federal income taxes are examples for negative incentives, while allowing individuals or firms to deduct from their tax returns contributions they made to political parties is an illustration of a positive incentive.)

This and the previous considerations lead Olson (p. 34) to two basic conclusions. One is that groups with access to selective incentives will be more likely to act collectively than those which cannot institutionalize such incentives, and the other is that smaller groups will be more prone to collective action that larger ones. Together with these conclusions, the logic of collective action leads Olson to draw far-reaching implications to which we now turn.

First, in every society there will be some large social groups which cannot institutionalize the selective incentives necessary to secure the support of their members. These groups will not organize for collective action and consequently will be left out of the social bargaining. Their exclusion casts doubts on the overall merit of free bargaining. The conviction that such bargaining is essential for economic efficiency may be adequate for an atomistic society of separate individuals; but, in reality, where some individuals act collectively while most others cannot, the gains for the bargaining parties often come at the expense of those who were left out. According to Olson, this simple consideration serves to indicate that neoclassical assumptions about rational behaviour do not necessarily imply social harmony and overall economic prosperity. In the context of collective action, rational action is in fact a major *antagonistic* force and, hence, even in the absence of any other obstacle, 'a society that would achieve either efficiency or equity though comprehensive bargaining *is out of the question*' (p. 37, emphasis added).

Second, the problem is greatly aggravated by the specific nature of collective action. While every group in society is normally interested in overall efficiency and growth, says Olson, only a few will find it beneficiary to *contribute* toward such ends. This becomes evident if we view aggregate growth and efficiency as public goods available to all groups in society. Following the logic of collective action, a group should strive to promote broad social ends only if its expected net benefit from such action is positive; in other words, only if the expected gross benefit *to the group* exceeds the cost it must incur in order to obtain these benefits *for society as a whole*.

For small groups, the expected net benefit of such action would usually be negative and, hence, although such groups may wish to enjoy macroeconomic prosperity, they will rarely sacrifice their own resources to promote it.[2] Apart from striving to *increase the social pie*, the only other course of action open to small groups is to try and *obtain a larger share of that pie*. The net benefit from following this latter strategy will usually be positive and this, too, follows directly from the logic of collective action. An attempt by a group to redistribute income in its favour is likely to cause a misallocation of social resources and an overall reduction of aggregate output. These are collective misfortunes and are detrimental to all members of society. The benefit from redistribution, on the other hand, accrues only to the group itself. Now, for a small group, the potential gains from redistribution will normally be vastly larger than the share of the social cost the group must incur in the process and, hence,

> the typical organization for collective action within a society will, at least if it represents only a narrow segment of the society, have little or no incentive to make any significant sacrifice in the interest of society; it can best serve its members interests by striving to seize a larger share of the society's production for them. . . . *[T]here is for practical purposes no constraint on the social cost such an organization will find it expedient to impose on the society in the course of obtaining a larger share of the output for itself.* (p. 44, emphasis in the original)

Since most organizations for collective action are small relative to society, Olson concludes that, far from being conducive to growth, these groups are strongly disposed toward acting as *distributional coalitions*, seeking to redistribute existing income and wealth at any cost to the rest of society.

Third, distributional coalitions are relatively slow to act and that, too, has grave implications. For a distributional coalition, the most contentious issue in deciding on a common strategy is the 'proper' allocation of cost and gains among group members. Small groups often try to solve the problem *via* 'consensual bargaining,' while in larger groups, where consensus is difficult to achieve, decisions are commonly arrived through 'constitutional procedures.' Both of these processes are time consuming, particularly when groups have crowded agendas. In order to avoid paralysis, many distributional coalitions tend to bypass the allocation problem by opting for a common price policy, leaving the allocation of quantities to the market or to some other abstract forces. This bias toward price fixing has devastating consequences, particularly for market economies, since it undermines the allocative role of the price system. Furthermore, because they are slow to react, distributional

[2] Note that the argument here refers only to group action aimed directly and exclusively at promoting broad social ends. While striving to achieve other goals, a small group may also have a positive effect on overall efficiency and growth, but this effect is only indirect and hence does not bear on the issue at hand.

coalitions tend to reduce the long-term vitality of their society. Not only do they make the economy less responsive to changes in tastes, technology and natural conditions, but they also obstruct the creative faculties of society by slowing down the assimilation of new innovations. According to Olson, this inherent inflexibility works not only to restrict the absolute levels of output and employment, but also to reduce the economy's rate of growth.

Fourth, the economic significance of distributional coalitions is strongly tied to their profound impact on the political and cultural transformation of society. Distributional coalitions serve their member by lobbying for favourable government policies or by colluding to alter market outcomes. Over time, with the progressive accumulation of such coalitions (as described below), there is hence a gradual reallocation of resources away from production and toward lobbying and collusive activities. This shift occurs also because the very activities of distributional coalition tend to make the legal system ever more intricate; they complicate the web of laws, regulations and decrees and swell the private professions and governmental bureaucracies which strive on them. The progressive transformation from production to redistribution increases the political intervention in markets, augments the economic role of governments and, in general, makes political life more divisive and antagonistic. In parallel, the growing focus on economic collusion and redistributional struggles creates a complicated system of formal and informal 'understandings' between the different distributional coalitions. The complexity of these latter institutional arrangements makes productive activity more risky and less appealing. Finally, beyond their direct effects on economic and political life, the gradual emergence of distributional coalitions changes the direction of social evolution by slowly degrading the cultural status of productive work in favour of 'predatory' activities related to redistribution.

Fifth, the problem of distributional coalitions is far from being static and tends to grow over time. The process of organizing a group for collective action is costly and often could be initiated only in the presence of some unique and exceptionally favourable circumstances. As a result, organized groups and collusions would tend to emerge over a considerable period of time. On the other hand, customs, traditions, habits and the interests of group leaders work to reinforce those collusive organizations which have been successfully established and, short of forced elimination, such organizations could survive indefinitely. The combined effect of these two dynamic attributes is that 'stable' societies would tend to 'accumulate' distributional coalitions over time.

Sixth, the social damage of distributional coalitions could have been somewhat lessened had these groups been sufficiently large but, unfortunately, there are several factors which tend to limit the number and significance of large groups. When distributional coalitions are relatively large, they have some incentive to make society more prosperous and also to minimize the social cost associated with their redistributional undertakings. The rationale behind this proposition is, again,

straightforward. Both the benefit to a coalition from promoting overall prosperity and the share of the social cost it must bear to achieve a redistributional gain tend to grow with the size of the coalition relative to society. Thus, 'encompassing organizations' which represent a considerable segment of society may often find that the broad consequences of their actions have a substantial impact on their own particular interest. Under certain circumstances, the particular interests of encompassing coalitions may drive them to promote the overall interests of society. This mitigating effect should not be overstated, however. Because they are easier to organize, small groups will establish themselves faster than large ones and will hence tend to have a disproportionate power in society. In a 'stable' society, this power differential will tend to diminish somewhat with the eventual organization of larger groups, but it will not be completely eliminated. Being first to organize, smaller groups would capture strategic positions which then become unavailable to the larger latecomers. Another factor limiting the incidence of large groups is the tendency of distributional coalitions to be exclusive rather than inclusive organizations. Depending on the circumstances, there is always some minimum size that a distributional coalition must reach before it can achieve its goal. Yet, since the redistributional gain available for the group is usually given, any further enlargement of the group beyond that minimum will only serve to diminish the distributive shares of existing members. Furthermore, by adding new members, the group may find it more difficult to agree and act collectively. Thus, once they are sufficiently large, distributional coalitions will seek to restrict the size of their own membership and, hence, narrow coalitions will rarely develop into 'encompassing' groups.

Building on the simple neoclassical principles of self-interest and rational action, Olson leads the reader into the seemingly inevitable conclusion that a stable society is intrinsically 'self-destructing.' While social stability is a prerequisite for economic prosperity, it also provides the breeding ground for distributional coalitions which relentlessly labour to arrest overall efficiency and growth:

> To borrow an evocative phrase from Marx, there is an 'internal contradiction' in the development of stable societies. This is not the contradiction that Marx claimed to have found, but rather an inherent conflict between the colossal economic and political advantages of peace and stability and the longer-term losses that come from the accumulating networks of distributional coalitions that can survive only in stable environments. (p. 145)

Thus, contrary to the conviction of some conservatives, the fact that social institutions such as special interest groups survive for a long time does not at all mean that they are necessarily useful to society. Moreover, distributional coalitions are not an exogenous 'imperfection' which merely 'distorts' the proper functioning of

production and markets. Instead, these special-interest groups are the *normal* outgrowth of the very economic process they work to obstruct.

The logic and implications of collective action, Olson argues, could help explain a diverse array of social phenomena across time and space. One of these phenomena is the perplexing disparity since the Second World War in growth rates of developed democracies. While some countries, like Japan and Germany, experienced phenomenal economic growth, others, most notably Great Britain, showed a remarkably dismal performance. Much of these differences, Olson suggests, could be attributed to the sweeping repercussions of dictatorship, war and occupation for the delicate networks of distributional coalitions. Countries like Japan and Germany had undergone traumatic political upheavals which weakened and in many cases destroyed their dominant special-interest organizations and coalitions. In Germany, Hitler annihilated the labour unions and the post-war denazification and decartelization programs of the Allied forces considerably weakened right-wing organizations and business collusions. The post-war emergence of labour unions was encouraged by General Clay who, fearing grass-root socialism, decided to encourage the controlled rebirth of the labour movement under the auspices of the old Social Democratic leaders.[3] These unions later evolved into highly encompassing structures rather than into narrow distributional coalitions. In Japan, the militaristic regime oppressed left-wing groups and, after the war, General McArthur acted to officially dissolve the *zaibatsu*. This forced weakening and eradication of distributional coalitions gave Germany and Japan an enormous advantage over other developed countries which had not suffered dictatorship and occupation. With relatively little growth-retarding institutions, these two countries were well posited for an 'economic miracle' of rapid growth (which they sustained only until distributional coalitions again became dominant in the 1970s.) In this sense, victory was a mixed blessing for the Allied countries. The best example is the case of Great Britain which, among developed democracies, enjoyed the longest impunity from the hardship of revolution, dictatorship and invasion. The economy of Great Britain has been suffering from lacking vitality and slow growth, but this 'British Disease,' Olson reminds us, is a relatively recent phenomenon which emerged gradually since the late nineteenth century and became acute only after the Second World War. In fact, during the Industrial Revolution, Great Britain had the fastest growing economy in the world and that, according to Olson, was greatly facilitated by the relative openness and mobility in British society, particularly when compared with the semi-feudal structures which still dominated Continental Europe. Since the middle of the nineteenth century, however, Europe has been inflicted with a barrage of wars and revolutions which decimated existing growth-impeding institutions, while Great Britain continued to enjoy uninterrupted stability. Consequently, even the *laissez faire* regime which prevailed in Great Britain between the middle of the nineteenth

[3] See Barnet (1983), ch. 1.

century and the inter-war period was insufficient to prevent the inescapable accumulation of distributional coalitions and these, in Olson's opinion, eventually debilitated the British economy and contributed to the decline of the British Empire.

Other developed economies were also affected by the history of their distributional coalitions. France, for instance, has been subject to recurrent political instability which, although harmful to capital accumulation, restricted the evolution and accumulation of distributional coalitions and helped to preserve the long-standing vigour of the French economy. The Norwegian, Swedish and Swiss economies have attained very high per capita income levels and that makes their continuous growth somewhat surprising. Yet, according to Olson, these cases too could be partially explained by their institutional structures. Given their relatively stable history, Norway and Sweden did accumulate considerable distributional coalitions but, for most part, these tended to be highly encompassing groups which were only marginally detrimental to overall growth. In Switzerland, the accumulation of distributional coalitions has been checked by exceptionally restrictive constitutional arrangements which make it difficult to pass new laws and consequently limit the lobbying power of the coalitions. The case of the United States is more difficult to assess because of its size and diversity, but something could still be said on the experience of individual regions. By comparing the history of the different states, Olson found that their growth rates were negatively related to the time elapsing since their first year of statehood. In his opinion, the latter variable could serve to indicate the extent to which distributional coalitions had accumulated and thus its negative correlation with growth rates is hardly surprising.

Modern theoretical language and examples from recent history may give the false impression that distributional coalitions are a relatively recent institution, but, in fact, argues Olson, the decline of such coalitions could help explain the very emergence of modern capitalism. During the medieval era, the economic development of Europe was constrained by the gripping hold of guilds. These associations of master craftsmen, merchants and journeymen served their members with typical distributional-coalitions tactics, using their monopoly power and political influence to advance their own interests at a considerable cost to most other members of society. The eventual expansion of mercantilist trade and the subsequent emergence of capitalistic production was conditioned, to a large extent, on the decline of the guild system which started to disintegrate as the process of 'jurisdictional integration' gained momentum. The broadening of markets beyond the traditional limits of the major cities, the freeing of trade and increased factor mobility and, finally, the progressive centralization of previously decentralized political institutions, all had devastating consequences for the guilds. Improved transportation enabled enterprising capitalists to move their activities from major cities to smaller urban areas and to the countryside, where the absence of the guilds made production much cheaper. The freer trade and enhanced factor mobility broadened the market and hence destroyed the guilds' cartelistic advantage which

could be sustained only within narrower trade boundaries. Lastly, the centralization of political power undermined the existing networks of political lobbying on which some of the guilds' power had rested. By contributing toward broader jurisdictions, these transformations slowly stripped the guilds of their destructive faculties and hence turned them into increasingly irrelevant social institutions. According to Olson, a similar institutional restructuring was apparently crucial in many other cases of jurisdictional integration. For example, the continuous geographical expansion of North American markets in the nineteenth century curbed the accumulation of distributional coalitions and that helps to explain the phenomenal vitality of the American economy at the time. Similarly, the jurisdictional integration of European economies into the Common Market was so successful partly because the removal of trade barriers and the centralization of certain important political institutions deprived distributional coalitions from some of the cartelistic and political privileges they previously enjoyed in their own countries.

Note the significance that Olson attaches to 'free markets' or 'free trade' goes beyond their presumed impact on specialization and the division of labour. These latter processes have attracted much attention from economists and are certainly crucial for prosperity, he says; but such economic processes could not fully develop *unless* free markets and trade also succeed in checking the pernicious emergence of distributional coalitions. That *laissez faire* can indeed fail in this task is perhaps best illustrated by British economic policies in India, where

> more than a half-century of laissez-faire did not bring about the development of India or even get it off to a good start. The laissez-faire ideology in its focus on the evils of government alone *clearly leaves something out*. I submit that it is the distributional coalitions, which over millennia of history in India had hardened into castes. (p. 179, emphasis added)

Ironically, this same failure occurred in Great Britain itself:

> During the nineteenth and early twentieth centuries, precisely when and where laissez-faire policy was at its peak, Great Britain acquired a large proportion of its dense network of narrow distributional coalitions. It was in this same period, too, that the British disease emerged and British growth rates and income levels began to lag. (p. 180)

Thus, contrary to the presumption of many economists, a lack of government intervention is not a sufficient recipe for economic success, simply because free markets do not assure freedom from distributional coalitions:

> As I read it, the ark and covenant of the laissez-faire ideology is that the government that governs least governs best; markets will solve the problem if

> the government only leaves them alone. There is in the most popular presentations of this ideology a monodiabolism, and the government is the devil. If this devil is kept in chains, there is an almost utopian lack of concern about other problems. . . . The government is by no means the only source of coercion or social pressure in society. There will be cartelization of many markets even if the government does not help. Eliminating certain types of government intervention and freeing trade and factor mobility will weaken cartels but will not eliminate them. (p. 177-8)

Finally, and perhaps most importantly, 'the absence of government intervention (even if it were invariably desired) *may not be possible anyway*, because of the lobbying of special-interest groups.' (*ibid*, emphasis added)

The robustness of Olson's propositions seems remarkable indeed. The logic and implications of collective action provide a common denominator linking diverse historical phenomena such as the emergence of European capitalism, the post-war economic miracle of Japan and Germany, the long-term stagnation of India and the British disease. That does not mean, of course, that all other theories should now be conveniently discarded. A monocausal explanation for the complex processes of growth, stagnation and decline is not only infeasible, but also undesirable and Olson is very careful to stress that his theory has no such claim of omnipotence. As he sees it, the problem of existing theories is not that they are incorrect but rather that they are *incomplete*. Two centuries of economic theorizing have indeed provided highly revealing (often indispensable) insight into most broad economic phenomena but that is still insufficient. To comprehend the dynamic nature of broad economic processes, he says, we must also look under the surface for the latent institutional causes of economic change. Unless we specifically deal with the dominant groups in society and *how they evolve*, our economic understanding will remain critically flawed.

2. Distributional Coalitions and Macroeconomics: Beginnings

One area in which such *dynamic* institutional insight is desperately needed but conspicuously lacking is the modern macroeconomic theory for unemployment and stagflation and, according to Olson, this is also where the theory of distributional coalitions gains its strongest conformation. Since Keynes, most macroeconomists who have dealt with involuntary unemployment found it convenient to rely on some notion of price 'stickiness.' Using a conventional diagram of supply and demand, involuntary unemployment is said to exist when, at the prevailing price, the quantity supplied of a given factor exceeds the quantity demanded of that factor and this discrepancy occurs when the price exceeds its market-clearing level. From this perspective, it is clear that, while involuntary unemployment may arise for a variety of reasons, it could *persist* only if prices remain 'sticky,' failing to converge to their equilibrium vector. Any explanation for involuntary unemployment based on supply

and demand must hence answer the basic question of *why* prices are sticky and this is precisely where most macroeconomic theories fail. From an overall social viewpoint, sticky prices are Pareto suboptimal. With prices being 'too high' and quantities being 'too low,' there is an unrealized hedonic 'surplus' which sellers and buyers could exploit through mutually advantageous transactions at the equilibrium price. In this context, where buyers and sellers have a mutual interest in equilibrium prices, sticky prices are highly embarrassing because they indicate that buyers and sellers in fact *fail* to act in their own common interest! According to Olson, the paradox is of course more apparent than real and its solution lies with the logic and implications of collective action.

While society as a whole could do better without sticky prices, small, special-interest coalitions – particularly collusive oligopolies and labour unions – often see things quite differently. In the labour market, the unemployed are too numerous and dispersed to organize for collective action and that means they could not obtain employment in return for some negotiated wage-transfer schemes with the labour unions. Under these circumstances, the best course of action open for labour unions is to try and bloc mutually advantageous transactions between employers and the unemployed; and, once this has been achieved, the next step is to strive for higher-than-equilibrium wage rates – which of course may perpetuate the unemployment problem. Similarly, since oligopolistic firms cannot establish income-transfer schemes with the multitude of unorganized consumers even if they wanted to, their best strategy is to fix their prices above competitive levels and, given sticky input prices, that, too, leads to involuntary unemployment.

The detrimental impact of collusive practices on unemployment is of course well known and has often been used by mainstream macroeconomists to explain sticky prices and other anomalies (see Nitzan, 1990a). Unfortunately, familiar anti-union sentiments and occasional references to restrictive business tactics are hopelessly insufficient as a basis for macroeconomic understanding. The problem, says Olson, arises because most macroeconomists treat 'monopoly power' not as an integral part of their theory but rather as an exogenous institutional 'distortion.' Given their excessive passion for 'generality,' some orthodox macroeconomists find it undesirable to base their (otherwise) universal models on what they see as exceptional structural 'imperfections,' and it is this very attitude which keeps the answers to their most burning questions safely out of reach. While students of economic structures and institutions have long realized the dynamic *historical* nature of their subject, macroeconomists have laboriously striven to strip their theories so that they could discover the static *timeless* laws of their discipline. With Keynes applying his multiplier principle to both Great Britain of the 1930s and to the slave society of Pharaonic Egypt, and with Friedman declaring that inflation was always and everywhere a monetary phenomenon, macroeconomists were led to believe that their field was indeed independent of both history and institutions. This *a*-historical framework might have been valid had macroeconomists succeeded in explaining the

cross-section variability in the performance of different countries, or why macroeconomic performance changed over time, but, unfortunately, these are questions for which macroeconomics has no convincing answers. Some macroeconomists have indeed suggested that differences in national labour practices and changes in government policies could account for spatial and temporal variations in macroeconomic performance, but these *ad hoc* explanations do not solve the problem. Instead, they lead the macroeconomists who use them into a theoretical limbo since standard macroeconomics has nothing to say on the *causes* for structural diversity and institutional change.

If sticky prices and involuntary unemployment indeed depend on the extent of 'monopoly power,' we must deal with the dynamic evolution of such power. If inflation is the outcome of expansionary government policies, we must explain the institutional forces leading to such policies. Unless we deal with the dynamic causes of such structural developments, we could say very little on why some countries have suffered greater unemployment than others, or on why stagflation seems to have intensified over the last several decades. In short, a theory which relies on institutions must also explain how those institutions arose, and since macroeconomics definitely needs to deal with *structure*, it must also deal with *structural change*. Viewed from this perspective, the theory of distributional coalitions offers much more than a static explanation for sticky prices and involuntary unemployment. It may also help us understand why these and other broad macroeconomic phenomena *evolve* over time.

Olson's logic of collective action says that distributional coalitions will tend to fix prices rather than quantities as has often been supported by evidence on the activities of business collusions and labour unions. It also implies that coalitions will be sluggish and, hence, that their prices will remain 'sticky' for considerable periods. Given their delayed reaction to changing circumstances, distributional coalitions will be slow to lower their prices, even when such reductions serve their group interest. When circumstances call for price increases, however, there will be tolerance and even encouragement for unilateral price hikes by individual members because that helps to bypass the lengthy decision-making process. As a consequence, coalition prices will exhibit less downward than upward flexibility and, that, too, is consistent with abundant evidence about ratchet-like oligopolistic pricing practices. Finally, the incidence of relative price inflexibility across different industries should be positively affected by the prevalence of narrow-interest coalitions. Such coalitions are easier to organize when groups are relatively small and, as many studies seem to indicate, price flexibility indeed tends to be inversely correlated with the degree of industrial concentration.

These assessments lead Olson to infer that, in the final analysis, distributional coalitions and not deficient demand are the *ultimate* source of involuntary unemployment. To explicate this conclusion, he points to a major qualitative change occurring in the way in which the U.S. economy has been responding to deficient aggregate demand. During the nineteenth century, there were substantial drops in

aggregate demand and these indeed led to recessions and unemployment. Yet, in comparison to the Great Depression, the declines in real output and employment were relatively minor and brief. The reason, Olson believes, was fairly simple. As a 'young' society with an expanding frontier, the United States had accumulated comparatively few distributional coalitions that could generate sticky prices and, in this context, even massive declines in aggregate demand were quickly translated into falling prices and left only a smaller mark on real variables. Things began to change with the closing of the frontier and the great surge in corporate concentration during the 1890s and, indeed, it was in that very period that the term 'unemployment' first came into common use. By 1929, on the eve of the Great Depression, the United States had already accumulated a dense network of distributional coalitions. When aggregate demand collapsed in the early 1930s, these dominant coalitions prevented the necessary price deflation and propagated the depression. The crisis was further aggravated by the official sanctioning of industrial 'self government' under the auspices of the National Recovery Administration, and by the legal promotion of unions and minimum wages *via* the National Labor Relations Act and the Wagner Act.

These and other historical examples lead Olson to suggest that aggregate demand has only an indirect effect on involuntary unemployment and that the precise magnitude of this effect is largely determined by the breadth and strength of distributional coalitions. Over time, as distributional coalitions accumulate and become more dominant in society, the 'price effect' of falling aggregate demand tends to diminish, the 'output effect' tends to rise and involuntary unemployment increasingly appears as a 'chronic' problem. Similarly, young societies, or those which have recently emerged from the turmoil of tyranny, revolution or foreign occupation, often recover fairly quickly from the recessionary effects of deficient demand (or other adverse shocks), whereas older, stable societies, where distributional coalitions had more time to accumulate and establish price-fixing mechanisms, experience much longer and painful recessions from which their recovery is commonly incomplete.

From this perspective, the emergence of worldwide *stagflation* in the 1970s does not seem anomalous at all. According to Olson, it is simply the next logical step in a continuous historical process. During a quarter century of relative political stability throughout the western world, the progressive accumulation of distributional coalitions slowly reduced the price effect of recessions until it eventually became positive. As Phillip Cagan describes it:

> the change in rates of change [of prices] from each expansion to the ensuing recession became less negative and, in the last two cycles, the change became positive – that is, the rate of price increase in the recession exceeded that in the expansion, perverse cyclical behavior not exhibited before. The distinctive feature of the post-war inflations has not been that prices rose

> faster in periods of cyclical expansion – many previous expansions had much higher rates – but that they declined hardly at all, or even rose, in recessions. . . . The startling failure of the 1970 recession to curb inflation *was not a new phenomenon . . . but simply a further step in a progressive post-war development*. (Cagan, 1979, cited in Olson, 1983, pp. 219-20, emphases added)

Under conditions of stagflation, it becomes even more evident that the primary cause of involuntary unemployment is not deficient demand. Since the 1970s, price increases were usually larger than the contemporaneous fall in real output which means that aggregate demand (in nominal terms) was in fact *rising* together with unemployment.

Olson's rationale for stagflation could be clarified by separating the long-term change in the rate of unemployment from its short-term fluctuations. Distributional coalitions act by setting their own prices, but the distributional outcome depends also on what happens to other prices. 'Optimal' pricing in this context requires an accurate prediction of future prices, but that is not easy to achieve because coalitions are usually slow to act. Olson maintains that, with their tardy reaction, distributional coalitions will generally *underestimate* changes in the future rate of inflation and that, in his opinion, helps to explain the familiar Phillips Curve relationship between unemployment and inflation over the business cycle. The mechanism is fairly simple. At any point in time, society suffers from a certain 'normal' rate of unemployment inflicted by coalition activity. Now, suppose that the rate of inflation increases 'unexpectedly.' The unanticipated rise means that existing coalition prices will now be lower than what the coalitions would have desired and that will cause the rate of unemployment to fall below its 'normal' level. The same process will work in reverse during periods of unexpected disinflation or deflation. As the rate of inflation declines faster than anticipated, sticky coalition prices will prove to be higher than 'optimal' and that will cause the rate of unemployment to exceed its 'natural' level. Provided that coalitions indeed tend to underestimate increases and decreases in the rate of inflation as Olson claims, unemployment will then be inversely related to variations in the rate of inflation. In this context, the stagflationary drift of the Phillips Curve arises primarily from the rising trend of coalition activity. Over time, the progressive accumulation of distributional coalitions and the consequent spread of sticky prices tend to increase the 'normal' or 'natural' rate of unemployment and that makes society increasingly susceptible to depression during deflation and to stagflation in periods of disinflation.

Unfortunately, this treatment of inflation and stagflation is deficient in a certain important respect. While Olson explains the impact of inflation on distributional coalitions, he leaves the more important question of how the coalitions affect inflation completely unexplored. This shortcoming, we argue, is not incidental, but stems from certain notable weaknesses in Olson's framework which must be

addressed. To begin with, it is not clear why distributional coalitions should tend to underestimate the rate of inflation when it is rising and overestimate it when it is falling. Suppose, for example, that the rate of inflation is 8 percent and is about to rise to 12 percent. Why should we assume that a price leader such as Philip Morris will tend to underestimate the coming change? Is it not possible for this company to predict that the future rate of inflation be 14 or 16 percent rather than 10, for instance? Or, consider a coming reduction in the annual rate of inflation from 20 to 15 percent. Is there any reason to assume that the steel lobby, in pressing the U.S. government for tariff protection, will not base its actions on an anticipated rate of inflation of 10 percent rather than say, 17 percent? Similarly, why should we expect economists working for the United Auto Workers Union to underestimate the wage increase needed to protect the real wage of their members? Could they not overestimate it instead? As we have shown in Nitzan (1990c), the notion that slow reaction somehow leads to expectational errors and, moreover, to a particular pattern of errors, is clearly unfounded. For Olson's model this obviously means that sticky coalition prices no longer explain the alleged Phillips Curve. For our purpose, however, the problem stems not so much from Olson's somewhat simplistic model, as from his fundamental assumption about coalition activity.

The notion that distributional coalitions generally suffer from inflation reflects a certain inconsistency in Olson's perception of 'power.' Distributional coalitions are portrayed as essentially rigid organizations with an inherent inability for rapid action. Since they are relatively cumbersome and slow to react, the coalitions are vulnerable to changing circumstances and hence have a strong vested interest in maintaining the *status quo*. Unfortunately, these characteristics are not entirely compatible with the manner in which distributional coalitions supposedly obtain and retain their power. Inherently slow action could explain why distributional coalitions are interested in impeding growth and arresting economic vitality, but it is not clear how cumbersome groups which chronically linger behind changing events could ever accumulate and sustain the power necessary to achieve those very aims. More importantly, it is hard to envision how distributional coalitions could become increasingly dominant just by *responding* to events and without taking *initiatives* toward altering them. As Olson himself argues, distributional coalitions will dominate the economic scene only as long as they continue to achieve redistributional benefits for their members and, in a dynamic society, that requires not only protecting existing benefits, but also striving to *create* new opportunities.

In focusing on how coalitions *react* to changing circumstances, Olson seems to have ignored the dynamic implications of his own theory. Distributional coalitions may indeed suffer from and object to changes which they have not initiated; but, according to Olson's theory, over time, that type of change should become decreasingly significant. As distributional coalitions accumulate and fortify their grip of society, *they themselves become the primary source of political-economic change*. The common bias of identifying change with 'progress' may mislead us to presume that,

being retardant to growth and impediments to prosperity, the coalitions must abhor all types of change. As we argue later in this essay, this view is entirely unfounded. Not all coalitions are born equal and they do not necessarily use the same redistributional tactics. In a capitalist economy, for example, the distributional success of labour unions may sometime depend on preventing certain change; but other groups, particularly business coalitions, often thrive by generating instability. If those latter coalitions become the dominant force in society, political-economic change will increasingly reflect their own actions and, in that context, care must be taken not to interpret coalition initiatives as 'responses.'

These comments help to illuminate Olson's inadequate treatment of inflation. As we have claimed earlier, his basic assumption whereby inflation creates 'suboptimal' distributional outcomes for the coalitions, is logically unsound and hence undermines the consistency of his Phillips-Curve model. That, however, is hardly the main point. The more significant implication of that assumption concerns not the effect of inflation on unemployment, but the cause of inflation itself. In arguing that distributional coalitions suffer from their slow *response* to inflation, Olson effectively suggests that those coalitions could not be the primary *source* of inflation and this is where the problem lies. Given this starting point, it is of course quite logical to focus on unemployment from which the coalitions benefit, and to neglect inflation from which they lose. From this perspective, there is certainly no need for a specific theory of inflation and, indeed, Olson makes no suggestion that the phenomenon may be somehow related to the evolution and activities of distributional coalitions. These presumptions are unacceptable, however. Inflation is neither a natural phenomenon, nor is it an exogenously inflicted 'disease' coming from the outside of society. It is a social process propagated by social institutions and, as such, we have no reason to assume it is independent from distributional coalitions. To suppose that, despite being the primary institutional force in society, distributional coalitions merely 'react' to inflation does not seem like a very plausible point of departure. The contention that distributional coalitions affect economic fluctuations, productivity and long-term growth – but leave no mark on inflation – requires some convincing theoretical and empirical evidence; it certainly cannot be taken as a basic truism.

Olson's concentration on the 'real' variables of growth and unemployment and his disregard for the 'nominal' process of inflation may also have additional, deeper roots. While he ridicules Keynes' and Friedman's claim for generality, his own theory seems no less ambitious. It presents distributional coalitions as a *universal* institution which tends to develop in *every* stable society, from Babylonia and Byzantium, through China and India, to Great Britain, the United States and the Soviet Union. Olson is, of course, careful to emphasize that those narrow-interest groups are unique to the historical context in which they emerge and operate; but given the professed breadth of his theory, he also insists that, underneath this heterogeneity, there lies a single unifying principle; namely, that all coalitions seek a redistributional gain and that they do so by inflicting a substantial loss on society.

Moreover, the coalitions' gain and society's losses are assumed to be *qualitatively identical*. Since both isolated individuals and organized groups are presumably driven by the same hedonic goal of utility maximization, the benefits for the coalitions and the cost for society could be denominated in the same universal units of 'purchasing power' (see the diagram on page 198 of Olson's 1982 book). This reliance on utilitarian principles could not be entirely accidental. Beyond being consistent with Olson's neoclassical leanings, it is also crucial to support his claim for historical generality. Distributional coalitions are said to be a natural outgrowth of *every* stable society and, within Olson's framework, the hedonic quest for material gain appears as the only common denominator which could bridge the vast differences existing between slavery, feudalism, mercantilism, capitalism and socialism. Unfortunately, generality is not always useful, as Olson himself aptly pointed out. By specifying the logic of collective action in 'timeless,' *a*-historic terms, Olson fell into the same methodological trap against which he warned his fellow economists. Being based on universal principles, the theory of distributional coalitions seems well suited to explain the 'real' phenomenon of growth and decline because these categories are presumably denominated in material terms common to every society; the theory is *too* general, however, for dealing with the 'nominal' phenomenon of inflation since that process is unique to *monetary* economies.

While price movements have probably occurred since the early appearance of markets, inflation emerged as a broadly based process only as economic activity became increasingly denominated in monetary terms. The great European inflation of the sixteenth century began after the discovery of America and the consequent outflow of silver and gold, but it is highly doubtful that this inflation would have happened without the concurrent emergence of European capitalism. Such a broad, *macro*economic inflation certainly could not have occurred earlier, in the middle ages for example, when more than 95 percent of the population were living of the land, under an autarkic system of feudal institutions. With only limited, mostly barter exchange, it is clearly meaningless to talk about a 'comprehensive increase in money prices.' An inflationary increase in money prices could constitute a significant phenomenon only in a predominantly monetary economy and it is indeed hardly surprising that the first theory of inflation – The Quantity Theory of Money – did not precede capitalism.

Olson suggested that the birth of capitalism was marked by the decline of medieval distributional coalitions. In his opinion, manufacturing and trade started to flourish as society was slowly liberated from the redistributional shackles imposed by the guilds. Yet the death of old distributional coalitions did not at all diminish the extent of redistribution. According to alternative interpretations (such as Galbraith, 1975, pp. 10-13, for example), capitalism was in fact conceived in an unprecedented massive redistribution of income from wages to profits and the chief vehicle for that process was no other than inflation. This link between inflation and redistribution does not necessarily imply a parallel link between inflation and distributional

coalitions, but it certainly does not preclude it. What seems clear, however, is that in order to investigate the potential relationship between distribution coalitions and inflation, we must abandon some of Olson's historical generalities and focus directly on capitalism.

3. Industry and Business

The first and probably only political-economist to view inflation as stemming directly from the evolution of distributional coalitions was Thorstein Veblen. Writing at the turn of the century, his analysis was markedly different from the dominant theoretical vogue of his time. While the neoclassicists searched for harmony of interests as the means and ends of economic activity, Veblen sought to unravel the antagonistic cultural traits which moved human history. In his opinion, society was governed not by a *universal* drive for hedonic pleasure, but rather by a *conflicting* duality of creativity and destructiveness which coexisted in human nature. With the rise of capitalism, this duality has slowly manifested itself through a growing demarcation between 'industry' and 'business.' The 'instinct of workmanship,' that combination of creative curiosity and a basic desire for human progress, thrived within the material and technological processes of the 'industrial system.' The inherent urge to acquire power and dominate others, on the other hand, revealed itself in the institutions of property and authority governed by the principles of 'business enterprise.' Gradually, as capitalism developed, the requirements of industry became increasingly incompatible with the needs of business and that brought the conflict between productivity and authority, or between workmanship and ownership, into the centre-stage. In the twentieth century, with the emerging 'new order' of big business, the conflict has culminated in the stagflationary growth of massive distributional coalitions. The larger use of credit fostered a rapid drive toward corporate concentration, and with the industrial system being 'inordinately productive,' the newly-formed coalitions of 'absentee owners' could sustain and expand only with persisting inflation and chronic stagnation.

Veblen's pioneering analysis of ownership sparked considerable interest in modern market structures; yet, interestingly, his profound insight into the interaction between ownership and inflation received little or no attention at all. In some respects, it appears as if this critical part of his theorizing was transparent and left no mark on its readers, at least on those who dealt with inflation. It is true that Veblen was sometimes vague in his formulations and that he zealously refrained from any formal 'modelling'; but as we demonstrate in the following sections, his analytical framework for inflation and restructuring rested on a logically consistent basis which remained remarkably relevant throughout the twentieth century.

The exceptional vitality of Veblen's analyses stems in large part from his emphasis on *processes*. He examined not machine production, but the machine process; his analysis of capital was focused on the processes of capitalization and

recapitalization; he was preoccupied not so much with prevailing institutions of ownership and power, as with their historical evolution; and he dealt not so much with prices, as with the inflationary process. In his work, Veblen always went beyond the static perspective for economic structure, seeking to explore the dynamic processes of restructuring. And so although his writings were anchored in his own time and elucidated with contemporary examples, they nevertheless seem 'timeless' and remain illuminating even after almost a century of capitalist development.

The basis underlying Veblen's approach to inflation and restructuring was the fundamental distinction between industry and business. The industrial sphere constituted the material and technological framework of capitalism. When considered in isolation of contemporary business institutions, the ultimate purpose of industry, its *raison d'être*, was an ever-growing quantity and quality of produced goods and services. The methods and aims of industrial production were dominated by the so-called 'machine process.' According to Veblen, the machine process involved more than the simple employment of machines; more broadly, it existed '[w]herever manual dexterity, the rule of thumb and the fortuitous conjunctures of seasons have been supplanted by a reasoned procedure on the basis of a systematic knowledge of the forces employed . . . even in the absence of intricate mechanical contrivances' (1904, p. 6).

Although machines were operated by individual employees working for individual firms, the machine process was essentially a *communal* activity, for two basic reasons. Firstly, modern industrial production was contingent on what Veblen called the 'technological heritage' of society. Technical knowledge of ways and means was obviously embedded in individuals, but the development and use of such individual knowledge already presupposed a general body of 'community knowledge' grounded in the 'accumulated wisdom of the past' (1908b, pp. 326-29). 'Evidently,' wrote Veblen (1923, p. 64), 'the state of industrial arts is of the nature of a joint stock, worked out, held, carried forward, and made use of by those who live within the sweep of the industrial community. In this bearing the industrial community is a joint going-concern.' Secondly, with the advancement of this technological heritage, production activities grew not only more complicated but also more interdependent and, consequently, the machine process became something more than a simple juxtaposition of separate productive undertakings:

> No one of the mechanical processes carried by the use of a given outfit of appliances is independent of other processes going on elsewhere. Each draws upon and presupposes the proper working of many other processes of a similarly mechanical character. None of the processes in the mechanical industries is self-sufficing. Each follows some and precedes other processes in an endless sequence, into which each fits and to the requirements of which each must adapt its own working. *The whole concert of industrial operations is to be taken as a machine process*, made up of interlocking detail

> processes, rather than as a multiplicity of mechanical appliances each doing its particular work in severalty. This comprehensive industrial process draws into its scope and turns to account all branches of knowledge that have to do with the material sciences, and the whole makes more or less delicately balanced complex of sub-processes. (1904, pp. 7-8, emphasis added)

Given this growing interdependency of both knowledge and processes, the efficiency of industrial production increasingly came to hinge on synchronization and standardization. There was a continuous pressure toward an interstitial adjustment of input and output flows between suppliers and buyers and a constant movement toward greater standardization of both production lines and consumption needs.[4] As a highly integrated system, industrial production was strongly disposed toward elaborate planning and close cooperation. Ultimately, it called for 'solidarity in the administration of any group of related industries' and, more generally, 'for solidarity in the management of the entire industrial traffic of the community' (1904, p. 17).

The principles of business differed from the practices of industry, both in methods and goals. Business enterprise meant *investment for profit*. It proceeded through purchase and sale toward the ulterior end of accumulated pecuniary wealth. While industry was a process of production, business was a matter of ownership. Whereas in the industrial sphere production was carried by the instinct of workmanship, in the business sphere ownership was manifested through the faculties of power. Where industrial activity required integration, cooperation and planning throughout society, business enterprise spelled conflict and antagonism among owners and a cleavage running between businessmen on one side, and the underlying population of working consumers on the other. These profound differences were crystallized into two different 'languages.' Unlike industrial activity, business traffic and business achievements were counted not in terms of some tangible, material units, but rather in strictly *pecuniary* terms:

> The all-dominating issue in business is the question of gain and loss. Gain and loss is a question of accounting, and the accounts are kept in terms of the money unit, not in terms of livelihood, nor in terms of serviceability of the industrial and commercial plants. For business purposes, and so far as

[4] Galbraith's later attack on 'consumer sovereignty' and his notion of the 'revised sequence' closely resemble Veblen's views on the subject: 'The frequency, duration, intensity, grade, and sequence [of consumed goods and services] are not, in the main, matters for the free discretion of the individuals who participate. Throughout the scheme of life of that portion of mankind that clusters about the centres of modern culture the industrial process makes itself felt and enforces a degree of conformity to the canon of accurate quantitative measurement' and 'those who would benefit by the advantages offered must adapt their schedule of wants and the disposition of their time and effort' (Veblen, 1904, p. 14).

> the business man habitually looks into the matter, the last term of all transactions is their outcome in money values (1904, p. 84)

Economists caught in a pre-capitalist habit of thinking have long struggled to reduce business magnitudes to 'real' utilitarian terms but, according to Veblen, such efforts were haplessly misdirected. The pecuniary nature of business terminology was not just a mere accounting convention. More profoundly, it reflected the very essence of business enterprise. The language of utility and serviceability, Veblen pointed out, belonged only to the tangible realm of industry and had nothing to do with the reality of business enterprise:

> In all these civilized countries where the price system has gone into effect men count their wealth in money-values. So much so that by settled habit, induced by long and close application to the pursuit of net gain in terms of price, men have come to the conviction that *money-values are more real and substantial than any of the material facts in this transitory world*. So much so that the final purpose of any businesslike undertaking is always a sale, by which the seller comes in for the price of his goods; and when a person has sold his goods, and so becomes in effect a creditor by that much, he is said to have 'realized' his wealth, or to have 'realized' his holdings. *In the business world the price of things is a more substantial fact than the things themselves*. (1923, pp. 88-9, emphases added)

All of this seemed to confirm that modern economic activity involved not one, but two distinct 'realities': one in which material facts were denominated in terms of heterogeneous units of input and output, and another where all substantial facts where incarnated in the universal category of money values.[5]

This fundamental distinction carries far-reaching implications for our study of inflation. Note that, in the most general sense, the 'overall price level' could be seen as the ratio between aggregate money values in the business sphere and the congeries

[5] At first sight, this distinction between industrial and business principles may resemble Marx's two modes of circulation. Industrial activity could be viewed as driven toward augmenting use value through a simple circulation (C-M-C'), whereas business enterprise might be perceived as an expanded circulation of exchange values (M-C-M'). This apparent similarity is deceiving, however. While Marx differentiated between simple and expanded circulation, he (and Marxists ever since) still tried to bring them back into a *common denominator* of labour values. For Veblen, on the other hand, there was a *complete separation* between industrial output and business values. Furthermore, as an integrated 'community activity,' industrial production could not be decomposed into separate 'factor contributions' and certainly could not be reduced to units of 'abstract labour.' And finally, in the new order of big business, prices reflected not competitive forces but distributional powers. As we argue below, these considerations served to eliminate the so-called 'transformation problem' (of converting values to prices) before it even arose.

of commodities produced in the industrial sphere. Although Veblen did not address this point explicitly, his dual framework clearly implies that the category of 'price' is neither an industrial magnitude, nor a business variable. Rather than belonging to either business or industry, commodity prices in fact constitute the ultimate link between these two spheres of activity. Veblen, much like the eminent classical political-economists before him, looked for the fundamental social causes behind the appearance of prices and inflation. If we interpret his framework in this light, we could say that, at any one time, the overall price level is much like a hieroglyph, a general code reflecting the underlying relationship between business and industry.[6] Following this logic, it then turns out that changes in the aggregate price level which we habitually perceive as commodity 'price-inflation' (or 'price-deflation') are in fact the universal image of an underlying dynamic interaction between the sphere of business and the realm of industry. In the specific context of mature capitalism, inflation becomes increasingly dependent on the ever-changing institution of absentee ownership and on the evolving forces of industrial creativity, and it is the *interaction* between these two pivotal processes which must be placed at the focus of our inflation analysis.

What was the nature of relationship between industry and business according to Veblen? When considered solely on its own terms, industrial activity was defined in terms of workmanship, cooperation, standardization and planning; yet, in practice, these aspects exerted only a secondary impact on the conduct of industry. In capitalism, industry was carried not for the purpose of serviceability and livelihood, but for profit and, in that context, the industrial system was subordinated to business ends. With capitalist development, 'those elements in the industrial world that take the initiative and exert a far-reaching coercive guidance in matters of industry go to their work with a view to profits on investment, and are guided by the principles and exigencies of business' (1904, p. 2). On the whole, wrote Veblen (1904, p. 26), '[i]ndustry is carried on for the sake of business, and not conversely,' and this particular line of dependency dominated the way in which modern capitalism evolved and functioned.

Now, while it might not be entirely clear at first sight, this view, whereby business aims dominated industrial activity, in fact inverted a conventional line of economic reasoning. Note that being a quest for profit, business enterprise was essentially a *claim* on earnings. It was wholly and only an act of *distribution*. Commodities against which profits constituted an effectual claim were created

[6] This may seem reminiscent of Marx's discussion of the *social code* embedded in *labour values*: 'Value . . . does not stalk about with a label describing what it is. It is value, rather, that converts every product into a social hieroglyphic. . . . The determination of the magnitude of value by labour-time is therefore a secret, hidden under the apparent fluctuations in the relative values of commodities' (Marx, 1906, Vol. 1, pp. 85-7). Yet, as we already noted and will further demonstrate below, Veblen's framework differed from Marx's analysis in certain fundamental respects.

elsewhere, in the industrial sphere of activity. Yet, given that industry was carried for the sake of business, it followed that, contrary to popular convictions, the primary line of causality ran not from production to distribution, but from distribution to production! From this perspective it was then clear that, in order to understand the fundamental processes of capitalism, our inquiry must start not from the realm of industry, but from the sphere of distribution.

Contrary to the neoclassical theory of marginal productivity promoted by his teacher J.B. Clark, Veblen maintained that the distribution of income had nothing to do with 'factor productivity,' simply because economic inputs did not possess any individual productivity to begin with. As we already noted, Veblen viewed industrial activity as an integrated community process in which the 'technological heritage' of society played the paramount role. In his opinion, 'technology,' or the 'immaterial equipment' of society as he also called it, was not just another factor of production which supplemented 'land,' 'capital' and 'labour'. Instead, it was the *vital* cultural substance which made raw materials, machines and physical human labour useful in the first place: 'To say that these minerals, plants and animals are meaningful – in other words, that they are economic goods – means that they have been brought within the sweep of the community's knowledge of ways and means' (1908b, p. 329). Without 'technology,' the physical factors of production were economically meaningless objects.

The fundamental importance of this 'technological heritage' could be illustrated with several simple examples. A peasant from biblical Mesopotamia, for instance, would have been useless in a twentieth-century Ford factory, not because he could not press a button or raise a lever, but because he would have been utterly displaced in the broad cultural sense. By the same token, an IBM engineer thrown into the Amazon forest is unlikely to survive not so much because of her physical inaptness, but more due to her alien cultural upbringing. Similarly with raw materials. Stone, which once was a prime raw material for utensil making, is quite useless in the production of modern tools. On the other hand, a crucial present-day raw material like petroleum would have been a largely useless substance in the agricultural manor of the feudal era. Finally, much like physical labour and raw materials, tools and machines also do not have any intrinsic productivity of their own. The usefulness of a modern robot depends crucially on the current 'state of technology.' With the arrival of a new production method, the older robot is most likely to end in the 'junk heap.' The new technology makes it economically obsolete and, although it may have lost none of its operating power, it is no longer a 'capital good.' As Veblen (1908b, p. 348, emphases added) put it, the 'specific technological expedient which it embodies ceases to be effective in industry, in competition with "improved methods." It ceases to be an *immaterial asset*. When it is in this way eliminated, the material repository of it ceases to have value as capital. It ceases to be a *material asset*.' This logic also works in reverse. A modern factory producing semiconductors would have been a worthless (and, in fact, meaningless) collection of physical objects

during Veblen's time, firstly, because it could not have been operated and, secondly, because its output would have had no perceptible use. In these and every other case, the transformation of a physical object into an economically useful capital good can neither lead nor lag behind the existing 'state of industrial arts.' As with the other inputs, tools and machines become 'productive' only within a historically-specific technological context.

From a neoclassical perspective, all of this may be interpreted as suggesting that there is perfect complementarity between technology, labour, land and capital goods, which in turn prevents us from discerning their individual productivity. This, however, was not what Veblen had in mind. In his opinion, our inability to estimate individual factor productivity had nothing to do with factor complementarity and he never suggested that labour could not be effectively substituted for capital goods or vice versa. The real problem with 'Professor Clark's Economics,' Veblen argued, was that, irrespective of factor proportions, production was always a community process and hence there was simply no such thing as *individual* factor productivity. The basic belief that labour, land and capital goods made *distinctly separate contributions* to the industrial process was fundamentally wrong. These inputs were obviously essential for production, but only because they were part of a comprehensive social and cultural process:

> The brute forces of the human animal are an indispensable factor in industry, as are likewise the physical characteristics of the material objects with which industry deals. And it seems bootless to ask how much of the products of industry or of its productivity is to be imputed to these brute forces, human and non human, as contrasted with the specifically human factors that make technological efficiency. (1908b, pp. 349-50)

All of that did not mean, however, that the distribution of income was unrelated to the process of production. According to Veblen, such a relationship did exist, but its nature was totally alien to the 'productivity doctrine.' While the common view held that distribution was a corollary of creativity, Veblen maintained it was a consequence of 'sabotage.' Whereas the customary perception was that income stemmed from the productive *contribution* of an input, Veblen suggested that it was in fact related to the potential *damage* the owner of that input could inflict on the industrial process. It is this 'negative' relationship between production and distribution which we now turn to explore.

4. Ownership, Earnings and Capital

Veblen addressed the question of ownership as belonging to the realm of social norms. Although the modern institution of private ownership appeared as an unassailable 'fact,' it was in essence a convention, a habit of thinking which has

slowly developed and crystallised into an unquestionable legal structure. Writing within the conventional framework of their own epoch, economists have seldom doubted (at least not until the twentieth century) the basic belief that ownership was grounded in productivity:

> This is taken, without reflection or question, to be the legitimate basis of property; he who has produced a useful thing should possess and enjoy it. . . . The main position is scarcely questioned, that in the normal case wealth is distributed in proportion to – and in some cogent sense because of – the recipient's contribution to the product. (1898, p. 32)

The roots of this conventional reasoning were so deep that they even transcended the wide divide between radical and conservative economists. For both sides in the economic debate, the ultimate justification for actual or desired ownership was the creative faculties of the owner:

> With the socialists it has served as the ground of their demand that the laborer should receive the full product of this labor. To classical economists the axiom has, perhaps, been as much trouble as it has been worth. It has given them no end of bother to explain how the capitalist is the 'producer' of the goods that pass into his possession, and how it is true that the laborer gets what he produces. (*ibid.*)

Over time, with the development of industry and the consolidation of capitalist institutions, the notion of ownership-by-creativity gained the ultimate status of a 'Natural Right' conferred by a coercive 'Order of Nature.' Gradually, it has risen above criticism and assumed a nearly axiomatic status, becoming not only a dominating principle of law, but also an integral part of the 'common sense.' These observations, of course, were concerned only with the conventional status of ownership. Viewed as a habit of thinking, the Natural Right of Ownership was obviously an undisputable social fact. From an analytical perspective, however, the question of whether or not ownership was based on productivity was open to serious doubts:

> This natural-rights theory of property makes the creative effort of an isolated, self sufficing individual the basis of the ownership vested in him. In so doing, it overlooks the fact that there is no isolated, self sufficing individual. . . . Production takes place only in society – only through the co-operation of an industrial community. . . . Since there is no individual production and no individual productivity, the natural-rights preconception that ownership rests on the individual productive labor reduces itself to absurdity, even under the logic of its own assumptions. (1898, pp. 33-4)

The source of this logical inconsistency, Veblen maintained, was a persisting failure to acknowledge the fundamental distinction existing between industrial workmanship and business power.

Given that production was always a social process, the overall productive capacity of a capitalist society was contingent on the size of its population and, most importantly, on the state of industrial arts. Examined from this broad, *long-term* perspective, stated Veblen (1923, p. 65) '[t]angible assets, considered simply as material objects, are inert, transient and trivial, compared with the abiding efficiency of that living structure of technology that has created them and continues to turn them to account.' Throughout history, the occasional destruction of material equipment and resources was usually a relatively minor inconvenience in the rebuilding of productive capacity. (Indeed, even in the twentieth century, when physical accumulation reached unprecedented levels, it took war-stricken Germany and Japan only few years to launch their 'economic miracles.') That did not mean, of course, that tangible equipment and resources were inconsequential. In the very *immediate* term (the so-called 'short run'), existing capital goods and natural resources were indispensable to the conduct of industry and this was where ownership came into the picture:

> For the transient time being, therefore, any person who has the legal right to withhold any part of the necessary industrial apparatus or materials from current use will be in a position to impose terms and exact obedience, on pain of rendering the community's joint stock of technology inoperative for that extent. Ownership of industrial equipment and natural resources confers such a right legally to enforce unemployment, and so to make the community's workmanship useless to that extent. *This is the Natural Right of Investment*.' (1923, pp. 65-6, emphasis added)

Seen in that light, the causal link ran not from the creation of earnings to the right of ownership, but rather from the right of ownership to the appropriation of earnings. 'Capital goods' yielded profits not because of their individual productivity, but because they were privately owned *to begin with*. Business enterprise thrived not on creative contributions, but on the implicit threat or explicit exercise of power embedded in ownership. The logic behind these arguments was quite simple. As a community joint-venture, the cooperative undertaking of industry required the use of tangible assets. From an industrial perspective, any withdrawal of these equipment and resources would have the negative consequence of undermining the effectiveness of industry and of cutting the livelihood of the industrial population. From a business perspective, however, the threat and occasional exercise of such 'withdrawal of efficiency' was a wholly beneficial tactic. Since tangible assets used by the industrial community were held under private ownership, the negative effect of their potential

withdrawal on industry could be capitalized into a positive business value. In this context, the various forms of profit were not at all a 'remuneration' for the productive contribution of the owned assets, but rather a 'ransom' claimed by their owner for allowing the industrial system to function:

> Plainly, ownership would be nothing better than an idle gesture without this legal right of sabotage. Without the power of discretionary idleness, without the right to keep the work out of the hands of the workmen and the product out of the market, *investment and business enterprise would cease*. This is the larger meaning of the Security of Property. (1923, pp. 66-7, emphasis added)

Thus, the flow of profit, rent and interest derived not from the owner's creative *contribution*, but rather from his or her established right to forcefully *curtail* the community's creative capacity. For Veblen, the Natural Right of Ownership was vested in nothing more than the vested power to incapacitate.

This language may have seemed exceptionally strong, but according to Veblen, that, too, reflected conventional habits of thinking. The attribution of earnings to 'forceful seizure' and 'sabotage' appeared offensive primarily because it referred to the *contemporary* institution of capitalism. Yet, as Veblen (1908b, p. 334) pointed out, the ownership of industrial capital was not a 'fact of nature antecedent to all human institutions,' but rather a very late historical innovation which has evolved from earlier forms of private property. Despite their differences, all forms of ownership, including capitalist ownership, were based on the same principle of coercive appropriation dating back to the initial emergence of predatory social customs:

> The earliest occurrence of ownership seems to fall in the early stages of barbarism, and the emergence of the institution of ownership is apparently a concomitant of the transition from a peaceable to a predatory habit of life. It is a prerogative of that class in the barbarian culture which leads a life of exploit rather than of industry. The pervading characteristic of the barbarian life that precedes it, is the element of exploit, coercion, and seizure. (1898, p. 44)

In itself, the institutionalization of forceful seizure has always been intimately connected to the technological evolution of society and, in particular, to the extent and nature of the tangible implements necessary to carry on production. In the earlier stages of social development, forced appropriation was limited if only because there was very little to appropriate. The technological heritage of society was manifested through the use of relatively simple appliances and there was no real advantage in seizing a bow or a spear which could easily be replaced. Eventually, however, as the 'immaterial assets' of the community start to develop and grow,

> it becomes worth while – this is to say, it becomes feasible – for the individual with the strong arm to engross, or 'corner,' the usufruct of the commonplace knowledge of ways and means by taking over such of the requisite material as may be relatively scarce and relatively indispensable for procuring a livelihood under the current state of the industrial arts. (1908b, p. 332)

Historically, property rights and the principle of ownership as a habit of thought were conventionally settled on those material items which enabled their owner to partially appropriate the community's industrial efficiency. The first form of property rights, according to Veblen, was the ownership of people, particularly women.[7] With the early division of labour between hunting and domestic work, slaves became an increasingly important repositories of knowledge and slavery became the most common form of private property. The subsequent evolution of agricultural technology turned domesticated animals and land into the most important requisite of production and, gradually, their ownership surpassed slavery in social significance. Now, the important point in this historical retrospect was, that unlike the ownership of capital, slavery and the feudal institution of landed wealth were never justified on grounds of productive contributions. As Veblen (1908b, p. 335) pointed out,

> it needs no argument to enforce the proposition that it is a *record of economic dominion* by the owners of the slaves or the land, as the case may be. The effect of slavery in its best day, and of landed wealth in mediæval and early modern times, was to make the community's industrial efficiency serve the needs of the slave-owners in the one case and the land-owner in the other. (emphasis added)

Why was it, then, that economists who found no difficulty in associating earlier forms of ownership with vested power and forced seizure, still insisted that the ownership of capital was different, stemming from the productive contribution of the owner? The answer to this question, argued Veblen, was rooted in the transitory institutions which existed during the *transformation* from feudalism to capitalism.

As the feudal seizure of agricultural produce grew more 'efficient,' a small but growing portion of the underlying population lost its feudal allegiance and drifted

[7] Veblen (1898 and 1899) tried to demonstrate that the primal origin of both private property and the patriarchal household was the early ownership-marriage of women. In this regard, it is interesting to note that much of the Hebrew vocabulary for property and martial/sexual relationship stems from the same linguistic roots. For example, the Hebrew verb BAAL means literally 'to own' as well as 'to marry,' 'to have a sexual intercourse with a woman,' 'to rule over' and 'to master.' Similarly, the noun BAAL means 'an owner' and 'a possessor,' as well as 'a husband,' 'a master' and 'a lord.'

toward the expanding industrial towns. These so-called 'Masterless Men' constituted the backbone of handicraft and it was their daily experience which provided the backdrop for the emerging ideology of ownership-by-creativity:

> Out of this workday experience appears to have arisen the common-sense notion that ownership is a 'natural right'; in the sense that what a man has made, whatever 'he hath mixed his labor with,' that has thereby become his own, to do with it as he will. . . . So the thing is his by virtue of having made it. 'Natural' ownership is workmanship wrought out and established in material objects. (1923, p. 48)

As their name suggested, the Masterless Men of the handicraft era worked for themselves with their own material appliances. They were free to do with their produce as they saw fit; in other words, they could sell it for an 'income.' In that way, the petty trade occurring in conjunction with handicraft helped institutionalize pecuniary earnings as a natural extension of ownership-by-creativity. Sale and purchase became part of the Natural Right of Ownership and the earning of income was then seen as a proof of productivity.

Yet, the substitution of a new liberal ideology of Natural Rights for the earlier feudal convention of Divine Rights did not alter the ultimate essence of ownership. In both of these forms, ownership was and remained an *individual* right to appropriate part of the *common* social output. This could be seen from the very notion that one could 'gain' from trade. The idea that buying and selling could generate a profit had no root in the productivity doctrine which traced income to workmanship rather than exchange. The origin of this convention (before the subsequent elaboration of utilitarian arithmetic for 'consumer-surplus' and 'producer-surplus') seemed much closer to the long feudal and mercantilist experience of gain by seizure. More importantly, the system of handicraft which had such a profound impact on economic thinking did not last for very long and, while the economic creed of Adam Smith was gaining prominence, the institutions on which it was based were quickly fading into oblivion. The apparent overlap between ownership and workmanship which existed during the relatively brief era of handicraft, disappeared with the coming industrial revolution. As with the earlier systems of property, capitalist ownership too was an outgrowth of technological developments, in particular, the emergence of production on a *large scale*:

> In the leading, aggressive industries which were beginning to set the pace for all that economic system that centered about the market, the unit of industrial equipment, as required by the new technological era, was larger than one man could compass by his own efforts with the free use of the commonplace knowledge of ways and means. (1908b, pp. 340-41)

The 'productivity doctrine' of income distribution was embedded in and dependent upon the existence of a freely competitive system of 'equal opportunity' – but with large-scale industry the very possibility of 'equal opportunity' and perfect competition has become *technologically obsolete*. The modern machine process required an ever-growing concentration of tangible assets which meant that the 'natural right of property' could no longer be akin to the cannons of 'natural liberty' and 'equal opportunity.' In other words, the capitalistic development of large-scale industry *inevitably* led to the separation of distribution from production:

> So soon as the capitalist régime, in this sense [of large-scale industry], comes in, it ceases to be true that the *owner* of the industrial equipment (or the controller of it) in any given case is or may be the *producer* of it, in any naïve sense of 'production.' He is under the necessity of acquiring its ownership or control by some other expedient than that of industrially productive work. The pursuit of industry requires an accumulation of wealth, and, barring force, fraud, and inheritance, the method of acquiring such an accumulation of wealth is necessarily some form of bargaining; that is to say, some form of *business enterprise*. . . . Taking the situation by and large, looking to the body of business enterprise as a whole, the advantageous bargaining from which gains accrue and from which, therefore, accumulations of capital are derived, is necessarily, in the last analysis, a bargaining between those who *own* (or control) industrial wealth and those whose *work* turns this wealth to account in the productive industry. (1908b. p. 342, emphases added)

In the early stages of capitalism, production and business were still interwoven, and the 'captain of industry' was seen as a creative factor, acting both as a master workman, as well as a businessmen. With the expansion of traffic, however, business became increasingly separate from production. The managing of production was delegated to hired managers and professionals, so as to enable the owner to concentrate on the demanding tasks of business. Gradually,

> [t]he visible relation between the owner and the works shifted from a personal footing of workmanship to an impersonal footing of absentee ownership resting on an investment of funds. Under the new dispensation the owner's guiding interest centered on the earning of the concern rather than on the workmen and their work. (1923, p. 59)

Seen from this perspective, capitalism meant not merely the accumulation of 'capital goods' under *private ownership*, but more profoundly, a division between business and industry affected through the rise of *absentee ownership*.

The institution of absentee ownership altered the nature and meaning of 'capital.' With the new order of large-scale industry, the capitalist became an

absentee owner of pecuniary wealth, an investor of funds whose activity no longer belonged to the realm of industry. Instead of being a creation of capital goods, investment now meant a business transaction in which the investor acquired a claim over a stream of money income. Likewise, accumulation no longer meant the augmentation of physical means of production, but rather the expansion of financial values. Under absentee ownership, the object of investment and accumulation – capital – was stripped of any physical characteristics and assumed the universal appearance of money value. While many economists still viewed capital as an amalgamation of machines, structures, and semi-finished commodities, for the businessman capital signified something totally different. In the eyes of a modern investor, capital meant a *capitalized earning capacity*. From the businessman point of view, his capital consisted not of the factories, mines, railways, or retail establishments under his absentee ownership, but of the present value of the expected earnings which would accrue to him by force of that ownership.

Absentee ownership and pecuniary investment emerged during the transition to capitalism, initially in commercial ventures and, subsequently, in industrial undertakings. The practice of pecuniary investment spread rapidly and persistently yet, for more than a century after the publication of Smith's *The Wealth of Nations* (1776), this development left little or no impact on the writing of economists who, for the most part, remained preoccupied with the tangible substance of capital goods. It was only with the overwhelming growth of big business in the end of the nineteenth century, that economists finally began to catch up with reality and started to ponder about the business view of capital. Though even then, the notion that capital values represented a capitalization of earning capacity was rarely seen as a contentious issue. Indeed, until the Cambridge Controversy of the 1960s, most economists saw no contradiction between the value of capital and its physical appearance. The conventional view was (and remained) that there existed a causal, positive relationship between price and quantity/quality. In the final analysis, things were valuable because they were useful and capital goods posed no exception to that rule.[8] According to the classical and then neoclassical 'productivity doctrine,' income stemmed from and was proportional to the productive services of individual factors. From that perspective, the nominal value of a capital good should indeed be equal to the sum total of its future productive contributions, denominated in nominal terms and discounted to their present value.[9] The value of 'capital' and the tangible

[8] The hedonic basis of prices is assessed in Nitzan (1989).

[9] The Cambridge Controversy illustrated that such a computation was logically inconsistent. It was shown that in order to find the rate of return on capital we must first know the value (or 'quantity') of capital and that already assumed a given rate of return. Put somewhat differently, the value of capital, considered as a capitalization of earning capacity (or productive contributions), was a function of earning capacity and the rate of interest, yet the rate of interest was nothing but the ratio of earning capacity to the value of capital, which meant that the value of capital depended on . . . the value of capital!

substance of 'capital goods' were seen as two sides of the same coin. In the writings of Veblen's contemporaries, such as J.B. Clark and Irving Fisher,

> much is made of the doctrine that 'capital' and 'capital goods' are conceptually distinct, though substantially identical. The two terms cover virtually the same facts as would be covered by the terms 'pecuniary capital' and 'industrial equipment.' They are for all ordinary purposes coincident with Mr. Fisher's terms 'capital value' and 'capital' . . . [According to J.B. Clark] 'Capital is this permanent fund of productive goods, the identity of whose component elements is forever changing. Capital-goods are the shifting components of this permanent aggregate' . . . Mr. Clark admits . . . that capital is colloquially spoken and thought of in terms of value, but he insists that in point of substantial fact the working concept of capital is (should be) that of 'a fund of productive goods,' considered as an 'abiding entity.' (1908d, pp. 195-6)

It is needless to say that such logic did not stand well with Veblen. The neoclassicists, he observed (1923, p. 59), were captured in a pre-capitalist habit of thinking and thus 'endeavored to formulate the new facts in terms derived from an earlier state of things.' By superimposing the concept of capital on a hedonistic-utilitarian system of refined barter, mainstream economists were trapped in a historical absurdity. They were using 'the alleged facts of primitive industry, when there was no capital, for the elements out of which to construct a capital concept, instead of going to the current business situation' (1908d, p. 197). Clark's notion that capital was 'a fund of productive goods' was almost a contradiction in terms. If capital and capital goods were indeed the same 'thing,' how could capital move from one industry to another, while the capital goods, the 'abiding entity' of capital, remained locked in their original position? Similarly, how could a business crisis diminish the value of capital when, as a material productive substance, capital goods remained unaltered? Or, how could existing capital be denominated in terms of its productivity, when technological progress seemed to destroy its pecuniary value? For Veblen, the answer to these questions was straightforward. Capital was simply not a double-sided entity. It was a pecuniary magnitude and *only* a pecuniary magnitude, and it was generally independent of the specific industrial function performed by 'underlying' capital goods.

The value of capital depended on pecuniary earnings, and the right for such earnings, as Veblen repeatedly emphasized, was based on business ownership, not industrial production. 'It is the ownership of materials and equipment that enables the capitalisation to be made,' he wrote (1923, p. 61), 'but ownership does not of itself create a net product, and so it does not give rise to earnings, but only to the legal claim by force of which the earnings go to the owners of the capitalized wealth.' The earnings on which capitalization was based were business earnings, the income

of an entire 'going-concern.' In the final analysis, these earnings depended not on the *productive* contribution of the owned capital goods and not even on the overall productivity of the company's industrial apparatus. Instead, they hinged on the *institutional* ability of the individual firm, operating as a business undertaking (rather than as an industrial unit), to appropriate part of the community's technological efficiency. In other words, what was being capitalized was not the *ability to produce*, but the *power to appropriate*.

The contention surrounding the link between profit and power persisted partially because the historical consolidation of property rights slowly turned the forceful appropriation of profit into a relatively peaceful process. Under modern capitalism, the right to profit became a common and legal norm which, in turn, reduced the need for explicit use of violence. Yet the fact that profit was now an accepted social norm did not mean that profit no longer depended on power. The change was primarily of form, not substance. Instead of relying on the use of violence, the exercise of economic force was now institutionalized through the conventional subordination of industrial activity to business ends.[10] Under the system of business enterprise, production was controlled toward generating the largest possible profit for the absentee owner[11] and, as it turned out, that could be achieved only through the *strategic limitation* of productive activity. It was in this strategic limitation of industry, or 'sabotage,' as Veblen liked to call it, that economic force was now manifested.

Given the negative connotations arising from this strong use of language and given the popular notion that business enterprise in fact *promotes* industrial initiatives and productive creativity, it is necessary to try and clarify the meaning of 'sabotage' here. Seen as an entire social order, the regime of business enterprise has surely been far more productive than any earlier mode of social organization; yet, according to Veblen, this immense productive vitality was an industrial rather than a business phenomenon. In the final analysis, business enterprise was possible only in conjunction with large-scale industry, but the potential capacity of large-scale industry was not at all conditioned upon business institutions. The practices of business – purchase, sale and the institutions which surrounded them – were of course related to industry, but only in point of control, never in terms of production and creativity. From this *a priori* vantage point, business could never 'boost' industry. Even companies which are considered to be at the cutting edge of technological progress do not promote industrial creativity, but merely relax some of the constraints which are usually being imposed on such creativity. A business enterprise will certainly seek to incorporate new methods or products, but only insofar as they

[10] The violent use of force was never abolished, of course. Instead, it was reduced to the status of a latent sanction to be invoked against those found in breach of legal business conventions.

[11] The drive toward the 'largest possible profit' is not synonymous with the neoclassical notion of 'profit maximization.' Instead, it merely denotes the subjective goals of businessmen which may or may not be related to the objective opportunities open to them.

confer an adequate differential advantage. The research and development laboratories of Sony and Intel, for example, have generated many more and better innovations than what has been actually used for profitable ends. The production of DAT (digital audio tape) recorders in the early 1990s, for instance, has been postponed (to the point of making the technology outdated) because several large firms could not come to a consensus regarding its effect on recording profits.[12] Similarly, there is usually a substantial lag between the development and subsequent introduction of a new Intel microprocessor, depending on the success of existing models and the threat from potential competition. Moreover, the very development of new technologies and products is often conditioned by their potential effect on existing profit and capitalization. Thus, the petroleum companies, for example, would be interested in new drilling technology but opposed to the development of alternative sources of energy, while the automobile companies would favour the development of manufacturing robots, but object to innovations which could facilitate efficient public transit.[13] The common thread going through all of these examples is that business enterprise can and does benefit from the 'state of industrial arts,' but only by *restricting* it to its own ends.

Why is it so essential for business to restrict the activities of industry? In order to further clarify the imperative of such 'strategic limitation' it is convenient to speculate on what might happen in the complete absence of industrial sabotage. Consider the following hypothetical illustration. Suppose that, in 1990, General Electric had ordered its production managers and development engineers to start producing at the highest possible rate and to continue in pursuit of that creative goal for an unlimited period of time, irrespective of 'what the market could bear.' In particular, these professionals would have been expected to develop the best possible products (rather than products that just 'beat the present competition'), to bring these products to the production line as soon as possible (rather than to follow the standard product-cycle tactics) and to produce as much as they possibly could (rather than as much as the market could 'absorb'). In other words, they would have been expected to utilize productive capacity to its *fullest possible potential*.

Note that the meaning of 'full capacity' here differs from conventional uses of this term. Popular indices for capacity utilization, such as the ones currently published by McGraw Hill, the Board of Governor of the Federal Reserve Board, the U.S. Bureau of Economic Analysis and the Wharton School, consider the magnitude

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[12] Sony was caught in the ambivalent position of standing to gain from its DAT development and lose from the impact it might have on its CBS Records unit.

[13] Business attempts to control the overall direction of industrial development are well known. During the 1970s and 1980s, for example, the large petroleum companies lobbied extensively against the development of non-fossil fuels and even took on themselves to 'develop' such fuels in order to minimize their potential repercussions. Earlier in the century, companies such as General Motors, Goodyear, Firestone, Exxon and Chevron went even further, by purchasing and then dismantling 100 electric railway systems in 45 U.S. cities. See Barnet (1980), ch. 2.

of 'full capacity' as representing what is feasible *under the existing social order of business enterprise and production for profit*. Veblen, on the other hand, thought of full capacity as a physical limit imposed by purely *technological* considerations. For him, it denoted what could have been produced had the community's industrial efficiency, its labour force and its physical resources been 'managed with an eye single to turning out a serviceable product, instead of, as usual, being managed with an eye single to private gain in terms of price' (1919b, p. 79).[14] He then provisionally estimated that 'under ordinary conditions of business-like management the habitual net production is fairly to be rated at something like one-fourth of the industrial community's productive capacity; presumably under that figure rather than over it' (1919b, p. 81).[15]

We have no comparable estimates for General Electric, but if prior to the new directive set in our hypothetical illustration the company operated only 25 or even 50 percent of its maximum potential capacity, the new policy of producing at full capacity would have at least doubled the company's output and culminated in business havoc. Markets in which General Electric occupied the first or second position, such as aircraft engines, circuit breakers, defence electronics, electric motors, engineering plastics, factory automation, industrial power systems, lighting, locomotives, major appliances and medical diagnostic systems, would be 'flooded,' while other markets in which the company held a lesser stake would also be 'glutted' with forthcoming supply.[16] Initially, General Electric might increase its market shares and perhaps even its profits, but that situation could not last for very long. Sooner or later, the relentless pressure of oncoming goods would lead to an inevitable breakdown of oligopolistic cooperation and the onset of downward price spirals in all respective markets. Now, improved production technology could operate to reduce unit cost but that would make a bad situation even worse. Since the company was now committed to producing as much as it could, the prompt implementation of new production techniques would cause an additional increase in output, leading to further declines in prices (growing demand for specific raw materials, special machinery and particularly for expert manpower, might exert some upward pressure on unit cost, but that is likely to be more than offset by the overall deflationary trend). Eventually (and that could happen fairly quickly), collapsing prices would drive the profits of General Electric down to zero and, if the engineers continued to

[14] For an excellent review and appraisal of the literature on capacity and excess capacity, see Foster (1986), ch. 5.

[15] An estimate of 25 percent for normal capacity utilization may not be as far fetched as it seems. Blair (1972, p. 474), for example, provided internal company data suggesting that, contrary to common views, General Motors normally utilized not 80 percent, but less than one half of its existing productive capacity. This figure would have been even lower, had we accounted for superior technology and resources which, although readily available, were considered unprofitable to use. These conjectures are also supported by other estimates described in Foster (1986, ch. 5).

[16] On the relative market positions of General Electric, see for example Sherman (1989), p. 40.

reign in that fashion, losses would start to mount. Moreover, although the disturbance was generated by the peculiar behaviour of a single company, the interconnectedness of business activities would likely drive many other firms toward the same fate.

With this partial scenario in mind, consider now what might have happened if *every* firm behaved in that unusual way, allowing the 'instinct of workmanship' to determine the level of industrial activity. According to Veblen (1923, p. 373),

> such a free run of production, such as the technicians would be ready to set afoot if they were given a free hand, would mean a full employment of the available resources of industry, regardless of what the traffic would bear in point of net profit from sales; it would bring on such an inordinate output of vendible goods and services as to glut the market and precipitate an irretrievable decline of the price-level, and consequently also a fatal decline of earning-capacity. . . .

Surely, some firms, particularly those operating in areas in which rapid increases in output are not feasible, might increase their profits, but the vast majority of companies would quickly go out of business. It appears that the immediate cause behind such a business breakdown was an increase in 'competition,' but that does not get to the root of the issue. Businessmen could compete vigorously and still earn a profit, provided that production remains subordinated to business ends. In our imaginary example, the collapse ensued not because of a greater competition per se but, ultimately, because industry was no longer subordinated to business ends. It was by surrendering their control over production that absentee owners lost their vested power to extract profits. In this light, it becomes clear why, in Veblen's opinion, 'such a free run of production has not been had nor aimed at; nor is it at all expedient, as a business proposition, that anything of the kind should be allowed' (1923, p. 373). While profits are certainly inconceivable when there is no production, they are also impossible under a 'free run' of production. Again, for profits to exist, business enterprise must *partially restrict human creativity and livelihood below their full potential capacity*.

Veblen identified a variety of business methods of industrial sabotage. In principle (although not always in practice), we could classify these as belonging to one of two categories: (1) *universal* practices carried routinely and uniformly by all firms as part of their usual business activity, and (2) *differential* practices carried by only a single company or group of companies. Veblen's taxonomy in this area was somewhat different; but as will become evident in the following section, our own classification into universal and differential practices is useful because it forms the conventional basis on which assets are capitalized. We turn now to consider this classification, beginning with its first category.

The 'universal' forms of industrial sabotage were not at all clear at first sight and for a very good reason: they were implicit in the 'normal' way of doing business. Routine business practices and conventions obviously made no pledge to industrial sabotage. An unsuspecting observer might plausibly argue that businessmen appeared to be interested in earning profits, not in limiting industrial output and, as evidence, point out that business firms normally did not try to restrict their own sales. In fact, contrary to the 'sabotage thesis,' the standard practice in modern business was to set a price and then produce *as much as needed* in order to satisfy demand! But was this practice as benign as it seemed? Veblen's answer to that question was negative, for while firms usually did not strive to limit their own production, their pricing policies led to that very result: 'The broad principle which guides producers and merchants, large and small, in fixing the prices at which they offer their wares and services is what is known in the language of the railroads as "charging what the traffic will bear"' (1904, pp. 53-4). Prices were set in order to achieve a certain target for profit, which could be obtained only when industrial output fell short of its full potential, which was exactly what happened when firms charged 'what the traffic will bear'! In the normal course of modern business enterprise, industrial sabotage was brought about only indirectly, thought the vehicle of profitable pricing practices.

The link between pricing policies and profit leads us to the question of 'power.' The notion that production was restricted by the ability of firms to *set* profitable prices implied that such firms possessed a certain 'monopolistic' power. Indeed, Veblen took it for granted that, even in the absence of open business cooperation, modern forms of business competition were usually 'imperfect,' or 'monopolistic,' something which Chamberlin (1933) and Robinson (1933) started to emphasize only three decades later, after the onset of the Great Depression. In his words,

> [I]t is very doubtful if there are any successful business ventures within the range of the modern industries from which the monopoly element is wholly absent. They are, at any rate, few and not of great magnitude. And the endeavor of all such enterprises that look to a permanent continuance of their business is to establish as much of a monopoly as may be. (1904, p. 54)

Veblen emphasized that the term 'monopoly' was used in the 'looser sense which it has colloquially, not in the strict sense of an exclusive control of the supply.' In other words, he used 'monopoly' as an umbrella term to cover the multitude of market institutions currently included under the modern terminology of 'monopolistic competition' and 'oligopoly.' Unfortunately, however, basing the link between profits and industrial sabotage solely on the presence of explicit 'monopolistic' institutions could be a double-edge sward, simply because it fails to explain profits under conditions of 'perfect' competition.

The difficulty arising in the case of perfect competition is fairly straightforward: How could firms which have no discretion over prices be said to exercise industrial sabotage? The answer to this question is surprisingly simple, provided we could transcend some conventional habits of thinking. Instead of concentrating on what an individual owner of a perfectly competitive firm is doing, let us contemplate on what she is unwilling to do. Take the example of mining, where world prices for many primary commodities could not be affected by individual firms. Could we argue that the existence of 'market' prices for such raw materials removes the spectre of business sabotage? The answer is clearly negative, for, even in these cases, normal production levels are set not by technological feasibility, but by business profitability. That is, the actual output of a single firm, as well as the number of firms in operations, are bound not by the state of industrial arts, but by what could be sold at a 'reasonable' profit. In fact, this is exactly what standard neoclassical theory has to say to an owner of a perfectly competitive firm: in the long-run, allow your managers to produce only if you expect to earn at least the 'normal' rate of return on your investment. Otherwise, you should shut down. Now, for those who endorse the neoclassical view, where the 'normal' rate of return is, by definition, equal to the marginal revenue product of capital, this mechanism simply assures the efficient allocation of resources. On the other hand, if we accept Veblen's fundamental distinction separating industry from business, production from earnings, and capital goods from capital, it becomes clear that the unwillingness to produce for less than some conventional rate of return is the very manifestation of industrial sabotage. And, so, even though the perfectly competitive firm does not determine prices, it is still true that the productive activity of such firms – individually and in the aggregate – is usually *limited* by what could be produced at the on-going 'normal' rate of return.

The 'normal' rate of profit, of course, was not a given, stable magnitude. Different businessmen held different views about what constituted the 'ordinary' rate of return, and their views varied across time and place. The important point, however, was that they all believed that, under normal circumstance, profits were intrinsic to the way of doing business.[17] While under earlier economic systems, the gain from investment was taken as 'fortuitous matter, not reducible to a stated rate,' with the advent of capitalism, '[a]t any given time and place there is an accepted ordinary rate of profit, more or less closely defined, which, it is felt, should accrue to any legitimate and ordinarily judicious business venture' (1904, p. 88). Thus,

> in place of the presumption in favor of a *simple pecuniary stability* of wealth, such as prevails in the rating of possessions outside of business traffic, there prevails within the range of business traffic the presumption that there must

[17] The classical economists went even further, making the 'normal' profit a necessary cost of production.

> in the natural course of things be a *stable and orderly increase* of the property invested. (1904, pp. 85-6, emphases added)

All of this suggested that the immediate cause leading to the most fundamental form of industrial sabotage was not some definite 'monopolistic' institution, but simply the unshaken *belief* among businessmen that the ownership of capital goods vested them with a 'natural' right to profit. For the absentee owner,

> [t]he returns actually accruing to him under competitive conditions would be a measure of the differential advantage held by him by virtue of his having become legally seized of the material contrivances by which the technological achievements of the community are put into effect. (1908d, p. 200)

The progressive proliferation of business principles turned the convention of 'normal' profit into one of the most potent vehicles of industrial sabotage. Even in the absence of any explicit binding arrangement, businessmen still felt compelled to restrict industrial activity. Their expectation for a 'normal' profit institutionalized a steadfast unwillingness to let excessive industrial production undermine those profits.

The 'normality' of profits was so thoroughly accepted that the industrial sabotage on which these profits were based was no longer self-evident. The business imperative of limiting production below its potential capacity was obscured by defining capacity along the conventions of business rather than those of industry. The view of 'full capacity' as denoting the output consistent with the 'normal' rate of profit meant that a certain level of industrial sabotage was now considered to be 'natural' to the working of the economy. This conventional view is evident in prevailing attitudes toward persistent unemployment. Over the 100 years between 1890 and 1989, the average rate of unemployment in the United States was 7.1 percent. Even if we ignore the period of the Great Depression (between 1930 and 1940) as being 'exceptional,' the average for the remaining 90 years was still 5.7 percent.[18] But given that 6 or 7 percent for the average rate of unemployment was consistent with 'business as usual,' many economists grew accustomed to talk about such levels as representing the 'natural rate of unemployment.'[19]

The significance of these propositions is far reaching. They indicate that *all* profitable firms must enjoy a certain explicit or implicit monopolistic power. If all profits, including those earned under perfect competition, could be attributed to the

[18] There were only 10 years during the entire century in which the rate of unemployment fell below 3 percent and another 15 years in which it lied between 3 and 4 percent. (These figures are based on data from the U.S. Department of Commerce, published in *Historical Statistics of the United States, Colonial Times to 1970*, Part 1, Series D86, p. 135, and from *Citibase*, 1990, Series LHUR, p. IX-1-6.)

[19] For more on the 'natural rate of unemployment,' see Nitzan (1990a).

vested capacity of absentee owners to limit, or 'monopolize' productive activity by 'doing business on their own terms,' we could say that the *overall* share of profits in the national income is thus a manifestation of the *average* 'degree of monopoly' prevailing in the economy. Note that this interpretation for the 'degree of monopoly' is more comprehensive than the one initially elaborated by Kalecki during the 1930s and 1940s. In Kalecki (1943), for example, the 'degree of monopoly' indicated the ability of capitalists to affect income shares under conditions of mark-up pricing. Based on Veblen's interpretation for monopolistic power, however, we propose that the 'degree of monopoly' is relevant not just under mark-up pricing, but for the distribution of income in general.

Let us now take the discussion one step further. Observe that the normal way of doing business which gives rise to the average 'degree of monopoly' is merely a reflection of all the concrete practices employed toward earning profits. Underlying the ability to earn a 'target' rate of return or to obtain the 'normal' rate of profit are the actual activities of businessmen, and these are commonly *differential* in their aims. What businessmen believe they are entitled to under normal circumstances is not what they seek to get in practice. The primal drive of business enterprise is not to strike the average, but to exceed it. Business performance is denominated in relative, not absolute terms, and it is 'getting ahead of the competition' which constitutes the final aim of all business endeavours. This compelling desire to earn *more*, grow *larger* and expand *faster* than the 'others' is perhaps the most fundamental drive of business and, in that sense, even members of the tightest oligopolistic coalition are fiercely competitive.[20]

In order to surpass the average and beat the competition, firms must go beyond the universal methods of normal business. Doing what everyone else is doing does not get you very far in business. To get ahead, you must do better than your rivals; you must employ a *differential* business practice. The essence of such practices is that they confer on their undertaker an advantage unavailable to other firms. To be effective, a differential practice must not only provide a benefit for the firm, but also *prevent* that benefit from accruing to other companies. In fact, the immediate goal of most differential practices is simply to undermine the business ability of other firms!

The list of business endeavours designed to establish a differential advantage is potentially endless, but it is useful to go through several examples to clarify their common nature. Irrespective of their concrete form, differential practices are

[20] As noted in the preceding section, business performance is measured not in units of 'effective consumption,' but in purely pecuniary terms. While absentee owners may look on consumption as the ultimate end toward which their efforts should eventually converge, the daily management of business enterprise, and particularly of big business, is completely independent of such hedonic considerations. Indeed, it is hard to envision the Ford family, or a large institutional investor driving to fire chief executive officer Petersen because the Ford company lost money during a severe recession, but it is easily conceivable that they would seek replacement if, despite a large rise in 'real' profits, the company fell from second to third place among the leading automobile firms.

invariably institutional in their nature, seeking to alter the existing structure of business arrangements in favour of their promoters and to the detriment of whoever it may concern. For example, the hundreds of patents Xerox registered on its copying machines, or those awarding Bayer an exclusivity over the production and sale of Aspirin, were sought by these companies in order to prevent other firms from using the relevant inventions;[21] the exclusive franchising until the late 1970s of bottling rights by companies like Coca-Cola and Pepsi-Cola, or of dealerships by General Motors were both aimed explicitly at limiting the number of participants in those business areas;[22] the charted monopoly over telephone services which AT&T enjoyed until 1984 effectively barred other companies from providing these same services; the concession of the Aramco partners (Exxon, Texaco, Mobil and Chevron) over Saudi oil closed this source for other petroleum companies; the registration of a five-edge star as a trade mark by Texaco or the advertisement of toothpaste by Proctor and Gamble help to differentiate an essentially homogenous product in order to protect or increase the company's market share on account of its competitors; the attempts by Bechtel to influence the lending policies of the Export-Import Bank helped to increase the loans Bechtel obtained from that bank to the obvious disadvantage of all other potential borrowers, and its activities with the Atomic Energy Commission helped it win contracts against other engineering firms;[23] the ability of General Dynamics to avoid paying any Federal income taxes during the period between 1975 and 1984 (although its reports recorded profits in 9 out of these 10 years) put this defence contractor at a considerable advantage against similar firms who were unable to win such concessions;[24] the voluntary quotas on automobile imports from Japan to the United States were beneficial not only to the U.S.-based producers, but also to the Japanese makers, who continued to restrain their exports even after the agreement ended in 1985: both the domestic and Japanese firms used the output restriction in order to boost profit markups.[25] Despite their diversity, all such arrangements are similar in that they increase the profits of their undertakers above what they otherwise would have been and, given that these practices are differential

[21] Veblen (1908c, pp. 364-65) emphasized that, although 'the invention or innovation covered by the patent right is a contribution to the common stock of technological proficiency,' the patent right itself 'must be considered a detriment to the community at large, since its purport is to prevent the community from making use of the patented innovation, whatever may be its ulterior beneficial effects or its ethical justification.'

[22] For numerous other illustrations of patents and exclusive franchising, see for example Kefauver (1965), ch. 1 and Scherer and Ross (1990), chs. 15 and 17.

[23] See McCartney (1988), chs. 9 and 14.

[24] See Wildstorm (1985).

[25] See 'U.S. Car Quotas: How Less is More for Japan,' in *Business Week* (November, 7, 1983, pp. 61-2), 'A Misstep by the Auto Makers,' by the Editors of *Business Week* (January 19, 1985) and 'Why Carmakers Will Mourn if Export Quota Die,' in *Business Week* (February, 18, 1985, p. 46).

in nature, the said rise in profit invariably leads to a *redistribution* of income in favour of those who initiate them and on account of everyone else.

At first sight, it may seem that, because they are concerned with *redistribution*, differential business practices merely shift income from one group of firms to another and hence should have no detrimental effect on industry. This neutrality is more apparent than real, however. Some practices, such as the ability to avoid taxes or to win a government contract, indeed appear to be purely 'distributional,' but the industrial effect of most differential tactics is not neutral in the least. In issuing patent rights, in awarding exclusive dealings, in organizing a cartel, or in establishing tacit collusion, the undertakers improve their relative position precisely by undermining the *industrial* activity of their existing or potential rivals. Moreover, these differential tactics form the ultimate basis on which the universal principles of full-cost pricing and the 'normal' rate of return seem to rest.

The link between differential and universal practices appears on two levels. First, under so-called 'imperfectly' competitive conditions, the ability to price products toward a target rate of return depends directly on the presence of some differential institutions to prevent unruly increases in production. Now, given that under modern business enterprise, 'imperfect' competition is the rule rather than the exception, it follows that 'monopolistic' market arrangements will have a disproportionate effect on what is considered to be 'normal.' In particular, the average ratio between profits and capitalization prevailing under these arrangements influences the conventional views among businessmen on what constitutes the 'normal' rate of return.[26] But this 'normal' rate is precisely the one governing industrial activity under 'perfect competition' – which leads us to the second point, namely, that the universal behaviour of purely competitive firms is in fact regulated by the differential 'monopolistic' arrangements existing elsewhere in the economy! This important relationship is so obvious that we often tend to ignore it. An alternative to investing in an agricultural or mining venture where there are no 'monopolistic' institutions is to buy the shares of IBM, Daimler Benz or Exxon, where returns are clearly affected by differential 'monopolistic' arrangements. In other words, a small investor will expect her financial investment in a perfectly competitive industry to yield a return determined by oligopolistic giants![27]

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[26] Capitalization, which bears heavily on the issue, is of course not 'exogenously' given. The process of capitalization is discussed in the next section.

[27] We should emphasize that this link depends on viewing investment and capital as purely financial magnitudes. In other words, the indirect impact of monopolistic institutions on so-called perfectly competitive markets depends on the extent to which such markets are brought into the modern system of financial investment. In this connection, it should be noted that the institutional arrangements prevailing during the emergence of commercial and then industrial capitalism could rarely be characterized as being 'purely competitive.' The concessions, charters, certificates and franchises awarded to early commercial undertakings, together with the limited availability of machinery which typified the early rise of industrial production prevented competition from becoming 'perfect' in the neoclassical sense of the

As an interim summary, we can say that business profits are possible because absentee owners can strategically limit the industrial process to their own ends. The control of production by business is carried out routinely, either by pricing products toward earning a 'target' rate of return at 'normal' capacity or by conditioning industrial activity on the prospects of earning of a 'normal' rate of return. Underlying both of these universal business principles are the numerous differential practices of individual firms or groups of firms, who try to redistribute income in their favour by altering the institutional circumstances under which they operate. The aim of most (though not all) differential tactics is to undermine the industrial activity of existing or potential business rivals. The aggregate effect of such practices is hence detrimental to the industrial community at large.

The conceptual dichotomy separating universal from differential means of industrial sabotage fits neatly with the two basic cleavages which Veblen identified in the modern context of business enterprise: the one between absentee owners and the industrial community and the other among absentee owners themselves. Absentee owners struggle over differential pecuniary gains and their struggle is carried by means of mutual industrial sabotage. On a disaggregate level, the distribution of profits among absentee owners is roughly related to the balance of *business* damage they inflicted on each other. On an aggregate level, however, the total profits earned by all absentee owners depend (although not in any linear way) on the overall *industrial* damage arising from the business warfare raging among them. In other words, business goals revolve around the distribution of profits, while business methods of sabotage assure that these profits will be available in the first place.

The discussion so far suggests one primary reason why Veblen's analysis did not acquire too many followers: it leads to the conclusion that, in a certain fundamental sense, business capital is a *negative* industrial magnitude! Provided that this conclusion is indeed warranted, it serves to undermine the basis on which both the neoclassical and Marxian schools of thought rest. The neoclassicists viewed capital as a physical entity operating in harmony with the other factors of production toward a mutual hedonic goal of utility maximization. Capital values represented a capitalization of productive contributions and hence capital must be viewed as a positive force advancing a common social interest. Marx, by contrast, identified the antagonistic social basis on which capital rested, but he too considered the pecuniary accumulation of capital as a powerful engine of industrial progress. Profits in the Marxian scheme were derived through the exploitation of labour but, given Marx's competitive framework, the endurance of each individual capitalist was contingent on a relentless drive to improve productivity. To remain in business under the overriding discipline of market-determined prices, capitalists had no choice but to continuously seek and incorporate the best production methods. Some producers

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word. This form of market (or something approximating it) emerged only later, as capital goods became more 'abundant,' that is to say, when capital became a pecuniary magnitude.

might have enjoyed a 'monopolistic' advantage conferred by the use of a better technology but, in the absence of protective institutions, their differential gains were necessarily temporary. The ultimate drive for higher productivity was not monopoly, but survival. So, although profits and capital accumulation were based on an antagonistic system, the conditions under which capitalists operated compelled them to use their capital in the most productive possible way.

This view of capital as a productive agent is still endorsed by most neo-Marxists. In laying the foundations for a theory of *Monopoly Capital*, Baran and Sweezy (1966) argued that the emergence of oligopoly as the typical organization of capital made technological progress even more appealing, because the benefits of such progress were increasingly accrued to the giant corporation in the form of higher profits (or surplus), rather than to society at large in the form of lower prices.[28] This view on the productive essence of capital should not be confused with Baran and Sweezy's main argument on the inherent tendency of monopoly capital to generate industrial stagnation. The overall stagnation tendency arose not from the industrial environment in which oligopolies operated, but from the aggravating impact of monopoly capitalism on the so-called 'realization problem.'

Even British contributors to the Cambridge Controversy of the 1960s were still ambiguous on the industrial footing of capital. Srafa's demonstration that there was no unique association between the rate of profit and output per head suggested that the value of capital depended on the distribution of income and not the other way around; and this reversal, according to Robinson (1971, p. 20), 'destroys the presumption that the rate of profit measures the contribution of investment to national income (let alone to human welfare).' Given the conventional link between accumulation and economic growth, the positive connotations assigned to such growth were now called into question. With the 'conspiracy of silence' finally broken, the central issue became 'the manner in which a capitalist economy operates.' In other words,

> does the balance of power in bargaining between employers and workers determine the share of wages in net proceeds, or is it rather the requirements of profits that determine what is left over for wages from a given level of physical output? (*ibid.*)

Yet, these questions remained confined to the realm of distribution and failed to address the possible link between the distribution of income and the control of industry. Robinson admitted that, until the late 1970s, she was simply unaware that Veblen in fact anticipated much of her claims; yet, unfortunately, even then she

[28] Veblen (1904, p. 242) was well aware of the ability of large corporations to appropriate most of the pecuniary advantage of technological progress, only that, in his opinion, that advantage stemmed not from technological progress per se, but from the ability to strategically limit it for business ends.

failed to identify where their arguments differed.[29] While the Cambridge Controversy raised the possibility that capital *could* be unproductive, Veblen contended that, from an industrial point of view, it was *necessarily* counterproductive.

Veblen's broke away from the neoclassical and Marxian schemes by *a priori* separating business from industry. That separation led him to argue that profits *required* business to 'monopolize' industry by limiting output below its full potential. Without that right for a 'conscious withdrawal of efficiency' there would have been no profit and thus no investment and capital. In other words, profits and capital were determined not only by what was produced, but also by what was *not* produced! From this perspective, the institution of capital was, in its very essence, a fetter on industrial progress.

It is essential to accentuate again the *a priori* nature of this position. For Veblen, the modern machine process was the latest stage in a relatively unbroken process of technological progress unfolding since the dawn of human civilization. The technological heritage of society evolved only from the 'instinct of workmanship.' Institutions of social power and subordination could never enhance that instinct, but only limit it to a greater or lesser extent. Given the scope of his inquiry, Veblen considered business enterprise and the price system as a transient mode of social organization. Ultimately, business enterprise was a consequence rather than the cause of machine production and, hence, could be replaced with an alternative system of economic organization. Whether such alternative institutions would be less disruptive to the instinct of workmanship and human welfare than business enterprise, was and remained an open question.[30] The important point was that Veblen's *a priori* separation of production from distribution implied that *any* extra-industrial system of distribution could operate only by limiting productive activity. In other words, even if business enterprise were shown to be the least industrially harmful of all potential modes of distribution, that still would not turn capital into a 'productive' magnitude. Within the context of business enterprise, profits for absentee owners could be appropriated only because ownership allowed the strategic limitation of output and that meant that business capital was necessarily a restrictive industrial institution.[31]

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[29] See Robinson (1979), p. 60, and Robinson (1980) pp. 115-16.

[30] Veblen's own suggestions enumerated in the *Engineers and the Price System* (1921) were never tried. The post-war Communist experience removed some of the industrial limitations of business enterprise, only to replace them with other, perhaps more detrimental ones.

[31] Knight (1921, pp. 188-89), for instance, could argue that Veblen's notion of capital as a limitation of technological knowledge and industry was 'absurd,' precisely because he refused to separate business from industry. Indeed, for him 'productivity is a matter of limitation,' that is, a direct consequence of property rights.

Corporation Finance and the Structural Roots of Inflation and Stagnation

The appearance of business capital as a manifestation of distributional power is intimately linked with the emergence of the modern corporation since the latter half of the nineteenth century. The gradual separation of business from industry occurred as owners became *absentee* owners; that is, as profits became a question of industrial *control* rather than productive activity. The ability to 'control' industry was contingent on the institutional arrangements of business enterprise, particularly on the extent and nature of cooperation among absentee owners. The critical foundation of such cooperation was the modern corporation.

According to Veblen (1923, p. 82) the corporation was 'an incorporation of absentee ownership, wholly and obviously,' that is, a business concern, not an industrial unit:

> It is a means of making money, not of making goods. The production of goods or services, wherever that sort of thing is included among the corporation's affairs, is incidental to the making of money and is carried only so far as will yield the largest net gain in terms of money, – all according to the principle of 'what the traffic will bear,' or of 'balanced return,' which underlies all sound business, and more particularly all corporation business. (1923, p. 85)

Mainstream economists have tended to explain the rise of corporations in technological terms. The popular view was that the corporation was the most 'efficient' mode of business organization in that it enabled society to enjoy the benefits offered by economies of scale. The corporation was economically rational and that supposedly made it historically inevitable.[32] If we followed Veblen in separating business from industry, however, this kind of reasoning could no longer be accepted, simply since 'the use of a large scale of production is a technological devise, whereas the corporation is a business arrangement' (1923, p. 84). From this perspective, the causes which led to the rise and growth of corporations must be denominated in business terms; that is, in terms of pecuniary gains on investment. Under certain conditions, a larger scale of production might indeed be more productive and hence socially beneficial, but that in itself was quite irrelevant. The crucial question was not whether the corporation was more productive than other

[32] There has been very little change in the popular conventions regarding this issue. Samuelson, Nordhaus and McCallum (1988, p. 453) are typical in emphasizing the 'efficiency rationale' behind the corporation: 'Large-scale production is technically efficient, and a large corporation is an advantageous way for investors to pool the irreducible risks of business life. Without limited liability and the corporation, a market economy simply could not reap the benefit that comes when large supplies of capital need to be attracted to efficient-sized corporations. . . .'

forms of business organization, but whether it was more profitable. 'To employ a large scale of production,' argued Veblen (1923, p. 85), 'is a sound business proposition only so long as this larger scale will bring an increased net gain in the aggregate price of the output' and that, of course, *may or may not* be true under different circumstances.

More importantly, contrary to the conventional wisdom, the expansion of corporate finance had no immediate impact on the process of industry. The common view identified the mobilization of finance with the expansion of productive capacity:

> It is . . . a part of the folklore of Political Economy that the corporation – jointstock company – has exerted, and continues to exert, a creative force in productive industry, in that it draws out of retirement many small accumulated hoards of savings, and so combines them and puts them to work when they would otherwise remain idle. By this means the active capital is augmented by so much; which is believed to augment the materials and appliances of industry by so much, and thereby to increase the volume of work and output in a corresponding degree. This faith in the creative efficiency of capital funds and capitalized savings is one of the axioms of the business community. It is a safe presumption that no sound business man would question it. Savings will produce goods as soon as they are invested and capitalized. (1923, p. 86)

But was that view at all warranted? For Veblen, the answer was definitely negative. What was being mobilized and capitalized were pecuniary savings, not useful industrial items:

> In practical fact, the savings in question have existed and continue to exist only in the form of records of ownership, commonly evidences of debt. What was transferred in the transactions by which the savings are taken over into corporate capital is commonly some form of credit instrument; and the transaction results in an augmentation of the volume of outstanding credit instruments. Whether there are any physically useful goods anywhere held in store back of these funded savings – physical goods which are in any special sense 'represented' by these funds – is an open question, with the presumption running strongly to the contrary. [By and large] . . . the saved up funds foot up to an absentee claimant's undifferentiated claim on a share in the outstanding stock of merchantable goods at large. Any multiplication of such claims, or any mobilisation of an added number of them, adds nothing to the stock of goods on hand; it only reduces the share per unit of effectual claim. (1923, pp. 86-7)

Business investment, then, is merely a credit transaction 'by which the corporation financier comes in for the use of additional funds and is enabled to increase the capitalization and the purchasing-power of the business concern for which he acts' (1923, p. 87). These funds may or may not be used to purchase some physical 'capital goods,' but even when they are used for such a purpose, that merely transfers the ownership of the said capital good. The actual manufacturing of capital goods is not a business activity; it is an industrial process controlled for business ends.

The confusion between the act of financial investment and the increase of industrial capacity is reflected in common views about the nature of corporate securities and assets. An investor in corporate securities can purchase either bonds or shares.[33] Business and legal conventions establish a certain 'hierarchy' of risk among these two types of securities. Bonds are considered less risky, firstly because they give their owner some precedence in the disbursement of profits and, secondly, because their holder has a statutory priority over the tangible assets of the corporation in case of bankruptcy. Equity shares are more risky because they provide no legal right for dividends and, more importantly, they are often covered only partially or not at all by any type of tangible asset. It is indeed customary to view equity shares as representing primarily the intangible assets of the firm.

This correspondence between assets and securities is, of course, only a matter of informal business conventions, since corporate balance sheets do not associate specific assets with particular liabilities. Yet, the very habit of distinguishing between tangible and intangible assets seems to suggest that, from the outset, some forms of financial investment have nothing to do with the creation of productive capacity. The intangible assets of a corporation consist of items such as patents, government charters, legal quotas and franchises, as well as the catch-all article of 'goodwill.' These items of 'immaterial wealth,' as Veblen called them, do not and cannot 'produce' anything. Instead, they are the institutional manifestations of differential practices of earning profits. If a granting of a patent generates expectations for higher profits, these expectations could be capitalized through the issuance of new shares, or an augmentation of the market value of existing shares. Similarly, a merger between two very large business rivals would normally not increase their ability to produce goods and services, but it may produce anticipations for higher profits which could then be capitalized with new shares backed by fresh 'goodwill.' In other words, to the extent to which corporate shares represent intangible assets, they merely institutionalize the corporation's own differential or 'monopolistic' practices and, hence, investment in such equities is only an evidence of distributional power. Given that differential tactics commonly operate by *limiting* the use of productive capacity,

[33] For the purpose of our analysis here, 'bonds' consist of all credit extensions on fixed charges, including debentures, mortgages and direct loans a corporation receives from other corporations, financial institutions and individuals. Similarly, 'shares' refer to all credit extensions made with no commitment for repayment, including all forms of common and preferred stocks sold to investors.

it is clear that equity investment based on such practices could not be thought of as *creating* new capacity.

At first sight, the dissociation between investment in equity and the formation of industrial capacity may seem to suggest that such capacity must hence be created by the issuance of debt instruments. Unfortunately, this convention, too, is open to serious doubts. Tangible assets consist of physical items, such as machinery, structures and semi-finished commodities, but they also include various 'contractual obligations' like government securities, commercial paper of other firms, outstanding loans, accounts receivable, bank deposits and cash. These 'contractual obligations' have nothing to do with the productive capacity of the corporation which owns them. They are classified as 'tangible' assets, but it is patently clear that their pecuniary value hinges on purely 'immaterial' arrangements, particularly on the solvency of the corporation's debtors and the ability of the corporation to 'compel' these debtors to pay when the time comes.[34] In other words, many of the items which we customarily classify as material items of wealth are in fact highly intangible in nature. Or, putting it bluntly, some corporate debentures may be covered with 'nothing but air.' The increase since the early 1980s in the use of 'junk bonds' to finance corporate takeovers is a clear case in point. The immediate facts created by business amalgamations are purely institutional in nature, belonging solely to the realm of business restructuring; and to the extent that 'junk bond'-financed mergers have a subsequent bearing on industry, their significance usually lies not in creating, but in dismantling industrial capacity! The conspicuous example of 'junk bonds' is perhaps somewhat atypical, yet it could be argued that, in a certain fundamental sense, the pecuniary value of *all* bonds rests on a similar 'immaterial' basis.

Consider now those bonds which are indeed 'covered' by industrially productive assets such as plant, equipment and inventories of finished and semi-finished goods. The market value of such bonds may exhibit some positive relationship to the market value of the underlying articles of tangible wealth, but that in itself may have very little to do with the productive capacity of these industrial items. What buyers may be willing to pay for 'means of production' such as a supertanker, a cooper mine, a light-bulb plant or an inventory of microprocessors depends on business rather than industrial considerations. To a potential owner, these items are valuable only to the extent of their anticipated income-yielding capacity and, in general, the prices of these 'investment goods' could not exceed the present value of what they are

[34] Note that the ability of the corporation's debtors to fulfil their obligations need not be related to their own productive capacity. Governments can repay their debts through taxation, additional borrowing, or by printing money and these payments could be made even if there are no productive increases occurring anywhere in the economy. As far as the corporation's business debtors are concerned, their solvency usually depends not on their productive activity per se, but on their ability to strategically limit such activity toward profitable ends.

expected to yield in profits.[35] The income-yielding capacity of 'capital goods' depends directly on the control of industry by business, either 'at large' or 'in detail.' For example, the maximum price for an earth-removing machine used in a competitive mining industry would be governed by 'normal' returns expected to accrue under such conditions, while the price of a new passenger jet would not exceed the present value of the 'target' income that a typical oligopolist like Texas Air or United Airlines expects to earn by using these aircraft.[36] That prices for capital goods depend on profitability and only indirectly (or often not at all) on their productivity becomes evident during a business crisis. The collapse in the price of crude petroleum during the mid 1980s, for example, led to a 'glut' of supertankers. What solvent shipping companies (or speculators) were willing to pay for such tankers depended on their expected earning capacity and, given the grim business outlook, that was often well below the relevant replacement cost. Bond holders of bankrupt shipping companies hence found out that, although the tankers 'backing up' their debentures were as 'productive' as ever, what they could recover by selling the tankers was only a fraction of their original investment.[37]

A similar line of reasoning led Veblen to conclude that there was no fundamental difference between debt and equity. Even in the 'ideal' case where bonds covered only the tangible means of production and shares represented only the intangible assets, these evidence of ownership were both capital only to the extent of their capitalized *earning capacity*. Part of this earning capacity was habitually attributed to the 'capital goods' held by the corporation and covered by debt. The earnings were imputed by applying to the price of capital goods the prevailing 'normal' rate of return, but that, of course, was a business procedure, not a theoretical explanation. Rather than stemming from the material facts of industry, the 'normal' rate of return and, hence, the very prices of tangible assets were largely a manifestation of the average 'degree of monopoly.' In other words, the value of bonds expressed the universal control of business over industry. The same logic applied to the case of equity which covered the remaining earning capacity of the

[35] The profit expectations and the discount rate used in capitalizing them may be (and often are) partially or even entirely subjective, but that has no bearing on the present argument.

[36] Since we are talking about upper limits, our conclusions are independent of the particular circumstances under which investment goods are being produced. That is, even if Boeing, McDonnell Douglas and Airbus organized into a formal cartel, the prices they could charge for their commercial jets would necessarily be limited by what the airlines could pay for such aircraft; or perhaps more precisely, such prices would be constrained by what the airlines would consider as 'acceptable,' given the business circumstances and their own targets for profit. In this sense, the prices of capital goods reflect the balance of distributional powers between those who sell them and those who buy them. The *ex post* outcome determines the respective shares of profit accruing to the various business concerns operating along the vertical process of production.

[37] The effect of a business boom on the value of bonds is not symmetrical. A rise in the price of tangible collateral would tend to increase the number of such bonds while having only a marginal impact on their price.

corporation. The customary view was that excess earnings over and above the imputed 'normal' stemmed from some positive 'business qualities' which the firm owned through its formal binding arrangements and informal 'goodwill.' Yet, what turned these binding arrangements and goodwill into valuable assets in the first place were differential business practices aimed at increasing profits at the cost of whoever may be concerned.

These arguments suggested that the *entire* body of business capital rested on the intangible foundations of 'power.' From the point of view of the absentee investor, business capital was nothing but a claim on profits and, as we have seen, profits were determined not by the industrial productivity of underlying assets, but by prevailing business arrangements. If there was a difference between stocks and bonds, it was hence mostly a difference in the extent to which business power has been institutionalized. Bonds were commonly used to capitalize those business arrangements which were more or less thoroughly accepted as the 'normal' order of things, while stocks were usually issued to capitalize the 'singular' business arrangements which differentiated between individual or groups of firms. Even this difference between stocks and bonds was only temporary and tended to disappear over time, as the depreciation of tangible assets and the amortization of intangible assets converted both of them into the universal form of money assets.

Given these views on the nature of business capital, we can now turn to examine the *dynamic* aspects of its accumulation. Received economic doctrines tend to interpret the process of capital accumulation in 'backward-looking' terms. For the classicists and neoclassicists, capital was a physical means of production, accumulated in the past for future use.[38] For the Marxists, capital was not a physical thing, but a social relationship embedded in physical articles yet, they, too, regarded accumulation in terms of 'dead labour.' The value of capital was denominated in units of human effort (or socially necessary labour time) spent in producing capital goods and in reproducing the labour force.[39] Even the neo-Marxists who dwelt on the significance of monopoly capitalism retained that same framework. Although they no longer argued for a link between value and prices (even in the absence of the 'transformation problem'), they still viewed the price of capital in terms of the cost of producing its fixed and variable components, irrespective of how such cost were determined. Veblen's framework for capital was radically different in that it anchored the pecuniary value of capital not in past or even current prices, but in *future* prices.

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[38] See for instance, Marshall (1920), pp. 647-51, and Schumpeter (1954), pp. 631-37.

[39] See for instance, Wright (1977), p. 200. Cross-section differences in the organic composition of capital created a 'transformation problem' of converting input values into input prices, but this does not bear on the issue here. The discrepancy between prices and their respective labour values was essentially a question of inter-industry redistribution which did not impinge on the basic presumption that prices could still be denominated in units of dead labour. See for example, Sweezy (1942), ch. 7, and the more recent summary in Catephores (1989), pp. 87-106.

For Veblen, the current value of tangible capital goods (and certainly of intangible ones) was ultimately determined not by what it cost to produce (or institutionalize) them, but by what they were expected to generate in profit.[40]

In a sense, it was Veblen more than the neo-Marxists who succeeded in adapting Marx's view of capital to the new order of business enterprise and monopoly capitalism. The 'backward-looking,' cost-based interpretation of capital was perhaps adequate during the era of so-called competitive capitalism. The early development of capitalism occurred within the framework of a *money* economy. Although the separation of business from industry began already in the early stages of capitalism, it was initially quite limited in scope and all but negligible in its impact on the dominant habits of thinking. Until somewhere around the mid-nineteenth century, the business institution of capital was still very much mingled with the industrial reality of capital goods and, hence, the value of capital could rightly be seen in terms of its cost of production. The circumstances started to change, and rather rapidly, with the widespread growth of business corporations in the latter part of the nineteenth century. The methods of corporation finance converted a money economy into system based on *credit*. The primary significance of this transformation arose not from the use of credit to defer payments, but from the impact of credit on the institution of ownership. Under the earlier system, the owner-producer operated means of production valued in money prices. With the progressive incorporation of business activity, however, the archaic 'captain of industry' has slowly disappeared as the tone-giver, giving rise to the 'captain of business,' an absentee owner of financial capital whose value was denominated in credit prices. Corporate ownership was increasingly created through the extension of credit and, in Veblen's opinion, it was this 'larger use of credit' which more than anything affected the dynamic development of modern business enterprise. Clearly, if 'capital' was to be viewed as reflecting the contemporary system of social relationships, its nature as credit could no longer be ignored.

With corporate ownership being increasingly based on credit extensions, capital accumulation was becoming more and more a 'forward-looking' process. In a chronological sense, the accumulation of corporate capital tends to occur not after, but *before* profits are earned. This process becomes quite evident when we examine the financial activities of large corporations where there is a more or less complete separation between industry and business.[41] For firms like General Dynamics,

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[40] At a danger of some repetitiveness, it should be emphasized that this view could not be reconciled with the neoclassical approach, where the equilibrium between the marginal revenue product of capital and the rate of profit assured that the past be ratified by the future. For Veblen, there was no such thing as marginal productivity and, in any case, the cost of producing a commodity and the price at which it was sold were both business, not industrial magnitudes.

[41] In the case of smaller firms, in which the major owner also operates as an industrial entrepreneur, 'forward-looking' credit extensions may still be obscured by parallel 'backward-looking' capitalization of cost.

Lockheed, Philip Morris, Pepsico, or Chevron, assets tend to expand through the issuance of stocks and bonds and these are sold on the basis of a *putative* increase in earning capacity, in other words, on the *anticipation* of rising profits. To raise cash through equity or debt, Chevron need not show a higher profit or even begin drilling. An announcement of a new oil project, or heightened expectations for rising petroleum prices are usually sufficient to enable new credit extensions; in order to borrow on the bond market, Philip Morris and Pepsico do not have to increase their market share and profit, but rather persuade investors that they will do so in the future; similarly, companies such as General Dynamics or Lockheed do not have to actually manufacture and sell new aircraft before they can issue more shares or bonds. The very anticipation of a new Pentagon contract or a widespread belief in an imminent Middle East conflict could be enough to generate a warm market reception for newly issued securities. Of course, in order to constitute a solid basis for new capitalization, profit expectations must be 'institutionalized' to some extent; in other words, they must be widely shared among investors, or they should at least outweigh expectations for falling profits. Furthermore, investors must regard the presumed increase in profit as sufficiently 'permanent.' Yet, regardless of all such considerations, at the point of credit extension, these expectations are purely hypothetical. In this sense, the accumulation of credit capital is very much a 'capitalization of make-believe.' That is clearly evident from fluctuations in the stock and bond markets, where *de facto* capital prices are largely a matter of 'folk psychology,' as Veblen (1904, p. 149) already observed, but it is also true for so-called *de jure* capitalization as recorded in corporate financial statements. The expansion and contraction of corporate liabilities may be slower and less erratic than the fluctuations in market quotations, but they, too, ultimately hinge on forward-looking suppositions. '[I]n the enlightened modern business usage,' wrote Veblen (1904, p. 127, emphasis added), all forms of capital are nothing but 'capitalized *presumptive* earning-capacity.'

It should be stressed that none of the forgoing suggests that capital values are somehow independent of current realities. Indeed, a prolonged drop in profits is likely to make it difficult for IBM to raise new capital, or a decision by ITT to cut its dividends could trigger an immediate drop in its share prices. Given this relationship, it seems reasonable to ask why does it matter that capitalization looks 'forward' to profit rather than 'backward' to cost? The answer to this question is somewhat subtle. Note that current events affect capital values only to the extent to which they bear on future expectations. In principle, then, the chronological sequence begins with accumulation and only ends with profits. In this sense, the modern methods of capitalization turn the process of accumulation into a *leading* economic force. The meaning of 'leading' should not be confused with 'significant' or 'primary.' All received economic doctrines emphasize the paramount role of capital accumulation but, since they view capital in backward-looking terms, its accumulation necessarily

appears as the 'goal' or the 'end result' of a sequence, rather than its initial step.[42] Under the new order of business, however, capital values are forward-looking and accumulation occurs 'up front.' With the 'larger use of credit,' business activity tends not to end but to *begin* with capital accumulation and that shifts the focus of attention from the effect of current economic magnitudes on accumulation, to the impact of accumulation on the current development of business and industry. The accumulation of capital has two immediate corollaries to which we now turn.

The first consequence of accumulation is an *inflation of the aggregate money value of corporate assets*.[43] This effect could be explicated by considering the two processes through which corporate assets tend to expand. The first process involves the direct *creation* of new ownership titles. It occurs when a corporation obtains or institutionalizes some intangible assets – and then either distributes new shares or bonds to 'cover' these intangibles, or lets the price of the outstanding shares and bonds rise. This type of accumulation is characteristic of business restructuring. It often happens in the initial act of incorporation, when the owners give themselves shares to cover the original 'goodwill' of their association; it also takes place when a merger or an acquisition is believed to have 'generated' new intangibles – intangibles which could then be covered by higher asset prices or with new stocks and bonds allocated to original owners and third parties. This form of capital accumulation stems from the creation of 'new,' previously-nonexistent assets and hence adds to the aggregate value of outstanding corporate assets.

The second mode of accumulation occurs indirectly, through the *transfer* of ownership titles, whereby the investor advances cash in return for commercial paper or some other evidence of debt. From the investor's perspective, the reduction in cash balances is compensated by an increase in corporate securities, leaving his or

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[42] In tangible terms, accumulation is said to occur as new means of production are produced and added to the existing stock. In value terms, capital is accumulated by adding to the initial value of constant and variable capital (or to the value of machines and the wage fund) the surplus value (or profit).

[43] Note that we specifically refer to the *aggregate* value of corporate assets, rather than to their *average* value. In order to measure the average value of corporate assets we need to divide their aggregate value by their total 'quantity' and that may not be so easy to do. The conceptual difficulty is well illustrated by the attempt of Alchian and Klein (1973) to devise a price index for assets. Following the footsteps of Fisher (1911), they assume that the 'price level of "life"' must reflect prices of both future as well as current consumption services. In their opinion (p. 173), this means that '[a] correct measure of changes in the nominal money cost of a given utility level is a price index for wealth,' and hence that a truly comprehensive price index 'must include asset prices.' The basic presumption is hence that the 'quantity' of assets could be counted in terms of some future hedonic services, but then Alchian and Klein are quick to admit that these services could not be observed in practice. In other words, that it is impossible to determine whether a change in the aggregate value of assets is a pure price change, a pure quantity (quality) change, or some mixture of the two. Alchian and Klein point out that the concept of 'quantity' is also ill-defined in the computing of standard price indices for current services, but that, of course, does not solve the problem (see Nitzan, 1989).

her total assets unchanged. From the corporation's point of view, however, the transferred cash constitutes a 'new,' previously-nonexistent asset (covered with new liabilities) and is hence an addition to the aggregate value of outstanding corporate assets.

It is fairly clear, then, that the accumulation of corporate assets creates 'new funds.' Much like bank deposits – corporate bonds, stocks, bank loans, accounts payable and other records of ownership are all pecuniary magnitudes and, when they expand, they inflate the aggregate sum of money values existing in the economy.[44] Furthermore, since the accumulation of capital is 'forward-looking,' the inflation of pecuniary values occurs without a concurrent change in the congeries of goods and services, or in the capacity to produce them. It is like diluting water with water. As we argue below, the accumulation of capital may or may not lead to changes in industrial conditions – but if it does, the change will occur *after* accumulation has taken place.

Following Veblen, we can hence argue that, *ceteris paribus*, capital accumulation is a purely inflationary process. The meaning of this statement must be interpreted with caution. We do not claim here that accumulation raises or will raise the average price paid for goods and services (although that may very well happen). Instead, we simply state that, at the moment of accumulation, there is an inflation of the aggregate sum of pecuniary values without any change in the existing quantity of goods and services.

This line of reasoning may seem reminiscent of the 'quantity theory,' but the similarity is more apparent than real. While accumulation is always an inflationary process, it is never a uniform one and, so, contrary to the monetarist perspective, the inflation of capital values is anything but 'neutral.' Indeed, the second immediate corollary of capital accumulation is *redistribution in the control of pecuniary values*. The expansion of assets occurs either when the corporation takes over another firm,

[44] Bank deposits are records of ownership. They cover part of the capitalized earning capacity of a corporation (the bank) and are hence capital for all intent and purposes. There is nevertheless a difference between the creation of bank money, which is sometimes restricted by reserve requirements, and the expansion of non-bank liabilities, which is potentially limitless. To illustrate that there is no technical ceiling on the expansion of such 'new funds,' consider a hypothetical scenario with only two corporations – AAA Inc. which has $1 million worth of machines capitalized in the form of shares, and BBB Inc. which has $1 million in cash, also capitalized in the form of shares. The owners of AAA Inc. could use their assets as collateral to borrow $1 million in cash from BBB Inc. Following the transaction, the total assets of BBB Inc. remain unchanged, but those of AAA Inc. now stand at $2 million. In the second stage, BBB Inc. could generate expectations for new profits and use them to sell $1 million worth of shares to AAA Inc., thereby increasing its own assets to $2 billion. In the third step, AAA could create expectations for further increases in future profits and use them to sell $1 million in bonds or shares to BBB Inc., raising its assets to $3 million, and so on. Since there is no required reserve ratio preventing non-financial corporations from having all their assets invested in financial papers, this kind of expansion could (at least in principle) go on for ever.

thereby adding to its own assets what was earlier controlled by the acquired entity, or when it increases its assets without there being a corresponding change in the value of assets controlled by other companies. In both of these cases, the increase in the corporation's assets is *differential*, meaning that the corporation now controls a larger share out of the aggregate pecuniary values in the economy.[45] In other words, the accumulation of capital is a process not of *inflation*, but of *inflationary redistribution*. It involves not merely the expansion of assets but, more profoundly, the *restructuring of power through the differential revaluation of pecuniary values*.

Given to the foregoing, we can argue that the accumulation of corporate capital is purely a business process, consisting of an inflation of assets and a redistribution in their control. Yet business is never independent of industry which means that a theory for business accumulation must include both its industrial causes and industrial consequences. In the United States, 'forward-looking' accumulation of corporate capital emerged as a result of some fundamental economic changes occurring in the later half of the nineteenth century. First was the decline in the pace of population growth. Between 1790 and the civil war, the U.S. population grew very rapidly, expanding at an average annual rate of 3.0 percent. The conquering of the western 'frontier' brought a sharp drop in that rate. From the civil war until the turn of the twentieth century, the population expanded at an average rate of only 2.2 per annum, and that fell even further, to 1.6 percent, between the turn of the century and the onset of the Great Depression.[46] The second significant development occurring in the latter half of the nineteenth century was the rapid expansion of 'industrial arts' and the consequent surge in productivity growth. During the 1860s, there was still a

[45] To illustrate both forms of redistribution, consider the 1986 takeover of RCA by General Electric. (Details are from *Moody's Industrial Manuals*, 'General Electric Company,' 1986, Vol. 1, pp. 348-64.) To finance the deal, General Electric borrowed $5.4 billion, thereby augmenting both its total assets and its total liabilities by a corresponding sum. The borrowing brought no parallel increase in corporate assets elsewhere in the economy and hence raised the relative share of General Electric in the aggregate value of outstanding assets. Next, General Electric paid $6.4 billion (the borrowed funds plus $1 billion of its own cash) to acquire all of RCA's outstanding stocks from its current shareholders. This action eliminated RCA as a going concern and erased the value of its shares from the economy's balance sheet. If we stopped at this point, it might have appeared as if General Electric was simply transferring values from its own creditors to the shareholders of RCA, thereby leaving the aggregate value of outstanding assets more or less intact. That is not what happened, however. The elimination of RCA as a going concern redistributed all of its assets – about $6.7 billion – to General Electric, but the sum added to General electric's balance sheet was $2.7 billion *larger* than the $6.7 billion erased from the RCA accounts! The reason was that what General Electric paid was deemed to be higher than the 'fair market value' of RCA's shares. In other words, the acquisition was seen as creating $2.7 billion worth of 'goodwill' which were duly added to the assets of General Electric. All in all, the accumulation of $9.4 billion by General Electric involved a direct reshuffling of $6.7 billion worth of existing assets previously controlled by RCA, and a creation of an additional $2.7 billion worth of new assets.

[46] Computed from data published by the U.S. Department of Commerce in *Historical Statistics of the United States, Colonial Times to 1970*, 1975, Part 1, Series A2, p. 8.

substantial positive gap between the rates of growth of population and productivity. In manufacturing, for example, labour productivity rose at an average annual rate of only 0.5 percent, while the population expanded at an average annual rate of 2.7 percent. This gap was closing very rapidly, however. In the 1870s, the rate of population growth declined to 2.6, while productivity growth almost doubled, to 0.9 percent. Then, during the 1880s, while the population continued to grow at an annual rate of 2.6 percent, productivity growth more than doubled again, to 2.1 percent. Finally, during 1890s, when the rate of population growth dropped to 2.1 percent, the gap turned negative because productivity was now expanding even faster, at 2.3 percent.[47] According to Veblen, the interaction of these parallel processes had a decisive impact on the nature of business institutions. Until the latter part of the nineteenth century, markets (both domestic and foreign) tended to expand faster than productive capacity and the main concern of individual firms was how to satisfy the growing demand for their goods:

> [D]uring all that period which can properly be called the era of free competition the industrial system never reached such a pitch of efficiency that it could properly be called inordinately productive; that is to say, production was not at that time continually in danger of outrunning the capacity of the market. . . . The growth of population and the growing extension of trade into foreign parts afforded an outlet for an ever increasing production of goods, at reasonably profitable prices, that is to say at increasingly profitable prices. So that business considerations during that time called for no vigilant restriction output, on the whole; and the sagacity of the captain of industry was therefore habitually directed to a cheap and large output of goods. . . . (1923, pp. 72-3)

The situation started to change toward the end of the nineteenth century. The post civil-war period witnessed an unprecedented increase in the use of new raw materials, in the development and assimilation of innovations and new production techniques and in the diversity of products – all of which contributed to a notable acceleration in the expansion in productive capacity. On the other hand, the decline in population growth significantly reduced the growth of demand. This combination of rising productivity growth and slower increases in population meant that, from a business perspective, the industrial system became 'inordinately productive.' If the earlier pattern of competitive production were to continue, industry would tend to

[47] The figures for population growth are from *Historical Statistics of the United States, Colonial Times to 1970*, 1975, Part 1, Series A7, p. 8. Data on productivity growth are based on the Frickey Index for manufacturing Production, published in *Historical Statistics of the United States, Colonial Times to 1970*, 1975, Part 2, Series P17, p. 667, and on the number of production workers in manufacturing establishments, published by the U.S. Department of Commerce in its *Census of Manufacturing, 1982*, Vol. 1, Summary and Subject Statistics, pp. 1-2.

generate much more output that what could be sold at profitable prices. In other words, it would bring business enterprise to an end.

The 'unruly' development of the machine process threatened to undermine the very control of industry by business. If until the latter part of the nineteenth century profits arose from the private ownership of 'scarce' industrial capacity, from that period onward, business was faced with a chronic predicament of 'excess' capacity. The industrial apparatus was still privately owned, but its was no longer scarce, at least not in relation to what could be sold under prevailing conditions. In order to maintain profitability, there was now a constant need to reestablish scarcity, either by raising sales above capacity, or by curtailing capacity to 'what the market could bear.' The difficulty for business was that a shift toward such 'institutional' scarcity could not be accomplished when firms acted at cross purposes. An increase in production might be profitable for one or several firms only insofar as all other firms did not try to do the same thing. Similarly, there was no point in curtailing your own capacity if other businesses maintained or increased theirs. Whereas firms previously acted as competitive *producers* in an 'open' market, they now had to struggle as competitive *sellers* in a 'closed' market and, under these circumstances, atomistic competition was a sure way for extinction. Excess capacity was an *aggregate* problem and hence could be solved only through *concerted* action. According to Veblen (and many others since then), it was this persistent need for collective restriction of output which underlies the new order of business combinations.[48]

Large scale coordination of business activity first emerged in the United States around the 1870s. It started with the early organization of national business and trade associations, continued with the formation of trusts and reached its institutional maturity with the rise of 'big business' during the first wave of mergers and acquisitions extending between the late 1880s and the early 1900s.[49] By the first decade of the twentieth century, the institutional dynamics of U.S. business were more or less thoroughly transformed from unregulated competition to oligopolistic interaction. The transformation did not make business less 'competitive' as firms were still seeking, perhaps more than ever before, to beat the average and outperform their rivals. The fundamental change was rather in the mode of competition. Instead of pursuing their goals by means of *individual* competition, firms were continuously drawn into collective action and their struggle was increasingly carried through business *coalitions*.

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[48] The largest combination of its time – the 1901 formation of U.S. Steel – was explicitly motivated by the spectre of excess capacity, as were many other mergers at the time (see Ross and Scherer, 1990, p. 155 and Chandler, 1959, p. 285). Even when there was no immediate danger of excessive output, business combination facilitated industrial rationalization when the need eventually arose.

[49] On the beginning of 'big business' in the United States, see Chandler (1959). Extensive discussions of the early merger movement could be found in Markham (1955), Nelson (1959) and Lamoreaux (1985). Additional reviews and selected bibliographies are given in Scherer and Ross (1990), ch. 5, and in Bowring (1986), ch. 3.

The most significant development enabling the formation of such coalitions was the emergence of corporations as the common form of business organization. Business combinations were initially formed through loose associations, pools and trusts, but these were often unstable and not very successful.[50] As Olson (1965 and 1982) convincingly argued, collective action is usually difficult and often impossible for large groups and an excessive number of firms was indeed a primary factor contributing to the relative fragility of these early combinations. There was hence a pressing need to reduce the number of firms and the most effective way to do so was through the merging of existing companies into larger ones.[51] Mergers, however, were not only structural transformations, but also financial transactions. They involved the buying and selling of capital which meant that firms had to have a pecuniary value. Capital had to become 'vendible' and that was achieved through the widespread incorporation of business firms, the rapid development of stock and bond markets and the growing use of credit instruments during the final decade of the nineteenth century. It was in that period that the separation of business from industry was finally completed, with investors becoming absentee owners of 'forward-looking' capital values.

These transformations set a qualitative pattern which characterized the dynamic interaction between business and industry throughout the entire twentieth century. By and large, industrial productivity continued to expand much faster than 'what the market could bear,' making excess capacity a chronic business problem. If business enterprise were to survive, the 'scarcity' of capital goods had to be continuously reestablished, which meant that the only 'permanent' solution was a *ceaseless restructuring* of business institutions. The problem was and remained an aggregate one, and so business restructuring continued to involve the formation and reformation of business coalitions. Given that the effectiveness of collective action is negatively related to the number of participating units and positively related to their average size, the incentive for mergers in fact tended to increase with the process of corporate concentration and the progressive increase in corporate size. Mergers were financial transactions of credit expansion and so, ever since the first major restructuring of U.S. business, they were unfolding together with the expansion of credit and the accumulation of corporate capital.

Note that in identifying this historical pattern we do not claim that it stemmed from some iron 'laws of motion.' The new order of large-scale industry and big business was *driven* by the antagonistic interaction between the 'instinct of

[50] See for example Chandler (1977), pp. 317-18, Cochran and Miller (1961), pp. 140-46.

[51] This rationale for the growth of large firms differs from the traditional emphasis on the technological benefits of large scale. Indeed, according to different evidence analyzed by Edwards (1979, pp. 217-24), the growth of firm size after the turn of the century generally exceeded the need for technical efficiency. Furthermore, even in the presence of economies of scale, the ultimate purpose of corporate mergers was not to increase, but limit industrial activity.

workmanship' and the quest for profit, but the *outcome* arising from this interaction was in no way 'inevitable.' The economic history of the twentieth century was dominated not by atomistic units of negligible size, but by giant corporations and massive coalitions. This meant that the broad forces of industry and business operated not through the abstract gestures of an 'invisible hand,' but rather through the singular actions or inaction of particular corporate groups. The question now was not only whether business *needed* to reestablish scarcity, but also the extent to which it *succeeded* in doing so and, under the new circumstance of differential power relations, that question could have no 'deterministic' answer.

The significance of this view becomes clearer when illustrated with specific examples. Consider first the process of industrial development and the efforts of corporate coalitions to arrest that process to their own ends, namely, for the purpose of maintaining and, if possible, increasing the profits of their constituent members. For example, steel profits in the United States were affected by diverse factors such as the dramatic improvements in the production of steel, the formation of U.S. Steel Corporation, the collusive 'Gary dinners' and the recent challenge from Korean steel producers. Yet the fact that these industrial and business developments have taken place does not necessarily mean they were 'inevitable.' Had the Bessemer process not been invented, had Carnegie refused Morgan's merger offers, had collusive pricing practices been prosecuted, or had the Koreans been less successful with their cost cutting – steel profits were sure to have been drastically different from what they were. The same could be said on the experience of the oil business. The development of petroleum refining methods by Silliman, the discovery of major oil fields in Pennsylvania, and the growing energy requirements were not more inevitable than the rapid concentration of the oil industry, the dynamic interaction between large oil companies and oil-producing countries, and the political and military events in the Middle East – which have all affected the shifting fortunes of the large petroleum companies. Similarly, the development of the internal combustion engine and the Ford assembly line were not inescapable, and neither were the subsequent consolidation of the automobile oligopoly, the failure of General Motors to raise $3 million in 1908 and $8 million in 1909 to acquire the Ford Company, or the recent rise of foreign automobile companies. Finally, the invention of the airplane and improvements in aviation technology were not necessary historical developments and the same could be said on the formation of a three-firm oligopoly in the civilian aircraft industry, or on the looming challenge from Japanese conglomerates.

Similar indeterminacy prevails when we consider the record of business coalitions in combating excess capacity by augmenting demand for their products. Since the turn of the century, sales increases were achieved by two principal strategies – either through advertisement, repackaging, remodelling and other methods of salesmanship designed to affect consumer and business purchases, or by

less overt practices aimed at raising government spending.[52] These strategies have not been always successful, however. In an oligopolistic situation, the effect of increases in total selling expenditures on the aggregate profits of the group is positive only up to a certain 'optimal' level, after which it becomes negative. Individual oligopolies may prefer that their group gravitates toward such 'optimal' levels, but there is no reason to assume that they will necessarily succeed in doing so. The ability to limit excessive selling expenditures depends not only on what is desired, but also on what is feasible, and that may hinge on the internal cohesiveness of the oligopolistic group and its capacity for collective action. The inability to reach mutual understanding in this area is reflected in the extent to which selling cost is institutionalized as a 'necessary' cost of doing business.[53] The automobile companies in the Unites States, for instance, have been spending considerable amounts on annual model changes – more than 25 percent of the purchase price according to a famous study by Fisher, Grilliches and Kaysen (1962) – and it is highly doubtful that these promotional spending have raised sales let alone profits by a comparable amount. The failure of the automobile oligopoly to restrict annual remodelling has probably reduced its aggregate profits, but that impact was blurred because the expenditures on remodelling were increasingly seen as a necessary cost of production.

The significance of collective action is also apparent when we examine the ability of corporations to affect governmental demand for their product. For example, after the Vietnam War, there evolved in the United Sates an 'armament core' of large corporations which obtained spectacular increases in profits by augmenting their arms sales to the U.S. government and to foreign countries.[54] The present structure of this coalition and its influence on domestic and foreign government policies may no longer be sufficient, however, to prevent decreases in military spending. Given the deepening fiscal crisis in the United States and the end of the cold war, the prosperity of these firms will now depend either on their ability to prevent arms sales from falling, or on their capacity to raise profit margins – both of which may require a further consolidation of their coalition. These contingencies meant that the future fate of the 'armament core' and the related course of future military spending are not really 'predictable' in any scientific sense. Both depend on the extent and effectiveness of future institutional changes and these are simply not 'written in the cards.' With this 'historical indeterminacy' in mind, we could finally turn to assess the interrelated dynamics of distributional coalitions and stagflation.

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[52] Veblen was probably the first to identify the significance such 'extra' spending and their effect on the emergence of 'institutionalized waste.' The role of wasteful expenditures under monopoly capitalism was examined and debated mainly by neo-Marxist writers such as Kalecki (1933), Sweezy (1942), Steindl (1952) Baran and Sweezy (1966), Magdoff and Sweezy (1983 and 1985) and Szlajfer (1984a and 1984b).

[53] On the view of selling expenditures as a necessary cost of production, see for example Veblen (1923) ch. 11 and Baran and Sweezy (1966) ch. 5.

[54] On the emergence and activities of the 'armament core,' see Bichler *et al.*, (1989), Nitzan *et al.* (1989) and Rowley, *et al.* (1989).

6. Toward a Dynamic Theory of Distributional Coalitions and Stagflation

The relationship between the processes of inflation and stagnation on the one hand, and the institutional restructuring of business coalitions on the other, could be presented in the form of three related hypotheses.

(1) Following Veblen, we have argued that the appropriation of profits depends on the strategic control of industrial activity for business ends. The control of industry by business is possible because the capital goods needed for the *cooperative* process of production are held under *individual* ownership. The businessman has the vested right to curtail industrial production, and it is this institutional power to inflict 'scarcity' which gives capital goods their pecuniary value. The institutional basis of 'scarcity' remains obscure as long as the population grows faster than industrial productivity. Under such circumstances, the physical capacity to produce falls short of market requirements, making 'scarcity' look like a natural barrier imposed by limited resources. Profits, though, are accrued not because there are not enough capital goods, but because business owners have the right to withdraw the industrial services of such goods. The right to 'sabotage' need not always be *exercised*, however. With markets growing faster than productivity, the latent *threat* of a 'hold-down' is usually sufficient to allow owners to 'do business on their own terms'; that is, to earn a profit even though industry is producing at full capacity. All of this changes with large-scale industry, which tends to increase productivity much faster than the pace of population growth. Under this new situation, a failure to actually exercise the 'right for sabotage' may diminish 'scarcity' to the point of zero or negative profits. To prevent that from happening, industrial activity must be curtailed below its maximum potential capacity, which in turn implies that some 'means of production' must remain industrially idle. In other words, under the normal conditions of large-scale industry, the earning of business profits requires that there be an 'excess industrial capacity' of unemployed labour, resources and technology. This requirement leads us to our first tentative hypothesis, namely, that under 'mature' capitalism, *business prosperity necessitates industrial stagnation*.[55] Note that this logic says

[55] It should be emphasized that we use 'stagnation' here only in the relative sense of *under*-capacity utilization, with full capacity delineated by technological rather than business constraints. Consequently, the extent to which industry stagnates below its full potential need not be related to the pace of growth of industrial output. To illustrate this argument using conventional (if objectionable) categories, let capacity C be given by the product of total available inputs N and total input productivity q, such that $C = N \cdot q$. Capacity utilization CU could then be defined as the ratio of output Q to capacity, so $CU = Q / C$, or $CU = Q / (N \cdot q)$. From this last equation, it is clear that, for a given value of N, capacity utilization is positively related to output and negatively related to total input productivity. For instance, if, when industry operates at 70 percent of its capacity, there is a 6 percent increase in output (due to higher utilization of inputs) coupled with an 8 percent increase in productivity, then capacity utilization will, by definition, fall by 1.85 percent to 68.7 percent. On the other hand, if output grows at a rate of only 5 percent but productivity rises at 3 percent, then there must be an

nothing on the specific relationship existing between business prosperity and industrial stagnation which need be neither linear nor stationary. Moreover, it does not even imply that industry *must* stagnate. All it says is that, *if* the technical capacity to produce expands faster than market requirements, and *if* business enterprise nevertheless prospers, than such prosperity could occur only with industry stagnating below its full productive potential.

(2) The strategic limitation of industrial activity could be implemented only through successful business cooperation, which in turn requires that business activity be dominated by sufficiently large coalitions. Furthermore, to the extent that productivity growth continuously outstrips the growth of the market, there is a constant need for further limitations of industry, which is easiest to achieve through additional business concentration. The process of concentration tends both to reduce the number of large firms and to increase their relative size, enabling a more effective cooperation between and among business coalitions. These considerations lead to our second tentative hypothesis – namely, that there exists a significant relationship between the *extent of industrial stagnation* on the one hand, and the *process of business concentration and the consolidation of large business coalitions* on the other. Again, there is nothing immanent in these developments. We do not argue that industrial or aggregate concentration ratios have to rise, or that business coalitions must become more effective, but rather that, *if* business continues to prosper despite the excessive growth of industrial capacity, such prosperity is likely to occur through an ongoing process of corporate concentration and a progressive consolidation of corporate coalitions.

(3) The 'success' of business cooperation has a direct bearing on the process of capital accumulation. The extent to which corporate concentration and the strengthening of corporate coalitions increase expected profits is promptly reflected in the capitalization of affected groups. An increase in the anticipated level of profits raises the expected rate of profit on current capitalization above the prevailing 'normal' rate of return (adjusted for 'risk'), thus justifying a recapitalization. The recapitalization usually occurs through a combined increase in both the number and average market value of outstanding stocks, bonds and other commercial papers which, together, lead to an inflation in the aggregate value of corporate assets. Hence, our third tentative hypothesis is that, under the new order of business enterprise, *the tendency toward industrial stagnation is accompanied by a progressive asset inflation*; in other words, that *stagnation and inflation tend to appear together as 'stagflation.'* The meaning of stagflation here differs from conventional uses of this term. It refers not to the quantity and prices of produced goods and services, but rather to the relative utilization of industrial capacity and to the aggregate nominal

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increase of 1.94 percent in capacity utilization to 71.4 percent. The faster output growth in the first case is associated with deepening stagnation, while the slower growth in the second case is accompanied by lessening stagnation.

values of outstanding records of ownership. Moreover, there is no 'unique' relationship between the tendency toward 'stagflation' of under-capacity utilization and asset inflation on the one hand, and the temporal movements of output and prices on the other. Attempts to curtail industrial activity below its full capacity will reduce the growth of output below what it would otherwise be; but in the dynamic context of rising productivity, that need not always result in falling or even stagnating output. Similarly, the inflation in asset values will tend to raise the aggregate turnover and hence the overall value of sales but, if aggregate output rises even faster, asset inflation need not be associated with commodity price inflation. Yet, whether or not we can identify a stationary *statistical* relationship here, it is nevertheless clear that, from a *causal* perspective, 'stagflation' of under-capacity utilization and asset inflation tends to reduce output growth and increase price inflation.

To summarize, our three tentative hypotheses suggest: (1) that in a 'mature' capitalist economy, business prosperity necessitates industrial stagnation; (2) that the extent of industrial stagnation is affected by the process of business concentration and the consolidation of large business coalitions; and (3) that since business restructuring occurs through capital accumulation, the tendency toward industrial stagnation is accompanied by a progressive asset inflation – or, in other words, that stagnation and inflation tend to appear together as 'stagflation.'

Taken together, these three tentative hypotheses enable us to approach the evolution of modern capitalism as a dynamic, double-sided process. On the *disaggregate* level, there is a relentless process of business restructuring, involving continuous changes in corporate concentration and in the organization of corporate coalitions. The differential effect of this restructuring on profitability is revealed on the *aggregate* level in the form 'stagflation.' We can hence view the disaggregate restructuring and the aggregate stagflation as two sides of the same process of capital accumulation. Seen from a long-term perspective, the ongoing consolidation of business power generates rising expectations for profits which in turn fuel the accumulation of capital. In this way, the pattern of business restructuring is 'imprinted' on the annals of accumulation through the differential recapitalization of assets. At the same time, the extent to which corporate restructuring generates higher profit expectations depends on both the limitation of industry and the related inflation of assets and sales, which means that capital is accumulated by capitalizing 'stagflation' tendencies.

This 'stagflationary restructuring' could be understood only as a *dynamic* process. It is not business power per se, but rather *changes* in that power which generate stagflation. To explore the institutional roots of stagflation, we have to examine not only the broad facets of structure, but most importantly, the continuous process of *re*structuring. Stagflation requires that markets be dominated by oligopolies and business coalitions, but the mere existence of these institutions is still insufficient to explain the temporal nature of industrial stagnation and asset inflation. It is the

continuous process of institutional change which enables business to restrain the ever increasing productivity of industry and to recapitalize this industrial limitation through an inflationary accumulation of capital.

The dynamic essence of 'stagflationary restructuring' becomes evident when we take a bird's eye view on the evolution of U.S. business since the mid nineteenth century.[56] The emergence of the new order of business enterprise was characterized by severe instability. Initially, the increasing use of loan credit brought frequent and violent credit cycles. The onset of a business boom raised profit expectations, inducing both borrowers and lender toward further credit extensions which, in turn, tended to fuel inflation and further credit extensions. However, given the competitive nature of production, the inflation of asset values was not accompanied by a comparable increase in profits, leading to an eventual decline in the rate of return, an immanent panic and a downward rerating of capital values. The situation changed with the dual emergence of large-scale industry and big business. The progressive formation of business coalitions and the expanding capitalization of their rising profits helped rationalize the control of both industry and credit. There was a widespread proliferation of oligopolistic practices based on price leadership and a 'target' rates of return, which tended to stabilize the flow of profits. On the other hand, the incidence of unruly speculative booms was greatly reduced by the coordinated actions of the large financial institutions and Federal Reserve Board. As a result of these qualitative transformations, the violent cycles of inflationary booms and deflationary busts gave way to chronic industrial stagnation coupled with a persistent inflation of assets. These new 'stagflationary' circumstances were not 'inevitable.' They reflected the ongoing processes of business concentration and consolidation of corporate coalitions, and there was no 'iron law' which guaranteed the success (or even continuation) of such restructuring. But while the new order of 'big business' did not ascertain an ongoing 'stagflationary restructuring,' it was nevertheless highly conducive to this outcome. In particular, it mobilized the *differential* use of credit capital which tended to augment the relative power of big business, thus intensifying the related processes of stagflation and corporate restructuring.

Taken in the aggregate, the overall expansion of credit instruments need not reflect changes in business power. A universal inflation in the prices of all commodities may justify a larger capitalization of credit, even in the absence of any increase in the overall 'degree of monopoly' or any changes in the distribution of business power. But the emergence of big business introduced an inherent inequality in business power and that had a profound effect on the significance of credit for the process of restructuring. For most corporations, particularly smaller firms which are not organized for collective action, credit is essential in order to meet the expanding requirements for working capital. Given the non-cooperative environment in which

[56] For more on these transformations, see Veblen (1904), ch. 7, and (1923) ch. 12.

such firms operate, the usual basis supporting these credit extensions is not a differential application of industrial 'sabotage,' but simply the overall inflation in commodity prices and the resulting rise in nominal profits. For the larger corporations, however, the situation is radically different. Here, credit extensions are based not only on the overall rate of price inflation, but also on the ability of such firms to alter the institutional circumstances within which they operate. Unlike the smaller firms for which credit extensions are merely a *response* to changing conditions, for the big corporations, the accumulation of credit obligations is an evidence of an institutional *initiative* toward changing these conditions. Furthermore, the progressive capitalization of profit expectations by large firms tends to become much like a 'self-fulfilling' prophecy.

From a technical perspective, capital accumulation is indeed a 'forward-looking' process which should be reversed if the expectations on which it was based prove to be false. The likelihood of such negative rerating, however, tends to diminish with the growth of corporations and the consolidation of their coalitions. First, the increased interdependency between large lenders and borrowers heightens their sense of 'common cause' and increases their willingness to act together toward preventing any serious financial failure – either through further credit extensions to a beleaguered corporation, or through a takeover in which the existing capitalization is maintained by a process of merger. Second, with the growth of large corporations, the spectre of a major bankruptcy tends to become politically intolerable, thus making governments and central bankers more inclined to 'intervene' in serious cases. Furthermore, it is precisely the large corporations which have the political leverage to induce such 'bailouts.'[57] Thus, for the largest firms, the extension of loan credit is not only an anticipation of increased earning capacity, but also a most powerful weapon in realizing that increase. This strategic use of credit is more or less limited to large firms and its effectiveness tends to increase with corporate size – two realities which together mean that the larger use of credit is, in itself, a catalyst for 'stagflationary restructuring.'[58]

[57] The government role could be 'overt,' as in the bailouts of Chrysler during the early 1980s, of Continental Illinois in 1984, and of the savings and loans industry since the late 1980s; or it could be 'covert,' for example, in the form of extended government contracts or tax savings to a large defence contractor.

[58] Writing before the new order of business enterprise had begun, Marx (1906, Vol. 1, p. 687) was prophetic in his observations about the role of credit in corporate restructuring: 'In its beginning, the credit system sneaks in as a modest helper of accumulation and draws by invisible threads the money resources scattered all over the surface of society into the hands of individual or associated capitalists. But soon it becomes a new and formidable weapon in the competitive struggle, and finally it transforms itself into an immense social mechanism for the centralization of capitals.'

These considerations are highly important because the differential accumulation of credit seems to be rooted in the competitive essence of business enterprise.[59] The accumulation of assets usually offers a corporation a differential advantage *vis à vis* rivals who fail to augment their assets or those who expand at a slower pace. The advantage is clearly evident under the 'normal' circumstances of rising markets, when the cost of new capital is commonly lower than the additional profits it is expected to generate, but the drive to accumulate exists even in the absence of such apparent monetary gains. The relative magnitude of a corporation's assets is of such paramount importance in the competitive struggle for business, that firms may often feel compelled to increase their overall size, even when the expected addition to profit does not exceed and sometimes falls below the cost of added capital. In other words, 'under the régime of competitive business whatever is generally advantageous becomes a necessity for all competitors' and, so, '[s]peaking broadly, recourse to credit becomes the general practice, the regular course of competitive business management. . . .' (1904, pp. 96-7).[60]

Stagflation, then, is driven not only by the relentless progress of industrial productivity, but also by the compelling need to accumulate credit capital, and these two tendencies tend to reinforce each other. The ultimate yardstick for business success is the differential pace of capital accumulation. A faster accumulation requires an increasingly effective administration of differential industrial sabotage which is, in turn, facilitated or 'validated' by the differential inflation of credit. From this perspective, the accumulation of corporate assets and, hence, the inflation and redistribution of pecuniary values, are no more accidental than the tendency for chronic industrial stagnation. Both are intrinsic to the new order of large-scale industry and corporate finance and tend to intensify with the progressive growth of 'big business' and consolidation of corporate coalitions.

These arguments imply that the structural roots of stagflation should be traced not to the accumulation of distributional coalitions in general, as suggested by Olson, but specifically to the emergence and consolidation of *business* coalitions. Recall that Olson made no fundamental distinction between the distributional activities of labour and business coalitions, and that he identified no significant difference in their macroeconomic impact. If we adopt Veblen's framework, however, we can no longer treat labour unions and business coalitions in the same way. It is true, wrote Veblen

[59] Again, 'competitiveness' here refers to the elemental drive for differential gain which exists irrespective of business cooperation (see Section 4).

[60] The competitive need for new capital is so strong that it continues to exert pressure even during a business stagnation. As Veblen (1923, pp. 94-5) acutely observed, despite the severe recession following the Armistice of 1918, 'the generality of business concerns are and have all this time been seeking additional funds, but evidently not to increase the output of goods, since neither the equipment controlled by these concerns nor the available man-power are or have been employed more than one-half their capacity.' This tendency is still evident in our contemporary economy, where despite considerable unused capacity, the quest for new funds continues unabated.

(1923, pp. 296-98), that, with the evolution of business enterprise, both employers and workers have increasingly come to realize that 'the sole decisive argument on either side is a refusal to go on' and, so, on the face of it, trade unions appear to follow standard business tactics of 'mutual defeat.' Yet, beyond this apparent similarity there lie some critical differences in both the *modus operandi* and eventual consequences of the two types of coalitions.

First, unlike the goals of business, not all the aims of organized labour could be denominated in pecuniary terms. To increase profits and accumulate assets, a business coalition requires that industry stagnates below its full capacity, but the stagnation itself is not a matter for business concern. Labour unions, on the other hand, are caught in an uncomfortable dilemma, for they seek not only higher wages, but also secured employment.[61] Veblen also pointed out to a significant sentimental difference that partially inhibits the business-like behaviour of labour unions. Caught in their 'instinct of workmanship,' he wrote (1923, p. 295), '[t]heir spiritual complexion is not yet fully commercialized, even though the great body of them may already have begun to realize that sabotage is the beginning of wisdom in industrial business. They may already believe it with their head, but they do not yet know it with their heart.'

A second difference between labour unions and business coalitions concerns their mode of organization. Unlike business cooperation, the collective action of workers must be *overt*. Since labour unions can achieve their goals only through a process of bargaining, both the organization of a labour union and its subsequent activities are necessarily open to public and legal examination. Business activity, on the other hand, is essentially unilateral. The right to set prices and output levels is conferred by the cannons of private property. It requires no consent from workers or consumers and, in general, is not subject to legal scrutiny. In this context, collective business action could remain *tacit* and, indeed, with the exception of official cartels, most business coalitions have no *de jure* existence. In fact, the most obvious form of business cooperation – the corporation itself – is normally not considered to be institution of collective action.

The third and perhaps most important difference between labour and business coalitions stems from the institutionalization of their distributional power. The successful achievement of wage increases by a labour union would not usually affect the future ability of that union to obtain additional wage increases, or even to maintain current wage levels. For a business coalition, on the other hand, differential

[61] 'Despite decades in which unions have been part of the economic scene,' write Freeman and Medoff (1984, p. 6), 'economists lack an accepted maximizing theory of union behavior that would predict the results of bargaining within the union over wage goals. Under some circumstances a union may seek a high wage at the cost of employment; under others, it may be more moderate in its wage demands to preserve jobs. This union concern is quite distinct from the worries of a monopolist, whose sole goal is to maximize profits, regardless of what happens to the number of units sold.'

increases in profits are promptly capitalized. In other words, unlike labour coalitions, the success of corporate coalitions allows them to increase their financial leverage and to further augment their distributional power.

This last difference helps to resolve a major weakness in the way in which Olson approached the dynamic accumulation of distributional coalitions. His attempt to formulate a 'universal' theory which would explain the rise and decline of nations across time and place made it difficult to devise a uniform criterion for coalition power. In the absence of such a common gauge, Olson used the *number* of coalitions as a proxy for their aggregate economic significance, which amounted to assuming that all coalitions were 'equal' and, of course, biased his discussion toward overt labour coalitions and away from covert business coalitions.[62] If we agree to restrict our analysis only to mature capitalism, however, we do not have to assume that all coalitions are alike, or to use membership counts as a proxy for coalition strength. In the case of business coalitions, the most straightforward index for distributional power is not the number of participants, but rather the differential financial performance of coalition members. In fact, for business coalitions, a decline in the number of firms is often associated with an increase, not a decrease in distributional power.

There are also substantial differences between the impacts that labour and business coalitions have on the process of stagflation. First, given that wages are a cost of production, the power of organized labour is ultimately limited by the power of organized business. In other words, the extent to which unions limit industrial activity and in that way lead to higher prices depends on the distributional power of the corporations for which union members work. There is no similar dependency for corporate coalitions. Their profits are often related to the overall consumption of wage earners, but they rarely depend on the purchasing power of their own workers. We could hence argue that the stagflationary effect of labour unions is constrained by the stagflationary effect of corporate coalitions. Second, in the context of an 'inordinately' productive industry, business prosperity *necessitates* a process 'stagflationary restructuring' of corporate coalitions, but there is no similar imperative requiring the growth and consolidation of labour unions. Under the new order of business enterprise, a failure to continuously restructure the business control of industry will eventually eliminate profits and bring capitalism to a standstill, but the failure of workers to repeatedly reorganize their collective action will lead to no comparable cataclysm. This leads us to the third difference – between the 'static' impact of labour unions and the 'dynamic' effect of corporate coalitions. Unlike Olson, Veblen differentiated between the aims of labour and the goals of business. Following Marx, he identified well being as the ultimate purpose of wage labour, which meant that the goals of organized labour could be denominated in terms of

[62] In cases where even the number of official coalitions was unknown, Olson resorted to *time* as an index approximating the increasing number (and hence power) of the (unknown) coalitions.

levels. Workers were interested in higher wage levels, which, under certain circumstances, may lead to higher price levels and lower levels of output. Business, on the other hand, strove not for higher 'purchasing power,' but for differential pecuniary gain. Consequently, the target of business coalitions was not high profits, but ever-increasing profits, which in turn implied not high prices and low output, but *inflation* and *persisting stagnation*.[63]

The views and analyses examined in this essay point to a pressing need to redefine our theoretical and empirical programme for the study of stagflation. We hope to develop such programme in our future research.

[63] It should be emphasized that we talk here not about the subjective preferences of individuals, but the objective pressures imposed on distributional coalitions. Many workers would obviously like to see their consumption rising continuously, while some businessmen may lose sight of what 'makes them run'; but, in both cases, their actions would still be dictated by the objective circumstances – the static circulation of labour power in the first case, and the dynamic requirements for differential business performance in the second.

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