Comment

A Response to Professor Foss

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We are grateful to Nicolai Foss for his comment on our article. Although we do not agree with his argument and consider it to be based on a fundamental misconception, his comment nevertheless raises an important point and gives us the opportunity to clarify our position on the role of institutions in the coordination of investment in a capitalist economy.

Foss takes issue with our argument that the fundamental systemic problem of capitalism is the inability of atomistic decision making to take account of the interdependence of investment. Our argument may be summarized as follows. In a capitalist economy investment is undertaken on the basis of expected profitability. Since the profitability of an investment depends on the stream of future profits it is necessarily subject to uncertainty. This uncertainty is of two sorts: primary uncertainty that would exist in any form of economic organization; and secondary or market uncertainty that arises from the atomistic organizational form of a (capitalist) market economy. Since primary uncertainty is common to all economic systems, we are concerned here with secondary uncertainty — the uncertainty that is due to the fact that, when undertaking investment, capitalists do not know what interdependent investment (on which the profitability of their own investment depends) is being undertaken simultaneously by other capitalists. Given this ignorance, there is no reason to suppose that expected and realized profitability will be the same. Indeed, it is precisely the difference between the
two that provides the market signals: realized profitability above or below expected profitability causes capitalists to revise their investment decisions and reallocate resources.

This is, of course, just a description of the operation of market forces, of the way in which investment decisions that in the aggregate produce too much or too little capacity in relation to demand are revised. It is through this process that the decentralized decisions of atomistic self-interested agents are coordinated, but they are coordinated ex post — after the decisions have been implemented and the outcomes that were uncertain at the time of the decision have become known. Smith called this process the invisible hand; Marx called it the anarchy of production; Foss appears to wish to deny it.

Foss’s discussion is certainly interesting. He claims that our argument may be pertinent in the context of “frankly, outdated” economic models, which he equates with neoclassical perfect competition equilibrium. Yet at the same time he argues that Hayek’s celebrated (1945) article, with its tin mine example, applies precisely, and only, to such a model. We welcome this acceptance that in a pure market economy the market cannot transmit information about decisions on planned investment or disinvestment but merely reflects the consequences of those decisions once they have been implemented. However, we do not accept Foss’s argument that our analysis of the operation of capitalist market forces is valid only within such a framework. It is absurd to claim that Smith’s and Marx’s conceptions of competition, however they may differ, can be equated with neoclassical perfect competition.

The crux of Foss’s position is that capitalist economies are not pure market economies but “contain cooperative mechanisms for information dissemination.” He develops his case by referring to Richardson’s argument that what are seen as “imperfections” within a neoclassical framework are actually institutions or norms that have evolved for the purpose of “coordinating plans among independent but interdependent producers.” Following Richardson, two types of investment decision are distinguished — complementary and competitive — and each is considered in turn. In relation
to complementary investment, the institutions or norms mentioned are reputation, trust, contractual arrangements, informal understandings, vertical integration and codes of business behaviour; in relation to competitive investment we are referred to cartels, price notification schemes and other (unspecified) "restrictive" practices. The conclusion drawn is that in capitalist reality, as opposed to neoclassical perfect competition, "numerous institutions support the operation of the pure price mechanism, thus ... assisting the coordination of plans, partly through disseminating information." What are we to make of this argument? There is now widespread agreement among economists of all schools of thought that the market cannot operate as a free-standing institution but must be embedded in a network of supporting institutions. Indeed, one could cite a far more extensive body of theoretical and empirical evidence than that referred to by Foss to support this proposition, e.g. the literature on indicative planning, the experience of MITI's industrial policy in Japan, and the role of the state in the industrializing countries of South East Asia. There is also the rapidly growing literature on alternative forms of capitalism, with a basic distinction being drawn between Anglo-Saxon capitalism, on the one hand, and Japanese and West European capitalism, on the other. The general conclusion of this literature is that the former, based on short-term, arms-length contractual market relationships, has been relatively unsuccessful, by comparison with the latter, based on long-run relationships supported by various forms of intermediate institutions that enable cooperation and competition to be combined.

However, to recognize that capitalist economies combine markets and other institutions (including, of course, the state) is in no way to establish that these other institutions enable investment to be coordinated in a way that overcomes the operation of market forces or the anarchy of production. It is significant that Foss's comment is concerned overwhelmingly with complementary investment: "[t]he importance of 'imperfections' for the effective working of the economy is perhaps most obvious in the coordination of complementary investment projects"; and "[f]irms enter into cooperative
relations when they need access to complementary but dissimilar activities." Complementary activities are concerned with different stages in the production chain — input suppliers, including finance and R&D, sales outlets, etc. An example of cooperation in relation to such activities may be found in the Japanese keiretsu system. However, cooperation in relation to complementary investment is undertaken in order to be able to compete more effectively with rivals. Thus, the competitive dynamic of the Japanese economy takes the form of keiretsu competition. Not surprisingly, where institutional arrangements like the keiretsu system have developed to facilitate cooperation in order the better to compete, capitalist groupings have been more successful in world markets than where they have not.

None of this, however, has anything to do with the fundamental systemic problem of capitalism, which relates to competitive investment. The problem can be divided into two parts. First, independent capitalists acting atomistically in relation to investment decisions cannot know what investment their rivals are undertaking simultaneously, yet that investment will affect their realized profitability. Even when they agree to exchange information about their plans, as in the case of indicative planning, they cannot be certain that their rivals will act as they say they will. Indeed, indicative planning has always failed in the absence of state policies to underpin it. Second, even if capitalists somehow get to know what their rivals are doing, or make conjectures about their rivals’ actions that turn out to be correct, this still would not mean that expected and realized profitability would be the same. Capitalists may all agree that aggregate planned competitive investment will create capacity in excess of demand, but each capitalist expects that its investment will be successful at the expense of its rivals and that it will increase its share of the market. Since they cannot all be right, some will find their profitability expectations realized, others will not, and some will exit. This is how capitalism works.

What does Foss offer us by way of institutions or norms that promote the coordination of competitive investment? He mentions only cartels, price notification schemes and other unspecified “imperfections.” Our position is that rival
capitalist firms enter cartels and price notification schemes when they contribute to their profitability, and cheat or leave when they cease to do so. For periods of time such arrangements may reduce uncertainty, create greater predictability and thus promote investment. They are more likely, however, to be defensive measures, in the face of excess capacity, or forms of monopoly rent-seeking behaviour. Whichever way one views them, they are notoriously unstable and, when underlying conditions change or the relative strengths of the rival capitalists alter, they break down. Thus, Foss’s argument that such institutions enable the coordination of competitive investment in a capitalist economy cannot be taken seriously. Indeed, he hardly seems to believe it himself, claiming at one point only that they “have the effect of reducing the severity of the coordination problem.”

Having responded to Foss’s major argument we end by commenting on two minor issues he raises. First, in note 18 he states that we do not discuss the epistemological issues that arise in relation to the problem of making tacit knowledge explicit. This is correct, but we did not set out to discuss these problems and such a discussion is not necessary for our argument. Indeed, Foss himself refers to the fact that cooperation may make “largely tacit capabilities visible” without entering into these epistemological issues. Second, in note 19 Foss accuses us of neglecting the fact that current prices partially reflect producers’ plans, that futures markets exist, and that it is possible to form expectations on the basis of past behaviour. Although we did not explicitly mention these issues, it will be clear from our discussion above that they make no difference to our basic argument. The only circumstance that would undermine our position would be the neoclassical assumption of a complete set of perfectly known futures markets for all commodities, but we take it that Foss is not suggesting this.

In our view, the existence of the sorts of institutions discussed in Foss’s comment and in this response certainly reflects a need for the \textit{ex ante} coordination of investment. However, we have argued that this need can at best be only partially and temporarily met in the context of capitalist market forces. We therefore reject Foss’s conclusion that the coordination of
investment, as well as the discovery of tacit knowledge, is effectively achieved within a capitalist economic system. We reiterate our conclusion that these two desirable objectives can only be realized through a system of participatory democratic planning.

Notes


2. This may not be strictly true since different forms of economic organization may affect the extent to which changes in, say, technology or demand can be foreseen. See, for example, Pat Devine, Democracy and Economic Planning (Cambridge: Polity Press, 1988). However, it is a reasonable assumption in the context of the present discussion.


4. Ibid., p. 154.

5. Ibid., p. 153.


9. Ibid., p. 159. Foss also cites the rapidly developing literature on institutional economics in support of his conclusion.

10. It was the naive or ideological denial of this obvious reality that led to some of the most irresponsible advice given to the ex-Soviet block countries, as they sought to move towards a capitalist economic system, with chastening consequences.

11. See, for example, R. Appelbaum and J. Henderson (eds.), States and Development in the Asian Pacific Rim (Newbury Park, Ca.: Sage, 1992); and Devine, Democracy and Economic Planning.


16. Ibid., p. 158.