Business organization and the myth of the market economy

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Introduction: the wealth of three nations

Historical foundations for the “invisible hand”

In 1975 the noted institutional economist Robert A. Gordon entitled his American Economic Association presidential address "Rigor and Relevance in a Changing Institutional Setting." Gordon argued that "the mainstream of economic theory sacrifices far too much relevance in its insistent pursuit of ever increasing rigor. " "We economists," he complained, "pay too little attention to the changing institutional environment that conditions economic behavior." Gordon continued, "We do not often enough reexamine our basic postulates in light of changes in this environment, and, perhaps more important, we shy away from the big questions about how and why the institutional structure is changing — and where it is taking us."1

In the history of economic thought, economists have not always ignored the "big questions." Indeed the attempt to relate economic institutions to economic development was first taken up in a serious way in the late eighteenth century when Adam Smith inquired into the "nature and causes of the wealth of nations." Writing on the eve of the world's first industrial revolution in an era when ownership and control of the manufacturing enterprise were a proprietary affair, Smith emphasized how the growth of economic individualism would benefit the growth of the economy. And, indeed, as I shall outline in Chapter 1, Britain's rise to its position of industrial leadership in the nineteenth century did rely on highly specialized proprietary firms, the activities of which were coordinated by market relations. Yet a closer look at the content of Smith's own ideas as well as the longer-run historical causes of the wealth of the British nation reveal that the link between individualistic institutions and Britain's rise to economic dominance can be overdrawn.2

Smith encapsulated his theory of economic development in the dictum

2 For an extended version of the following argument, see William Lazonick, "El capitalismo moderno" [Modern capitalism], paper presented at the colloquium entitled "Ideology, Enterprise, and Development," sponsored by Instituto de Investigacion para el Desarrollo Economico Nacional (IDIDEN), Lima, Peru, June 19–21, 1990.
"Division of labor is limited by the extent of the market." The more extensive the demand that a firm, industry, or national economy faces, the more extensive the specialized division of labor that the firm, industry, or national economy can put in place. And for Smith, the more specialized the division of labor, the greater the productive powers of labor.

Smith did not argue that this specialized division of labor itself had to be coordinated by the market. Indeed, in Smith’s famous example of the division of labor in pin manufacture, a capitalist employer, not the market, coordinated the specialized division of labor. Rather, Smith’s arguments for laissez-faire had to do with eradicating legislated barriers to the mobility of capital into those uses in which its owners deemed it most profitable to employ it — that is, into those uses that offered the most scope for specialized divisions of labor. If the barriers to entry into productive activity and product markets were broken down, Smith argued, the invisible hand of self-interest would guide capital into those uses in which the division of labor could be carried the furthest.

In making these arguments, Smith was proposing institutional change. In the British context of the 1770s, the political purpose of the Wealth of Nations was to attack the mercantilist institutions that the British economy had built up over the previous two hundred years. Yet in proposing institutional change, Smith lacked a dynamic historical analysis. In his assault on these institutions, Smith might have asked why the extent of the world market available to Britain in the late eighteenth century was so uniquely under British control. If Smith had asked this “big question,” he might have been forced to grant credit for Britain’s extent of the world market to the very mercantilist institutions he was attacking.

In particular, Smith might have recognized the importance of the joint-stocks trading companies such as the East India Company and the Royal Africa Company, chartered by the British monarchy, in opening up new markets around the world to British goods, particularly yarn and cloth exports. In turn, these companies, with their organizations abroad and their armed merchant fleets, became the bulwarks of British international political and military power.

Smith might then have mentioned Britain’s use of its political power to stifle the growth of the textile industries of Portugal and Ireland in the eighteenth century, thus leaving the extent of the market for these tradable goods to be supplied by British manufacturers. He might also have emphasized how Britain’s victorious wars against the Spanish in the sixteenth century, the Dutch in the seventeenth century, and the French in the eighteenth century helped to ensure that British ships would be free to trade where and when they pleased. Smith might have conceded that, from the late seventeenth century, Britain’s growing extent of the market depended on its national power, exercised both militarily and diplomatically, to impose and enforce the Navigation Laws. These laws, which ensured well into the nineteenth century, secured Britain’s position as the entrepôt of the world and effectively protected British manufactures from foreign competition in the home market. In short, Smith might have recognized the integral relation between economic and political power in the rise of Britain to international dominance.

With his focus on division of labor as the source of economic development, Smith also oversimplified the transformations that enabled British industry to supply the growing extent of the market. History shows that Britain’s supply-side response was not simply a more specialized division of labor, as depicted in Smith’s example of pin manufacture. More profoundly, this response entailed a reorganization of the ways in which productive labor was performed in both agriculture and industry.

In agriculture, the emergence and growth of market opportunities to sell wool and grain — opportunities that were opened up by mercantile ventures supported by the power of the state — created incentives to reallocate the use of land from traditional subsistence crops to the production of these tradable commodities. The reorganization of agricultural land, which went forward in Britain from the sixteenth century under what has become known as the enclosure movement, inevitably undermined the viability of traditional peasant agriculture. While the enclosure movement permitted British agriculture to take advantage of new opportunities for commercial farming, it also created a sizable labor force of dispossessed peasants with only tenuous attachments to the land. To earn a living, many of these peasants turned to “domestic industry” — the production of goods in their cottages. The most important branches of domestic industry were textiles — at first woolens, using the homegrown raw
material, but increasingly from the eighteenth century, cottons, using the raw material imported into Britain on the third leg of the triangular trade with Africa and the Americas.*

It was the eighteenth-century expansion of domestic industry, with capital flowing to workers in the English countryside, that laid the basis for the British Industrial Revolution. The emergence of labor-saving machine technologies in the later decades of the eighteenth century transformed the productive potential of textile manufacture. Increasingly, the technologies were housed in factories, but during the Industrial Revolution domestic industry based on handloom weaving expanded to service the factory system based on mechanized spinning. Ultimately, as the nineteenth century progressed and as the textile industries became increasingly more export oriented, mechanization ousted hand methods, and the factory replaced the family home as the predominant site of production.9

The rise of the factory represented a dramatic social change in the way in which workers sought to earn a living. Yet even with the coming of this more collectivized mode of production, the ownership and management of firms remained under the control of individual proprietors or close partnerships. As I shall outline in Chapter 1, beyond the well-known entrepreneurs of the early Industrial Revolution such as Arkwright and Peel, the capitalist-employers who ran the British factories of the nineteenth century tended to possess relatively narrow managerial skills and limited financial capital. Hence, they generally chose to set up shop in narrowly specialized branches of industry and in geographic locations that already possessed ample supplies of key resources, particularly skilled workers (themselves the legacy of the prior prevalence of domestic industry) who could keep imperfect machines running and goods in process on the shop floor. Vertical specialization and industrial localization spawned horizontal fragmentation. As a result, there emerged structures of industrial organization internal to Britain’s major industries in which the market coordination of economic activity played a dominant role.10

It was the emergence of these highly individualistic structures of industrial organization in the nineteenth century that lent credibility to the idea of the efficacious running of the economy by an “invisible hand.” Given the competitive advantages in international competition that British industry had attained as a result of the Industrial Revolution, British manufacturing interests also saw fit to make the argument that unfettered market forces should operate in the international economy as a whole. The nineteenth-century British advocated laissez-faire because, given the advanced economic development that their industries had already achieved, they thought that their firms could withstand open competition from foreigners. The ideological goal of the British manufacturing interests was to convince other nations that they would be better off if they opened up their markets to British goods.

The argument for laissez-faire in international trade found theoretical justification in David Ricardo’s theory of comparative advantage – a set of propositions that still appears in economics textbooks and that in retrospect marks the beginning of static analysis as a methodological feature of Anglo-American economics.11 What the British advocates of laissez-faire neglected to talk about was the role that a system of national power had played in creating conditions for Britain to embark on its dynamic development path. In the last half of the nineteenth century, the proponents of the unfettered operation of international markets accepted as a natural fact of life Britain’s dominant position as the “workshop of the world.” They did not bother to ask how Britain had attained that position, while they conveniently ignored the ongoing system of national power – the British Empire – that even at the beginning of the twentieth century continued to support Britain’s position of international economic leadership.

But the ultimate critique of nineteenth-century laissez-faire ideology is not that it ignored the role of national power in Britain’s past and present. Rather, the ultimate critique is that laissez-faire failed to comprehend Britain’s economic future – a future in which, confronted by far more powerful systems of national capitalism, the British economy would enter into a long-run relative decline from which it has yet to recover.12 In contrast to the message of those who propound what I call the myth of the market economy, Britain’s problem in the twentieth century was not that it relied too little, but that it relied too much, on market coordination

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9 On the often complementary coexistence of hand methods and machine methods, see Berg, Age of Manufacturers; Raphael Samuel, “Workshop of the World: Steam Power and Hand Technology in Mid-Victorian Britain,” History Workshop, 3 (1977), 6–72; Royden Harrison and Jonathan Zeitlin, eds., Divisions of Labour: Skilled Workers and Technolo (Change in Nineteenth Century England (Sussex: Harvester Press, 1985). See also Chapter 1.


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of its economic activities. Moreover, Britain’s problem lay less in an inadequate involvement of the state in the economy than in an inability of its business organizations to engage in the planned coordination of the specialized divisions of labor that were coming to characterize the ascendent capitalist economies abroad.

Modern capitalism: mythology and reality

In Chapter 8, I shall show how some twentieth-century economists, namely, Allyn Young and George Stigler, have misused Adam Smith’s notion that the division of labor is limited by the extent of the market by assuming that the supply-side response – the specialized division of labor – would be coordinated by markets. Such ideological preconceptions have both sustained the myth of the market economy and enabled modern economists to avoid asking what Gordon called the “big questions.”

Gordon specifically identified Stigler as a modern economist who took refuge in conventional economic theory to avoid confronting the issue of the evolving relation between theory and reality. In typical neoclassical fashion, Stigler used conventional theory to evaluate reality rather than vice versa. Gordon quoted Stigler’s defense of this mainstream methodology:

The dominant influence upon the working range of economic theorists is the set of internal values and pressures of the discipline. The subjects of study are posed by the unfolding course of scientific developments. . . . This is not to say that the environment is without influence [in determining the questions that economic theorists ask]. [But] whether a fact or development is significant depends primarily on its relevance to current economic theory.

Gordon aptly remarked on Stigler’s statement: “What a curious relating of rigor to relevance! Whether the real world matters depends presumably on ‘its relevance to current economic theory.’ Many if not most of today’s economic theorists seem to agree with this ordering of priorities.”

There are undoubtedly mainstream economic theorists who, disagreeing with Gordon, would argue that they have always been asking the “big questions”: What is the optimal allocation of scarce resources and how can it be achieved? To such economists, I would respond that the focus on the “optimal allocation of scarce resources” cannot generate answers to the questions I shall pose in this book: How are productive resources developed and, once developed, what determines the extent of their utilization? Neoclassical economists begin their analyses of the “optimal” allocation of scarce resources by assuming a given endowment of productive resources. They simply do not ask how a society overcomes scarcity by changing the quality and quantity of productive resources that it uses—what is, by developing and utilizing its productive resources.

I would argue, moreover, that the propensity of mainstream economists to look first and foremost to market coordination to allocate resources serves as an intellectual barrier to perceiving the changing institutional reality of successful capitalist development; for as history shows, this changing institutional reality is characterized by the growing importance of planned coordination within the business organization and the growing dominance of the business organization over the determination of economic outcomes. Through the process of innovation, particular business organizations gain competitive advantage, thus driving the development process. Mainstream economics contains no theory of innovation and no theory of competitive advantage.

Some of today’s mainstream economists might well agree with Gordon’s perspective on the narrowness of conventional economic theory as it existed in the mid-1970s but contend that, since then, neoclassically trained economists have by no means been impervious to the existence of “imperfect markets” in the real-world economy. In general, however, the explanatory power of these explorations of market imperfections remains constrained by the static methodology and individualist ideology of conventional economics. Despite the broadened scope of their inquiry, economists who remain bound by these intellectual constraints fail to address, let alone provide answers to, the question of how successful capitalist development occurs.

The modern theorists of “imperfect markets” continue to view a perfectly competitive market economy as the ideal, even if unattainable in practice, against which the phenomena that they study must be judged. Their obsession with equilibrium means, moreover, that their conception of this ideal is static. The theory of the market economy, as it has been elaborated in the twentieth century, contains no theory of economic development, and hence no conception of “ideal” economic outcomes that

15 Ibid.
are themselves subject to continual change. History shows that the driving force of successful capitalist development is not the perfection of the market mechanism but the building of organizational capabilities.

Indeed, as I shall argue in my critique of the transaction cost approach of Oliver Williamson, what mainstream economists view as “market failures” I view as “organizational successes.” They have difficulty comprehending the increasingly important role of the planned coordination of specialized divisions of labor in generating successful capitalist development. Their modeling techniques are much more sophisticated than economists such as Joan Robinson and Edward Chamberlin used over a half-century ago to analyze “imperfect competition.” But by their very proficiency in utilizing their training in the static methodology of mainstream economic theory and by their unquestioning acceptance of the ideology that views the perfection of market coordination as an economic ideal, the new theorists of “imperfect markets” have become intellectual captives of the myth of the market economy.

In contrast to the vision of the efficacy of market-coordinated individualism inherent in the theory of the market economy, let me summarize my general arguments concerning the changing institutional foundations of successful capitalist development. The superior development and utilization of productive resources increasingly requires that business organizations have privileged access to productive resources. Inherent in such privileged access is the supersession of market coordination to some degree. The shift from market coordination to planned coordination within business organizations has become an increasingly central characteristic of a successful capitalist economy.

In the past a prime locus of superseded markets was the business firm. But for some time the locus of superseded markets has been shifting from the business firm itself to the business organization that links business firms engaged in interrelated productive activities. In today’s most successful capitalist economies—Japan in particular—formal ownership of the assets of specific firms does not constrain cooperation among firms that have common interests.

This cooperation, moreover, is aimed less at maintaining high prices or creating barriers to entry than at enhancing the capabilities of the participating enterprises to develop and utilize their productive resources. This is not to say that Japanese business enterprises do not compete with one another. As Michael Porter has shown, by international standards leading Japanese industries have a relatively large number of competitors, and these enterprises compete for market share. At the same time, however, these enterprises recognize the importance of sharing basic technical information for the sake of developing the national industry as a whole.18

As I shall argue in this book, privileged access to finance, labor, and technology by firms and industries may be critical to the process of industrial innovation writ small and the process of economic development writ large. A theory of economic activity that assumes from the outset that the absence of market coordination represents a failure in the economic system cannot grasp the growing importance of planned coordination for generating economic growth.

Business organization and economic theory

The main objective of this book is to demonstrate the need for an alternative conception of the capitalist economy that can account for shifts in international industrial leadership and that can make the discipline of economics relevant to what were once considered the big questions: the nature and causes of the innovative enterprise in which the dynamic interaction between business organization and technological change is central. The theoretical framework that I shall present builds on basic cost concepts that can be found in any economics textbook. But whereas the textbooks ask how strategic decision makers in the firm optimize subject to given cost structures, I ask how the business organization can attain and sustain competitive advantage by contributing to the generation of new cost structures. By summarizing the comparative history of capitalist development in Britain, the United States, and Japan—three national economies that have been world leaders in industry over the past century—I shall show the growing importance of planned coordination for attaining and sustaining competitive advantage. I shall also provide a conceptual outline of the


related roles that organizations and markets play in a modern capitalist economy, with a particular focus on how people as individual economic actors try to make use of organizations and markets in pursuit of their own economic strategies.

Through the critical evaluation of the theories of economic development put forth by three leading economists, Karl Marx, Joseph Schumpeter, and Alfred Marshall, I shall show that the failure of modern mainstream economists to construct a relevant theory of capitalist development cannot be attributed to a lack of relevant theory in the history of economic thought. Marx with his focus on the utilization of productive resources, Schumpeter with his focus on the development of productive resources, and Marshall with his focus on planned versus market coordination in the generation of cost reductions all provided theoretical arguments that constitute points of departure for a theory of capitalist development that is of use today. We need not accept all of the conclusions reached by Marx, Schumpeter, or Marshall to recognize the importance of their major insights into the process of capitalist development. Indeed, it should be possible to integrate their insights into a theoretical structure that, in terms of understanding the dynamics of capitalist development, offers more than the sum of these three major contributions taken separately.

Beyond merely asserting that mainstream economics has ignored key contributions in its own intellectual tradition, I shall also trace the manner in which, over the course of the twentieth century, this neglect of both the history of economics and the history of capitalist economics has occurred. Since the late nineteenth century, a defining characteristic of mainstream economic theory has been an obsession with finding equilibrium solutions — that is, with finding the relationship among economic variables in situations where change does not occur. To this intellectual endeavor, the big questions that Marx, Schumpeter, and Marshall posed concerning the process of economic change were anathema. Given the nature of the questions that mainstream economists ask, it is by no means inappropriate that conventional economic theory assumed the label “marginalist.”

To make the search for equilibrium solutions the end of economic science is to ignore the process of capitalist development. At issue is not the logic of marginalist thinking; it can be employed by a number of theoretical frameworks, including those of Marx and Keynes. But it is only because neoclassical economics ignores the process of economic development that marginalist logic can be central to its methodology. In contrast, this logic plays a trivial role in a theoretical framework that seeks to comprehend the process of economic development.

It is not, however, just its static methodology, and its consequent focus on equilibrium solutions, that renders neoclassical economic theory irrelevant. It is also its assumption that, in a well-functioning capitalist economy, it is market coordination that determines the allocation of productive resources, with business enterprises adapting to changes in market prices subject to given technological constraints. This assumption accords well with individualist ideology. It does not accord well with the realities of successful capitalist development.

It was by combining a methodological obsession with equilibrium and an ideological obsession with market coordination that mainstream economic theory lost touch with the realities of successful capitalist development and its practitioners became intellectually bound by the myth of the market economy. As I shall detail in Chapters 6 and 7, even an economist such as Oliver Williamson, who has sought to comprehend the “nature of the firm” in order to elaborate a theory of the relation between markets and hierarchies in the capitalist economy, has constrained the scope of his inquiry by his adherence to the myth of the market economy. In particular, Williamson portrays the nature of the firm very differently than does the great business historian Alfred Chandler. Ideologically smitten by the “marvels of the market,” Williamson has failed to recognize the organizational success wrought by the “visible hand.”

Fortunately, not all major economists of the last half of the twentieth century have been intellectually constrained by static methodology and individualistic ideology. As I shall summarize in Chapter 8, over the course of the twentieth century some prominent economists, seeking to comprehend the dynamics of capitalist development, have built on the insights of Marx, Schumpeter, and Marshall. Fortunately as well, these lines of inquiry are still in progress and their intellectual momentum may even be gathering force.

The rise of Japanese industry to a position of international leadership, moreover, has begun to open some conventional economic eyes. In his Business Week column dated October 8, 1990, Alan Blinder, a well-known Keynesian economist, observed:

Much has been written about Japan's formidable challenge to American industrial preeminence. But the amazing Japanese economy poses another challenge — one that has been barely noticed. I refer to Japan's challenge to received economic doctrine. Stated briefly and far too boldly, the Japanese have succeeded by doing everything wrong (according to standard economic theory). That should make economic theorists squirm.

After citing a host of "market imperfections" in the operation of the Japanese economy — everything from cartels to permanent employment — Blinder commented:
All in all, economists weaned on Western economic thought must conclude that Japan does almost everything wrong. Such a litany of errors should cost them dearly. Yet Japan’s economy is a dynamo. How do they do it?

Blander continued:

American capitalism rests on a grand theory begun by Adam Smith. There is no comparable theory of Japanese capitalism, but we need one if we are to formulate an intelligent economic policy toward Japan. The Japanese themselves seem less concerned with conceptualizations than with results. So, we may have to produce that theory ourselves. 21

Blander’s conventional eyes are only partly opened. Before U.S. economists take up the challenge of producing a theory of Japanese capitalism that will permit us "to formulate an intelligent economic policy toward Japan," we must produce a theory that can comprehend the rise and decline of U.S. managerial capitalism. Only then can we, to paraphrase Blander, formulate an intelligent economic policy toward the United States; for as I shall argue in this book, not only is the standard economic theory to which Blander refers wrong for Japan, it is wrong for the United States. Indeed, when the histories of capitalist development in both the United States and Japan are properly understood, the institutions of planned coordination that have been responsible for Japan’s rise to international industrial leadership will be seen to represent not so much a departure from U.S. experience as a more thoroughgoing elaboration of the institutions of planned coordination that had previously brought leadership to the United States.

Lessons of history

Economic dominance, once attained, does not last forever. With the culmination of the postwar Japanese "miracle" over the past two decades, U.S. industrialists, politicians, and academics have begun to learn this lesson of history. Indeed, it is a lesson that the British had learned before World War II. Yet there is scarcely a consensus concerning the means to restore the industrial competitiveness of once-dominant economies such as Britain and the United States, in large part because there are deep disagreements concerning the sources of Japanese success and the causes of national economic decline.

The conventional wisdom has it that the erosion of national competitiveness is simply the result of a maladjustment of market forces that can be corrected by changes in relative wages, exchange rates, and the elimination of unfair trade practices. The economics of Britain and the United States are, after all, "market economies." Let the market work to equilibrate supply and demand and "get prices right."

So mainstream Anglo-American economists tell us. But the history of modern capitalism tells a different story— one that challenges beliefs that letting the market work will either generate industrial success or reverse competitive decline. Since the late nineteenth century, the most successful capitalist economies have moved away from market coordination toward the planned coordination of their productive activities. The movement to planned coordination has not occurred solely, or even primarily, at the level of the state, but at the level of the business organization. Far from economic prosperity requiring a "perfection" of the market mechanism, the experience of the twentieth century has shown that the wealth of different nations has become increasingly dependent on the planned coordination that takes place within business organizations.

There was a time and place when market coordination sufficed in international economic competition. The time was the late nineteenth century, the place was Britain, the world’s first industrial nation. The institutional basis for market coordination was the proprietary firm—an enterprise owned and managed by family members or a closed partnership for their own benefit. Constrained by limited managerial and financial resources, the proprietary firm tended to be a single-plant operation that specialized in a narrow range of activities. It therefore had to rely extensively on market relations to supply its various inputs as well as to distribute its products. The state maintained internal law and order, undertook essential welfare programs, provided elementary education, and ensured the defense of the realm. But in the coordination of economic activity, industry was left to react to the unregulated forces of supply and demand.

By the 1870s market-coordinated proprietary capitalism had made Britain the "workshop of the world." In 1870 labor productivity was higher in Britain than in the United States—14 percent higher by one estimate. 22 In the early 1880s Britain had more than 40 percent of world manufactured exports and the United States only 6 percent. 23

The following decades, however, saw a reversal in the relative productivity levels of the two nations and dramatic changes in their export market shares. U.S. productivity had caught up to the British level by 1890, if not before, and on the eve of World War I was at least 20 percent

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greater. From the 1890s the British share of manufactured exports steadily eroded while the U.S. share steadily increased, until by 1929 Britain exported 24 percent of the world’s manufactures and the United States 22 percent. Britain remained an advanced industrial economy in the twentieth century, but continually lost ground not only to the United States but also to nations such as Germany and Japan.

In the passing of industrial leadership from Britain to the United States, the institutional character of capitalism changed dramatically. In contrast to the small, vertically specialized proprietary firms that had characterized Britain’s rise to economic dominance, U.S. competitive advantage came from managerial enterprises that operated a number of geographically dispersed plants and offices and that integrated a number of vertically related activities.

Internally generated funds financed the expansion of U.S. managerial enterprises. If necessary for further industrial expansion, successful industrial firms were able to draw on the services of Wall Street investment bankers to supplement retained earnings with long-term bond finance. The growth of managerial enterprises also created a need for a large number of qualified line and staff personnel. In response, large-scale infusions of business and public funding transformed the educational system to meet the demand for “organization men” (and much later “organization women”).

Besides its critical role in the expansion of higher education, the U.S. government stood ready to provide tariff protection to industry. But it was the rise of planned coordination within, by, and for the private-sector economy that marked the rise of U.S. managerial capitalism. By the first decades of the twentieth century, managerial capitalism with its planned coordination had replaced proprietary capitalism with its market coordination as the most powerful generator of economic growth.

The recent emergence of Japan as an economic power does not signal a reversion to proprietary capitalism, despite the number and importance of proprietary firms in the present-day Japanese economy. The vast majority of proprietary firms in Japan are integral elements of networks of enterprises, each group dominated by powerful industrial, commercial, and financial firms. Far from turning toward market coordination, the basis of Japanese economic success over the past decades has been a more far-reaching elaboration of the institutions of managerial capitalism that underlay U.S. international competitive advantage in the first six decades of this century. Through Japan’s enterprise group system, planned coordination extends across legally distinct firms to ensure that their various activities coalesce in the pursuit of common goals. Within the dominant Japanese firm, planned coordination extends further down the organizational hierarchy to include male blue-collar workers as members of the business organization, thus facilitating the managerial function of ensuring that shop-floor activities further organizational goals.

Much more than was the case with the rise of managerial capitalism in the United States, the Japanese state has played an important role in preserving the home market for Japanese firms. By influencing the distribution of income, the organization of industry, the availability of finance, the education of labor, and even the patterns of consumer demand, the Japanese government has gone much further in creating conditions supportive of economic development. Yet ultimately the Japanese economy relies on the strategies and structures of private-sector enterprises to generate the high-quality products at low unit costs that have enabled Japanese industry to capture major shares of world markets.

Underlying the phenomenal success of the Japanese economy since the 1950s, therefore, have been the willingness and ability of its corporate enterprises to extend the principle of planned coordination—a principle that served American corporations so well in the rise of managerial capitalism—across firms, within firms, and to business-government relations. The Japanese have not rejected managerial capitalism, but have elaborated it into a set of institutional relationships that I call collective capitalism.

What was it about managerial capitalism that enabled U.S. industry to gain competitive advantage over the market-coordinated British economy in the first decades of this century? And what is it about collective capitalism that has enabled Japan to outcompete the United States more recently? More generally, what is the relation between economic institutions and economic performance, and how have the economic institutions of the most successful capitalist economies changed over the past century?

The answers to these questions require an understanding of the value-creating capabilities of different modes of economic organization in different social contexts. The first and fundamental step is to comprehend how, in general, a capitalist economy creates value—products that people desire at prices they can afford. Because capitalist economies ultimately rely on the strategies and structures of business enterprises to create value, the analysis of the process of value creation requires an explicit conception of the value-creating business organization. The analysis must then explore why specific modes of coordination of the activities of business enterprises have possessed superior value-creating capabilities in particular times and places. Finally, the analysis must ask why those national

24 Maddison, Phases of Capitalist Development, 252–4; Matthews et al., British Economic Growth, 435.
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economies that had gained international dominance on the basis of one mode of economic coordination – for example, Britain on the basis of proprietary capitalism and the United States on the basis of managerial capitalism – have had difficulty responding to the new competition based on more highly organized institutional structures.

This book does not provide all the answers to these historical questions. Rather, its goal is to provide economists and historians with the intellectual orientation that is critical to historical analysis. In explicating this intellectual orientation, this book also confronts conventional academic views about the relation between economic institutions and economic prosperity. The ideology that rules the thinking of mainstream economics, in the English-speaking world at least, is that well-functioning capitalist economy is a market economy. Although mainstream thinking has shown great ingenuity in considering the nature of “imperfect” markets and their impacts on economic outcomes, the unquestioned underlying assumption is always that the perfection of markets, if only attainable, would result in the most efficient economic outcomes.

I call this misguided assumption the “myth of the market economy” because it is contradicted by the reality of successful capitalist development in the twentieth century. In its seemingly endless search for solutions, both theoretical and political, to remedy the “disabilities” of imperfect markets, mainstream economics has failed to recognize the growing importance of business organization relative to market exchange for generating economic development. In particular, the neoclassical perspective on the operation of the “market economy” that fills economics textbooks, classroom lectures, and academic journals contains no theory of the innovative business organization – an organization that generates the higher-quality products at lower unit costs that are the essence of the process of economic development. In this book, I shall outline a theory of the innovative business organization that provides the foundations for explaining shifts in international industrial leadership and changes in the wealth of capitalist nations. The elaboration of such a historically relevant theory is a worthwhile project in its own right. In the process, however, I also hope to explode the myth of the market economy, if only because it represents such a formidable ideological impediment, both within academia and in the world beyond, to understanding how we might shape social institutions to manage the economic future.

The ordering of the chapters is designed to emphasize the use of comparative historical methodology to develop dynamic theory and the use of historically relevant dynamic theory to critique static methodology and misinformed ideology. Synthesizing recent empirical research (including my own), Chapter 1 provides a historical analysis of the changing institutional foundations of international industrial leadership as it has moved from Britain to the United States to Japan over the past century. On the basis of this historical synthesis, Chapter 2 proposes a conceptual framework for understanding how and why organizations characterized by the planned coordination of specialized divisions of labor have increasingly superseded markets as the institutional basis for successful capitalist development. Drawing on the historical analysis and conceptual framework, Chapter 3 transforms the static theory of the firm of the conventional textbooks into a dynamic theory of the business organization as an engine of economic growth.

Just in case the reader finds my theoretical, historical, and conceptual arguments in the first three chapters novel, Chapter 4 outlines the influence on my approach of the work of two economists, Karl Marx and Joseph Schumpeter, and two historians, Alfred Chandler and David Landes. My purpose is not to render praise unto these scholars, but to provide accessible critical evaluations of their work so that economists might build relevant intellectual traditions without, as is so often the case, having to reinvent the intellectual wheel.

The importance of building on relevant intellectual traditions, and of using intellectual traditions in a relevant way, should become apparent in Chapter 5. Here I show how the work of Alfred Marshall could have contributed to the analysis of business organization and economic development. I argue that the application of his concept of internal economies of scale to the analysis of capitalist development could have long since dispelled the myth of the market economy. I recount how, from the turn of the century, mainstream economists managed to miss the significance of both the advent of managerial capitalism and Marshall’s framework for analyzing the sources of economic development. Instead, mainstream economists constructed a theory of the firm in equilibrium. I go on to illustrate how, during the 1960s and 1970s, some prominent economists – specifically Gary Becker, Harvey Leibenstein, and the team of Armen Alchian and Harold Demsetz – whose work raised important issues concerning the origins, operations, and impacts of the modern business enterprise, nevertheless remained prisoners of an outmoded market mentality.

Chapter 6 develops the theory of the innovative organization and uses it to critique the transaction cost approach of Oliver E. Williamson. Transaction cost theory permits Williamson to recognize the empirical importance of administrative coordination in economic activity while still extolling (as he put it) “the marvels of the market.” I characterize his approach as a theory of the “adaptive” organization, in contrast to the theory of the “innovative” organization – a theory that I argue has become central to any analysis of the dynamics of economic development in the advanced capitalist nations.
In Chapter 7, I take the critique of Williamson’s transaction cost approach further by showing how, for lack of a theory of the innovative organization, Williamson misinterprets critical institutional transformations in U.S. business history as documented by Alfred Chandler. One purpose of this chapter is to show how an ill-suited, preconceived theory can result in the misuse of history, as (whether consciously or not) the “facts” are made to fit the theory. Another purpose of this chapter is to provide the reader with a summary of what Chandler really said in his path-breaking book *The Visible Hand*. A final purpose of the chapter is to debunk a common view that the economist Williamson and the historian Chandler are simply making the same arguments from different disciplinary perspectives. They are not. Although both deal with the relation between business organizations and market exchange in advanced capitalist economies, one has succumbed to the myth of the market economy, while the other has not.

I conclude the book with two chapters that aim to help overcome the intellectual constraints that render mainstream economics largely irrelevant for comprehending the process of capitalist development and shifts in international competitive advantage. In Chapter 8, I outline how the Marxian, Schumpeterian, and Marshallian theories of capitalist development must be revised in order to capture the essential features of the relation between economic institutions and economic performance in leading capitalist economies. Indeed, I review the ways in which, over the past few decades, leading neo-Marxians, neo-Schumpeterians, and neo-Marshallians have undertaken such revisions. I critically evaluate the extent to which these revisions of the three lines of theoretical inquiry provide foundations for future research into the historical dynamics of economic development in the advanced capitalist world.

To overcome prevailing intellectual constraints, however, relevant theory is not enough. Precisely because we are analyzing the process of change, theory is only a guide to ongoing empirical analysis, and not (as is generally the case among mainstream economists) a substitute for it. It is on the basis of rigorous historical analyses, brought up to the present, that one can continually reassess the relevance of existing theory for guiding political intervention into the process of change. To do rigorous historical analysis requires not only a relevant theoretical framework, but also an appropriate historical methodology. For understanding the dynamics of capitalist development in the late twentieth century and beyond, mainstream economics is constrained by its adherence not only to the theory of the market economy, but also to the methodology of constrained optimization. Chapter 9 explains the intellectual constraints inherent in an exclusive reliance on the constrained optimization methodology and then, by considering the work of economic historians and institutional economists in the United States, seeks to provide methodological content to the intellectual phenomenon that Joseph A. Schumpeter called “historical experience.”