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Reevaluating The Chicago School Paradigm For Promoting Innovation and Competitiveness

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It is an honor to be a participant with such an outstanding group of colleagues — panelists and audience. Twenty-five years ago when I was a graduate student, the best book that I read in preparing for my oral comprehensive was the *Structure of Scientific Revolutions* by Thomas Kuhn.[1] I was fascinated to see the first public reference to it, that I have noticed, shortly after President Clinton's inauguration. It was reported to be one of his favorite books. Kuhn's basic argument is that ideas and knowledge advance with paradigms or models. These are theories of how the world works which can never be strictly proven or disproved, but which do have a plausibility and a contemporaniety, leading one paradigm rather than another to become the prevailing model. Once a new paradigm takes hold there is an expanding, limning of the paradigm. At a certain point, though, inconsistencies show up and there is a fraying at the edges. At that point a new, Copernican-like paradigm — often after hundreds of years of development — will come and take its place. By the 1400s the Ptolemaic view of the universe, while very sophisticated in its later stages, was ready to be supplanted — before being definitively disproved. As one can see in a couple of the great cathedrals in Europe, some Ptolemaic views of the solar system and the universe were calibrated with a high degree of mathematical precision. In fact, they explained for most purposes, the way the universe worked from the point of view of astronomers. The problems were that some of the calculations were off by a few seconds, or a few thousand miles. It was the accumulation of these small errors that helped, over time, to lead to an overthrow of the paradigm.

I have been an antitrust lawyer for about twenty years. During this period we have had a Kuhnian model in antitrust in the United States which was largely defined and articulated by what has come to be known as the Chicago School of economic analysis. The basic notion of the Chicago School relevant to a discussion of industrial policy is that any policy involving focused government intervention to improve the competitiveness of enterprises fundamentally harms economic welfare and is incompatible with the promotion of competitiveness.

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The following text was compiled from the transcript of the remarks made by Mr. Rosenthal at the Conference.

[1] THOMAS KUHN, STRUCTURE OF SCIENTIFIC REVOLUTIONS (U. of Chi. Press 1962).

President Clinton seems to have said that what he means by industrial policy is bringing about change in the competitiveness of American industry. We have talked a lot about what industrial policy is, but a common theme running through this conference will be whether we can, in fact, promote greater competitiveness by some forms of focused government intervention.

Competitiveness can be measured in various ways. One of these is the ability to get market share to be a player in global markets. This involves the ability to show productivity gains, and to be a leader in technological innovation.

American competitiveness was an issue in the last presidential campaign. The United States was seen to be stumbling in the 1970s and 1980s compared to earlier periods. Under the paradigms that ruled in antitrust in the United States for the last twenty years, the basic explanation for the facts presented was that we still were not doing enough to remove government regulation. Those who are still tenaciously holding to the paradigm of the Chicago School, in the Kuhnian sense, would argue that the sufficient cure for the problems of American and Canadian competitiveness is a much greater cutting away of government regulation. For much of the twenty years, this paradigm was robust. I think that it still remains powerful for three reasons.

First, it is undeniable that in the last ten years we have seen the collapse of state socialism; this is the discredited paradigm, of the state interventionist alternative; industrial policy as theology. The collapse of state socialism occurred, not only in the Communist states, but in Sweden as well. I suppose one can argue, that a very water-downed form of state socialism, more state paternalism, was abandoned in Canada under Prime Minister Mulroney.

The second factor that helped the robustness was the coherence of the elegance of Chicago School micro-economics. It is a superbly elegant theory. It simplifies everything greatly. It says one does not need to worry about transaction and information costs, and that markets will basically work if they are unimpeded. The theory is that if you give the sovereign consumer and the sovereign producer the full freedom to make his or her own rational choices, without barriers to exercising those choices, or artificial restrictions to the availability of resources to either, then we will have the most efficient allocation of resources. It really makes the prescriptions very simple.

One of the implicit assumptions of the Chicago School theory is that innovation necessarily will be maximized by the freedom of the entrepreneur and consumer. For the reasons we have heard about the difficulty of governments predicting winners, we have been told it is the unencumbered American or Canadian entrepreneur who will do the best job of predicting winners. It is being in close touch with the consumer that will send the quickest signals of whether one is succeeding or failing. For the last twenty years we have had no good competing economic theory to seriously challenge the Chicago School theory of firm and consumer behavior in the marketplace. The Chicago School has also had the advantage of three very powerful pamphleteers. One is Richard Posner, who had a powerful influence in the government and in academics. Another is William Baxter. Baxter won a profound victory for the role of competition in industrial policy. He was able to persuade President Reagan to break up AT&T and not to listen to Casper Weinberger who insisted it would be a disaster for American national security if the Defense Department did not have an integrated AT&T to work with for the security of defense-related telecommunications. There was an article in the *New Yorker* magazine recently concluding that AT&T is an infinitely healthier company today because it was forced to divest itself of the Baby Bells. Third, of course, you have Robert Bork — a powerful Chicago School pamphleteer.

The third factor, that was very important for the robustness of this paradigm, and which I will concentrate on, is confidence in the American management philosophy. There are two very important management ideas which held ascendancy in the last twenty years, and which were generally hospitable to Chicago School thinking, and vice versa. Although perhaps one could quarrel about their theoretical compatibility, these were two sets of prevailing ideas that were very powerful in American management. The first was the idea reflected in articles in *Fortune* magazine in the 1960s and 1970s about the management style of Harold Geneen of ITT. The way to run a company was with financial experts. These financial experts would keep very close tabs on sales, profits, costs of production, and get the numbers within weeks or days to central management. They would find out which divisions and which products were profitable on a month-to-month basis. If you had diminished profits then the focus was to cut costs aggressively to restore profitability. If you were unable to restore profitability over a period of eighteen months then you would shed the company or the division or the product line and find something else to manage.

The other idea was often associated with the Boston Consulting Group. This idea was that the general strategic approach of an American company should be to develop an innovative product, test it, market it and then price it to recover monopoly profits right up front, while one had the innovative edge over the competition. The next step would be to plow the money back as much as you can, giving some to shareholders so you get the stock price up as well, but recognize, as inevitable, that you will eventually lose market share, that your high profits will bring competition into the industry, that you may not be able to hold your innovative leadership and that you really want to pull your profits out during the early years when you have the innovative advantage. The industry will mature, either sooner or later. At the point of maturity profits are going to be substantially reduced. Hopefully, by that point, your goal could be reached — to be one of the two leading firms in the industry from which position you could still be realizing economies of scale and, presumably, still be competitive. If at that point your profits are substantially down and you have not maintained that leadership position, then shed your position in that industry and move on.

I do not have an alternative model to this; although we now learn that there is some reason to have some doubts about the validity and wisdom of many of these ideas.

As to the first reason, the collapse of state socialism, we do have some examples of where some industrial targeting and some conduct by monopolists was counter-intuitive to Chicago School theory. A monopolist, DeBeers, was the technological leader in developing synthetic diamonds in competition with the natural diamonds which it monopolized. A monopolist has maintained a substantial market leadership position in one industry for ninety years. The Chicago School would predict that a DeBeers should, over time, as a monopolist, necessarily cease to be an innovator and thus cease to be a monopolist.

Another example is the Bell Labs. Some of the greatest innovations in twentieth century technology like the analog computer, came out of the Bell Labs; it was financed by a monopolist, AT&T. AT&T did not work under the discipline of the marketplace.

To give another example, the role of the French Government in developing a nuclear power industry. It was costly and wasteful government-targeting at the beginning. However, it is looking more and more successful as we approach the year 2000. Costs of nuclear power in France are far lower than any other power source in Europe. Government utilities in other European states are unhappy about competition from the cheap French power. So far, counter-intuitively, the French have dealt very well with the threat of nuclear accidents and the supposed near-impossible difficulties of environmentally-safe utilization of nuclear fuel. This is not to say that governments should be invited to engage freely and abundantly in industrial targeting. What I am merely suggesting is there are some threads that are loosening in the fabric of the Chicago School paradigm. That should lead us to reevaluating whether that paradigm is the only constructive one for considering the issue of industrial policy and competitiveness in the future.

An alternative explanation of why the United States and Canada are not doing so well, consistent with the Chicago School paradigm, is that North American exports have restricted access to foreign markets and North American producers are victims of rapacious predatory conduct by foreign exporters, by "others". We are told that when one says "others", one is really using a code word for the Japanese.

S. Linn Williams' analysis, I find, from my experience and readings to be essentially correct. The high watermarks of restriction on access to *industrial products* in Japan are behind us. For General Motors to suggest that it is Japan's fault that it has had difficulty being competitive in North America is pure scapegoating. In fact, most of the complaints about the problems of American competitiveness being attributable to Japan is scapegoating.

The third factor, the Cold War, is important and I think must be recognized. I would like to introduce it into our more general discussion. We made a non-economic choice, in the United States, of spending huge amounts of our natural resources on a military policy to resist the threat of Communist expansion. Perhaps the major accomplishment of the Reagan Administration was to load so much spending on Star Wars, and missile deployment in Europe, that Mr. Gorbachev and his colleagues finally recognized that they could not compete with the West militarily and economically. It is as much to that as to any other single factor that we can attribute the end of the Cold War.

What Mr. Reagan and his economic advisors did not appreciate, just as perhaps German economic officials are beginning to appreciate in the context of the difficulties of integrating East Germany into West Germany, is the enormous price we paid for that success. We are now in a situation where our economy has been so skewed that we cannot afford to stop building weapons for which there is no longer a good use. We cannot afford the economic dislocation of whole communities. We are going to have a readjustment problem for years, so that we cannot productively redeploy our resources without continuing massive waste. One of the reasons that the United States does not have a domestic electronics industry anymore is not just that the Japanese beat us on it, but it was also the disincentive to compete for the television market that our major manufacturers had in light of the high-profit margin demands to build nuclear warheads and other high cost military hardware for the United States Government. The focus and the orientation of American industry was, of course, skewed by the imperatives of our military spending for the Cold War. I can well understand, from a Canadian vantage, a sense of indignation and dismay at the indirect subsidies that may have been conferred by America's military expenditure program. However, I assure you, from the vantage of an American taxpayer, those benefits are far outweighed by the disadvantages of an economy carrying a military expenditure six or seven times the military expenditure of any other American ally. We are now saddled with a natural debt which precludes infrastructure spending, Marshall Plan-type aid to Eastern Europe and the Middle East and use of tools of economic development that might promote prosperity and greater worldwide democracy.

A fourth factor that may explain the problems that we have, that is neither consistent nor inconsistent with the Chicago School paradigm, but that certainly should be opened to criticism, is that American management ideas of the last twenty years may have been less sound than Japanese management ideas. Of course, as the Japanese like to point out, the ideas that they are now employing so successfully are really ideas that come from an American, Edward Demming, who went over to Japan starting in 1950, and communicated his ideas.

The basic ideas of Demming, which are antithetical to the Harold Geneen and the Boston Consulting Group model of appropriate industrial organization, are that the central goal of a corporation must be to try to define a product where there is a demand; which can be produced cheaply; at high quality; and then devote your energy to a continual effort to produce the highest quality version of that product possible. The effort to define the product is not over when you have that first innovation that you bring to market. You need constantly to renew and improve that product. The commitment to selling a product in an industry is a long-term commitment to stay in that industry, to be there, to build market share, and to build a leadership position. After perhaps ten or even twenty years you will begin to be in a position to exercise your strength; after such a period you will know your product and customers much better than when you started. The idea is quality-control instead of the American model of looking at the bottom line. You cannot look at the bottom line because if the way you show profits to a Mr. Geneen is by cutting quality, you are going to kill your long-term market. Every customer who is driven away by an inferior quality product means five other customers lost because he will complain to the others and the others will be concerned about your product.

It would be nice for Robert Cassidy and his clients if we could solve the problem of the American automobile industry by a simple reduction of access of Japanese cars to the U.S. market. It is undoubtedly true — and I have gone out and bought a Ford Taurus and find it to be a fine car — that many of the new American cars are substantially improved in quality. One of the things that Demming and the Japanese understand very well is that after somebody becomes disillusioned with inferior products you cannot simply turn it around and offer them a new product and expect them to come back in the first year. It takes a long time to win back lost customers.

Similarly with the Japanese there is a radically different approach from that of the Boston Consulting Group. The Japanese approach is that if you have defined and produced a high quality product for which there is a consumer demand, you do not come to the marketplace and price it at a monopoly level. Your policy should be one of forward pricing; pricing it at a level you think can become a profitable price in two years — after you have built market share, and after you have taken advantage of the learning curve and the economies of scale that come a few years down the line on the learning curve. For example, the price of color televisions has steadily gone down in real dollar terms since the early 1970s, even though quality has gone up and competition has come in from other Asian nations. Market share has been built up so that several of the largest and most successful firms are continually innovating and renewing, without having captured monopoly profits, at least in the United States. Yet, we have designed our dumping laws so it does not take account of forward pricing. If you engage at all in a forward pricing strategy, which seems to be a rational strategy in terms of being competitive in the marketplace and seeking long-term competitiveness as a goal, you are certain to be caught up as a dumper under national dumping laws.

A reexamination of the assumptions of the Chicago School is now building. Economically-trained lawyers and economists are reexamining many of the assumptions. Many of the "questions", that were thought to be closed before, are now reopening. There is vigorous debate in the American intellectual community today as to whether there ought to be a significant efficiency defense in merger analysis. There is debate today about whether we should be concerned about price signalling in oligopolistic markets and whether that should be dealt with under the antitrust laws. That issue is raised by the Justice Department's civil case against several U.S. domestic airlines. We are reexamining the supposed proper balance between the protections of the intellectual property laws and competition laws and policies. The law in this area is in the process of evolution. We are focusing on whether we should be concerned about control over parts and maintenance aftermarkets by manufacturers who have some control over the distribution and maintenance of their own brand of complex durable goods like computers, copiers, and medical imagers. We are rethinking whether predatory pricing is something we should be concerned about, after the Chicago School told us predatory pricing is an incoherent and implausible doctrine.

Competition will play a greater role in industrial policy. Competition should also play a greater role in trade policy. The Chicago School paradigm is still sound in its skepticism about certain forms of overregulation by the government. However, I think we have to be open to a new examination of the paradigm and a search for new paradigms. The Chicago School seems, in important ways, to have failed to explain and promote technological innovation. We cannot be complacent that all we have to do is have a free market to maximize innovation and productivity. It seems a lot more complicated than that.