Innovative Enterprise and Sustainable Prosperity

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The Many Futures of Work Conference
Chicago
October 5, 2017
Large corporations dominate the US economy
Economic performance depends on corporate resource allocation

<table>
<thead>
<tr>
<th>2012</th>
<th>Percent of US business total</th>
<th>Firms</th>
<th>Employees</th>
<th>Payroll</th>
<th>Revenue</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>No of employees</td>
<td>No of firms</td>
<td>Average employees</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>All sizes</td>
<td>5,726,120</td>
<td>20</td>
<td>100.00</td>
<td>100</td>
<td>100.0</td>
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<tr>
<td>500 +</td>
<td>18,219</td>
<td>3,286</td>
<td>0.32</td>
<td>52</td>
<td>58</td>
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<tr>
<td>5,000+</td>
<td>1,909</td>
<td>20,366</td>
<td>0.03</td>
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<tr>
<td>10,000+</td>
<td>964</td>
<td>33,542</td>
<td>0.02</td>
<td>27</td>
<td>31</td>
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</tbody>
</table>

- Less than 1,000 firms with 10,000+ employees have a huge influence on US economic performance.
- How senior executives decide to allocate corporate resources affects employment, productivity and pay.

https://www.census.gov/econ/susb/data/susb2007.html (most recent data)
The increasing divergence of productivity from pay


WHEN PRODUCTIVITY AND WAGES PARTED WAYS
From 1948 to the mid-1970s, increases in productivity and wages went hand in hand. Then a gap opened between the two.
Career employment: Key driver of the productivity-pay relation

Old Economy Business Model
Career-with-one-company norm: employees share in profits through job security, pay raises, and defined-benefit pensions
Source: Bureau of Labor Statistics

New Economy Business Model
Insecure jobs, globalized labor, defined-contribution pensions
Massive stock buybacks and exploding top executive pay
Erosion of middle-class employment opportunities as careers in companies disappear
Stock buybacks are an important explanation for both the concentration of income among the richest households and the disappearance of middle-class employment opportunities in the United States over the past three decades. Over this period, corporate resource-allocation at many, if not most, major U.S. business corporations has transitioned from “retain-and-reinvest” to “downsize-and-distribute,” says William Lazonick in a new paper.
The looting of the US industrial corporation


Federal Reserve Flow of Funds: Net equity issues, annual average 2007-2016=-$412b

SEC Rule 10b-18 November 1982
The era of downsize-and-distribute:
The U.S. corporate economy is a “buyback economy”

<table>
<thead>
<tr>
<th>Period</th>
<th>Net equity issues by US industrial corporations, 2015$ billions</th>
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<tbody>
<tr>
<td>1946-1955</td>
<td>143.2</td>
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<tr>
<td>1956-1965</td>
<td>110.9</td>
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<tr>
<td>1966-1975</td>
<td>316.0</td>
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<tr>
<td>1976-1985</td>
<td>-290.9</td>
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<tr>
<td>1986-1995</td>
<td>-1,002.5</td>
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<tr>
<td>1996-2005</td>
<td>-1,524.4</td>
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<td>2006-2015</td>
<td>-4,466.6</td>
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</table>

Net equity issues, industrial corps. 2016=-$568b.
Since the mid-1980s, senior executives have been allocating substantial resources to buybacks in addition to dividends for 236 companies in the S&P 500 index in January 2016, publicly listed 1981-2015.
Buybacks (BB) and dividends (DV) by 461 companies in the S&P 500 Index in January 2017 that were publicly listed 2007-2016

Total BB: $3.9t., 54.5% of net income (NI)
Total DV: $2.9t., 39.3% of net income (NI)
<table>
<thead>
<tr>
<th>RANK</th>
<th>Company Name</th>
<th>Ticker Symbol</th>
<th>NI, $b</th>
<th>BB, $b</th>
<th>DV, $b</th>
<th>BB/NI %</th>
<th>DV/NI %</th>
<th>(BB+DV)/NI%</th>
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<tr>
<td>1</td>
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<td>XOM</td>
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<td>120</td>
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<td>4</td>
<td>IBM</td>
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<td>5</td>
<td>WAL-MART</td>
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<td>150</td>
<td>67</td>
<td>51</td>
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<td>6</td>
<td>CISCO SYSTEMS</td>
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<td>63</td>
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<td>CHEVRON</td>
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<td>65</td>
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<td>38</td>
<td>58</td>
</tr>
</tbody>
</table>
Shareholders should support a buybacks ban

- In the U.S. economy as a whole, buybacks have come on top of dividends, not instead of them.

- Dividends are the traditional way for a publicly-listed corporation to provide income to shareholders for (as the name says) holding shares.

- Moreover, if the firm retains enough profits to finance investment in productive capabilities, there is the possibility (although by no means the certainty) that it will generate competitive products that will lift its future stock price. When shareholders who have benefited from a stream of dividend income decide to sell some or all of their shares, they stand to make capital gains.
Buybacks benefit *professional sharesellers*

- In contrast to dividends, buybacks create immediate demand for shares, boosting the stock price. **Buybacks reward sharesellers, not shareholders.**

- The most prominent sharesellers are those stock-market traders – corporate executives, investment bankers, and hedge-fund managers – who are in the business of **timing stock sales** to take advantage of buyback activity done as open-market repurchases.

- **Buybacks also automatically increase EPS by decreasing the number of shares outstanding.** If higher EPS causes stock prices to rise, stock-market speculators can sell shares at a gain even in the absence of increased corporate revenues or profits.
The damage that buybacks do:
Undermining the foundation of corporate finance

**Retained earnings are the foundation for investment in the productive capabilities of the firm.**

Companies invest in
- Plant and Equipment (P&E)
- Research and Development (R&D)
- Training and Retaining (T&R)

Until the 1980s, executives and economists worried that dividend payouts might be too high to sustain the growth of the firm. Since the mid-1980s, in the name of “maximizing shareholder value,” that concern has (literally) “gone by the board.”
The damage that buybacks do: Concentrate income at the top while failing to invest in the middle class

Labor in the Twenty-First Century: The Top 0.1% and the Disappearing Middle-Class

The ongoing explosion of the incomes of the richest households and the erosion of middle-class employment opportunities for most of the rest have become integrally related in the now-normal operation of the U.S. economy.
The disappearing middle class

Unemployment rate (July)

Retain-and-reinvest

Downsize-and-distribute

FINANCIALIZATION

1940s to 1980s: career-with-one-company norm (mainly white males)

1980s: rationalization

1990s: marketization

2000s & beyond: globalization

Three sources of structural change in US corporate employment relations since the 1980s

1980s: Rationalization: permanent layoffs of blue-collar workers

1990s: Marketization: end of the career-with-one company norm

2000s: Globalization: international flows of jobs to labor and labor to jobs

- All three transformations in employment resulted in the erosion of “middle-class” jobs in the United States
- But the corporations that had employed these people did not disappear, and many remained or became highly profitable

Q. Why didn’t US corporations invest the gains from rationalization, marketization, and globalization in the next generation of higher quality jobs?

A. Financialization of corporate resource allocation (i.e., buybacks)
“Salaried” incomes of the top 0.1%, 1916-2011

“Salaries” include gains from stock-based pay

http://topincomes.parisschoolofeconomics.eu/#Database: United States, Top 0.1% income composition.
Average total pay by ACTUAL REALIZED GAINS and % shares of pay components, 500 highest paid US executives in each year, 2006-2015

Source: S&P ExecuComp database; calculations by Matt Hopkins, theAIRnet
### Comparative remuneration, corp. execs. and HFM, 2014

<table>
<thead>
<tr>
<th>Corporate Executives</th>
<th>Pay</th>
<th>Hedge Fund Managers</th>
<th>Pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>David A. Ebersman Facebook</td>
<td>$388 M</td>
<td>Kenneth Griffin Citadel</td>
<td>$1.3 B</td>
</tr>
<tr>
<td>Leslie Moonves, II CBS Corp</td>
<td>$259 M</td>
<td>James Simons Renaissance Technologies</td>
<td>$1.2 B</td>
</tr>
<tr>
<td>Sumner M. Redstone CBS Corp</td>
<td>$225 M</td>
<td>Raymond Dalio Bridgewater Associates</td>
<td>$1.1 B</td>
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<tr>
<td>Leonard Bell, M.D. Alexion Pharmaceuticals</td>
<td>$196 M</td>
<td>William Ackman Pershing Square Capital Management</td>
<td>$950 M</td>
</tr>
<tr>
<td>John C. Martin, Ph.D. Gilead Sciences</td>
<td>$193 M</td>
<td>Israel (Izzy) Engleander Millennium Management</td>
<td>$900 M</td>
</tr>
<tr>
<td>Timothy D. Cook Apple</td>
<td>$154 M</td>
<td>Michael Platt BlueCrest Capital Management</td>
<td>$800 M</td>
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<tr>
<td>Sumner M. Redstone Viacom</td>
<td>$120 M</td>
<td>Larry Robbins Glenview Capital Management</td>
<td>$570 M</td>
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<td>David M. Zaslav Discovery Comm</td>
<td>$118 M</td>
<td>David Shaw D.E. Shaw Group</td>
<td>$530 M</td>
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<tr>
<td>Martin Ellis Franklin Jarden Corp</td>
<td>$118 M</td>
<td>O. Andreas Halvorsen Viking Global Investors</td>
<td>$450 M</td>
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<tr>
<td>Reed Hastings Netflix</td>
<td>$117 M</td>
<td>Charles (Chase) Coleman III Tiger Global Management</td>
<td>$425 M</td>
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<tr>
<td><strong>Average</strong></td>
<td>$189 M</td>
<td><strong>Average</strong></td>
<td>$822 M</td>
</tr>
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</table>
Remuneration of the top 15 hedge-fund managers, USA, 2016 (top15 average=$606 million)

<table>
<thead>
<tr>
<th>Name</th>
<th>Hedge Fund</th>
<th>Take-Home Pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>James Simons</td>
<td>Renaissance Technologies</td>
<td>$1.5 billion</td>
</tr>
<tr>
<td>Michael Platt</td>
<td>BlueCrest Capital Management</td>
<td>$1.5 billion</td>
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<tr>
<td>Raymond Dalio</td>
<td>Bridgewater Associates</td>
<td>$1.4 billion</td>
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<tr>
<td>David Tepper</td>
<td>Appaloosa Management</td>
<td>$750 million</td>
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<tr>
<td>Kenneth Griffin</td>
<td>Citadel LLC</td>
<td>$500 million</td>
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<tr>
<td>Daniel Loeb</td>
<td>Third Point</td>
<td>$400 million</td>
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<tr>
<td>Paul Singer</td>
<td>Elliott Management</td>
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<tr>
<td>David Shaw</td>
<td>D. E. Shaw &amp; Co.</td>
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<tr>
<td>John Overdeck</td>
<td>Two Sigma Investments</td>
<td>$375 million</td>
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<td>David Siegel</td>
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<td>Michael Hintze</td>
<td>CQS LLP</td>
<td>$325 million</td>
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<td>Jeffrey Talpins</td>
<td>Element Capital Management</td>
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<tr>
<td>Stanley Druckenmiller</td>
<td>Duquesne Family Office</td>
<td>$300 million</td>
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<tr>
<td>Brett Icahn</td>
<td>Icahn Capital Management</td>
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<td>David Schechter</td>
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<td>$280 million</td>
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</table>
In the growth of the U.S. economy the key function of the stock market was *control*. Specifically, the stock market enabled the separation of managerial control over the allocation of corporate resources from the ownership of the company’s shares.

Yet, assuming that the key function of the stock market is *cash*, economists known as agency theorists see this separation of control from ownership as the “original sin” of American capitalism, and argue that the evils of managerial control can be overcome by compelling corporate managers as “agents” to maximize the value of corporate shareholders as “principals.”
“Agency theorists” view the business enterprise as a “market imperfection”, in need of the MSV solution

- **MSV:** rooted in the theory of the market economy in which the business enterprise is a massive market imperfection with “inefficient” capital markets
- **Critical assumption of agency theory:** all economic participants receive guaranteed market returns except for *shareholders who bear risk by making investments without guaranteed returns*
- It is then assumed that this risk-bearing function results in a more efficient economy
- It follows that those who bear risk should control the allocation of the economy’s resources
Jensen: “Disgorge” the “free” cash flow

Solution to the agency problem:
To make markets efficient, “disgorge free cash flow”:

“Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below cost or wasting it on organization inefficiencies.”


Integral to disgorging corporate cash is the alignment of the interests of managers as agents with shareholders as principals by giving managers stock-based pay.
Fundamental problem with MSV: erroneous assumption that shareholders are the only actors who invest without a guaranteed return

NOT SO: Taxpayers through government agencies and workers through business employers regularly make risky investments in productive capabilities. From this perspective, both the state and labor have economic claims on profits if and when they occur.

Irony of MSV: public shareholders typically never invest in the company’s value-creating capabilities. They invest in outstanding shares, hoping for a rise in price. Following MSV, executives fuel this hope by “disgorging” cash as dividends and buybacks.
MSV is a theory of value extraction, not value creation

- Economic activity and performance depend on resource allocation decisions
- We rely on corporate executives to make resource allocation decisions
- Stock-based compensation enriches top corporate executives in the name of MSV, and gives them incentives to encourage speculation in and engage in manipulation of the price of their company’s stock
- Stock buybacks: The prime mode of corporate resource allocation for the purpose of manipulating stock prices
Agency theory lacks a theory of value creation, or what I call a “theory of innovative enterprise”

The value-creation process requires three social conditions of innovative enterprise: *strategic control, organizational integration, and financial commitment.*

The functions of the stock market may *support or undermine* the types of strategic control, organizational integration, and financial commitment that can result in the generation of high-quality products at low unit costs (i.e., innovative enterprise)

**Key question:** How do the functions of the stock market affect the conditions of innovative enterprise?
The innovation process

How does a business enterprise deliver a higher quality product at a lower unit cost than its competitors?

Innovation is uncertain, collective, and cumulative.

- **Uncertain**: If one knew how to produce a higher quality product at the time when investments are made, then it would not be innovation!
- **Collective**: Innovation cannot be done all alone. It requires teams of people engaged in organizational learning processes.
- **Cumulative**: Innovation cannot be done all at once. Collective learning takes time, and what was learned today determines what can be learned tomorrow.
The innovative enterprise

Innovation requires strategy, organization, and finance.

- **Uncertain**: Innovation requires strategy. It matters who exercises strategic control.

- **Collective**: Innovation requires organization. Skills and efforts require organizational integration into collective—and cumulative—learning processes.

- **Cumulative**: Innovation requires finance. Through financial commitment, the learning processes must be sustained until they generate financial returns.
Social conditions of innovative enterprise

- **Strategic control**: a set of relations that gives decision-makers the power to allocate the firm’s resources to confront uncertainty by transforming technologies and accessing markets to generate higher quality, lower cost products.

- **Organizational integration**: a set of relations that create incentives for people to apply their skills and efforts to engage in collective learning.

- **Financial commitment**: a set of relations that secures the allocation of money to sustain the cumulative innovation process until it generates financial returns.
High quality at low unit costs

The key to innovation is collective and cumulative learning that develops a higher quality product.

- But the high fixed costs of developing a higher quality product will place the firm at a competitive disadvantage until it can get a large market share to transform high fixed costs into low unit costs.

- There are added fixed costs of accessing the market, including learning from buyers and convincing them that the firm has a higher quality product.

- But as the firm gains a greater extent of the market, it transforms high fixed costs into low unit costs—and competitive disadvantage into advantage.
By creating new sources of value embodied in higher quality, lower cost products, the innovative enterprise makes it possible (but not inevitable) that, simultaneously, all participants in the economy can gain:

- **Employees:** Higher pay, better work conditions
- **Creditors:** More secure paper
- **Shareholders:** Higher dividends or share prices
- **Government:** Higher taxes
- **The Firm:** Stronger balance sheet

AND

- **Consumers:** Higher quality, lower cost products
Innovative enterprise and sustainable prosperity

Business governance and employment relations determine whether the operation and performance of the business enterprise contribute to stable and equitable economic growth.

- **Stability**: Productive careers through which employees engage in collective/cumulative learning

- **Equity**: Employees share in productivity gains through security, pay, benefits, and work conditions

- **Growth**: Employees’ earnings rise, yet the business is more profitable because its employees are more productive
How MSV undermines innovation

Maximizing Shareholder Value (MSV) is an ideology that is destructive of innovative enterprise

- **Strategic control:** MSV permits separation of interests of top executives from interests of the corporation; executives use MSV to justify resource allocation for their personal gain

- **Organizational integration:** MSV undermines the incentives and abilities of the labor force to engage in collective and cumulative learning, which is the essence of the innovation process

- **Financial commitment:** MSV drains the company of financial resources that are needed to fund, and sustain, innovation—in the name of MSV, top executives and activist shareholders make tens or hundreds of millions of dollars as predatory value extractors
BAD NEWS FOR “WELL-TRAINED” ECONOMISTS: Whether applied to rich nations or poor nations, a theory of economic development must begin with the analysis of how organizations generate productivity and influence the distributions of the productivity gains.

Developed markets are results, not causes, of development, and must be regulated or they will undermine innovative enterprise.
Comparing optimizing and innovating firms

$p = \text{price}; \, q = \text{output}; \, c = \text{perfect competitor}$

$p_{\text{min}} = \text{minimum breakeven price}; \, q_{\text{max}} = \text{maximum breakeven output}$

How does the innovating firm transform high fixed costs into low unit costs?

Technological and market conditions are given by cost and revenue functions. The “good manager” optimizes subject to technological and market constraints.

Through strategy, organization, & finance, innovating firm transforms technologies and markets to generate higher quality, lower cost products. There is no “optimal” output or “optimal” price.
Strategy: *innovation is uncertain* – abilities and incentives of strategic decision-makers are of critical importance to the types of investments that are made.

Organization: *innovation is collective* – development & utilization of productive resources requires integration of labor into collective learning processes.

Finance: *innovation is cumulative* – committed finance (“patient capital”) is needed to sustain the innovation process until it generates financial returns.

Innovative strategy results in low units costs only if products can be sold: bring product market demand into the analysis.
Accessing market segments: product innovation

What is the source of high income demand?
For example: integrated circuits - military; jet engines - military; orphan drugs – national healthcare system; calculators - engineers

In advanced economies, the developmental state invests in advanced technology
In developing economies, the developmental state provides committed finance.

Entry through process innovation.

Key to indigenous innovation strategies of developing nations: e.g., Japan from 1950s, Korea from 1980s, China from 1990s.
Proof that “perfect competition” is superior?

The theory of monopoly supposedly proves the superiority of “perfect” competition by showing that monopoly results in higher prices and lower output than perfect competition.

But how did the monopolist gain a dominant market position? It is ILLOGICAL to assume that the cost structures of firms in “perfect” competition are the same as that of a firm that dominates the industry.
The innovating firm transforms technological and market conditions that the optimizing firm accepts as “given” technological and market constraints.

**Monopoly and competition: ILLOGICAL COMPARISON**

- Marginal cost
- Marginal revenue
- Average revenue

**Innovating and optimizing firms LOGICAL COMPARISON**

- Marginal cost
- Marginal revenue

\[ p_m = \text{monopoly price}; \quad q_m = \text{monopoly output} \]
\[ P_c = \text{competitive price}; \quad q_c = \text{competitive output} \]

\[ p_{min} = \text{lowest breakeven price, optimizing firm} \]
\[ q_{min} = \text{lowest breakeven output, optimizing firm} \]
How did agency theorists get it so wrong?

They are “well-trained” neoclassical economists: they posit that the most unproductive business firm is the foundation for the most efficient economy

- It’s an absurdity taught by PhD economists to millions of student around the world, year in and year out – it’s called “perfect competition”

- The large-scale business enterprise is a massive “market imperfection”; not a value-creating social organization that must distribute gains to value creators and defend itself from value extractors

- With their adherence to “the myth of the market economy, even progressive economists have been blind to the looting of the US industrial corporation
Most of my recent writing on innovative enterprise and sustainable prosperity can be found on the website of the Institute for New Economic Thinking:
https://www.ineteconomics.org/research/experts/wlazonick