COMMENTS ON A PAPER BY POSNER

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The paper by Posner is interesting both for what it says and for the way it says it. He has written a good old-fashioned polemic disguised as a reasonable man's survey of today's consensus position. Posner proposes that "the Chicago school" no longer should be viewed as one of the competing schools of thinking about industrial organizations. In his opinion, it has become by now the only really respectable school of thinking, even though a couple of old fuddie duddies from an older school fail to understand this. Posner contrasts the "old" school of industrial organization (Harvard) which he proposes was atheoretic with the "new" school (Chicago) which based itself rigorously on price theory. But the price theory to which Posner refers is the old-fashioned price theory of the textbooks of twenty years ago. What Posner does not see is that over the last decade or so a newer price theory is replacing the old. I suggest that the new price theory probably provides better support for the old industrial organization than it does for what Posner calls the new. Indeed, the journals are full of a "new new" industrial organization literature based on the newer price theory, viewing the problem in a way that is more consistent with old Harvard than the new Chicago.

I will make these remarks more explicit by first briefly discussing some of the propositions of the new industrial organization that Posner claims are now consensus positions and then describing some of the key elements of the new price theory and the new new industrial organization.

Posner proposes that a significant achievement of the Chicago school of industrial organization was to reveal that a number of the vertical arrangements and policies—tie-in arrangements, resale price maintenance, forward vertical integration—which made the old industrial organization economists nervous, are unlikely to extend the monopoly power of the initiating firm. In general I believe Posner is right in this regard. But the analytic argument hinges on the proposition that the initiating firm initially was maximizing profits and that consumers correctly maximize utility. What if the initiating firm is interested in sales as well as profits but is constrained to earn at least a certain rate of return? Or what if consumers

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are not particularly good calculators of what a package of items would cost them, and tend to pay attention primarily to the price of the central commodity? An analysis of vertical arrangements making one or the other of the above assumptions, and not assuming faultless profit and utility maximization, might suggest that such arrangements are not necessarily benign.

Posner argues that the Chicago school of industrial organization has effectively been undermining the notions that barriers to entry into an industry, stemming from scale economies and advertising, might be a problem. I think this proposition by Posner reflects that he has been talking mainly to his friends. The Chicago proposition that scale economies don't serve as a barrier to entry hinges on explicit or implicit assumptions about perfect capital markets and no adjustment lags or costs. Admit capital market imperfections, and that getting into an industry takes time; then a firm that is already present in the market has an advantage over an entrant simply because the former is there and the latter is not. Similar implicit assumptions, and others that I will mention later, underlie the argument that an established brand name and past advertising do not provide a barrier to entry. The Chicago propositions regarding these matters have not been very persuasive to economists who were not predisposed to be persuaded.

Posner proposes that an important accomplishment of the new industrial organization is that the old paranoia of some non-analytic economists regarding advertisement has been shown up for what it is, and that now all sensible (new or Chicago) industrial organization economists agree that advertising is desirable, because it carries information, and not undesirable. Even the oldest of the old style industrial organization economists, however, would concede that in many cases advertising carries information. Surely it helps consumers to know certain attributes of a product and the product's price before they go to a store. But as I look at my television set of an evening, I wonder what kind of information "great balls of comfort" is meant to convey. Is it really information for me to know that "if I'm out of Schlitz, I'm out of beer"? A sensible analysis of advertising has to recognize that consumers have a wider range of difficulty in making choices than is caught by the proposition that they may be uncertain about price and about certain easily specifiable product attributes. Much of advertising reflects firms' awareness of consumer uncertainty regarding what kind of a product would be nice to have, taste, and live with. In the language of the new new price theory, much of advertising involves signalling rather than providing information. And most models that I know of in which signalling is an activity do not show that natural market forces generate the right kind or amount of signalling.

More generally, the old price theory on which the "new" industrial organization rested assumed faultless profit maximizing on the part of firms and utility maximizing on the part of consumers (sometimes in the expectational sense). It assumed long-run equilibrium in markets. Some aspects of that old new price theory treated uncertainty and search activity, and admitted transaction and control costs. But these features tended to be introduced to explain and justify certain phenomena, like advertising. They were treated as addenda to or complications of the simple optimization problem. The added problem, and the bigger problem, was assumed to be solved optimally, with only limited explanation of what might be involved for a super-optimization postulate to be plausible as a characterization of the behavior of firms and consumers. And there was an implicit carrying over of the "hidden hand" theorems of the consonance of individual maximization and social maximization that characterized the simpler structure to the more complex one. This jump of reasoning, while perhaps plausible at first thought, has been shown to be quite unjustified by subsequent research.

What I have called the "new new" price theory focuses on those aspects of economic behavior that the old new price theory identified but did not analyze adequately—uncertainty and search, and transaction and control costs. The emerging conclusions are changing significantly the way theorists view the strength and weaknesses of market-guided systems.

The new new price theory takes as a basic premise that information is costly to acquire, store, send, and process. It recognizes a diversity of kinds of information in the system. When one analyzes information systems carefully, one discerns important difficulties with market-guided information allocations that were repressed in analyses based on the old new price theory. For one, as mentioned above, equilibria regarding signalling are extremely unlikely to be Pareto optimal. For another, costly consumer search means that one firm producing a product identical to those of other firms may have a degree of "monopoly power."

The new new price theory also is characterized by closer attention to transaction and control costs and systems. The new institutional analysis has provided a number of insights into the merits of nonmarket mechanisms of interaction and transaction. But this strand of analysis also has led to a deeper understanding of omnipresence of frictions in both markets and hierarchies, and certainly carries the implication that in a dynamic world it is highly unlikely that prevailing structures are optimal in any non-sophistical sense. This is not necessarily a position leading to enthusiam for intervention. But the new new economic theorist no longer makes company with Pangloss.

There are signs that the new attention being paid to information and organizational structures for patterning interactions is leading to greater theoretical interest in innovation, the economic structures that support and mold innovation, and the effect of innovation on economic structure. The old verbal ideas of Schumpeter, which certainly were a part of the thinking of the old industrial organization economists, are now beginning to receive serious theoretical attention. And here too the "new new" economic theory is emerging with insights about the strengths, and weaknesses, of market competition that diverge significantly from orthodox views guided by an older price theory. In some of the new models the Schumpeterian insights about the importance of a degree of monopoly power as a base for innovation have been given rigorous basis. These models call attention to a phenomenon neglected by Schumpeter but feared by the "old" industrial organization economists—a tendency for dynamic competition to destroy competitive structure.

In all three respects—a concern about information, internal organizational structure, and dynamics—the recent theoretical developments are exploring issues that the old industrial organization economists knew were important. If they were atheoretic, perhaps the fault should be laid to the oversimplicity of the theory that then was available. I find it interesting how many of the older views are being supported by the new new price theory. The new new theory provides comfort neither to those who travel with Pangloss, nor to those that seem to see remediable monopoly practice or structure everywhere. The economic system is complex; it works in a certain fashion, if not optimally. It may be easier to identify warts than to perform surgery that does not leave scars or have other nasty side effects. But this does not mean that a steady alert and occasional operation are not called for. Maybe this really is today's consensus of reasonable scholars.