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Pricing Power and the Public Interest: A Study Based on Steel, by Gardiner C. Means

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BOOK REVIEWS

PRICING POWER AND THE PUBLIC INTEREST: A STUDY BASED ON STEEL.

By Gardiner C. Means. New York: Harper and Brothers, 1962.
Pp. xxi, 359. \$7.50.

In defending the pricing policy of United States Steel since the beginning of World War II, the President of that company closed his formal statement to the Kefauver Committee of the United States Senate with these words: "So, in the light of these facts and all of these responsibilities, I commend to the thoughtful consideration of this committee the question of whether or not our price action was responsible and in the public interest."¹ Part I of *Pricing Power and the Public Interest* meets this question squarely and marshals the evidence to support the author's conclusions that United States Steel's pricing policies since 1952 have not been in the public interest. Parts II, III and IV of the book go on to suggest that the important social and economic problems raised by the existence of an unhealthy degree of pricing power on the part of United States Steel and other giant manufacturing enterprises can be solved. This solution depends upon the adoption of a new set of standards of business performance by management, stockholders, the courts and the federal government. The author translates his theory into a new law which, while requiring extended discussion and refinement, he believes would be effective.

Mr. Means begins his examination of steel price behavior by noting that administered prices have three major characteristics. They tend to remain constant over long periods of time in spite of fluctuations in demand and supply and in the resulting rate of operation; different companies tend to set the same prices for the same product; and price leadership by one company exists. The evidence demonstrates that steel prices possess all of these characteristics, and that, except in rare situations, United States Steel fills the role of price leader. These facts form the basis for the conclusion that this company has a degree of discretion in setting its prices which constitutes a significant amount of economic power. The question of whether or not this power has been used "responsibly and in the public interest" is brought sharply into focus.

After explaining the expected effect of various forms of inflation

1. P. 45.

upon administered prices, the author considers the reasons for the rise in prices of steel since 1942. For purposes of analysis, he divides this twenty year period into two parts: 1942-1953 and 1953-1962. He begins his analysis of prices in 1942 because at this point, traces of the post depression reflation appear to have ended. Between 1942 and 1953, finished steel prices rose almost 100%, while the wholesale price index for the same period rose only 72%. While the evidence on the subject is acknowledged to be incomplete, it does indicate that some of the rise in steel prices in excess of the rise in the wholesale price index is accounted for by increased nonproduction labor costs and by the increased cost of raw materials and purchased services.

That the entire increase was justified and reasonable seems to be indicated by the fact that while the producer margin per unit of product remaining after meeting operating expenses rose 101% during this period, increased taxes ate up all but 53% of the rise. Furthermore, the increase in total capital required per ton of steel rose 46% for the same period. Therefore, when factors of inflation are considered, it appears that in 1953, in spite of the 53% rise in producer margin after taxes, the rate of recovery of capital was approximately the same rate that existed in 1942.

Using the same type of analysis, Mr. Means finds no justification for the steel price increase after 1953. His economic analysis of price behavior in that period leads him to conclude that a 7% price increase was necessary to offset increased labor costs, a 4% price increase to offset increased costs of materials and services, and a 4% price increase to cover the needed increase in producer margin in order to maintain the rate of return on capital. Therefore, an overall 15% price increase would have been justified. During this period, however, steel prices rose 36%, of which 21% appears to have gone into increased profits over and above the satisfactory level of profits maintained in 1953.

The author then returns to the question posed at the beginning. Has the price action of United States Steel been "responsible and in the public interest"? Mr. Means refuses to brand the conduct of the company as having been irresponsible, since no new standards of corporate responsibility have been spelled out to replace the older and now outdated standard requiring management to make the highest possible profits. On the question of public interest, however, an answer can be given. The public interest is served when prices just cover economic costs, including a fair rate of return on capital. This rate of return is equal to the cost of capital in the market. Steel prices in the period under consideration have consistently yielded a much greater return after taxes than any

conceivable reasonable rate at which capital is available.²

In considering possible solutions to the problem which he has posed, the author begins by making an analysis of the possible applicability of the rules of classical competition to the steel industry. While admitting that the existence of classical competition would serve the public interest, he states that “. . . one glance at the steel industry leaves no doubt that modern industry does not, *and cannot be made to*, meet the conditions of classical competition.”³ This conclusion is based on two arguments. In the first place, there are so few facilities for the production of pig iron and certain steel products that even if each unit of production were owned by a different company, there would still be too few enterprises in any given geographical market to make up the “forest of enterprises” necessary for classical competition. In the second place, maximum efficiency calls for the existence of large vertically integrated steel enterprises with multiplant operations. Carl Kaysen and Donald F. Turner in their recent book throw some doubt upon this second assumption.⁴ According to them, “all of the technical economies of scale are achieved at the level of the plant rather than of the firm, and the greatest part of the size difference between very large and large firms (say \$500 million and over assets in the first class, and \$50 to \$500 million in the second) lies in the number of plants they operate rather than in the size of the plants themselves.”⁵ Therefore, these authors would deny the existence of substantial savings in terms of efficiency in the very class of enterprises in which Mr. Means finds this to be an important consideration. In spite of the lack of conclusive empirical evidence on either side of the question, they would require giant enterprises to bear the burden of show-

2. The author discusses in greater detail the harm to the public interest which is brought about by these “premium profits” on page 159. It should be noted that the claim which is frequently heard that modern corporate enterprises must make higher than normal profits for purposes of reinvestment in the business in order to expand to meet increased demand is unfounded. What this amounts to is an avoidance on the part of the enterprise of paying for the increased capital which it needs in order to expand. The costs of such capital are shifted from the corporation where they belong to the consumers who are later asked to pay prices resulting in more premium profits for products resulting from this “free” capital investment by the corporation.

3. P. 182. (Emphasis in original.)

4. Kaysen & Turner, *Antitrust Policy: An Economic and Legal Analysis* (1959).

5. *Id.* at 6. At page 183 of his book, Mr. Means points out the economies which result from keeping the steel hot through successive stages of the manufacturing process. While this is a valid example of economy resulting from large-scale operations, it applies, as Mr. Means points out, to an integrated *plant*. This does not dispute the point which Kaysen and Turner are making, namely, that such economies are made at the plant level and not at the firm level through multiplant activities. It is Mr. Means' argument in favor of the existence of economies resulting from multiplant operations that appears to be vulnerable. Of course, this assumes that a correct definition of “plant” could include facilities for steel making comprised of several production units, *i.e.*, blast furnaces and steel furnaces. I believe this to be a valid approach.

ing that structural reorganization would lead to loss in terms of production efficiency.⁶ Therefore, until satisfactory evidence is presented, it would seem that Mr. Means' rejection of divestiture and dissolution on the grounds of loss of production efficiency is based upon an unwarranted premise.

Mr. Means also rejects the idea that increased government regulation of prices would be a good solution to the problem of private pricing power. In discussing the drawbacks of such an approach, he points out that increased government control would have a number of economic disadvantages.⁷ In the first place, the costs of regulation would be great, and the profit pressure on management for economic efficiency would be weakened. Due to the delay occasioned by working with a government commission, flexibility of enterprise would be reduced; furthermore, in a regulated industry, venturesomeness on the part of management is limited. Other disadvantages to be weighed are the inevitable conflict between the industry and the government regulating agency and the danger that the regulatory commission will become a political instrument or subservient to the enterprise over which it exercises control.

At the same time, administrative competition, which exists today in steel and other industries, does not serve the public interest. In the case of industries in which prices are administered and entry is easy, the ease of entry may act to reduce premium profits, but part or all of this reduction is brought about by increased costs due to the inefficiency and merely partial operation of the more numerous enterprises which come into being because of the profit lure. This is competitive waste which does not serve the public by reducing consumer prices. In the case of industries in which prices are administered and entry is difficult, the producer can set his price below the monopoly price but above the price which would eliminate premium profits. Many firms in this category have adopted a system of target pricing, which is pricing for a target rate of return on investment over a period of years. This procedure does not serve the public interest, because many of the enterprises which employ target pricing set a target which is well above that required to make prices just cover economic costs, including a fair (or competitive) rate of return on capital.

Another possible solution to the existence of private economic power which adversely affects the public interest is an appeal to the management (or owners) of giant enterprises to consider the public

6. *Id.* at 269. For a discussion of the evidence on this question, see Bain, *Industrial Organization* ch. 9 (1959).

7. P. 191-92.

interest in setting prices. This approach is flatly rejected on the grounds that common sense and human nature indicate that it is really little more than wishful thinking. Furthermore, managers are not in the best position to gauge the public interest. For this reason, even conscientious management would probably not be successful in protecting the public from the harmful economic effects of the existence of giant enterprises.

Before posing his own solution to the problem, the author attempts to re-evaluate some of the basic philosophy underlying the traditional economic theory of classical competition. His first observation is that a separation of control and ownership has occurred in the large collective enterprises under consideration. This separation makes inapplicable the theory of classical competition which assumes that the functions of control and ownership will be found in the person of one entrepreneur. Since this separation is a fact, in whose interest should a collective enterprise be run? Since the owners of the corporation have surrendered an important part of their "rights" in the corporation, should they retain all of the other property rights which are normally associated with ownership? The theory of classical competition which permits the full play of the profit motive breaks down since the highest profits, at least if distributed to the owners, are not providing any incentive to the managers of the business. On the other hand, no answer is to be found by permitting the profits to supply incentive to management and simply pay the "wages of capital." This would lead to an unregulated profit drive on the part of management which would hardly serve the public interest.

The harmful effect of the drive for profits upon the public interest is fourfold. (1) Because it leads to premium profits, it creates a distorted ratio between prices and costs; (2) These same premium profits lead to a distortion in the division of income; (3) Generally, they will bring about an inefficient use of resources;⁸ (4) Finally, while technical progress may be great under such a system, adoption of technological improvements will be slower, since innovations will not be accepted until they can earn premium profits.

This analysis of the failure to achieve the results of traditional economic theory in the large-scale collective enterprise points out the need for reducing emphasis upon the drive for corporate profits and for seeking what the author calls economic performance in the operation of these enterprises. Mr. Means states two basic principles which he be-

8. The author explains this in the following manner: "If some prices are out of line with costs and others are not, the best use of resources would not be made. Too little would go into the high-priced production and too much into the low. For example, if steel prices were too high in relation, say, to lumber, there would tend to be an overuse of lumber in construction and less than optimum use of steel." P. 273.

lieves are essential to this idea. In the first place, "management will and should run a collective enterprise in its own interest." Secondly, "conditions can and should be established, so that when management operates a collective enterprise in management's own interest, the public interest will also be served."⁹

The author's practical application of these two principles involves the use of target rates of return by collective enterprises. The target rates set, however, should be such that the resulting prices will just cover economic costs (including a fair rate of return on capital). The second major aspect of the proposed program is the use of new bonus incentives which, unlike present bonus plans, will reward management for achieving economic performance rather than high profits.

In order to implement this program, the adoption of a new federal law, the Economic Performance Act, is proposed. The new law would contain four major sections. The first of these would be one establishing a legal category (for tax purposes) for the *collective* corporation. The determination of collective status would be left to a semijudicial commission. The basic guideline for this determination would be "the existence of unregulated pricing power of sufficient magnitude to affect the corporation with a substantial public interest."¹⁰ As a general proposition, the author suggests that any manufacturing corporation controlling assets of half a billion dollars would have the burden of overcoming the presumption of collective status. Firms in the \$100 to \$500 million class would be subject to consideration under the new program, however.¹¹

The second major section of the act would permit special tax deductions for corporations operating under the new law. These deductions would apply to the bonus system developed as a reward to management for economic performance. While the definition of the term economic performance raises difficulties, the author feels that a general definition specifying, largely in terms of the effects of classical competition, the end result to be achieved will be sufficient for the time being.

The third section of the act would require a system of target pricing bearing a reasonable relation to costs of capital. The corporation would have a period of time (five years) in which to submit an acceptable target pricing plan to the commission for approval. Such plans

9. P. 277.

10. P. 298.

11. Figures presented at congressional hearings indicate that in 1957 there were 62 industrial corporations controlling assets of over half a billion and 200 with assets between 100 and 500 million. The Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, U.S. Senate, 85th Cong., 1st sess., pursuant to S. Res. 57, pp. 100-916. The reader will have recognized that smaller but oligopolistic local or specialty firms would not be covered initially by the author's program.

would be worked out initially without interference from the commission or any other government agency.

Finally, the act would contain a section inducing security holders of a corporation to adopt the new program. This might include a provision for an excess profits tax which applied only to legally determined collective enterprises which failed to make the shift to the new mode of operation. This would make it more profitable in the eyes of the stockholders for the corporation to assume its new responsibilities. A voluntary break-up into smaller units would remain as an alternative. At the same time, of course, the act would have to be couched in terms consistent with constitutionality.

Every phase of this new program raises important and difficult questions of interpretation. What, more precisely, is meant by the terms "collective status" and "economic performance"? What is a fair target rate of return, and how is such a rate to be determined? The author acknowledges that several years of discussion and refinement are necessary before his proposals could be made workable. He invites this discussion after giving some of his own ideas on all of these matters. That his new program is far from ready for legislative consideration is beside the point. What is important is that the author has developed a theory of dealing with the problem of privately held economic power on the part of a group of corporations controlling perhaps two-thirds of the instruments of manufacturing production and accounting for half of the manufacturing output in the United States.¹² While he is unable to adduce empirical evidence in support of all of the economic theory underlying the new proposal, the author has argued convincingly on the basis of the evidence available. One is convinced that the new proposal, whether workable or not, takes account of realistic economic considerations. If it were to be accepted, the legal problems it involves could doubtless be resolved by the professional skill and statesmanship that would be needed.

Most important of all, Mr. Means has developed a plan for avoiding one of the characteristics of possible alternatives which many individuals on both sides of the problem deplore: government control over the flow of decisions in the management of business enterprises. Moreover, to the extent that dissolution and divestiture are not practical (or possible under existing law), the Economic Performance Act offers a possible alternative. *Pricing Power and the Public Interest* deserves the consideration of all who believe that the question to which the author

12. P. 299.

addresses himself is vital and that original and intelligent analysis is the first and perhaps most important step toward solution of the problem.

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DECISION AT LAW. By David W. Peck. New York: Dodd, Mead & Co. 1961. Pp. vii, 303. \$4.00.

Judge Peck is a distinguished jurist with an engaging writing style. His latest book can be read with pleasure and profit by many Americans.

The image of the lawyer in America is complex. It includes the Perry Mason picture of the clever fellow who brings justice in roughly the same way the Marines or Cavalry of the movies bring help in the nick of time. It also includes the picture of the scheming shyster who uses his knowledge of legal intricacies to fill the pockets of his client and himself, regardless of where truth or justice may lie. There is a feeling that lawyers use the intricacies of the law the way pharmacists use the hieroglyphics on prescriptions, to bilk customers or clients of fees which can be levied because no one except the initiated is allowed access to the key which would translate the mumbo-jumbo into straightforward information for which no specialist would be required as interpreter. Finally, there is a body of opinion which regards the lawyer as a member of an elite group in our society, making valuable contributions to the successful conduct of our societal and interpersonal affairs.

Most laymen know too little about the ways of the law to do more than take on faith this last picture of the lawyer as society's servant. Judge Peck's book is designed to provide its readers with information from which they can derive an appreciation of the role which the lawyer performs and of the ways in which our courts adapt existing laws to the new situations which our system continually produces.

In *Decision at Law* Judge Peck has presented in disarmingly informal fashion studies of a series of difficult legal problems with which courts and lawyers have been forced to deal in recent decades. The subject matter may be familiar to lawyers, but to the non-lawyer the questions presented are fresh and fascinating. Most non-lawyers, for instance, have not even wondered whether an unborn child should count as an heir. As presented by Judge Peck, descriptions of several matters of established law such as this are frequently as intriguing as the story

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