The correspondence between Baumol and Galbraith (1957-1958) An unsuspected source of managerial theories of the firm

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Abstract: Baumol's impact on the development of managerial theories of the firm is investigated here through material found in Galbraith's archives. In 1957 Galbraith published a paper claiming that the impact of macroeconomic policies varies with market structures (competitive *versus* oligopolistic). This publication prompted Baumol (1958b) to send Galbraith a manuscript dealing extensively with a crucial question of managerial theories of the firm, namely, the "trade-off" between sales and profits. I argue that Baumol's critiques and Galbraith's answers largely explain the way Baumol (1958a, 1959) framed his alternative model of the behavior of big corporations. He reasoned in terms of maximization of sales with a profit constraint as their main objective. In return, *Business Behavior, Value and Growth* fostered the development of Marris's (1964) and Galbraith's (1967) theories of the corporation. Contrary to the narrative by Tullock (1978) in which the sales maximization hypothesis has two main branches – Baumol for the one and Galbraith-Marris for the other – I argue here that these branches are at least partially connected.

Keywords: Baumol – Galbraith – Theory of the firm – Managerialism – Sales maximization hypothesis

JEL Codes: B21 – B22 – D21 – D43 -

Introduction

William J. Baumol (1922–2017) contributed to many subfields of economics including New Welfare Economics, Macroeconomics, Industrial Organization, Operational Research, and the Economics of Art. The focus here is on a very specific object lying at the crossroads of several of these subfields, that is, his first model of the firm (1958a, 1959).[1] Baumol is unanimously recognized as one of the leading contributors to the development of managerial theories of the firm in the early 1960s. With Berle (1959), Downs and Monsen (1965), Galbraith (1957, 1967), Kaysen (1959, 1965), Marris (1964), Williamson (1964), and then Wood (1975), Baumol belonged to an informal group of authors challenging the neoclassical theory of the firm that hinges on the traditional hypothesis of profit maximization.[2]

In an earlier work I showed that, notwithstanding their specificities, these managerial theories of the firm share many points in common (Chirat 2020). Three are particularly relevant with respect to Baumol's contribution, which focuses on how to model the behavior of the firm and its macroeconomic implications.[3] First, as explained in the pioneering works of Berle and

[1] Baumol provided a second model in 1962, where the maximization of sales revenue subject to a profit constraint is replaced, from a dynamic perspective, by the "maximization of *the rate of growth* of sales revenue" as the firm's main objective (Baumol 1962, 1085).

[2] At that time, the neoclassical theory of the firm was also challenged by the behaviorist theories of the firm developed by Simon (1962) and Cyert and March (1963). Unlike Baumol, they not only challenged the idea of profit maximization but also the corollary hypothesis of rationality. For Baumol's views on behaviorist theories of the firm, see Baumol and Stewart (1971).

[3] The scope of the theories developed by Berle, Galbraith, and Marris is broader in that they produced managerial theories of the firm in order to analyze the transformation of the whole socio-economic system.

Means (1930, 1932), ownership of the corporation does not necessarily confer control of its activities on owners. The power of control, because of technological and organizational requirements, has gradually and to a large extent fallen into the hands of "managers" or the "technostructure". Second, managers pursue their own interests, which may diverge from those of stockholders or "businessmen".[4] Consequently, and thirdly, profit maximization is not necessarily the objective pursued by a corporation. It might even pursue several goals at once.

To challenge the neoclassical theory of the firm, these authors needed an alternative explanation for the firm's behavior. Several old institutionalists, from Veblen to Galbraith by way of John Maurice Clark, reflected on alternative conceptions of the firm's behavior. William Baumol played a crucial role here. Whereas old institutionalist did not embrace the post-war wave of formalization and mathematization in economics, Baumol did.[5] This is why he provided – and is praised for – one of the earliest formalizations of an alternative. In his static model, large firms maximize growth of sales under a profit constraint rather than simply maximizing profits (Baumol 1958a, 1959). What is less widely known, though, concerns the origins of Baumol's model. Thanks to archival material, especially a manuscript by Baumol addressed to Galbraith in 1958, it can be shown that their private exchanges were historically decisive to understanding Baumol's alternative hypothesis.

The first section gives an account of Galbraith's paper, "Market structure and stabilization policy". The second presents the main contents of Baumol's manuscript, "Price behavior, stability and growth", written largely in answer to Galbraith's paper. The third section presents the main issues of their correspondence in order to attest how they go to the heart of the managerial theory of the firm set out by Baumol in *Business Behavior, Value and Growth*. The fourth and final section highlights the pivotal role of Baumol's contribution for subsequent developments of managerial theories of the firm.

1. Galbraith's challenge to the hypothesis of profit maximization and its macroeconomic implications

Although it is not widely known, John Kenneth Galbraith, influenced by the works of Berle and Means (1932) and Chamberlin (1929, 1933), was quick to express doubt about the relevance of the hypothesis of rationality and profit maximization in accounting for the behavior of firms, especially in the oligopolistic sector (Galbraith 1936, 446). The long-term horizon of big corporations, the role of average rather than marginal cost in pricing behavior, and the tacit collusion preventing cutthroat competition in oligopolistic markets are the three main explanations put forward. In *American Capitalism*, a book hinging on the development of industrial organization written after his return at Harvard, Galbraith added that "one of the seemingly harmless simplifications of formal economic theory has been the assumption that producers of consumers' goods sell their products directly to consumers"; a simplification that blinds us to the role of retailers. Yet retailers are mainly interested in the volume of their sales (1952, 117). Five years later, Galbraith published "Market Structure and Stabilization Policy" in the *Review of Economics and Statistics*. Galbraith aimed foremost at highlighting the different sensitivities of the market sector

[4] The distinction between "businessmen" and "managers" is rather vague in Baumol (1959, 45).
[5] On Baumol's conception of economic modelling and the relationship between models and realism, see Baumol (1959, 1-10) and Baumol (1961).

and the oligopolistic sector when confronted with macroeconomic public policies. He postulated that whereas increasing or decreasing demand engenders price adjustments in the market sector, it generates quantity adjustments instead in the oligopolistic one. His conclusion was that public policies to curb inflation, especially monetary policies, are inefficient with regard to oligopolistic pricing behaviors. They need to be more drastic than is conventionally supposed in models relying on the profit maximization hypothesis.

Galbraith argued, for the three reasons already set out in his 1936 paper, that corporations have a preference for price rigidities in order to reduce uncertainty, so the pricing behavior of corporations does not aim at maximizing (short-run) profits. Consequently, there could be, after an increase in demand which is not matched by price increases by oligopolistic firms, "unliquidated monopoly gains". That concept allowed him to account for an empirical observation that prices rose in some industrial sectors, such as steel, in spite of there being excess supply relative to demand. He argued that prices rose because of wage increases. These were accepted by corporations as long as their market power enabled them to increase prices to capture some of these "unliquidated monopoly gains". With this model sweeping aside the profit maximization hypothesis, Galbraith thought he had provided "the first wholly satisfactory integration of the wage-price spiral with aggregative demand and price analysis" (1957, 129). On 5 December 1957 Baumol asked Galbraith for a copy of his "very interesting article". Galbraith sent him one on 9 December 1957.[6] A month later Baumol sent Galbraith a draft written for a publication for the Joint Economic Committee entitled "Price Behavior, Stability and Growth". This draft would become a part of *Business Behavior, Value and Growth*. In the enclosed letter of 6 January 1958 Baumol told Galbraith that he did not "fully agree" with his "position" but considered his analysis as "important and cogent enough" to discuss it at length.[7] This draft and the following exchanges between Baumol and Galbraith would seem to be an unsuspected source of managerial theories of the firm.

2. Baumol's comments and Galbraith's reply.

In his draft, Baumol was concerned with the linkage between business behavior, growth, and inflation, which "probably acts as a stimulant to growth" (1958b, 5). Baumol praised Galbraith for calling attention "to the fact that the process by which price changes occur is dependent on the nature of the market structure" (1958b, 8). However, Baumol tempered Galbraith's argument that oligopolistic firms are "conductors of inflationary pressure" and "relatively immune to counterinflationary influence of monetary and fiscal policy". Baumol agreed with Galbraith on the statement that oligopolies do "not normally set a price that maximizes profits". However, he reproached him for providing no alternative. Whereas the *behavior of prices* is explained by the idea of a preference for price rigidities, in order to reduce uncertainty, nothing in Galbraith's model explained the *level of prices*. Moreover, Baumol argued that, rather than Galbraith's "preference for price rigidity", the fact that corporations do not maximize their profits could be directly explained by their pricing behavior. He suggested an alternative hypothesis: the management of the firm seeks to maximize the "sales volume measured in money terms" (1958b, 11). Because of this hypothesis,

[6] These letters are in John Kenneth Galbraith's Personal Papers, JFK Library, Series 3, Box 13.

[7] This was their first correspondence. They respectively address each other as "Professor Baumol" and "Professor Galbraith". Three years later, when Galbraith sent Baumol a transcript of a talk he gave on "Economics, Art and the Environment", they addressed each other by their first names. Being president elect of the American Economic Association in 1971, Galbraith entrusted Baumol with organizing a session on the Economics of Arts. See JKGPP, Series 3, Box 21 and Series 5, Box 500.

Baumol claimed that restrictive macroeconomic policies, as well as wage increases, could affect oligopolistic corporations far more than Galbraith's 1957 analysis suggested. Such variations "hit the oligopolist where it hurts him most – not in his profit but in his sales volume" (Baumol 1958b, 12).

Reading Baumol's draft with "genuine interest", Galbraith sent him an answer five days later, on 13 January. After conceding some minor revisions suggested by Baumol, Galbraith told him that his paper "involves a major contradiction". On the one hand, Baumol argued that businessmen are interested in volume of sales; Galbraith agreed with that postulate, even if Baumol wielded it to challenge his own claim that oligopolists, when confronted with an increase in demand, adjust backlogs rather than prices. On the other hand, Baumol, dealing with the issue of investment behavior by the firm, looked to profits rather than sales as the criterion determining firms' decisions. Although the profit motive is still important, Galbraith highlighted that Baumol could not sweep aside his thesis on the asymmetric effects – depending on market structure – of public macroeconomic policies. He concluded that Baumol had provided "a skillful but altogether too flexible adjustment of [his] assumptions to the needs of [his arguments]".[8] On 17 January, Baumol admitted that "*sales and profits cannot both be more important than the other to the oligopolist*" and that "the nature of the compromise varies from firm to firm".[9] Pursuing his aim of providing an alternative to the neoclassical formalization, he finally wrote that "the best approximative generalization [he has] been able to come up with is that it is a constrained maximization in which the value of sales is maximized subject to the condition that profits do not fall short of some prestated minimum acceptable level". This is the core of his theory of the firm first proposed in *Economica* in August 1958 and the following year in *Business Behavior, Value and Growth* (Baumol 1958a, 1959).

3. Baumol's theory of the firm and the implications of the sales maximization hypothesis

In the preface to *Business Behavior, Value and Price*, Baumol does not thank Galbraith or even mention their correspondence. However, he indicates that the first part of the book, especially its chapters on the sales maximization hypothesis (chapter 6), its implication for the oligopoly model (chapter 7) and macroeconomic policies (chapter 8), was written "after the rest of the manuscript – about two months before it was sent off to the publisher". Hence the importance of his prior correspondence with Galbraith between December 1957 and January 1958. After reviewing the variety of theoretical solutions proposed by economists to tackle oligopolistic markets, Baumol provided his own alternative, that is to say the sales maximization hypothesis under a profit constraint. He argued that "this hypothesis can help to explain a number of well-known features of oligopolistic behavior" (1959, 14). In chapter six, Baumol explains that by sales, he does not refer to physical output but to the "total revenue obtained by the firm from the purchases of its customers", which is expressed in nominal dollars. Many arguments support the hypothesis that

[8] Stimulated by Baumol's draft, Galbraith sent him another letter two days later, on 15 January, in support of his rejection of the hypothesis of profit thanks to the distinction between "short-run and long-run profit calculation". He argued that the crux of the matter was to understand "the events that change the relation between the two". This suggested "that we have price increases following wage increases" precisely because these prices increases are not "jeopardizing" long-run perspective of profits. JKGPP, Series 3, Box 13.

[9] Emphasis added.

"sales volume ranks ahead of profits as the main object of the oligopolist's concern" (1959, 45-47). First, Baumol claimed that "declining sales bring with them all sorts of disadvantages", in particular the shrinking of market power and the disaffection of customers, retailers, and capital suppliers. Second, Baumol endorsed the thesis that modern corporations are characterized by the separation of ownership from management. Yet managers, who pursue their own interests, have many reasons to prefer an increase in the size of the corporation, which, contrary to an increase in profits, directly impacts their wages and the scope of the activities they control.

In chapter 8, on the welfare implications of his oligopoly model, Baumol developed an argument recalling Galbraith's *unliquidated monopoly gains* (1957).[10] Baumol argued that an oligopolist faced with an increase of his overhead costs will shift this burden onto consumers. This shiftability, Baumol added, is only possible if "the profit non maximizer has a reserve of *unclaimed profits* to fall back on when he is driven to do so by what he considers to be an unsupportable increase in his costs".[11] But contrary to Galbraith, Baumol insisted that this shift through a rise in prices is made "at the sacrifices of sales which mean so much" for the oligopolist (1959, 77-78).[12] Explicit references to Galbraith's 1957 paper immediately follow this section, when Baumol reshaped the argument he presented in his 1958 manuscript in order to deal with the monetary and fiscal implications of his model. He described Galbraith's contribution as "important" but providing "no alternative explanation of the price setting process" (1959, 78-79). Thus, Baumol put forward the hypothesis of sales maximization as an alternative both to neoclassical theory and to Galbraith's first intuition.

> It follows from [the sales maximization hypothesis] that Professor Galbraith is indeed right in asserting that the oligopolist's profit will not normally be maximized. But the reason is not that he is dominated by fear of making price adjustments, although such fears may also play their role. He will fail to maximize profits because he has another partially overriding purpose to which he is willing to sacrifice some profits. If this is correct, we must expect only under extraordinary circumstances to encounter the backlog of orders which Galbraith considers to be a normal feature of oligopolistic operation during an inflationary period. A firm which tries to maximize dollar sales will not hold back on production which can be sold without price reductions unless either the expansion of its capacity has been unable to keep up with demand or management is so fearful of the future that it hesitates to undertake required investment commitments. (Baumol 1959, 80)

4. From Baumol (and Marris) back to Galbraith

In a paper on the "Welfare effects of sales maximization", Gordon Tullock (1978) argues that "the sales maximization hypothesis in essence has two main branches": Baumol on the one hand and Marris-Galbraith on the other. First, Tullock claims that Baumol "presents his arguments largely in the context of an oligopolistic company." But this is precisely what Galbraith did. Second, Tullock states that Baumol "presents sales maximization not as an effort to criticize the capitalist system" but, contrary to Galbraith and Marris, "simply as an effort to improve the realism of

[10] On this subject see also Baumol (1964, 46-47) and Tullock (1978).
[11] Emphasis added.
[12] See also Baumol (1958a, 198).

models" (Tullock 1978, 113-114). Such a description ignores two historical facts. As shown in the previous sections, one origin of Baumol's alternative hypothesis comes from Galbraith's attempt to provide a more realistic model of the effect of macroeconomic policies on firms' pricing behavior. Moreover, we suggest in this section that Baumol's alternative hypothesis would lastingly influence the research agenda on managerial theories of the firm, and especially on Marris (1963, 1964) and Galbraith (1967).[13]

Alongside Baumol, Robin Marris (1963,1964) is considered as "the principal architect" of the theory of the managerial corporation (Weinstein 2012, 89). In "Model of the 'managerial' enterprise", a paper published in 1963 in *The Quarterly Journal of Economics* as a synthesis of his forthcoming book *The Economic Theory of Managerial Capitalism* (1964), Marris thanked Baumol, among others, and immediately referred to his 1959 attempt. He refined Baumol's static model in terms of "maximum revenue subject to a minimum profit constraint" by reasoning with "maximum growth rate of revenue, subject to the same constraint" (Marris 1963, 205). Marris acknowledged the proximities between his version and Baumol's 1962 dynamic model in which profits, formerly a constraint in his 1959 model, appear as an "instrumental variable", that is, a means to achieve the main objective of maximizing growth of sales revenues (Baumol 1962, 1085). One main difference is that Marris considered the rate of "growth of the corporate capital" rather than "growth of sales". Consequently, Marris put greater emphasis on the role played by retained earnings to finance that growth.[14] Notwithstanding the differences in their models, it is worth recalling that both Baumol and Marris "broke with the neoclassical theory of the firm on two points" related to "the objective function" of the firm (Weinstein 2012, 90). First, they concentrated on the growth of the firm.[15] Second, they produced theories of the firm that were free-standing, instead of being bound up with market structure analysis.

Whereas Baumol and Marris formalized their reasoning and came up with a hypothesis of rational maximizing behavior, Galbraith was not committed to such an approach.[16] Nevertheless, the works of Baumol and Marris were one of the two main additions that shaped his theory of the corporation between *The Affluent Society* and *The New Industrial State*.[17] Galbraith considered that they belonged, as Carl Kaysen (1957, 1965) did, to a "small group of scholars" who "accepted the separation of ownership from control in the mature corporation and its implication for profit maximization" (Galbraith 1967, 158). Galbraith's theory of the corporation hinged on the concept of the technostructure to characterize the group ruling the corporation as a planning entity transcending the market. So the objectives of the firm are the objectives pursued by the members of the technostructure.[18] The decision-making power of the technostructure is directly dependent on the control of the corporation as an organization. Thus its autonomy is a goal cherished by its members. Galbraith argued that "low earnings or losses" make it vulnerable to "outside influence"

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[13] See also Kaysen (1960) and Williamson (1963, 1033).

[14] Marris also introduced into his model the risk of take-over as a constraint on managerial decisions. For a summary on the issue, see Marris and Mueller (1980, 41-42). Adrian Wood (2017) recalls that Marris' theory of the firm was developed largely independently, even if he paid attention to the developments of Baumol (1959,1962) and Penrose (1959).

[15] "Theoretical formulations like those of Baumol and Marris, which posit growth maximization subject to profit constraints, rather than profit maximization, as the goal of managers, lead to the conclusion that managements would, in general, retain more earnings and pay out lower dividends than under profit-maximizing policies." (Kaysen 1965, 48)

[16] See Galbraith (1967, 213).

[17] After 1958 he was also greatly influenced by Herbert Simon's theory of organization. On Simon's influence on Galbraith, see James Galbraith (1984) and Chirat (2020).

[18] For more on Galbraith's theory of the corporation, see Baudry and Chirat (2018), Dunn (2011), and James Galbraith (1984).

whereas, "above a certain level, more earnings add little or nothing to its autonomy". That is why the managerial corporation does not seek to maximize profits.[19] When stating that a minimum of profits, rather than their maximization, is required by the technostructure, Galbraith explicitly referred to the works of Baumol (1959) and Marris (1964). He added that once such a minimum is guaranteed, then the technostructure tries to pursue "the greatest possible rate of corporate growth as measured in sales" (1967, 213). Galbraith's theory of the corporation and of its objective fostered many controversies. For instance, it was at the heart of the controversy between Galbraith (1967b), Marris (1967), and Solow (1967, 1968) that featured in the columns of the journal *Public Interest*.[20] Harold Demsetz (1974) tried to implement an econometric test in order to empirically challenge the Baumol-Galbraith hypothesis of sales maximization. But what is a particular matter of interest here is the reasons Galbraith decided to follow the path opened by Baumol's alternative explanation a decade earlier. He explained himself in a letter to Paul Sweezy dated 31 January 1973.

> I didn't really intend to juxtapose growth and profit maximization. But I do give the paramount role to growth because then, so it seems to me, everything fits. One has an explanation as to why the public doesn't live in a continuous state of revolt against monopolistic exploitation. One has an explanation for the comparative overdevelopment in the major areas of industrial concentration. One has a consistent view. It is growth that rewards the bureaucracy of the corporation with higher salaries, greater prerequisites and easier promotions. Growth is obviously tied to power. And, perhaps most important of all, we have an explanation as to why the society, including the economists, make an all-but-religious obeisance to economic growth. (Letter from Galbraith to Sweezy, 31 January 1973)[21]

Conclusion

The aim of the paper has been to highlight how the exchanges between Baumol and Galbraith formed an important step in the early development of managerial theories of the firm. Their notorious epistemological differences did not prevent them from pursuing common goals. Both tried to make their models of firms' behavior more realistic so as to account for the macroeconomic trends characterizing American post-war capitalism. In this regard, the relationship between Galbraith and Baumol can be viewed as one of several examples that support the thesis of the existence of a postwar pluralism among economists trained during the interwar period.[22]

[19] "By the most elementary calculation of self-interest, the technostructure is compelled to pure prevention of loss ahead of maximum return. Loss can destroy the technostructure; high revenues accrue to others [stockholders]. If, as will often happen, the maximization of revenues invites increased risk of loss, then the technostructure, as a matter of elementary interest, should forgo it […] The technostructure is protecting something more important than its profit – something, indeed, which profits themselves protect. That is its autonomy." (Galbraith 1967, 210-212)

[20] On this debate, see Chirat (2020) and Halsmayer and Hounshell (2020).

[21] JKGPP, Series 3, Box 163.

[22] This argument is defended in Chirat (2020).

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