Chapter 1

The Theory of the Firm in Historical Retrospect

It is appropriate to begin this book with a brief résumé of the development of economic thought relating to the theory of the firm.¹ Deciding where to begin, however, immediately presents problems. Whereas it is universally agreed that the work of Chamberlin and Robinson during the 1930s, to which we will shortly return, constitutes a cohesive theory of the firm, no such agreement exists with respect to the writings of late-nineteenth and early-twentieth century economists. In order to suggest why this is so however, we need to begin with the writings of Adam Smith in 1776, so that the reader can best be left to judge this issue for himself.

Smith was mostly interested in the supply or cost side of a firm’s operations ² since he held that the value of a good was determined by its production cost. He defined this cost to include an appropriate allowance for rents and profit, and was of the opinion that it was in the natural order of things for an entrepreneur to try to maximise his profits by holding down his other costs to a minimum. On the other hand, he did not see this objective as conflicting in any way with a competitive market structure which he expected to develop in almost all industries in the long run. Provided such competition was indeed
the order of the day then prices would be determined by costs and hence further analysis of demand conditions became superfluous.

The ascendancy of the proposition that a good’s value was directly dependent upon its costs of production lasted broadly until the 1870s. At this time several eminent economists began to reverse the logic of the argument. In their opinion it was not the cost of factors of production which determined a good’s value but the value of the good which determined how much the factors of production would be paid. Now the value of a good in this sense clearly depends upon the strength of the demand for it, with the result that the influence of supply upon price became greatly subservient to that of demand. It was further held, especially in England by Jevons, that the strength of the demand for a good depended upon the utility of that good to a prospective buyer, and Jevons re-introduced the notion, long since proposed by Bentham, that the price which a prospective buyer would be prepared to pay for a good would depend upon the utility of that good to the buyer at the margin. That is in the light of his previous purchases of the good, if any. Marginal utility was assumed to decline as consumption increased, hence yielding a demand curve falling from left to right. It is worth noting, however, that marginal analysis in the currently more familiar sense of the equating of marginal cost and marginal revenue was not given much attention at this point in time.

Curiously marginal analysis had quite a long history by the 1870s and it is worth a brief detour at this point to introduce the work of Cournot who in a sense put mathematical economics ‘on the map’, but who personally faded into almost total obscurity for over half a century. Writing in the 1830s Cournot utilised calculus in order to explore the situation of a monopolist, and went on from there to consider duopoly, oligopoly and thence eventually to free competition. He is best remembered for his duopoly model which involved two sellers of spring water (see pp. 41–4) but was himself of the opinion that free competition was much more pervasive in real life. As was true of almost all nineteenth-century economists Cournot retained the objective of profit maximisation, but differed from them in that he specified in mathematical terms how that objective could be attained.

The first real attempt to synthesise the production-cost and utility theories of value is associated with Marshall. In his view value was determined by the forces of supply and demand in more or less equal measure, an opinion adhered to subsequently by all of his successors.