Chapter Seventeen: The Neoclassical School – Departure from Pure Competition (pg 321-340)

Historic Background

Neoclassical economics had long recognized that pure completion
- Was a useful simplification, at best an approximation
- As a MODELING technique, it was very useful
  - Descriptively, it seemed inadequate
- It was useful in describing simple agricultural exchanges
  - Many buyers and sellers, instant transactions, no third parties
  - Perfect information, no "intermediate production", etc.

This was not a satisfactory model of more complex markets

So there arose various theories of "monopolistic competition"
- These are all still well within the neo-classical tradition

Methedologically, still
- Marginalism and Micro-economic in focus
- Abstract, Deductive in analysis
- Assume subjective valuation
- Assume rationality, Static Analysis, equilibriums
  - Fluctuations, growth and change are neglected

Monopolistic competition showed that
- Private enterprise does NOT Necessarily result in the best allocation of productive resources, or necessarily reward all factors of production appropriately

So there is now a role for the state in regulating business
- The Anti-trust rules in the U.S.

Piero Sraffa

Italian (1898 – 1983)

Moved to Britain, became a leading neoclassicalist
- Interned in U.K. in WWII, emerged as an important Keynesian

1926, pointed out that unit costs can fall over a wide range of production
- The theory of the "Natural Monopoly"
  - Pure competition and natural monopoly are extreme cases…
- Firms can individually have declining cost curves….
- And face INDIVIDUAL demand curves

So it isn't production costs that stop firms from producing more
- It is the inability to sell more goods without reducing prices

Two ways to raise profits ---
- Increase production, take market share from other firms
  - And reap the problems of a price war….
- Decrease production, get more per unit, and competitors gain share
  - And are happy, they don't compete with you

Not a fully developed theory, but very influential

Edward Hastings Chamberlin

American, (1899-1967), went to and became prof. at Harvard

Fused the theories of pure competition and pure monopoly

The theory of Monopolistic Competition

Based on his 1927 thesis, published in 1933

Introduced the concept of Product Differentiation

Cournot had already discussed the example of pure competition

Where MR = P, i.e. the MR curve and AR curve are identical

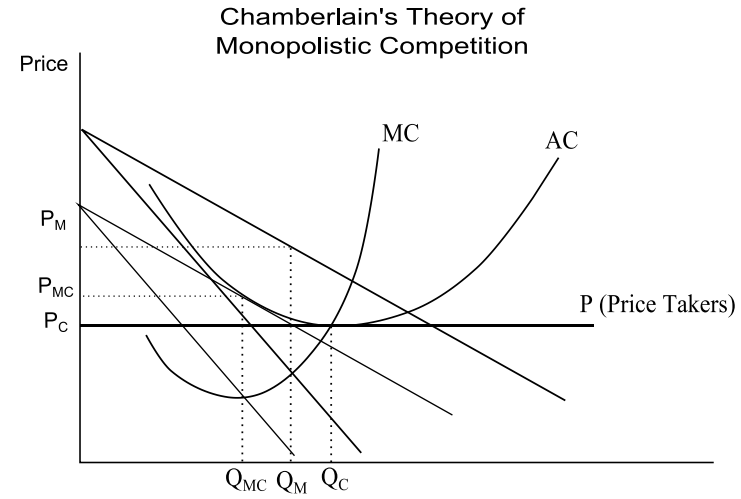
And pure monopoly, where MR < Price over a range

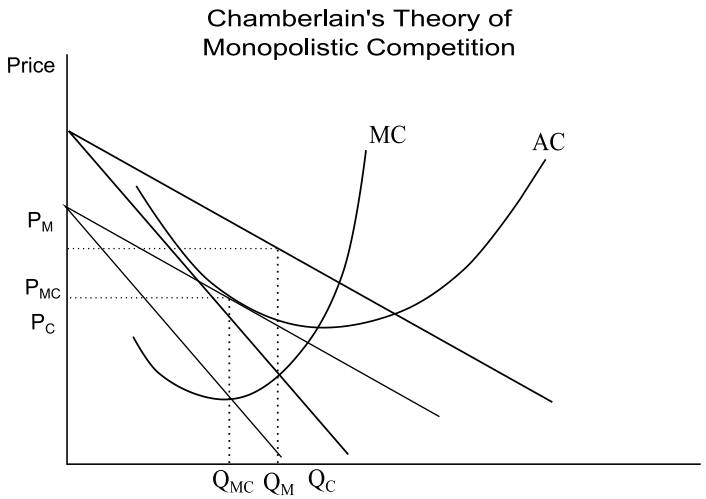
So the MR curve is below the AR curve…..

What if there are multiple firms where MR curve is below AR curve?

Step one: a competitive market with product differentiation

Firms have a downward sloping demand curve





Explanation of Graph above…..

Competition
Monopoly
Monopolistic Competition

Product Differentiation….

Results of this analysis
- Prices are above the competitive market price, firms are NOT price takers
- Firms are getting some monopoly profits,
  - Because they are charging above their MC
- And there is overcapacity – they have NOT minimized their average costs

Note, Chamberlin is assuming that…
- All firms have identical cost curves
  - Is that realistic if the products they are producing are differentiated?
    - Example, restaurants….
- He assumes those curves are identical in all situations
  - Would a "competitive" steel industry have the same cost curves
    - as one characterized as monopolistically competitive?
  - Example: Many blacksmiths, or a few blast furnaces
  - Pure competition may not provide the most goods at lowest prices
- Note, product differentiation is perhaps a good thing….
  - By differentiating, consumers get more choice,
    - And some of that choice is real

Joan Robinson
English, (1903-1983)
Student of Marshal's, became a long-time professor at Cambridge University
- Deserved a Nobel Prize, never got one…

The Economics of Imperfect Competition (1933)
- Covered much the same ground as Chamberlain, though not as elegantly
- But added to it a developed theory of Monopsony

Product-market Monoposony
- When there are many buyers of a commodity
  - A downwards sloping demand curve (based on Marginal utility)
- If there is only ONE buyer,
  - we can assume that the demand curve is unchanged
  - But the amount purchased will change….

- In competition, price = MC of production = MU
- In monopsony, price = MC of buyer = MU

- And the MC of the buyer is lower than the MC of production…..

Units	Price	Total Cost	Marginal cost	Marginal Utility
1	$1	1	1	$7
2	$2	4	3	$6
3	$3	9	5	$5
4	$4	16	7	$4
5	$5	25	9	$3
6	$6	36	11	$2

In competition, 4 units are produced and sold…..

The MC is equal to price, so purchase where $4 = $4

In Monopsony, only 3 units are produced and sold…

The Monopsonists MC is 5, and MU is 5, when 3 units are produced

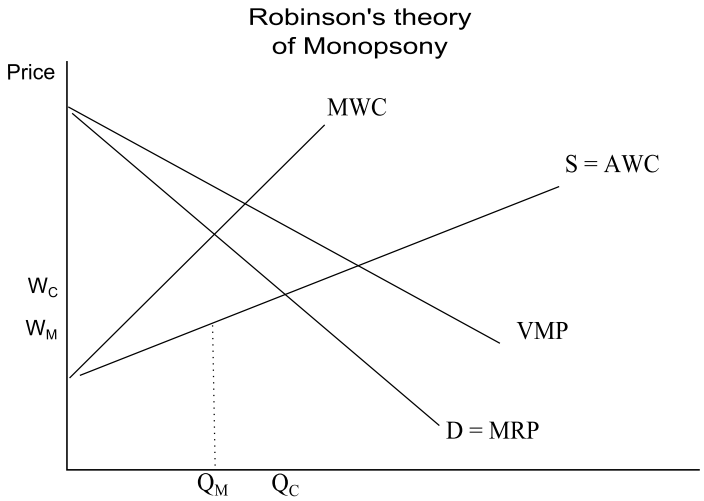
With an upward sloping supply curve, the monopsonist will buy fewer units, and at a lower price, than would be the case under competition

If the supply curve is perfectly elastic, no change.

If the supply curve is downward sloping (i.e. economies of scale), the monopsonist will actually buy more of the good than would be the case in competitive markets, since he can drive down average costs (and prices) by doing so.

This has implications for vertical integration and the theory of the firm

The Resource Market (the theory of exploitation)



In competition, wages are at WC, and the labor supply is at QC

(where the marginal revenue product of labor equals the Average wages)

But a monopsonist is different…., his wages are calculated at MWC

As he hires another worker, he has to pay them ALL more

He can’t price discriminate between his workers
So he will hire fewer workers (QM), and pay them less