Chapter Nineteen

The “First” Imperfect Competition Revolution

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19.1 The Leading Players

Imperfections and frictions in the workings of the forces of competition, such as institutional arrangements or monopolistic elements, have always been recognized by economists when representing market mechanisms (Cassells, 1937). However, it was believed that rigidities in the market mechanism did not seriously impede the working of competition and that it was therefore reasonable to make the general assumption of “perfect” or “pure” competition in the theory of markets, as a tolerably close approximation to the real world. In fact, the classical and neoclassical visions of the working of competition differed radically, as did their theories underpinning the price mechanism, but they were less distant as far as the generality of the assumption of abstracting from frictions and imperfections was concerned.

In the 1920s and 1930s a new wave of research gathered from the opposite presumption, namely that the perfect competition assumption lacked realism, drawing attention toward new market features and other forms of competition, and so specific apparatus to deal with them was sought after. However, like most intellectual “revolutions,” imperfect competition was more a reaction against rather than an endorsement of a unifying research program; in fact, there was a greater consensus on the reasons for abandoning perfect competition than on how to represent the working of “imperfect” markets.

The “leading players” in the imperfect competition revolution in the 1920s and 1930s were many; according to Samuelson, the list includes Kahn, J. M. Clark, Viner, Sraffa, Hotelling, Robertson, Robbins, Shove, Austin and Joan Robinson, Harrod, and Chamberlin (Samuelson, 1994, p. 55). While Marshall and Pigou certainly contain some “loose hints” to the “middle ground between monopoly and competition” (Whitaker, 1989, p. 189), it was the “new” generation of Cambridge economists who cultivated the new research ground. The path-breaking insights by Sraffa, the building up of a new theoretical system by Kahn and Robinson, and the extension of market imperfection to macroeconomics by Kalecki constitute the major achievements in the Cambridge (UK) tradition. On the other side of the Atlantic, in Cambridge, Massachusetts, Chamberlin and Triffin developed a system of thought that featured market competition based on strategic interdependence among sellers and product differentiation. While sharing with the other Cambridge authors mistrust in the perfect competition assumption, they were not ingrained in the Marshallian tradition and they drew their inspiration from different sources (Rheinwald, 1977).

By the early 1950s, after a heyday of nearly two decades, the imperfect competition revolution came under attack both by the Chicago school, which reinstated a free-market approach both to micro- and macro-issues and, surprisingly, also as a result of the lukewarm acceptance of the mark-up pricing approach within the Cambridge (UK) school (A. Robinson, 1950; Kahn, 1952). It was only in the 1980s that a “second” imperfect competition revolution took place, in reaction to the pervasiveness of the free competition assumption and in an attempt to give microeconomic foundation to the Keynesian approach to market failures. A new and rich literature, based on various types of imperfections and rigidities, has developed over the past 20 years, once again challenging the wisdom that competition can be treated in general as perfect. In the “second” imperfect competition revolution, uncertainty, asymmetric information, preferences, and nonincreasing costs have been given the central role in explaining the occurrence of imperfections and rigidities in the mechanism.

This chapter examines the development of the “first” imperfect competition revolution in the two Cambridges, briefly reviewing the work of the authors who were the major protagonists of a change in the economic representation of market mechanisms, and concluding with some thoughts on its legacy after the highs and lows of its fortunes.

19.2 Piero Sraffa

There can be no doubt that the real initiator of the imperfect competition revolution was Sraffa, in his article in the December issue of the Economic Journal of 1926, which set off a true “revolution” both for the novelty of the approach and for the implications it carried.

Sraffa gave two reasons why the hypothesis of perfect competition should be abandoned. First, he held that the theory in which that hypothesis was embedded was logically inconsistent; secondly, he argued that the behavioral descriptions implied in that hypothesis were at variance with the known facts.

The particular theory under attack was the Marshallian–Pigouvian representation of the working of individual markets. Drawing on his previous article,
published in Italian (Sraffa, 1925), Sraffa showed that many of the assumptions upon which the theory rested were ill-founded.

The assumption that long-period costs for the firm increase when conditions of perfect competition hold was the result of attributing to a single firm what was attributable, under particular circumstances, only to an industry. Since each firm is too small to have an appreciable influence on the price of its factors, the result of an increasing marginal cost for the firm can be obtained only by assuming that the number of firms is fixed within each industry and that each firm, as it expands production, experiences a decrease in productivity by a factor that is constant for the industry. But this can be justified only for an industry that happens to be the sole employer of a factor that cannot be augmented. Furthermore, the assumption that the number of firms within a given industry is fixed violates one of the postulates of perfect competition, namely the open entry and exit of firms from any industry.

The assumption of decreasing average costs is also shown to be inconsistent with the theory of perfect competition. If it is admitted that there is a firm whose costs per unit of output decrease when production increases, there is nothing to prevent that firm from expanding production indefinitely and becoming a monopolistic producer in that market.

If, on the other hand, it is assumed that firms operate with constant costs a further difficulty arises for the theory of perfect competition in the Marshall-Pigou tradition, which assumes that the firm faces a perfectly horizontal demand curve. In fact, given constant costs, either the equilibrium is undetermined or, if it is postulated that firms always produce as much as possible, the possibility of one single firm monopolizing the market cannot be ruled out.

The lack of realism in the assumption of perfect competition is revealed by the common knowledge that producers are not usually constrained by costs – which are normally diminishing for the producers of manufactured goods – but by demand. However, the theory of perfect competition assumes that while firms can sell any quantity whatever at the given market price, they are unable to lower prices or to increase marketing expenses in order to increase their market share. Unfortunately, quite the opposite behavior is observed in most markets.

On the other hand, while the producer cannot have any influence on price, the consumer is assumed to be indifferent as to the products of any given industry. The assumption of a perfectly elastic demand curve encapsulates the idea that products are homogeneous and therefore that there is perfect substitution or indifference in consumption.

Thus, in Sraffa, abandonment of the hypothesis of perfect competition means abandoning a particular theory; that is, a theory that sees competition as a situation in which expansion of firms is halted by rising costs. Far from being restricted to very special circumstances, the hypothesis that – within the Marshall-Pigou apparatus – firms should be regarded as single monopolies functions better than perfect competition, in accounting for the evidence; that is, that the expansion of firms is halted not by raising costs but by the limitation of demand. Sraffa’s insight, “by showing how limited is the domain of applicability of perfect competition, and by breaking the spell, so to speak of the perfectly elastic demand that faces the perfect competitor” (Newman and Vassilakis, 1988, p. 41), carried with it a radical change of perspective.

19.3 Richard Kahn

The first to pursue the line of research opened by Sraffa was Kahn in his fellowship dissertation, The Economics of the Short Period, which was written between October 1928 and December 1929, but remained unpublished in English until 1989. The reason Kahn gave for abandoning the hypothesis of perfect competition was that the Marshallian-Pigouian apparatus could not account for a fact observed during the Great Depression of the 1920s: that firms could earn a positive profit while working below capacity. If market conditions were perfectly competitive it would follow that, when price was greater than average cost, firms would be producing up to capacity output; when price fell below average cost, they should close down. On the contrary, in the 1920s Depression, when demand fell heavily, firms in the cotton and coal industries used “to close down the whole plant on some days and to work the whole plant a full shift on other days” (Kahn, 1989, p. 57).

The explanation of this behavior was sought by Kahn in the shape of their prime cost curve, reflecting the technical method with which output could be varied in the short period. When the plant and machinery could not be altered, as is the case in the short period, the relevant segment of the marginal cost curve is horizontal, which is then equal to constant average prime cost until full capacity is reached, when it becomes infinite. The shape of the prime cost curve – a reverse L – and the evidence of short-time working are a serious challenge to the prediction that whenever the price exceeds the average cost curve, firms produce at full capacity level of output. If this were so, only inefficient firms would be working below capacity; but this went against the evidence that showed that short-time working was a consistent behavior across all firms in the 1920s. Moreover, a constant marginal cost curve loses its significance as a determinant of output when faced by a perfectly horizontal demand curve, as is the case in perfect competition. Kahn found the solution by assuming that each firm was in fact facing a down-sloping demand curve and that competition was in fact “imperfect.”

The equilibrium level of output and price is then determined not as in perfect competition, by the equality of price and marginal cost, but as in monopoly by the product of output and the difference between price and average prime cost, as far as output is concerned, and on the basis of elasticity of demand as far as price is concerned. Kahn resorted here to the standard definition of Marshall’s “maximum monopoly net revenue” (Marshall, 1964, p. 397) – the point at which the difference between the monopolist supply price and demand price times output is a maximum – to determine the equilibrium level of output and price, and provided an ingenious method of measuring market imperfection (Maccuzzo, 1994, pp. 30–1). At the time the dissertation was written, marginal revenue remained an unnamed concept.
By introducing the imperfection of the market, Kahn was able to explain why at low levels of demand price does not fall to marginal cost, and why the equilibrium level of output is at less than full capacity.

19.4 Joan Robinson

As in the case of Kahn’s dissertation, the starting point of the Economics of Imperfect Competition is Sraffa’s proposal “to re-write the theory of value, starting from the conception of the firm as a monopolist” (J. Robinson, 1969, p. 6); the aim of the book was to extend the marginal technique, enriched by the discovery of the new concept of “marginal revenue,” to all market forms and to provide an answer to the challenge posed by Sraffa in questioning the consistency of the Marshall–Pigou apparatus.

The approach taken by Joan Robinson was to apply the technique based on average and marginal curves, incorporating various cost and demand conditions of commodities and factors of production, to all market forms. Perfect competition becomes a special case in a general theory of competition, allowing for various degrees of substitution and preferences on the part of consumers as captured by the value of the elasticity of demand for the firm. Perfect competition is then defined as a market condition characterized by a perfectly horizontal demand curve; that is, with infinite elasticity. On the supply side, various assumptions are allowed for in the behavior of costs, corresponding to increasing, decreasing, and constant cost cases. In fact, in an imperfect market, namely with a down-sloping demand curve facing each firm, any assumption about the shape of the marginal cost curve provides for the determinacy of equilibrium.

Full equilibrium conditions for any given industry are derived in both a perfect and an imperfect market: “An industry is said to be in full equilibrium when there is no tendency for the number of firms to alter. The profits earned by the firms in it are then normal” (J. Robinson, 1969, p. 93). Since profits are normal when price (average revenue, AR) is equal to average cost (AC) and firms are in individual equilibrium when marginal revenue (MR) equals marginal cost (MC), it follows that full equilibrium requires the double condition that MR = MC and AR = AC.

Proof is then given that the “double condition” can only be fulfilled when the individual demand curve of the firm is tangent to its average cost curve. Hicks neatly summarizes the main point: “Since the demand curve is downward sloping, the average curve must also be downward sloping at the equilibrium point. Equilibrium under monopolistic competition is only possible when average costs are diminishing; that is to say, the equilibrium output of a firm will be less than the output which would give minimum average costs – the output which would actually be reached under conditions of perfect competition” (Hicks, 1935, p. 140).

Therefore, comparison between equilibrium conditions of perfect and imperfect competition had a dismal welfare implication: in the former case marginal and average cost are equal at the point at which average cost is at a minimum, while in the latter case “the double condition of equilibrium can only be fulfilled for some output at which average cost is falling. The firms will therefore be of less than optimum size when profits are normal” (J. Robinson, 1969, p. 97).

19.5 Kahn versus Sraffa

With the change in perspective from seeing firms as identical and competing in a unified market to viewing them as single monopolies, each one with its individual market, the question arose as to whether “a world of monopolies” would imply different results as far as the determination of the equilibrium price was concerned. In other words, would price in an imperfect market be different from price in the case of monopoly?

This issue was at the heart of the contrast between Sraffa’s approach and that of Kahn and Robinson. Kahn declared that there was “a serious error in Sraffa’s exposition [in the 1926 article] since it implied that under conditions of uniformity among firms, provided that the market is slightly imperfect, the magnitude of the imperfection is irrelevant to the equilibrium price” (Sraffa, 1926, p. 549; Kahn, 1989, p. 94).

On the contrary, Kahn claimed that “a reduction of the amount of imperfection causes – in the short run at any rate – a fall in price and in profits” (Kahn, 1989, p. 94). He had reached this conclusion on the basis of an analysis of the individual demand curve facing each seller, indicating what the entrepreneur imagines to be the relation between his price and his output. The assumptions – “that are in the mind of the business man when he maximises his profit” (Kahn, 1989, p. 100) – are that when he alters his price or output, either the prices or outputs of the other firms remain constant, or they will react by varying their prices and outputs. In all three cases, Kahn argued, the aggregate demand curve of an industry in the hands of a single monopolist is steeper than the demand curve facing each in an oligopolistic industry. It therefore follows that “under conditions of polypoly the equilibrium price is less than under conditions of monopoly” (Kahn, 1989, p. 117), contrary to Sraffa’s assertion.

Kahn claimed that Sraffa had acknowledged “the force of my [Kahn’s] objection to his argument” (Kahn, 1989, p. 95). The extant evidence is not, however, to this effect. In the Lecture Notes of the course on Advanced Theory of Value, which Sraffa gave in Cambridge in 1928–31, in a note, added after Sraffa had read Kahn’s dissertation, he says:

To say that in imperfect competition price is always less than in monopoly, it means to fall into the [...] error, which is based on assumption that problem is independent of the relation between individual and collective elasticity of [demand]. The point is that I assume a slight, but finite, degree of imperfection (elasticity of demand not infinite). But in this case, with the rise in prices, the elasticity decreases all the time, without limit. (see Marcuzzo, 2001, pp. 88–9)

Kahn based his analysis on conjectural demand curves whose slopes embody various assumptions made by each firm about the behavior of other firms within
the industry. A change in price by any one firm does not leave the slope of the demand curves of all the other firms unchanged, because account is taken of the reactions of competitors. In general, when there is only one producer (as in monopoly), its demand curve is steeper than when there are many producers (as in oligopoly), because in that case the behavior of the other firms is not taken into account. Since the equilibrium price, for a given supply curve, is determined by the slope of the demand curve, it follows that price is higher in monopoly than in oligopoly.

On the contrary, Sraffa's argument is based on the degree of consumer preferences as shown by the value of the market elasticity of demand. Following an increase in price by one firm, demands for all firms are raised. Since the prices of substitutes go up, each buyer is willing to pay a higher price for the product of the firm from which he prefers to buy (Sraffa, 1926, p. 547). The limit to the price increase is given by the loss of customers to the market, not to the individual firm, since customers will return to the preferred firm when the other firms have also raised their price. Thus for Sraffa, unlike Kahn, "for an industry consisting of firms which are all similar and similarly situated" (Sraffa, 1926, p. 547) there is no reason why the price corresponding to the Marshall's "maximum monopoly revenue" should be different in monopoly and oligopoly.

19.6 SRAFFA VERSUS KAHN AND ROBINSON

As is well known, Sraffa lost interest in imperfect competition and soon abandoned the field, giving rise to much speculation. It has, for instance, been maintained that Sraffa's "profound objective" was to rid the analysis of all kind of subjective and mental determinants; it would have been the awareness that dealing with an imperfect market "renders the mental determinants of equilibrium unavoidable" (Dard, 2000, p. 131) that estranged him from the entire problem. This hypothesis is not, it seems to me, ultimately convincing, since we have other examples of Sraffa's readiness to describe market behavior in terms of beliefs and expectations. Actually, Sraffa was opposed to the neoclassical representation of behavior in terms of demand and supply curves, based on preferences and utility, scarcity, and factors of production, and he favored an approach - such as that of the classical political economists - which anchored economic behavior in the condition of production, the pursuit of self-interest by agents, and an understanding of competition as a force leading to uniformity of the rate of profit (Clifton, 1977). It was the demand (and supply) functions, and their usage in the determination of equilibrium within a partial approach framework, to which Sraffa was objecting. Similarly, in the case of Keynes's theory of the liquidity preference, he was objecting not to taking into consideration individuals' preferences and convictions, but to representing them in the shape of a demand for money function.

Sraffa's estrangement from the theory of imperfect competition had more to do with his rejection of the theory that underpinned it than any refusal to deal with motivations and interactions among economic agents (Marcuzzo, 2001).

19.7 MICHAEL KALECKI

Did working with the assumption of imperfect competition entail implications regarding the representation of the economic system as a whole? It is well known that Keynes remained unimpressed by the imperfect competition revolution he was witnessing, and worked his way through The General Theory without taking much notice of it; neither Kahn nor Joan Robinson made any attempt to bridge the two major events in Cambridge economics in the 1930s. In fact, it was Kalecki who "brought imperfect competition in touch with the theory of employment" (J. Robinson, 1969, p. viii) and who, in the second half of the 1930s, developed an approach based on imperfect perfect competition within a macroeconomic analysis of the economic system.

When Kalecki arrived in England in 1936 he had already worked with the imperfect competition assumption in his analysis of cartels in Poland and elsewhere (Sawyer, 2001, p. 246). At the end of 1937 he moved to Cambridge and became an active participant in Sraffa's Research Students seminar. Also, for two years he was involved in the Cambridge Research Scheme of the National Institute of Economic and Social Research into Prime Costs, Proceeds and Output (which was set up to keep him in Cambridge). Unfortunately, his results came in for very critical comments from Kahn and Joan Robinson, who objected in particular to his "degree of monopoly" concept: "it is not a thing in itself... [therefore] to say that there has been a 'change in the degree of monopoly' is never a final account of what has happened, and it is often unreasonable to expect a constant degree of monopoly in the face of other changes..." (R. F. Kahn's papers, King's College Archives, file 5/1). This criticism, while probably inducing Kalecki to resign from his Cambridge job, did not stop him from dedicating two articles (Kalecki, 1938, 1940) to working out the concept of the degree of monopoly within a macroeconomic framework, which did not rely on the assumption of free competition.

First, assuming that prices are formed by equating marginal cost to marginal revenue, market imperfection is defined by the elasticity of demand for the product of each firm as a function of the ratio between the price charged by the individual firm and the average price of the industry (an average of the prices charged by each firm, weighted according to their respective outputs). The degree of market imperfection is constant if, for each individual firm, the elasticity of demand is correlated solely with its price; otherwise, the degree of market imperfection varies.

Kalecki then drops the assumption that firms fix prices according to the equality of marginal cost and marginal revenue and examines the case of oligopoly. This case arises when the firm sets the price at a point at which marginal revenue is greater than marginal cost. The price is set at this particular level because each firm knows that a lower price would induce the rival firms to lower their prices, while a higher price would not make them raise it. Thus, in any given market, the degree of oligopoly is measured by the ratio of marginal revenue to marginal cost, which is, in general, greater than one (Kalecki, 1940).
Kalecki was highly original, although at the cost of simplification, in producing a methodology to study the aggregate effects of price policy by firms in a macroeconomic representation of the economic system (Marcuzzo, 1996, pp. 11–12). Last but not least, he could explain why there need not be an inverse relationship between real wages and unemployment, forcing Keynes to acknowledge the point (Keynes, 1973, pp. 499 ff.).

19.8 Edward Chamberlin

Much has been said about the curious coincidence of two books bearing almost the same title and dealing with almost the same topic being published in the same year in the two Cambridges, on either side of the Atlantic (Samuelson, 1967), Chamberlin’s Theory of Monopolistic Competition (1933), however, as repeatedly claimed by its author, was a book that did not draw its inspiration from Sraffa’s criticism of the Marshallian value theory, nor was it concerned with extending marginal analysis to all market forms. It was the observation of what was actually happening in the real world that pointed the way to abandoning any idea of identical firms working in homogeneous markets. Diversity and nonuniformity of behavior was the rule, and this needed to be brought together in a new vision of the market.

Chamberlin’s analysis is based on the recognition that each seller is a monopolist in the sense of having “complete control over the supply of a distinguishable product.” Yet, like any monopolist, each seller faces substitutes for his product; therefore competition, rather than being pure or perfect, should be conceived as monopolistic. Furthermore, the entry or exit of sellers “carries with it an expansion or contraction in the number of products in the whole system instead of merely a change in the number of producers of some given product […] Imperfection, although it may be made to include more by definition, has the strong connotation of general ‘frictions’, such as imperfect knowledge, irrationality or immobility, exerting an influence rather evenly over the entire market. But with the recognition of a different product and market for each seller presumptions as to uniformity in any sense disappear, and we have diversity…” (Chamberlin, 1961, pp. 526–7).

While in Joan Robinson’s Economics of Imperfect Competition the key position is held by the industry, in Chamberlin’s Monopolistic Competition the key position is held by groups, where each seller has a monopoly of his own distinguishable product and various types of group relationships between sellers are envisaged. Unlike Joan Robinson, who took preferences to be in the “minds of consumers,” Chamberlin saw product heterogeneity as a “competitive weapon” (O’Brien, 1983, p. 35) actively used by sellers to differentiate their products.

This second strand of thought of the imperfect competition revolution is centered not so much on “irrational” consumers’ preferences, or on decreasing costs, as on the idea of groups of sellers exploiting differences and diversity in their products to gain market power at each other’s expense. Many of the analytic results are similar to those produced by Joan Robinson, but Chamberlin’s analysis tries to escape the static, partial equilibrium framework without, however, succeeding in satisfactorily addressing the dynamic, strategic interdependence issues posed by oligopoly.

19.9 Robert Triffin

Only a few years afterwards Triffin, in his Ph.D. thesis written under Chamberlin’s supervision, was able to set up the agenda, if not the solution, posed by the theory of oligopoly as sketched out by Chamberlin.

He pointed out that the criterion for monopoly and competition is to be found in the nature of the relationship between firms, rather than in the situation characteristic of each firm as represented by the slope of its demand curve. This is why the approach taken by Chamberlin, who considers the set of reactions within a group of firms, is superior to that of Joan Robinson, who frames her analysis of identical firms within a partial equilibrium approach. In fact, in her approach changes in production by other firms in the industry are not taken into the picture, “but only entry or exit of firms and arbitrary shifts in the total demand for the commodity turned out by the industry” (Triffin, 1940, p. 44).

However, Triffin saw two aspects of the theory of imperfect competition as developed by Chamberlin and Robinson as equally unsatisfactory: (1) the reliance on ill-defined concepts such as “group” or “industry,” rather than a focus on the interdependence of firms; and (2) the assumption that the subjective demand curve, which expresses the expectations of the producers as to the relationship between the price they charge and the quantity the market will buy, is also an objective demand curve – “embodying the actual reactions of the market” (Triffin, 1940, p. 63).

For Triffin, the central concept is the elasticity of substitution between two products; when its value is not infinite, there is scope for an independent price policy by the producers of these two commodities and the question to be addressed becomes that of the general competitiveness between goods. “Only in the case of pure competition does the grouping of firms into one industry reduce to a more simple and more definite type of behaviour and reactions of sellers” (Triffin, 1940, p. 88).

In the work of Triffin, imperfect competition is rooted in the analysis of strategic behavior and the study of interdependence between firms. He rejected the classification of different forms of competition (pure or perfect, monopolistic or imperfect) based on the number of firms within a group or industry and on the differentiation of or absence of differentiation between the products of those firms, stressing the point that forms of competition are a matter of relations between sellers. The difficulty in the treatment of forms of competition other than pure or perfect arises not only from the influence of one firm upon other firms, but also from the chain reactions of other firms affecting the firm.

In conclusion, for Triffin, the perfect elasticity of the demand curve is not a good test for perfect competition. The essential element in the definition is “the perfect dependence of the firm’s sales upon the price charged by other
sellers... plus the inability of the firm to influence the price decision of these sellers” (p. 138).

19.10 The Legacy

The strand of the theory of imperfect competition that originated in Cambridge, England, was an attack on the Marshallian cost and demand curves launched by Sraffa in his 1925 and 1926 articles on the ground of lack of consistency and realism. In the work done first by Richard Kahn and then by Joan Robinson, imperfect competition was a means to supplement the Marshallian approach rather than a reason to discard it. Perfect competition was shown to be a special case, rather than the general case prevailing in actual markets, when supply and demand curves have a particular shape; but the whole marginal apparatus, embodied in the average and marginal curves, was reinstated against Sraffa’s criticism, in response to which particular assumptions and ad hoc definitions were fabricated.

Kalecki’s attempt to incorporate market imperfection into a macroeconomic analysis of the system in order to integrate firms’ behavior in a more realistic theory of price was only partially successful, but showed how to give more weight to effective demand, rather than to real wages, in determining the level of employment.

Chamberlin’s contribution did not grow in that milieu; its main argument rested on product differentiation and strategic behavior as central to the representation of market. Triffin clarified the set of issues that should be tackled if a satisfactory theory of oligopoly within a general equilibrium framework was to be developed.

However, the “first” imperfect competition revolution did not outgrow into an alternative research program, nor did it seriously undermine the perfect-competition approach to economics. Nevertheless, the imperfect competition revolution jeopardized the argument that competition results in economic efficiency, shaking confidence in markets as the best means to allocate resources and allowing for intervention and institutional changes.

The reaction came, in the late 1940s and early 1950s, from several Chicago-based scholars — in the main, Milton Friedman and George Stigler (Keppeler, 1994, 1998) — who formulated criticisms of monopolistic competition theory arguing against the claim that it was a more realistic model of the actual economy. The argument was that the value of a theory does not lie in the realism of its assumptions, but in the realism of its predictions. An example is provided not only by the famous 1949 article by Stigler in which he denounced imperfect competition as lacking generality and being empirically empty, but also in his attack on Paul Sweezy’s work on the kinked demand curve (Sutton, 1989; Friedman, 1995).

The first imperfect competition revolution was a reaction against the lack of realism of the perfect competition assumption but, ironically, was attacked for its inability to stand up to the test of its predictions. It has been aptly said that “The effect (and surely the purpose) of Friedman’s 1953 essay [Friedman, 1953] was to save the theory of value and distribution as logically consistent and widely applicable central core of economic theory and basis for applied economics” (Moss, 1984, p. 316).

Meanwhile, important articles and books based on market forms other than perfect competition continued to be written, but the main body of doctrine seemed to remain unscathed. Samuelson’s defense of imperfect competition as a true “revolution” is set against this background: “Chamberlin, Sraffa, Robinson and their contemporaries have led economics into a new land from which their critics will never evict us” (Samuelson, 1967, p. 138).

In recent years, however, we have witnessed the rise of a “second” imperfect competition in modern micro- and macromodels, as a way of contrasting and enriching the basic perfect competition models (see Dixon and Rankin, 1994, Gabszewicz and Thissee, 2000). Emphasis has been put on various forms of price rigidities, accounted for by information asymmetries and limited rationality, acknowledging that some markets do not exist — or if they do, that the agents lack the perfect information and perfect knowledge to make them work. While some reservations are held against this New Keynesian way of attempting to contrast the New Classical reinstatement of free-market economics, there now seems to be a greater consensus than in the past that market forces should be seen as limited, partial, and imperfect in their working. Moreover, an alternative approach to the analysis of markets and to modeling interactions among various types of agents has been developed in game theory, which does not rely on the distinction between perfect and imperfect competition. It is widely held that this approach is best suited to deal with oligopoly and strategic behavior, and is capable of solving many of the difficult issues involved in these matters.

The question then arises as to what is the real legacy of the first imperfect competition revolution. Does the departure from the basic model in the forms of allowance for consumers’ preferences, product differentiation, and strategic behavior in decision-making provide a real alternative to the case of perfect competition? Or is it, rather — as Sraffa probably meant it — that room has been made for a different price theory, which involves a different meaning of competition? The crux of the matter lies in the choice of either of the two diverging lines of research — in representing strategic decisions of agents or in developing a differently based theory of prices — which resulted from the “first” imperfect competition revolution.

I personally share the opinion expressed by a leadingplayer in the theory of oligopoly that we should “try to identify such objective elements as may, in real situations, serve as basis for price determination. Otherwise, we would run the danger of remaining in the fantastic world of reaction curves and conjectural variations — a world where everything might and nothing need happen” (Sylas Labiri, 1969, p. 34).

Bibliography


