

# The standard neoclassical view of competition economics essay



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Competition itself is just one of many constituents which combine to form macroeconomics. The schools themselves hold distinctly different views of the competitive process, which is the foremost concern with regards to Industrial economics. The two principle forms of competition are Perfect Competition and Oligopoly. Whilst the Perfect Competition market structure is key to the neoclassical view of competition, both the Austrian and Post-Keynesian schools believe Oligopoly to be of much greater significance to modern economics.

The Austrian school of thought is largely rooted in the works of Menger, Hayek, and Mises, in the early 20th Century. Unlike the Neoclassical view, these economists were more concerned with the importance of Subjectivism, Uncertainty, and Entrepreneurship in economic systems. Some of these ideas differ from the Neoclassical theories quite profoundly, and are therefore of critical in assessing the significance of this school of thought upon the traditional theory of the firm.

The second ideology which is essential to a comprehensive understanding of competition is the Post-Keynesian viewpoint. This movement began notably later than both the Neoclassical and Austrian theories, around the late 1950s and early '60s. Key figures which can be classified as Post-Keynesian economists are Davidson and Kalecki, who have further developed some of the basic ideas which were originally outlined by Keynes himself. The Post-Keynesian school can be seen to share some similarities with the Austrians. For example, they also believe that Uncertainty is very significant with regards to competition. However, their comprehension of the term is rather

different, which again has implications when assessing its significance as a criticism of neoclassical notions.

In order to fully appreciate these alternative ideas, one must first understand the original neoclassical ideas themselves, which are predominantly based around the idea that there is an ongoing process of utility optimisation in a Perfectly Competitive environment. Gossen's First Law dictates that, *ceteris paribus*, the marginal utility of goods or services decreases as they are added to available resources[1]. This is essentially the basis for neoclassical theories of marginalism and utility maximisation. Neoclassical economists believe that there is an optimal point, or equilibrium, where utility can be maximised. Further examples of this include profit maximisation, which is a fundamental aspect of any firm, within any market structure. By employing optimisation techniques, neoclassical economists believe that equilibrium can be found which allows a process of market clearing to take place. Whilst the Neoclassical theory provides a simple and perfected ideology of market function under Perfect Competition, in real world situations there are a number of other factors that must be included to effectively analyse competitive markets.

In contrast to neoclassical beliefs, the Austrian theory places much greater emphasis on the individual, rather than on a firm or industry level. Menger was a major figure in the Austrian theory, who outlined the importance of qualitative assessments, over the physical calculations of rationality which were used by neoclassical theorists. His work, combined with contributions from Hayek, form the principles of the Austrian school of economic thought.

Austrian theorists believe that the individual agents are inherently rational, <https://assignbuster.com/the-standard-neoclassical-view-of-competition-economics-essay/>

but only in the sense that they employ purposeful action; 'Menger incorporated the peculiarly human elements of purposeful action and uncertainty, the occurrence of errors, the information acquisition process, learning, and time into his economic analysis'[2]. Many of these aspects were not included in the neoclassical theory whatsoever. The significance of this is that the Austrian theory can be seen to take a much more ecologically valid approach toward economics.

One of Menger's most significant theories, along with Jevons and Walras, was the subjectivity theory of value, outlined in his work, *Principles of Economics*, in 1871. This theory proposed that 'the value of economic goods depends on the (subjective) utility they have to different individuals, and not on their (objective) cost of production'[3] which effectively disregards the primary neoclassical beliefs in optimization and marginalism. The ideas of subjectivity were furthered by Ludwig Lachman, who can be considered to be a 'radical subjectivist' in Austrian economics. Lachman often recited Heyek's statement that 'every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism'[4]. The principle of subjectivity was understood by Lachmann as key to modern economics and felt that the importance of the subjectivity of expectations, in particular, had been forgotten.

Lachmann believed that expectations are not as consistent as theorists such as Hayek had previously deemed. Lachmann understood that expectations differ from one person to another, and thus prevent the resolution of equilibrium. Expectations are likely to differ because the future, from an

Austrian perspective, is both unknown and unknowable, given that one can  
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never have true knowledge of future actions. This alternative view of uncertainty has led Austrian economists to attempt to explain the subject in more detail than was first outlined by those of the neoclassical persuasion.

Austrian theorist Frank Knight identified two types of uncertainty; the first is 'risk' and the second is fundamental 'uncertainty', which were outlined in his work, Risk, Uncertainty and Profit. Risk is the form of uncertainty which agents subjectively allocate over all future outcomes; 'The essential fact is that " risk" means in some cases a quantity susceptible of measurement'[5], as it is not possible to allocate the probabilities of fundamental uncertainty itself; 'We shall accordingly restrict the term " uncertainty" to cases of the non-quantitative type'[6]. From an Austrian perspective, agents act in an environment of fundamental uncertainty, meaning that the future cannot be foreseen in terms of the present, as is deemed feasible in standard neoclassical theory. Instead, Austrians believe that entrepreneurs are able to reduce uncertainty to risk through imagination.

The imagination of entrepreneurs is the final defining aspect of the Austrian theory. By understanding both the actions of the entrepreneur, and the conditions in which they work, Austrians are able to form a theory which can hold true in the real world, unlike those belonging to neoclassical economists. Austrians believe that due to the presence of fundamental, pervasive uncertainty, there are bound to be economic errors made in the pursuit of profit which lead to changes in the market. Kirzner attempts to outline an entrepreneurial theory of the market process that provides an explanation as to how the system finds an original equilibrium. This is a factor which is missed in neoclassical theory, and is explained by Kirzner as <https://assignbuster.com/the-standard-neoclassical-view-of-competition-economics-essay/>

the outcome of a series of correction of entrepreneurial errors through arbitration and speculation; 'For me the change the entrepreneur initiates are always toward the hypothetical state of equilibrium; they are changes brought about in response to the existing pattern of mistaken decisions'[7]. This process of ongoing correction, he believes, can be beneficial to consumers.

The resulting changes in the market are argued to be much more complex than can possibly be encapsulated by the equilibrium approach of the standard theory. The dynamics of the competitive process are altered by the actions of entrepreneurs, with the incentive of greater benefits for both entrepreneurs and consumers alike. Moreover, Austrian theorist Mises also questions the relevance of any Pareto Optimisation, which is a neoclassical theory that relies upon the idea that situations are always perfectly defined in terms of a 'means' and 'ends'. Mises argues that 'The characteristic mark of ultimate ends is that they depend entirely on each individual's personal and subjective judgment, which cannot be examined, measured, still less corrected by any other person'[8], which further supports the individualist approach of the Austrian school of thought. This concept effectively undermines the theories of the neoclassical approach, by establishing that individual judgements are too abstract to be quantified through neoclassical formulae.

The overall significance of these criticisms is that it may cause one to reevaluate the evidence supporting the original standard theories. However, the Austrian school of thought is not the only alternative collection of ideas which differ from the neoclassical. Another group, the Post-Keynesians, have <https://assignbuster.com/the-standard-neoclassical-view-of-competition-economics-essay/>

essentially tried to restructure theories which were originally formed by John Keynes. One such theory concerned uncertainty, although Post-Keynesians take a differing view to the Austrians.

For Keynes himself, uncertainty was not quantifiable, rather economic choices are based upon expectations. This is the idea that the future can be based upon historical averages. As result, problematic 'risk' and 'uncertainty' can be seen as being identical to one another. However, the ideas concerning probability and uncertainty were critiqued by the Post-Keynesian economist Davidson, who defined uncertainty as 'the absence of governing ergodic processes'[9]. A process can be described as ergodic if 'the stochastic [random] process is such that time and space averages will coincide for infinite realisations'[10]. His theory on the stochastic process argues that probabilities cannot be used to understand real world behaviour under uncertainty, and that future outcomes based upon past or current probabilities are frequently unreliable. Yet again, the validity of the original neoclassical theories are called into question, in favour of a much more realistic viewpoint.

Furthermore, this alternative view of uncertainty has also resulted in an alternative pricing theory to the marginalist approach of the neoclassical theorists. This new approach to pricing was envisaged by Kalecki, who found that firms act in an environment of 'pure imperfect competition'[11]. As a result, he argues that there is no real relationship between actual demand functions and the price of goods and services. Upon analysing real world examples, Kalecki found that prices were set using a mark-up rule based upon average prime costs, and found a formula to support this argument <https://assignbuster.com/the-standard-neoclassical-view-of-competition-economics-essay/>

which is based upon average prime costs. A firm's price can be set using the formula:

The  $U$  term depicts the unit prime costs, whilst  $P^*$  is the weighted average of all firms' prices in a given industry. Unlike the standard theory, Post-Keynesians believe that prices are determined by dominant firms in order to achieve specific objectives; often to further increase their power and dominance in the marketplace. Dominant firms have the ability to use their objectives as guidelines to set price, as opposed to a process of market clearing as described by the standard theory. Again, this is an idea that can be shown to truly occur in today's markets; the firm that holds the most market share is often able to undercut its rivals on price in order to augment their power.

The significance of both the Post-Keynesian and Austrian criticisms of the standard neoclassical view of competition can in fact be reduced to a fairly simplistic outcome; the alternative views force traditional economists to reassess the validity of their theories. Whilst the standard view may be true when looking at environments of perfect competition, they hold little value when looking at real world situations of oligopoly. This is the crucial difference between the neoclassical and alternative viewpoints. Theorists belonging to both the Austrian and Post-Keynesian schools, such as Kirzner, Davidson and Kalecki, have attempted to establish theories which, whilst perhaps are not as elegant and simple as those which neoclassical theorist formed, are able to be effectively put into practice in today's modern economies, and should be commended as a result.