Competition As A Factor Of Market Clearing And Pareto Efficiency

Introduction

Competition is a divisive subject which has led to differing approaches to how it is modelled. The most widely accepted is the neoclassical view, which argues the benchmark is perfect competition, equilibrium is market clearing and pareto efficient. Market clearing is where the demand for goods equals the supply of goods so that there is no leftover surplus. Whilst Pareto efficiency is where resources cannot be reallocated to make one individual better off, without making another worse off, hence, goods are allocated efficiently. The Austrian view supports that competition leads to markets clearing and pareto optimality but argue it is more a process than a state. The Marxian view disputes claims that markets clear and are pareto efficient, competition is viewed as inefficient due to the pursuit on profit maximisation.

Main

Neoclassical View

The neoclassical view benchmarks perfect competition, arguing it can be achieved if there are many small firms producing a homogenous product with no restrictions on entry into or exit from the industry. Assuming the absence of economies of scale, the equilibrium outcome of perfect competition is pareto optimal. The view supports welfare theorems which link pareto efficiency to perfect competition. Competition is fought through price and quality of products, as such the more participants in the market the better.

Structure-conduct-performance paradigm show below in figure 1 demonstrates that when there are fewer firms there are potential pareto improvements. In a monopoly firms can create barriers to entry into the market. This prevents competition from becoming perfect meaning price is above marginal cost, and it is possible that profits become abnormal. Price is predicted to be higher and output lower under monopoly than under a comparable situation of perfect competition, as well as greater welfare losses. When in monopoly or oligopoly stage, firms have an incentive to collude prices which goes against the neoclassical theory.

Perfect competition concept does not involve any rivalry, all firms are in harmony. Firms are price takers and the actions of other firms has negligible impacts on the industry, each firm operates in a vacuum where actions do not influence other firms. This may overlook the impact that both implicit and explicit collusion may play when there are fewer firms involved. However, collusion may be hard to follow as the other firm may “cheat” if it has the incentive to do so. Any deviation in a slightly lower price or higher quantity makes it more profitable for the firm and this may prevent collusion from being widespread.

The Austrian View:

The Austrian’s view competition as a process rather than a state. Perfect competition is only

achieved when the process of competition has exhausted itself. This approach does not view the process of competition reaching a final state unlike the Marxian view. Entrepreneurs are key individuals who recognise and take advantage of opportunities. The existence of economic profit is essential to spur on entrepreneurs.

Schumpeter's (1942) idea of "creative destruction" suggests new ideas are initially highly profitable but as a result any previous market power may be undermined which has the potential to be costly. Firms chase profits until they are gradually eroded, when this occurs competition is deemed perfect. Any existing market power can be undermined by further entrepreneurship. The invention of a new product creates a monopoly position for a firm introducing a product. Gradually other firms catch on and develop close substitutes reducing the high levels of profit from the monopoly.

Classical/Marxian:

The Marxian view depicts firms as profit seeking, the competition over profits inevitably leads to conflict. Firms are aware that collusion can bring higher profits than under competition meaning it is often in a firm's interest to set prices higher and produce less than the demand. Under a Marxian perspective competition is not pareto optimal. Suspending or removing rivalry is advantageous to a firm as it can seek higher profits. As such competition is not desirable to firms and if they aim to achieve long term profits it may be in their interest to remove competition.

The pursuit of profits leads firms to seek out opportunities to increase profits by moving into highly profitable areas. Lange (1937) argued free competition leads to a pursuit of maximum profit, but as many firms chase the profits they are eroded away. As such, capital filters from areas of low to high profitability, which over time equalises profits over different sectors.

Competition is widely perceived as for markets as a whole, because of this it is unlikely market clear or are pareto efficient. Firms are viewed as price makers which has large implications as this means that competition is fought through non-price mechanisms like advertising.

In the structure-conduct-performance approach monopoly and competition are opposites in that one increasing, decreases the other, however, this may not be the case. Marxists argue that monopoly spawns from competition. But competition may cease to exist in oligopoly and monopoly markets.

Monopoly capitalism is the theory that increasing returns to scale causes competition within markets to become unstable. A process of concentration begins where firms expand in size internally through investment. Externally growth is achieved through the process of centralisation by mergers and acquisitions. The two processes together result in markets dominated by a few firms, where price competition is limited, accept to deter new entrants or to eliminate weaker rivals. It makes sense to expand market share through aggressive price tactics to strengthen market position until there are few firms left. Baran and Sweezy (1966) recognise the tendency for surpluses to rise as few firms remain and are unable to singlehandedly dominate the market, so instead implicitly collude prices to gain a rate of profits higher than in competitive markets. The theory has its critics as technical change can drive increased competition which is often neglected.

Conclusion

Competition may lead to market clearing and pareto efficiency when it is perfect, but to achieve anywhere close to perfect competition, state intervention is needed. Marxian analysis of monopoly capitalism seems more relevant than the neoclassical view of structure-conduct-performance paradigm as most markets are dominated by few firms. A critique to the Marxian view outlined by Sawyer (1989) is that managers in control of firms may have differing goals to the owners, this has led to claims of the “soulful corporation” where managers operate for the greater good rather than the benefit of the owners. Managers as “soulful” individuals may be excessive as they often have bonuses dependent on performance for the firms which largely discredits this critique. Clifton (1977) argues that larger firms can implement competitive strategies with greater intensities, this implies with fewer small firms, competition would be greater. Auberach and Skott (1988) reinforce this view by stating the lowering of the costs of communication and transport have meant in recent years international competition than ever. Competition is unlikely to lead to markets clearing and pareto optimality because firms attempt to maximise profits. This creates a reluctance to perfect competition from firms where profits are minimal, consequently for the majority competition does not lead to markets clearing and a pareto efficient outcome.

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