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Competition and the Economists

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To Adam Smith and to his successors, "competition" was not a term defined with mathematical precision; it meant, generally, "free competition," i.e., competition unhampered by governmental grants of exclusive privilege. And "monopoly" tended to mean such grants of governmental privilege.

To Adam Smith, for example, "competition" was used in the common-sense way that businessmen use it: to mean rivalry between two or more independent persons or firms. "Free competition" meant absence of grants of exclusive privilege, freedom of trade and freedom of entry into occupations; "monopo1ies" meant grants of exclusive privilege.

When Smith used the term "competition," for example, he used it to describe the competition among buyers, which bids prices up when demand exceeds supply, or the competition of sellers, which bids prices down when supply is greater than demand.[1]

This is an unpublished memorandum written in May 1961 to "Robbie," who is likely Claude E. Robinson (1900–1961). A version of this memorandum appeared in *Strictly Confidential: The Private Volker Fund Memos of Murray N. Rothbard*.

[1] Smith (1937 [1776]), pp. 56–57.

When Smith referred to the evils of restraining competition, he referred to "the exclusive privileges of corporations... [and] an incorporated trade." Smith was describing the guild and licensing regulations of European towns.[2] That by "monopoly" Smith meant governmental grants of exclusive privilege may be seen in the following passage:

> A monopoly granted either to an individual or to a trading company has the same effect as a secret.... The monopolists, by keeping the market constantly under-stocked... sell their commodities much above the natural price... the price of free competition....
>
> The exclusive privilege of corporations, statutes of and apprenticeship, and all those laws which restrain, in particular employments, the competition to a smaller number than might go into them, have the same tendency, though in a less degree. They are a sort of enlarged monopolies, and may frequently... in whole classes of employments keep up the market price of particular commodities above the natural price.... Such enhancements of the market price may last as long as the regulations of police which give occasion to them.[3]

Smith's one important—and unfortunate—deviation from this view is his tendency to view land as a "monopoly" because the total supply of land in the society is more or less fixed.

Ricardo had virtually nothing to add to Smith's treatment. He said nothing at all explicitly about competition; and his reference to monopoly was only in two or three places, and there closely followed the Smith position. There are several pages of attack on the British colonial monopolies—grants of exclusive privilege such as the British East India Company, which Smith had attacked vigorously;[4] he also continued, and unfortunately sharpened, the other tendency of Smith to dub as "monopoly" a fixed supply, also indicating land: "Commodities are only at a monopoly price when by no possible device their quantity can be augmented...."[5]

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[2] *Ibid.*, pp. 118*ff*.

[3] *Ibid.*, pp. 61–62.

[4] Ricardo (1911 [1817]), pp. 229*ff*.

[5] *Ibid.*, p. 165.

Of the role of free competition among the classical economists, Gide and Rist write,

> their program includes liberty to choose one's employment, free competition, free trade beyond as well as within the frontiers of a single country, free banks, and a competitive rate of interest; and on the negative side it implies resistance to all State intervention wherever the necessity for it cannot be clearly demonstrated.... In the opinion of Classical writers, free competition was the sovereign natural law.... It secured cheapness for the consumer, and stimulated progress generally because of the rivalry it aroused among producers. Justice was assured for all, and equality attained, for the constant pursuit of profits merely resulted in reducing them to the level of cost of production. *The Dictionnaire d'Economie Politique* of 1852, which may perhaps be considered the code of Classic political economy, expressed the opinion that competition is to the industrial world what the sun is to the physical.[6]

John Stuart Mill continued in the same tradition. To him, too, "monopoly"—the opposite of competition—was artificial grants of exclusive privilege:

> The usual instrument for producing artificial dearness [by government] is monopoly. To confer a monopoly upon a producer or dealer, or upon a set of producers or dealers not too numerous to combine, is to give them the power of levying any amount of taxation on the public, for their individual benefit, which will not make the public forgo the use of the commodity. When the sharers in the monopoly are so numerous and so widely scattered that they are prevented from combining, the evil is considerably less: but even then the competition is not so active among a limited as among an unlimited number.... The mere exclusion of foreigners, from a branch of industry open to the free competition of every native, has been known, even in England, to render that branch a conspicuous exception to the general industrial energy of the country.... In addition to the tax levied for the profit, real or imaginary, of the monopolists, the consumer thus pays an additional tax for their laziness and incapacity.[7]

Mill, however, extended the discussion of monopoly beyond such "artificial" monopoly, to what he called "natural monopoly," which consisted of two categories: the familiar "land monopoly"

[6] Gide and Rist, (1930), pp. 357–358.

[7] Mill (1901 [1848]), p. 547.

caused by the fixed supply of land; and the "natural monopoly" of especially unique ability or skill of a laborer. In both cases, the "monopoly" gave rise to a "rent" income.

Amidst this general posture of classical economics, two classical economists deviated—in unfortunate ways—from this tradition, broadening the view of the pervasiveness of monopoly in the economic system. One was Nassau W. Senior. Senior anticipated the much later "monopolistic competition" theorists by seeing monopoly and monopoly elements everywhere. To Senior, if a commodity was not produced under strictly "equal conditions," monopoly, or elements of monopoly, appeared. Senior recognized that such "equal conditions" appeared very rarely. Senior was particularly ardent in pressing for the idea of a "land monopoly"; not only was land a monopoly, but every product into which land entered as a factor of production partook of a "monopoly" element—and this, of course, meant virtually every product.

Nassau Senior divided his concepts of monopolies into four classes: where one product is more efficient than another, and can thus produce at lower costs and sell at lower prices; fixed natural products (rare wines); patents and copyrights; and the "great monopoly of land."

Haney comments on Senior's theory:

> The weakness of defining monopoly in negative terms, as being the absence of equal competition, is apparent. Perfectly equal competition is rare, and ele-ments of differential advantage abound on all hands, so that such a definition would make monopoly the rule. The essential error of Senior's position, however, lies in the confusion of differential advantage with control over supply. The one is price-determined; the other price-determining.[8]

The other classical economist who widened the definition of monopoly was the last of the classicists: John E. Cairnes. In the first place, while the other classicists tended to define free competition as the system that, in the long run, leads to prices being equal to the costs of production, Cairnes defined the *result*—prices equaling costs of production—as free competition. Hence, Cairnes began

[8] Haney (1949), pp. 347–348.

the fatal modern propensity for defining the ideal of competition, not as the *process* that, in the long run, tends toward a certain equilibrium position, but as the *equilibrium condition* itself. Since the equilibrium position is never really reached, then a position such as Cairnes's, regarding all deviations from that equilibrium position as having elements of "monopoly," tends to brand the whole market economy as having elements of monopoly, as falling short of the ideal, etc.

The other unfortunate widening by Cairnes of the monopoly concept, was to expand on Mill's hint about monopoly of ability; extra skill and extra training of laborers, according to Cairnes, gave them a "monopoly," and therefore gave to higher-wage laborers a "monopoly return." (Classical economists always grouped productive factors: such as "labor," "land," etc. together, and tried to arrive at theories of pricing and distribution on this aggregate basis. Therefore the classicists had no real means of handling the pricing of *individual* labor or land or capital services of specific goods, or the "distribution" of income accruing to them. Cairnes's theory was an attempt praiseworthy in this sense, to break down this lumped mass factor "labor" into more realistic components. But, unfortunately, he termed the differentials in skills "monopoly.") Cairnes also dubbed the different groups of skills among laborers, "non-competing groups," i.e., that laborers only competed among themselves within each group, and not between groups.

It is important to realize that the various wings of socialists, during the nineteenth century, never accused the free-market capitalist system of being "monopolist" or "monopolistic." Instead, they agreed with the classical economists that the market economy was competitive; their strictures and attacks were directed elsewhere. In fact, they often attacked competition itself, as being wicked: Sismondi, the utopians, the Fabians, etc. Karl Marx not only agreed that capitalism was competitive, but the Marxian iron laws of labor, of labor theory of value, of equalization of profit rates, etc. built upon classical foundations, all assumed the workings of competition. It was only much later, at the turn of the twentieth century, that Lenin and other later Marxists coined the doctrines of "monopoly capitalism," of monopoly capitalism leading to imperialism, etc.

Meanwhile, unheralded and unrecognized at the time, the French mathematician Augustin Cournot, founded not only mathematical economics but also modern monopoly and perfect-competition theories, in his *Principes* in 1838. To make things easy for using the calculus in dealing with profits, revenues, and costs of a business firm, Cournot defined competition as that situation where price does not vary with the quantity of the good produced: i.e., where the demand curve for the firm is horizontal, or "perfectly elastic." Not only did Cournot thus found the basic axiom of perfect competition theory, he also believed that such a condition only obtains where the number of firms is large, and that when firms are fewer, "oligopoly" ensues. Cournot worked out a theory of "duopoly."

Thus, with Cournot, the seeds of modern perfect-competition and monopolistic-competition theories were already set, as well as modern mathematical economics: "competition" only occurs when the demand curve for the firm is horizontal; this takes place only when the number of firms in the industry is very large; a smaller number leads to "monopolistic" situations of "oligopoly," etc. Of course, a single firm in an industry, where the demand curve is of course falling, Cournot defined as a "monopoly."

The year 1871 marked the publication of three independent works which were to overthrow the classical era and inaugurate the neoclassical. One, by the founder of modern mathematical economics, was the *Elements* of the Swiss economist, Léon Walras. While Walras brought back Cournot, and Cournot's definition of monopoly as a single seller of a good, with price higher than cost of production, the emphasis in Walras was completely different.

As Walras put it, "Cournot... makes the transition from the case of a single monopolist to that of two monopolists, and, finally, from monopoly to unlimited competition. I have preferred, for my part, to start with unlimited competition as the general case, and then to work towards monopoly as a special case."[9]

Walras, in short, saw "free competition" as the ruling case, and monopoly as isolated, special cases of single sellers. Furthermore, Walras, while politically something of a Henry Georgist in favor of land nationalization, in economic theory deplored the idea of the classicists that land is a "monopoly," simply because it had a fixed or limited quantity. As Walras noted, "all productive services are limited

[9] Walras (1954 [1874]), p. 440.

in quantity.... When the meaning of the term monopoly is broadened to this extent, so that it includes everything, it means nothing."[10]

Carl Menger, the second neoclassical pioneer, founder of the Austrian School, regarded competition and monopoly in much the same way. The economy in general was characterized by competition; "monopoly," in contrast, referred to cases of single sellers. Not being a believer in mathematical economies, Menger was even less tempted than Walras to succumb to the Cournot propositions. While Menger was imprecise in defining "single sellers," the examples he used were those of grants of exclusive privilege by government: the British East India Company, the medieval guilds. Menger's great disciple, Eugen von Böhm-Bawerk, didn't discuss problems of monopoly, and in so doing, implied that the economic system was generally competitive.

Of the neoclassicists, it was the Englishman, William Stanley Jevons, [in] *Theory of Political Economy*, who propelled economic thought in the direction of "perfect competition," as compared to the plain classical and neoclassical view of "competition" or "free competition." For Jevons, "perfectly free competition" implied not only absence of price discrimination (which Walras also discussed), but also a large number of buyers and sellers in each industry.

Approaching the view of perfect competition (Jevons was also a mathematical economist, by the way), Jevons defined such a case as "a single trader... must buy and sell at the current prices, which he cannot in an appreciable degree affect." To Jevons, also, a "perfect market" implied "perfect knowledge of the conditions of supply and demand, and the consequent ratio of exchange" on the part of "all traders."[11] However, Jevons, while carrying on this Cournot tradition and giving it the name of "perfect," did not carry it through consistently. For he realized, in the preface to his second edition, that since all goods are, in a sense, unique, that (in this sense) "[p]roperty is only another name for monopoly." Therefore, Jevons saw that in the overall market economy "*monopoly* [as he defined it] *is limited by competition*, and no owner, whether of labour, land, or capital, can, theoretically speaking, obtain a larger

[10] *Ibid*., p. 436.

[11] Jevons (1888 [1871]), p. 87.

share of produce for it than what other owners of exactly the same kind of property are willing to accept."[12]

Jevons, however, had been the first to give a rigorous definition of "perfect competition." Continuing in this path was the English mathematical economist, Francis Y. Edgeworth, [in] *Mathematical Psychics* (1881). Edgeworth pressed on to more rigorous definitions, anticipating the modern position: perfect competition involved, Edgeworth maintained, an indefinitely large number of firms and complete divisibility of the product. The enormous influence of mathematics on Edgeworth's definition can be indicated from this passage:

> A *perfect* field of competition professes in addition certain properties peculiarly favourable to mathematical calculation; namely, a certain indefinite *multiplicity* and *dividedness*, analogous to that *infinity* and *infinitesimality* which facilitate so large a portion of Mathematical Physics (consider the theory of Atoms, and all applications of the Differential Calculus).[13]

Alfred Marshall, on this as in on so many other issues, was an eclectic tangle of confusions and inconsistencies, varying in his editions of his *Principles* (1st ed., 1890). There were two basic and conflicting strains in Marshall here. On the one hand, he had a position close to the classicists: considering free competition as a broad relationship holding throughout the market, and not feeling the need to make the definition of competition narrow and rigorous. In fact, he expressly attacked the doctrine of "perfect competition" in his eighth edition, and said that a negatively sloping demand curve to a firm was compatible with competition. The term "monopoly" was used but not precisely defined, but presumably referred to a single seller of a commodity.

On the "perfect knowledge" assumption in perfect competition, Marshall was properly caustic:

> we do not assume that competition is perfect. Perfect competition requires a perfect knowledge of the state of the market.... [I]t would be an altogether unreasonable assumption to make.... The older economists,

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[12] *Ibid*., pp. xlv–xlvi.

[13] Edgeworth (1881), p. 18.

> in constant contact as they were with the actual facts of business life, must have known this well enough; but, partly because the term "free competition" had become almost a catchword... they often seemed to imply that they did assume this perfect knowledge.[14]

On the other hand, Marshall, too, was influenced by mathematical economists to some degree, and therefore by Cournot. In the third edition of his *Principles*, he introduced the Cournot idea that the horizontal demand curve for the firm was the *ruling* fact in the economy, and that the falling demand curve was the exception. Here was the disastrous concession that perfect competition, or pure competition (the horizontal demand curve), while perhaps not necessary to the whole economy or even ideal, *was* the ruling case in the economy. This position appeared particularly in Marshall's famous Mathematical Appendix, which was heavily influenced by Cournot.[15] Also, Marshall made other concessions about various alleged deviations from the optimum in the free market, due to such things as "external economies" and "external diseconomies."

In 1899, the preeminent American neoclassical economist, John Bates Clark, published his *Distribution of Wealth*. Clark added more restrictions and unrealities to the Edgeworth definition of perfect competition. To the other requirements he added that labor and capital must be *absolutely mobile*; "perfect mobility" of factors had now become another requisite of "perfect competition." The Jevons-Edgeworth tradition of "perfect competition" *as* competition was further developed by the mathematical economist (American) Henry Ludwell Moore, who in a journal article in 1905–1906,[16] asserted that the influence of any one producer on price must be negligible, and also declared that no competitor must have to take into account the actions of any other competitor—another condition of perfect competition.

While John Bates Clark added to the development of the model of "perfect competition," he was the reverse of an advocate of using perfect competition as a measure and yardstick for the real economy. For Clark postulated, in the tradition of the classical

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[14] Marshall (1938 [1890]), p. 540.

[15] *Ibid*., pp. 849–850.

[16] *Editor's Note*: Rothbard does not specify, but this likely refers to Moore (1906).

economists, perfect competition as the *final equilibrium* point of the "static state"; he did not make the mistake of believing that perfect competition is, or should be, ruling in the actual, "dynamic" economic world. In his view of the real world, in fact, Clark was squarely in the classical-neoclassical tradition: he saw monopoly as only a single seller, and therefore he saw "competition" as the predominant fact of our economic system. Clark worked out his position on these "dynamic" problems, in his *The Control of Trusts* (1901), and his *Essentials of Economic Theory* (1907). Professor Shorey Peterson notes that

> Clark wrote prior to that unfortunate usage by which all that is not pure competition is labeled monopoly. By monopoly he meant unified control of a market, and by competition, in this context, "healthful rivalry in serving the public.[17]

Clark saw the advantages that could come from mergers and large firms:

> A vast corporation that is not a true monopoly may be eminently progressive. If it still has to fear rivals, actual or potential, it is under the same kind of pressure that acts upon the independent producer—pressure to economize labor. It may be able to make even greater progress than a smaller corporation could make.... Consolidation without monopoly is favorable to progress.[18]

Even if an industry consists of a single company, Clark, while considering the situation dangerous, could also see definite advantages of rule by the market. For here Clark saw the enormous importance of *potential competition*:

> The price may conceivably be a normal one. It may stand not much above the cost of production to the monopoly itself. If it does so, it is because a higher price would invite competition. The great company prefers to sell all the goods that are required at a moderate price rather than to invite rivals into its territory. This is monopoly in form but not in fact, for it is shorn of its injurious power; and the thing that holds it firmly in check is *potential competition*.... Since the first trusts were formed the efficiency of

[17] Peterson (1958 [1957]), p. 323.

[18] Clark (1907), p. 534.

> potential competition has been so constantly displayed that there is no danger that this regulator of prices will ever be disregarded.[19]

We see that Clark, building on the classical-neoclassical traditions, can be considered a founder of the modern doctrine of "workable competition," brought forth by his son John Maurice Clark in 1940, and highly influential since World War II.

Neither did Clark worry about the so-called problem of "oligopoly." He believed that "competition usually would, in fact, survive and be extremely effective" among just a few competitors, until or unless they formed a union with each other.[20]

Alfred Marshall, in his almost totally neglected applied economics work, *Industry and Trade* (1919) virtually anticipated all the significant developments since, by (a) first agreeing with the perfect competition people that "competition" can be defined as perfect; but then (b) saying that the real economic world is shot through with "monopoly" elements—but that this is a good thing (thus anticipating the final position of E. H. Chamberlin over thirty years later). This imprecise form of competition Marshall saw as perfectly proper. As for monopolies:

> Absolute monopolies are of little importance in modern business as compared with those which are "conditional," or "provisional"... [and the latter keep their position only if] they do not put prices much above the levels necessary to cover their outlays with normal profits.

Marshall also stressed the importance of potential competition, as well as the interindustry competition of substitutes: "a man of sound judgment... will keep a watchful eye on sources of possible competition, direct and indirect."[21]

In the meanwhile, while Clark and Marshall were contributing to the classical-neoclassical "workable competition"/"free competition" tradition, as well as giving some concessions to the perfect competition group, the perfect competition doctrine was moving ahead. Alfred Marshall's most famous pupil, Arthur C. Pigou,

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[19] *Ibid*., pp. 380–381.

[20] *Ibid*., pp. 201–302.

[21] Marshall (1919), pp. 395–398, 405–409.

insisted on perfect mobility and divisibility as part of the "perfect competition" ideal, and attacked the real world for its immobility and indivisibility.[22] Pigou also elaborated greatly on a few hints of Marshall's to coin elaborate doctrines of the failures of the free market in meeting "marginal social costs"—but this is a different field of inquiry. However, even Pigou did not believe that perfect—or what he called "simple"—competition, was technically feasible and therefore really ideal.[23]

We come finally to the culprit who drew all the elements together of what had previously been described as "perfect competition" and welded these elements into a fully analyzed whole. He also extended many of the most important of these elements and set forth a full-fledged theory of competition solely as "perfect competition." This culprit was Frank H. Knight, in his famous first book, *Risk, Uncertainty, and Profit*.[24] The whole of *Risk, Uncertainty, and Profit* is analyzed in terms of perfect competition, and perfect competition most rigorously defined. And, particularly important, whereas J. B. Clark had believed the concept of "perfect competition" applicable only to the static world of equilibrium and did not therefore think it a gauge for the real world, Frank Knight believed that the model *was* applicable as a gauge for the real world—that this was the only sense in which economists could use, analyze, and justify the very concept of "competition." Knight's competition involved complete foresight, perfect mobility, costless change, all elements—products and factors—continuously variable, and infinitely divisible. Demand curves were given and known to all, and exchange instantaneous and costless. Numbers were large, with demand curves to each firm horizontal.

It was this Frank Knight–type of theory—this use of the perfect competition model to describe the real world of the American economy—that Chamberlin reacted against in 1933. Chamberlin said, in effect, Right, "competition" *means* perfect (or rather pure competition—all the above conditions without "perfect knowledge"). But, in that case, Chamberlin declared, it is absurd to

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[22] Pigou (1912).

[23] Also see Pigou (1950). Pigou was virtually the creator of "welfare economics."

[24] Knight (1921).

keep using this model—as Knight and the others were doing—to describe the real world of business, which emphatically does *not* operate in anything like this way. *Therefore*, we must realize that the economy is *not* competitive, that it is shot through with elements of monopoly. The left-wing Chamberlinians (which partially included Chamberlin himself) used this as a beautiful handle to combine with the Marxists and other critics of business to denounce the whole capitalist system as "monopolistic," and therefore no longer explainable by economic theory. Henry Simons and the other students of Frank Knight during the 1930s advocated breaking up big business *into* atomized units that would be more nearly "perfect."

Finally, as I have indicated, the forgotten tradition of the neoclassical, roughly workable, free-entry concept of "competition" was revived by J. M. Clark and others after World War II. The Chicago School, while considerably mellowed since the 1930s, still uses the "perfect competition" model as the ideal and as the explanatory theory, and therefore still hankers, in many of its members, for rigorous trust busting. Chamberlin himself, realizing that perfect or pure compe-tition is the ideal, is fighting his way toward a theory of "workable competition," but has to do so in the trap of his own terminology. As J. M. Clark once chided Chamberlin, Why *call* this good, workable market economy "monopolistic," when it should better—and more palatably—be called "competitive"?[25]

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[25] In addition to the references listed above, see Stigler (1957), pp. 1–17.

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