Received Doctrine of Economic Theory

I. Demand

A. Individual consumer is defined as the quantity of a given commodity which a consumer will buy at all possible prices at a given moment in time.

B. Market demand is defined as the quantities of a given commodity which all consumers will buy at all possible prices at a given moment.

C. Change in demand – refers to a shift of the entire curve.

D. Movement along D curve – curve does not move – price change leads to different quantity demanded

II. Arc. Price Elasticity - a measure of consumer responsiveness in terms of amount demanded with a change in price

A. Elasticity over a range of D curve

B. \[ \frac{\Delta Q}{Q} = \text{elasticity} \]

C. Perfectly elastic \hspace{1cm} Unitary \hspace{1cm} Perfectly inelastic
Demand curve \hspace{1cm} Price elasticity \hspace{1cm} Demand curve

\[ \text{Diagram:} \]
III. Perfect Competition

A. Conditions

1. Many buyers and sellers – none by individual action can affect market price.

2. Perfectly homogeneous products

3. All buyers and sellers have perfect knowledge of market situation and alternatives.

4. All buyers and sellers behave rationally to maximize self-interests.

5. Freedom of entry into the market and perfect mobility of resources.

B. Competition – a messy concept.

There is no clean distinction between “competition” and “competitive market.” Thus, we have the paradox that every competitive act on the part of the businessman is evidence in economic theory of some degree of monopoly power - however small. Also, note that both monopoly and perfect competition have one characteristic in common—both constitute situations in which the possibility of any competitive behavior is ruled out - by definition. Perfect competition is a state or condition quite incompatible with any competitive actions, hence competition! The state of perfect competition when it exists is one “without (i.e. there is a complete absence) of competition.” Although the result of free entry and an infinitely large number of competitors, one equilibrium is reached—that is perfect competition prevails - it is an equilibrium state where further competition becomes impossible. As Cournot noted: “The effects of competition have reached their limit,” and Knight adds, “Perfect competition allows no presumption of psychological competition, emulation or rivalry.” It’s a continuing existence of an indefinitely large number of non-competing firms.” If you don’t agree ask yourself, “How may a business firm be expected to compete without monopolizing.” Thus, we really have had two simultaneous views or concepts of competition: (1) classical - a process, (2) neo-classical - a structure. The first is considered as a “guiding force” and the second as a “state of affairs.” They are incompatible in the sense that one is a state of equilibrium, the other the behavioral pattern leading to it. Thus, under the concept of the equilibrium state, the act or the function best characterizing competition in classical economics – the cutting of price to get rid of excess supply on the part of the individual firm is impossible. The very perfection of competition thus drained the concept of all behavioral content! The perfectly competitive firm is nothing more than a monopolist in a very special environment!

C. The firm and industry under perfect competition equilibrium
Industry Supply = Industry demand at price where average total costs of production for each firm (including returns for labor and investment) = price hence no “unfair” profits. In arriving at equilibrium some firms may operate temporarily with monopoly profits but new firms quickly spring up to imitate because of perfect knowledge and perfect resource mobility. Eventually an equilibrium is reached where no further competition can exist.

(1) Thus, under perfect competition consumers would get products at prices equal to their average costs of production (i.e. Lowest possible price) and (2) business firms would employ resources optimally, i.e. Resources would be employed to point where marginal contribution to value of output were equal to marginal cost of that resource. But this utopia never exists! We are always faced with less than perfection so trade offs become necessary in terms of seeking competitive conditions consonant with achieving optimum welfare.

IV. Other Competitive Conditions

A. Perfect monopoly - a single seller enjoying absence of any kind of competition with complete control over supply and control over entry into the industry.
The monopoly firm expands output to the point where MR=MC just as the firm does in perfectly competitive market, but there are no competitors to force prices down so monopoly profits can persist resulting in higher prices to consumers and possible distortions in resource use.

**B. Oligopoly** - A case where the number of sellers is small enough for the activities of a single seller to affect other firms and for the activities of other firms to affect him. Products are typically not homogenous - i.e. Some product differentiation. Also entry into the industry is restricted. Most effective restriction on entry are (1) smallness of market in relation to optimum scale of plant, large capital requirements, patent restrictions, technological sophistication required. No typical demand curve can be delineated – entirely dependent on action and reaction of competitive firms and on nature of product differentiation. Two models that have received considerable attention are illustrated below. They are by no means the most important.
The Split Market, Price Discrimination Model

Where price discrimination is associated with product differentiation and where the marginal cost function is the same for both products, this model explains the price discrimination within the same market. Examples are private and national brands produced by the same company and sold in the same store. Thus, a milk company may produce its own brand, and a brand for the retail store, and the store sells both brands in the same refrigerator, but at different prices, etc.
C. Monopolistic competition - a case where there are many sellers of a product, but
the product of each seller is in some way differentiated in the minds of
consumers.

Since each seller has a slightly differentiated product, there is no general industry
demand curve - each firm has its own demand curve. If entry is not blocked
outsiders will observe the profits being made and new entrants will come into the
market and drive the demand curve downward for existing firms.

The result is to eliminate pure profits – arriving at an equilibrium where the ATC
curve is tangent to the demand curve and $P = ATC$.

If entry is blocked – pure profits may be sustained.
Summary: Monopolistic competition is characterized by the product differentiation of each firm; equilibrium exists when each firm’s ATC is tangent to its AR curve; Entry and exit of firms is means of equilibrium being achieved. Firms each adjust price in manner of monopolist, but entry and exit force price quantity readjustments. Advertising has similar effect, but shows up in cost curves if not successful. If successful, both cost and revenue curves shift. If ad expenditures are budgeted on an annual basis, for year’s time, expenditure shifts ATC but not MC as expenditure like a fixed cost, not related to numbers of product units sold. If advertising is based on a differing amount for different levels of sales, then since ad expenditure is linked directly to numbers of product units, both ATC and MC would shift. Both price and advertising expenditure types of competition would lead to an equilibrium solution over the long run.