

The Emphasis on Competitive Markets in Introductory Microeconomics Courses

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Abstract:

The microeconomics principles course focuses on competitive markets far more than any other market structure. This paper considers the possible reasons. We suggest that this focus might be because: (1) competition is descriptive of many important real world markets (2) competition is viewed as a useful approximation to a wide array of real world markets that are not strictly competitive; (3) competition is emphasized because it is a simple model; (4) competition is viewed as an "ideal" market structure in efficiency terms, creating a standard used to evaluate other market structures and the merits of government intervention. We find none of these reasons convincing. We are led to conclude that either the focus on competition is an historical curiosity, which we can now dispense with, or it is the result of an ideological bias.

1. Introduction

Textbooks on the principles of microeconomics share a remarkably similar structure, at the heart of which lies the supply-and-demand (S&D) framework. Since textbooks both reflect and determine the nature of the courses for which they are adopted, we can say that the S&D framework forms the core of the typical microeconomics principles course. This paper asks whether this focus is appropriate.

We suggest four possible justifications for the overwhelming emphasis on competition found in the textbooks. First, the competitive market structure may actually be descriptive of many important real world markets. Second, competition may be a useful approximation to a wide array of real world markets that are not competitive. In other words, the emphasis is justified by the power of the model to correctly predict the real world. Third, perfect competition is emphasized because it is a simple model. Therefore, it has both methodological and pedagogical advantages over the alternative, more difficult, non-competitive models. Fourth, competition may be emphasized because of its essential role as an “ideal” market structure – an ideal that is used as a standard to evaluate other market structures (in efficiency terms) and to evaluate the merits of government intervention.

We discuss each of these reasons in turn, but find none of them convincing. We are led to conclude that either the focus on competition is a historical curiosity that we can now dispense with, or it is the result of an ideological bias. We urge teachers of micro principles to break free of the typical textbook framework, and conclude with a few suggestions of our own as to how this might be done.

We begin by evaluating the extent to which the competitive framework dominates the typical micro principles text.

2. The prevalence of perfect competition in the introductory microeconomics texts

The core of the typical microeconomics principles course looks like this. The introductory section consists of two or three chapters, which include a definition of economics, a discussion of fundamental principles (increasingly called “Thinking Like An Economist”) and a discussion of methodology. The discussion of methodology explains what a model is, the necessity of having one, and emphasizes the importance of predictive power rather than realism

of assumptions. Then we move straight into the S&D framework which constitutes Part Two of the book.

Both Parkin/Bade and Mankiw et. al. call Part Two "How Markets Work". Most books devote three or four chapters in this Part to both developing the framework and applying it to the real world. The usual applications are the labour market (minimum wages), the housing market (rent controls), and the farm sector (price supports and quotas).

Part Three of the typical textbook deals with the micro-foundations of the S&D framework. The consumption side emphasizes utility theory, derives individual demand functions and aggregates into market demand functions. The production chapter emphasizes 'U-shaped' cost functions. Very few applications are possible in these chapters.

Part Four of the typical text discusses market structure more formally. Again, we begin with the S&D framework, though the chapter is now entitled either "Perfect Competition" or simply "Competitive Markets". At this point half the textbook has been completed. [The completion of the perfect competition chapter marks the half way point of nearly all texts, whether we count in chapters or in pages.]

If we viewed the relative emphasis on competitive versus non-competitive markets as if it were a football game, the halftime whistle would have blown. The score? Let's regard the three introductory chapters (in Part One) like introducing the teams or the singing of the anthems. That leaves (around) six chapters, all of which deal with competitive markets.¹ So at halftime the score is 6-0 to competition. [Actually, it is worse than that in so far as very few teachers of micro principles cover the entire textbook. So while the textbook is half over, the typical course is more nearly two thirds done.] During the intermission we can expect the coach of the non-competitive market team to be giving his players a rousing talk. Surely they will do better in the second half!

Indeed, the halftime talk does pay off. The next two chapters deal with monopoly and other forms of imperfect competition. Two quick goals, but the comeback is short lived. The rest of the typical book sees competitive markets completely in control of the game and scoring at will.

For example, Part Five of the Parkin/Bade and Lipsey/Ragan textbooks (the two market leaders in Canada) deals with factor markets. Both of these texts emphasize the competitive determination of rates of return. For example, Parkin's chapter, entitled "Demand and Supply in Factor Markets", is thirty-

two pages long, all but six of which assume a competitive market structure. [In the six pages dealing with non-competitive markets they say "The main source of market power in the labour market is the labour union" (Parkin and Bade, 2003, page 341), and the monopsony "market type is unusual, but it does exist" (Parkin and Bade, page 344).]

Similarly, the typical textbook chapter on externalities assumes that they occur in an otherwise efficient market – a perfectly competitive market. Likewise, chapters on trade and comparative advantage treat market power as an isolated and minor exception, and competition as the norm.

As the match winds down, the score is perhaps nine or ten goals to the competitive market team versus two (or perhaps three) to the non-competitive market team. No wonder S&D is seen by many students to be synonymous with economics.

3. Is the Emphasis on Competition Justified?

We suggest four possible justifications for the overwhelming emphasis on competition found in the textbooks. In the process of evaluating each argument we will ask what the textbook writers themselves say about why studying competitive markets is important and why perfect competition plays the role it does in their exposition.

1. Many important real world markets are perfectly competitive

Opinions vary as to whether perfect competition describes many real world markets. Lipsey and Ragan (2001, p.206f.) do not claim wide practical relevance for the perfectly competitive model. They say "perfect competition is a theoretical ideal that exists in a small number of industries, is at best only approximated in many others, and is not even closely resembled in most" (ibid, 287).

Others are more optimistic. Joseph Berliner (1999, p.223) writes: "Markets for the primary products of the earth, such as foods, raw materials, metals, and so forth, are generally perfectly competitive. Among the most prominent are those whose market prices are listed daily on the world's commodity exchanges: soybeans, pork bellies, crude oil, platinum. On the local level, when the lobsterman ties up at the Provincetown fish pier, he has to sell his catch at the going price or he can sell nothing at all."

Berliner continues: "In earlier and simpler times a large proportion of all output was produced under conditions of perfect competition. In the modern economy, however, the products of each enterprise are physically different from those of the others, in varying degrees... In such industries, enterprises do have the power to set the prices of their products; indeed, a central preoccupation of management is 'price policy' – that is, how much to charge for the product."

So even if perfect competition was a reasonable description of how the bulk of output was sold in pre-industrial times, it no longer describes the reality of the markets in which most goods and services are sold. Rather, according to Berliner, it is restricted to the markets for primary products – foods, raw materials, and metals. In this limited but important area of the economy, Berliner believes the competitive model is still literally descriptive of reality.

Certainly one could subject Berliner's claim to empirical scrutiny. Just how many markets for primary commodities are perfectly competitive? Obviously diamonds, gold and aluminum are counter examples. Similarly, most foodstuffs are not produced in perfectly competitive markets – at least in North America. Rather, as Table 1 makes clear, most farmers are stuck in the middle, squeezed between oligopolistic suppliers of inputs and oligopsonistic purchasers of their outputs.

Table 1: *The National Farmer's Union Submission to the Senate Standing Committee on Agriculture and Forestry, May 2000.*

Modern food production takes place in a chain that includes oil, fertilizer, seed, chemical, and machinery companies on the input side, and grain companies, railways, packers, processors, retailers, and restaurants on the "downstream" side. Almost every link in this chain, nearly every sector, is dominated by between 2 and 10 multi-billion-dollar multinational corporations:

- Three companies retail and distribute the bulk of Canadian gasoline and diesel fuel.
- Three produce most of the nitrogen fertilizer.
- Nine companies make our pesticides.
- Four companies are gaining control of our seed market.
- Three produce most of our major farm machinery.

The situation is the same on the "downstream" side of the food production chain:

- Nine grain companies collect Canadian grain.
- Two railways haul it.
- Two companies dominate the beef packing sector and a few others dominate pork.
- Three large firms manufacture 87% of the pasta in Canada.
- Four corporations mill 80% of Canadian flour.
- Three companies manufacture the bulk of the soft drinks sold.
- Four companies produce most of the [breakfast] cereal.
- Five companies control food retailing in Canada.
- A handful of restaurant chains control a large and increasing portion of the restaurant business.

The single significant exception to the pattern of extreme concentration is the farm link. In Canada, that link is made up of over 270,000 relatively small family farms.

Source: Paul Philips (2003), page 18.

But such an empirical examination would probably not be worth the trouble. The point is that we can all agree that perfect competition describes only a "small" (and perhaps decreasing) part of the modern economy. In contrast, textbooks put between 3 and 5 times as much emphasis on competitive markets as on non-competitive markets. Since the relative emphasis on perfect competition in textbooks is so much greater than the relative

incidence of perfect competition in the real world, the latter cannot be the explanation for the former.

2. *Competition is viewed as a useful approximation to a wide array of real world markets that are not strictly competitive.*

Despite the fact that it is generally recognised that very few markets are perfectly competitive, all mainstream textbooks make frequent use of the S&D framework. As outlined above (in section 1), the typical book uses S&D in the initial "markets in action" chapters where the word "markets" is meant in a generic sense – widely applicable everywhere.

Not only are the texts happy to apply the S&D framework to a wide array of markets where the assumptions are not *strictly true*, they are also happy to apply it to markets where the assumptions are categorically *untrue*. For example, Lipsey and Ragan use the S&D framework to describe the selling of gasoline (p.91), a market that the authors later acknowledge is not perfectly competitive (p.207). Furthermore, most textbooks use the S&D framework to analyse the incidence of sales taxes. Lipsey and Ragan are not alone in applying this analysis to the case of cigarette taxes (p.81), although the four-firm concentration ratio in tobacco products is later acknowledged to be close to 100% (p.254)!

This use of the S&D framework in clearly non-competitive markets finds justification in the standard methodological position that a model should be evaluated by the accuracy of its predictions and not by the realism of its assumptions. While we have not found this justification explicitly given, circumstantial evidence is provided by the placing of the "markets in action" chapters directly after the methodology chapter that emphasizes this proposition.

So the key questions are these: First, does the S&D framework provide accurate predictions even for markets where its strict requirements do not hold? Second, and equally important, are the predictions gleaned from applying the competitive model in fact tested? – or, indeed are they testable? And third, are the predictions of the competitive model any different from those a noncompetitive model would yield when applied to the same phenomena? We will discuss these issues in reference to the usual textbook applications of the S&D framework: the labour market (minimum wages), the housing market (rent controls), and the farm sector (price supports and quotas).

2.1 Predictions concerning minimum wages

As far as predictive power goes, modern research is undermining our confidence in the competitive model in two of its core applications – minimum wages and rent controls. The important references here are Card and Krueger (1995) for the minimum wage debate, and Arnott (1995) for the rent control debate.

Of the two debates, that on minimum wages has had more influence on textbooks. Around five years ago, all major textbooks would routinely apply the S&D framework to analyse the effect of minimum wages. It is startling how many of those texts would state, without citing the source, that “a 10 percent increase in the minimum wage would lead to a decrease in teenage employment of between 1 and 3 percent.”

Nowadays, there is no uniform treatment of minimum wages in the textbooks. Some textbooks (such as Frank et. al.) dropped the minimum wage application from the Markets in Action chapter. Others (such as Lipsey and Ragan) choose to have a “competitive application” early in the book, and a “non-competitive” application later on. Others retain the application and mention the work of Card and Krueger in passing. Parkin and Bade fall into this category, though they are a little extreme in simply dismissing Card and Krueger as being wrong (2003, page 130). Finally, there are still some textbooks that simply ignore the debate entirely. Mankiw et. al. (1999) is an extreme example in so far as it even continues to cite the same mythical empirical result. They say, without citing any source, that “the *typical* study finds that a 10 percent increase in the minimum wage depresses teenage employment between 1 and 3 percent” (page 130, emphasis added).

The treatment of this issue in the Parkin and Mankiw books is hard to understand given that, as Krueger (2001) explains, it is not just their work that casts doubt on the adverse employment effects of minimum wages. It is all work, including those who were the source of the mythical quote still used by Mankiw. Krueger tracks this quote down to an article published by Brown, Gilroy and Kohen (1982), and points out that the same authors revised their estimates from “between 1 and 3 percent” to “at most 1 percent” in an article published the following year. Moreover, a recent update by Wellington (1991), that used the same specification as Brown, Gilroy and Kohen, was unable to reject the null hypothesis of no employment effect at all.

Two explanations have been suggested for this result. Stiglitz (1997) favours the efficiency wage explanation, while Card and Krueger themselves favour the dynamic monopsony explanation. It seems that the efficiency wage

explanation is more interesting to macroeconomists searching to deepen their understanding of the “natural” unemployment rate (or the NAIRU, if you prefer). On the other hand, labour economists seem more interested in the dynamic monopsony argument. Manning (2003) focuses on ignorance, heterogeneous preferences, and mobility costs as the sources of frictions that make it costly and time consuming for workers to change jobs. This gives firms market power in the labour market, which they exercise through setting wages. Manning shows that this model can improve our understanding of many phenomena including the distribution of wages, unemployment, and human capital, as well as the effect of minimum wages.

In any event, both the efficiency wage and the dynamic monopsony explanations require that firms have wage setting ability in the labour market, and this rules out using the competitive model.

2.2 Predictions concerning rent controls

On the other hand, the rent control debate has had hardly any impact on the typical textbook treatment. Reading Arnott’s (1995) useful summary, it is astonishing how compartmentalised intellectual endeavour has become. Whereas most housing economists have abandoned the competitive model as being more or less misleading, this research has had no effect on mainstream textbooks. [Similarly, labour economics textbooks contain very few references to firms having market power, whereas industrial organisation textbooks assume that almost all firms have market power. To quote Manning (2003, page 10): “This...is odd given that one might think that frictions were more important in the labour market, as it is more costly to change one’s job than to change one’s supermarket.”]

All introductory textbooks assume that rent controls are rigid price ceilings of the sort introduced in many North American cities during World War II. Every city, apart from New York City, abandoned this “first generation” rent control by the early 1950s. Subsequently, “second generation” rent controls were re-imposed in the 1970s to combat the effects of inflation. No book (as far as we are aware) distinguishes between first and second generation controls, despite the fact that second-generation controls are relatively flexible. They commonly allow automatic rent increases geared to increasing costs, have exemptions for new buildings, exclude luxury high-rent buildings, and provide incentives for landlords to maintain or improve quality. Yet, as Arnott emphasizes, they are also a relatively diverse body of regulation, that therefore needs to be evaluated – both theoretically and empirically – on a case-by-case basis.

Considering the details of some particular examples of second-generation rent controls would lead us to ask: is it *theoretically possible* to design legislation that improves over the unrestricted free market solution? Whether it could or not depends in part on whether the rental housing market really is accurately characterized as a competitive market. How good is the approximation? Or, if you prefer, how important is the fact that each apartment is unique in location and character, and how much market power does this give landlords? And how important are moving costs that cause both tenant and landlord to desire long-term relations? And given these costs, how important is the lack of information about who is a good landlord and who is a good tenant?

But textbooks do not ask these questions. Indeed, they cannot as long as they *assume* that the rental housing market is perfectly competitive. In the process they mislead the student into thinking that all rent control must be bad. Yet, the work of housing economists suggests this conclusion is erroneous – moderate and well-designed rent control can be beneficial to both landlords and tenants.

Moreover, the empirical evidence does not support the view that actual second-generation controls have been harmful. In reviewing the empirical evidence, Richard Arnott suggests that with the exception of New York City (which stuck with its first-generation controls) and perhaps Toronto (that had poorly designed second-generation controls), the effects of rent control in North America have been almost imperceptible. He concludes that too much attention has been paid to rent controls² and suggests that the reason is partly ideological – the issue provides a battleground between those who believe in the free market and those who do not. We return to this theme in a later section.

2.3 Predictions concerning the farming sector

The “farm problem” looms large in Canadian textbooks. It is used as an example when showing the effects of price floors and quotas, and the predictions of the competitive model seem amply supported by the facts. We know that when the government becomes the buyer of last resort to maintain a price floor, the result is overproduction and surplus produce. We know that if the government limits production through tradable quotas, that the market value of the quota will reflect the present discounted value of the increased revenue to the farmer. These are important results. What is the problem?

The problem though is that a non-competitive model would have the same

predictions. Price floors would still lead to surpluses in a non-competitive market setting. The necessity to buy a quota would still eliminate the benefit of having quotas to all except those who received the initial endowment. These predictions are not unique to the competitive model. These results do not favour it.

Moreover, the apparent success of the competitive model to explain some aspects of the farm problem has the effect that we tend to accept all its predictions – even those that deal with the question “what accounts for the death of the family farm?” Textbook answers to this question focus exclusively on technological improvements on the supply-side coupled with an inelastic demand for food. No doubt this is part of the answer. But is it the whole story? As Table 1 suggests, once we break out of the mould of thinking in competitive market terms, alternative hypotheses present themselves. For example, could it be that the family farm has been squeezed out by a gradual concentration of industry on both sides – on the farm input side and on the buyer side? How important a part of the story is this? Textbooks do not ask such questions. And as far as we know, there are no empirical studies to provide answers. Despite the fact that the concentration of industry on the farm input side must certainly be closely related to the development of seeds and fertiliser and other technology that is pushing the supply of food to the right.

2.4 Summing Up

If the competitive model is not literally true, it becomes an empirical matter just how good an approximation it is. It is our contention in this paper that for many questions the competitive model is not a tolerable approximation. On many issues it contains the wrong predictions or a misleading message. On the issues where its predictions are supported by the facts, non-competitive models contain the same predictions. Moreover, these models have the advantage of suggesting more probing questions than does the competitive model.

It is far from clear that the perfectly competitive model really applies to a wide array of markets as a “useful approximation”. Textbook content on minimum wages, rent control, and the farm problem may be more misleading than enlightening.

3. *Perfect Competition is emphasized because it is a simple model*

How do we decide which model to use when two models contain the same predictions? Answer: we choose the simplest. This makes both methodological sense, and in the context of a principles textbook, pedagogical sense.

For example, we know when trying to explain labour market phenomena that frictions are tremendously important. Time, dynamics, mismatches and search are of the essence. We know that these phenomena can lead to important and interesting predictions, like the possibility of multiple equilibria. But in a first year principles text we need to abide by the KISS principle – we need to keep it simple. We need to teach simple, easily understood models so that students first understand what is meant by equilibrium – let alone disequilibrium. Isn't this a powerful argument in favour of the competitive model and staying with its simple totem – the cross of supply and demand? Doesn't this justify the current layout of the typical textbook?

In our view the answer is 'no'. There are two critical points to made here: first, a simple non-competitive treatment is possible; second, a better pedagogical structure would be to develop several market structures before moving on to a "markets in action" chapter. We will consider these points in turn.

Consider the question of how to portray the labour market. Is it a choice between the totemic cross of S&D versus impossibly complicated matching models? No. If what we are trying to convey is the idea that frictions give employers market power, and as a result small minimum wage increases may actually increase employment, why not use the textbook static model of monopsony, but motivate it in a modern way? As Manning (2003, page 16) says: "Although the underlying model of the labour market with frictions may be relatively complicated with lots of dynamics and value functions, one can often represent and understand the decision problem of the individual employer... in terms of the textbook static model of monopsony."

Moreover, using the monopsony model as our main tool to analyse the labour market has the advantage that the range of applications is suddenly expanded enormously. In contrast to the competitive model, this model explains many observed phenomena. For example:

- the observed phenomenon that increases in the minimum wage do not necessarily lead to decreases in employment.
- the observed phenomenon that equal pay legislation improves the pay of women without hurting their employment prospects.

- the existence of a wage dispersion for identical workers, without the need to resort to “unobservable ability” or to deny the phenomenon.
- the fact that higher wage workers are less likely to be looking for another job. In this context, higher wage workers need not have more human capital – rather they have simply been lucky and found a better job.

Certainly, it has been the case that the intermediate ground between competition and monopoly has been difficult – difficult to model, difficult to teach. But modern developments are changing that. [We will have more to say on this later when we consider what an alternative focus might look like.]

In any case, there is always the option to sketch out the three main market types – competition, monopoly/monopsony and oligopoly/oligopsony – before embarking on a “markets in action” chapter. The downside of such an approach is that more material needs to be covered before demonstrating the usefulness of our tools through applications. But the upside is that we no longer need to pretend that all markets (generically) can be treated as if they were approximately competitive. Moreover, it allows us to break out of an overly simplistic portrayal of our methodology that amounts to saying predictive power is the only guide to model selection and realism is irrelevant.

To get a better sense of methodology students need to be confronted with the difficulty of model selection. For example, that decisions are necessary with regard to the most important ‘facts’ that need explaining; that sometimes models with identical predictions contain different social implications (for example, as to whether the free market is ‘ideal’); that it is difficult to refute ‘core’ hypotheses in any operational model; that repeated testing of a model may sometimes refute it and sometimes support it; and that sometimes it is important to make realistic assumptions. Trying to explain real world phenomena with a range of models in one’s “tool kit” achieves these objectives, and simultaneously makes economics more interesting. But more on that later.

Finally, for the discussion in this section to have made any sense, one has to have agreed that the competitive model is simple. Yet, when one thinks of the difficulties students have with the perfectly competitive model, this proposition is not obvious. Rather, it is the S&D framework, with its totemic cross and the intuitive meaning of its lines, that is simple – not the perfectly competitive model in all its technical glory. It seems strange to make a distinction between the two. Yet, this is precisely what all the mainstream

textbooks do, and why we have assumed in this section that it might appear that competition has got simplicity on its side.

4. *Perfect Competition is an 'ideal' market structure that serves as an important benchmark*

Even if no markets were perfectly competitive, and even if the model had no predictive power, perfect competition would still be an important market structure. The point is that we need a standard with which to evaluate the relative goodness (or badness) of any actual market structure. We need such a standard to *guide* government policy intervention, and to *evaluate* actual policy intervention. Most texts recognise this when they state that the fundamental aim of Canadian competition policy is to promote competition – the reason being that competition is regarded as “a good thing” on efficiency grounds.

Thus, all mainstream principles texts take the trouble to show that under perfect competition the socially ‘right’ amount is produced at the lowest possible cost. Without missing markets and externalities, perfect competition guarantees a Pareto-optimal outcome. In terms of efficiency, the invisible hand would work better than the perfect social planner – better because it would need no resources to operate. Government intervention would only be necessary to redistribute income to attain some conception of social justice.

By setting out the unattainable perfectly competitive “ideal” that features perfect co-ordination, no market power, no strategic interaction, no informational problems, and no externalities, each of these issues can then be progressively introduced and we can have some way of trying (perhaps very crudely) to assess how an “actual market” performs by comparing it with the benchmark. Students should not come away from the exercise thinking that the ideal benchmark is roughly the way that economies actually perform.

Having established the ideal, we can now assess actual government policy interventions. If they bring the economy closer to the competitive ideal, they are ‘good’, at least in terms of the efficiency criterion. In this sense, perfect competition provides the partial framework for a normative analysis of government policy. (The rest of the normative framework would have to deal with the equity criterion.)

Unfortunately, there are serious pitfalls associated with this approach, which are well-known, even if they are normally hidden from the eyes of undergraduates. These pitfalls include the following.

4.1 The theory of second best

In the real world, distortions are everywhere and the theory of second best shows that removing any one distortion, in the presence of others, might worsen the situation rather than improve it (Lipsey and Lancaster, 1957). For example, breaking up a monopoly or a cartel would normally be regarded as desirable on efficiency grounds. But if the producers in this industry were polluting or if consumption of the product involved negative externalities, then this "competition policy" could worsen efficiency.

4.2 Partially endogenous tastes

In reality, consumers' tastes are partially endogenous – they are shaped by social interactions and influenced by advertising. How do we know? The market tells us so. To quote Colander (2003, page 6): "When I see firms spending billions of dollars on ads to change people's tastes, I have a clear indication that tastes are endogenous."

If individuals' marginal benefits from consumption are endogenous, then the social marginal value of a particular amount of a good or service is not fixed, and the efficiency story is undermined.

4.3 The Second Theorem of Welfare Economics

The Second Theorem of Welfare Economics states that an initial distribution of income exists that allows any Pareto-efficient equilibrium to be attained. Stated like that it seems harmless enough. The point is that if income elasticities of demand differ across individuals, changes in the distribution of income will induce price changes. So, if the distribution of income is socially undesirable, then so must the relative prices derived from that income distribution. In other words, if there were an undesirable income distribution, perfectly competitive market prices would not reflect marginal social valuations, even without externalities. [The one exception being if everyone had the same homothetic tastes – then could we isolate income distribution from the efficient set of relative prices.]

4.4 The relation between costs and industry structure

The typical 'proof' that monopoly involves a deadweight loss assumes that

the monopolist's total costs would be identical to the sum of the costs of the perfectly competitive firms it replaces. But there is absolutely nothing axiomatic about this. It amounts to an assumption, upon which rests the entire presumption in favour of competitive markets.

We need to consider what we do not know – about minimum efficient scales of operation, the lumpiness of factors of production, methods of management, how size affects financing costs, the introduction of new products and technologies – to get the enormity of this assumption into perspective. Was Schumpeter wrong about monopolies having cost advantages when it came to innovation? None of these problems are discussed in mainstream textbooks. Instead, they simply assert that the structure of the industry has no effect on the costs of production. Therefore, the idea that competition is more efficient than monopoly is no more than an assertion.

When we move on to other market structures, we have even less to say. What efficiency story do we really have to tell about monopolistic competition? And oligopoly? We know that product differentiation has the offsetting benefit of more choice; and we know that most of the new products and new technologies are developed in those sectors.

The main benefit of the textbook emphasis on allocative efficiency is that it provides a way of organising our thoughts – though one we should apply with extreme caution. The cost, of course, is the opportunity cost – what we have to give up to do it. It is our position that the cost is too high. It takes the whole term to teach this apparatus. It takes an intermediate course to understand it. And then it takes an advanced course to learn that it is not rigorously true anyway. Ironically, one of the most commonly stated reasons for keeping the structure of micro principles unchanged, is to prepare students for upper level theory courses.

Moreover, there are precious few direct applications flowing from it. Certainly, all textbooks attempt to link the theory with policy. But textbook treatment of monopoly regulation is geared to explaining why regulation is difficult if not impossible; and the treatment of anti-combines policy (or competition policy) is not really informed by the theory covered.

4. Causes and consequences?

How did we get to where we are now? It would be interesting to analyse the

evolution of the micro principles text from a historical perspective to find out when the emphasis on competitive markets began, and to speculate on why. While a thorough analysis along these lines is outside the scope of the present paper, we offer the following remarks.

It is commonly stated that it takes a good deal of time for new ideas to filter down to the textbook level. A cursory examination of principles textbooks refutes that. Competition amongst textbook writers at the principles level is quite intense, and perhaps for this reason they respond quite quickly to new trends in the subject. For example, all texts now contain treatments of endogenous growth theory, game theory, hysteresis, principal agent theory, rational expectations, and tradeable emissions permits.

So, the ability of texts to incorporate new ideas is not particularly problematic. Rather, it is the fundamental structure of the texts that seems to be quite static. This is certainly related to the way textbooks are developed. Publishers want to capture as big a market share as possible, and therefore – like ice-cream sellers – aim for the middle ground. They want their texts to reflect the perceived pre-existing consensus. But what are the forces shaping this consensus?

Colander (2003) suggests that the current emphasis is the result of three forces. First, the historical effort of welfare theorists to rid the subject of normative elements led them to focus on allocation theory – and ironically, on the normative analysis of government policy. Second, the pressure of teaching technical issues (to prepare students for intermediate theory?) constrains what teachers feel can be done. Third, the pressure for policy applications forced textbook writers to fit policy into too narrow a market framework.

Colander feels that the current textbook structure misleads average students into thinking that economic policy is easier than it is; and fails brighter students who suspect that many important issues are being ignored. Moreover, it opens the profession up to the charge that we are unfairly advocating market solutions.

While Colander's concerns are slightly different to ours, we agree with him that the current structure of textbooks appears to create a bias in favour of the market. Whereas he is concerned that textbooks do not adequately address moral objections to market solutions, our main concern is that textbooks over-emphasize competitive markets – the one market structure where no-one has any market power over anyone else. Firms don't advertise and consumers' tastes are not manipulated. Workers can't be

threatened with firing by their employer because another job paying exactly the same wage is always instantly available. And unions have no role as a 'countervailing power' to the power of employers, but are only monopolists in another guise.

It is true that towards the end of the typical micro principles textbook issues of market power and market failure are considered. But in analysing bias – particularly ideological bias – issues of placement, emphasis and repetition are crucial. The fact that competition wins our imaginary football match 9 or 10 goals to 2 or 3 is telling.

Moreover, it is possible that ideology has an important role to play in explaining how we got to where we are now. In particular, our hunch is that the cold war played a key role in shaping micro principles texts. After all, for nearly 40 years this dominated the political and intellectual landscape. Students would wonder "whose system is better?" or "why do we have markets and they have central planning?". Nor was there a shortage of western intellectuals advocating the virtues of central planning. These debates continued to rage throughout the 1960s, 1970s, and even into the 1980s.

So it is instructive to go back to the 1940s – back before McCarthy and the rise of Cold War paranoia – and see whether micro principles books had the same emphasis on competitive markets and allocative efficiency. This led us to open up a copy of Samuelson's first edition (1948). And what a refreshing experience it was! Part One contains eleven chapters dealing with "basic economic concepts" which outlines the functioning of a "mixed capitalistic enterprise system." This part contains two chapters on the distribution of income, poverty, and wage differentials; two chapters on the role of the government; a chapter on the history of the American labour movement and its problems. Part Two goes on to macroeconomics. Part Three returns to microeconomics and opens with the determination of price by supply and demand, followed by the theory of consumption and demand. Next comes a single chapter dealing (in one stroke) with cost and the equilibrium of the firm under perfect and imperfect competition. In short, a match between competitive versus non-competitive markets fought on this terrain would have been a very even affair, with much more concern with fairness and a much greater role for the referee.

Perhaps, now that the conflict between capitalist and communist systems is a thing of the past, the time is ripe for change.

5. Conclusion

Our call in this paper is for less emphasis on competition, abandoning the S&D framework as a generic tool for all markets, and less emphasis on allocative efficiency. This leaves more room for what?

Once we break out of the mold, there are all sorts of possibilities. In suggesting any one of them, however, we are aware that we risk being hung by our own petard! Nevertheless, we do feel that modern developments in game theory and in public choice theory leave ample room to develop the micro principles course more purely around “positive” economics in a setting where the typical firm has some market power. Moreover, once the treatment of competitive and non-competitive models is more even, the emphasis can be shifted onto the process of model selection – which we feel is really the key issue in economics.

What about the objection that we cannot abandon the allocative efficiency story, because otherwise students would not be adequately prepared for the next level of theory? (This is the point raised by Colander to explain the inertia in the current textbook structure.) Our recommendation to any teacher of intermediate theory is to assume your incoming students know nothing – you will rarely be disappointed. The main job of the principles course is to get your students into the next level of theory – to keep them interested and engaged – not to tell teach them a complicated framework that is not rigorously true nor easily applicable.

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ENDNOTES:

1. Why do we view the chapter dealing with utility theory as “perfectly competitive” in orientation? Because we do not particularly need microeconomic underpinnings for market demand curves. As Joan Robinson (1970) pointed out eons ago, one can simply begin with the reasonable assumption that market demand will be downward sloping for most commodities. Moreover, downward sloping individual demand curves do not necessarily imply downward sloping market demand curves (since price changes affect income distribution). They would only do so if everyone had the same homothetic tastes.

The only reason mainstream texts cannot abandon individual choice theory completely is because they wish to relate demand to marginal benefit. The point of this is to show (several chapters later) that competitive markets produce where marginal cost equals marginal benefit; they produce the ideal amount at the lowest possible cost.

2. Arnott points out that an important question is “what is the cause of homelessness?” Rent control is relatively unimportant in this context. The more important reasons for the increase in homelessness include: the increase in poverty rates; decrease in the real wage and an increase in the unemployment of the unskilled; deinstitutionalisation of the mentally ill; a rise in substance abuse; the disintegration of the family; wider holes in the social safety net; a reduction in the stock of low-quality housing due to “gentrification” and closure of single room occupancy hotels because of failure to meet building code standards.