If the neoclassical model of perfect competition were an accurate portrayal of reality, or even nearly so, there would be no need for advertising, marketing, brokering, or, indeed, any other institution which addresses itself to the lack of knowledge about goods or services on the part of producers or consumers. But these professions patently do exist. They are alive, healthy,

1With regard to the condition of “complete knowledge,” Stigler (1965, pp. 258–59) maintains that brokers can exist in perfect competition: “Or let there be indefinitely many brokers in any market, and let each broker know many buyers and sellers, and also let each buyer or seller know many brokers—again we have perfect competition.” This follows immediately upon his statement that:

If each seller in a market knows any n buyers, and each seller knows a different (but overlapping) set of buyers, then there will be perfect competition if the set of n buyers is large enough to exclude joint action . . . [hence] knowledge possessed by any one trader need not be complete; it is sufficient if the knowledge possessed by the ensemble of individuals in the market is in a sense comprehensive.

However, “the” price would have to be higher if brokers are involved in order to cover the expenses thereof. Thus, it would seem that in a “perfectly competitive” market, the services of brokers would be competed out of existence, as would the services of any other middleman. This is not to deny his point that no single individual need have complete knowledge directly, provided that he does so indirectly, through appropriate overlapping sets of incomplete knowledge.

2Stigler (1965, p. 259) also maintains, contrary to the standard version of neoclassical theory, that there is a role for entrepreneurs in perfect competition:
and productive. We must conclude from this that perfect competition is a highly unrealistic model\(^3\) that can play little or no role in an understanding or explication of economic reality.\(^4\) The neoclassicals, including Stigler, take the benefits of the perfect competition model to be “predictions that will have wide empirical validity” and the provision of “normative properties that will allow us to judge the efficiency of [governmental] policies” (Stigler 1965, pp. 261–62). The only “cost” of the perfect competition model they recognize is that it is unrealistic. To them, the benefits obviously outweigh the costs, and therefore the perfect competition model is and should be the dominant one in economic theory. While not denying that some of the work by economists working in the neoclassical tradition has been useful, even seminal, in adding to our understanding of the real world in some cases,\(^5\) we maintain that the perfect competition model is unnecessary to these developments\(^6\); moreover, it has wrought far more harm than good. In what follows, first we identify both the positive and normative essences of this model. We then critique them, pointing out the real costs thereof.

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Since entrepreneurs in a stationary economy are essentially brokers between resource owners and consumers, it is sufficient for [perfect] competition if they meet this condition. That is, resource owners and consumers could dwell in ignorance of all save the bids of many entrepreneurs.

We repeat the problem pointed out in note 1 above: “the” price would have to be higher if entrepreneurs/brokers were involved in order to cover the expenses. Therefore, it would seem that in a “perfectly competitive” market, the services of entrepreneurs/brokers would be competed out of existence, as would the services of any other middleman.

\(^3\)As Stigler (1965, pp. 261–62) states:

We wish the definition [of perfect competition] to specify with tolerable clarity—with such clarity as the state of the science affords—a model which can be used by practitioners in a great variety of theoretical researches, so that the foundations of the science need not be debated in every extension or application of theory. We wish the definition to capture the essential general content of important markets, so the predictions drawn from the theory will have wide empirical reliability. And we wish a concept with normative properties that will allow us to judge the efficiency of policies. That the concept of perfect competition has served these varied needs as well as it has is providential.


\(^5\)See, for example, the work by Coase (1937) on the theory of the firm and by Williamson (2000) on transactions costs. See also, Cheung (1983) and Dauterive and Sibley (1990); for an Austrian perspective on the firm which does not rely upon perfect competition, see Machlup (1967); Lewin and Phelan (1999); Foss (1994); Klein (1999).

\(^6\)The unrealistic assumptions of perfect competition are unnecessary for supply and demand analysis.
Perfect Competition

What is perfect competition, and how does this doctrine create the difficulties outlined above? Machovec (1995), locating the origin of perfect competition, states that:

it sprang to life to satisfy Cournot’s pursuit of definitional rigour, and eventually became the principal instrument of the Elements (Walras). The perfectly competitive model did not make its real debut as an analytical tool until the 1920s—after the profession had digested Frank Knight and after the influence of Alfred Marshall had waned. Until that time, the way economists reasoned about the market was “structurally different.” (p. 12)

and:

the seeds of the perfect competitor were being sown by the upcoming, mathematically-oriented members of the profession, and this is the conception which, during the 1920s, came to dominate the new cerebrum of economics. The development of the perfectly competitive model can be said to have emanated from a unique seed planted in 1838 by Cournot—an atypical seed which did not even germinate until 1874 (in Walras) and finally reached maturity nearly a half century later in Knight. (p. 241)

In subsequent years it became ubiquitous within micro and managerial economics, spreading out to a whole raft of other subdisciplines of economics such as labor, international, public policy, public finance, industrial organization, etc. It has also taken the textbook world by storm,7 making it impossible for any student to be untouched by this simplistic and misleading model.

As a positive model, the core of perfect competition is a market in which the goods and services are homogeneous8; each firm is so tiny that it produces so insignificantly small a proportion of the total output that any increases in its offerings cannot effect price even by a minuscule iota9; and full information is available to all market participants about all goods and services.10

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7We defy the reader to unearth even one textbook that does not accord the perfectly competitive model a central position in economics, apart from Gordon (2000).

8Ultimately, this implies that there can be only one good in the economy; if there are any more than one, the cloven hoof of heterogeneity seeps in.

9This, too, is highly problematic as it would be true only in the case where a firm produced, literally, a zero amount, and continued to do so. Consider the opposite case. Assume there is a small automobile manufacturing concern that increases its annual output from two to three units. As long as there were a negatively sloped demand curve, it is not possible for there to be a zero reduction in price.

10It is important to stress that the assumption of full, complete, and accurate—indeed, perfect—information in a single, perfectly competitive market would mean that no firm in that market, qua its role in that market, could in any way benefit in the slightest from the
As a normative standard, the essence of the perfectly competitive model is that in equilibrium, a quantity $Q$ is produced and sold at which $Q$ the price, $P$, equals the marginal revenue, $MR$, which equals the marginal cost, $MC$, which equals the average total cost, $ATC$; that is, $P = MR = MC = ATC$. This is held to be the normative standard because of the following. First, as $P$ measures the marginal “social benefit” and $MC$ the marginal “social cost,” $P = MC$ insures that $Q$ is the socially optimum quantity; additional units of output will be produced and sold so long as the additional benefits thereof exceed the additional costs, and no unit will be produced if the cost exceeds its benefits. Second, as $MR$ measures the benefits to the producer (that is, the private benefits), $MR = MC$ ensures that $Q$ is the privately optimum (a.k.a. the profit maximizing) quantity. Third, $MC = ATC$ ensures $Q$ is the optimum quantity in the sense that no other level of output could be produced at a lower per-unit cost. Fourth, $P = ATC$ ensures that normal profits are earned. There are no above-normal (“economic”) profits to induce existing producers to increase the level of production or induce others to enter the market, nor are there below-normal profits (that is, “economic” losses) to induce existing producers to decrease the level of production or to exit the market; therefore the market is in (short- and long-run) equilibrium when operating at this optimal level of output, $Q$. Fifth, $P = MR$ ensures that the marginal social benefit ($P$) and the marginal private benefit ($MR$) are the same, and therefore there is no divergence between the condition for social optimality ($P = MC$) and that for private optimality ($MR = MC$).

It is not hard to understand how economists enamored of mathematical formalism and model building could be seduced by a model with such properties. What a standard—virtual perfection!

**Perfect Competition as a Positive Model**

The primary critique of perfect competition as a positive model is that it is so unrealistic as to be misleading.

Its main drawback as a normative standard is that no real-world firm, industry, or market can satisfy it and therefore governmental intervention to regulate the behavior of every firm, industry, and market is warranted, subject only to an analysis of each proposed intervention to ensure that the benefits exceed the costs.\(^{12}\)

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\(^{11}\)This ignores divergences that might arise on the supply side; that is, so-called market failures as a result of negative externalities. In contrast, negative externalities are a property rights problem; that is, they arise because the legal system either does not acknowledge or does not enforce property rights. See Cowen (1988).

\(^{12}\)This determination necessarily admits of at least some level of arbitrariness, given the essentially subjective nature of much in economics, particularly including so-called cost benefit analysis. On this, see Barnett (1989, pp. 137-38); Buchanan and Thirlby
Neoclassicals use an instrumentalist defense of perfect competition as a positive model, maintaining that it is but a mere endpoint of the analysis, the analogue of an ideal gas in chemistry or a frictionless system in physics. No one expects to actually encounter the situation depicted in this model; it serves only as a useful simplification of the real world in order to facilitate analysis. One reaches a “first-cut” analysis of economic activity using the perfect competition model; then, with that understanding, more accurate progress can be made by removing the attendant less-realistic, simplifying assumptions. Just as the assumptions of the ideal gas must be dropped by the physicist near the condensation point in order to understand the observed phenomena involving intermolecular attractions and condensation, so also must the simplifying assumptions of perfect competition be dropped in order to understand the observed marketing behavior. States Stigler (1965):

Finally, we should notice the most common and the most important criticism of the concept of perfect competition—that it is unrealistic. This criticism has been widespread since the concept was completely formulated and underlies the warm reception which the profession gave to the doctrines of imperfect and monopolistic competition in the 1930’s. One could reply to this criticism that all concepts sufficiently general and sufficiently precise to be useful in scientific analysis must be abstract: that, if a science is to deal with a large class of phenomena, clearly it cannot work with concepts that are faithfully descriptive of even one phenomenon, for then they will be grotesquely undescriptive of others. This conventional line of defense for all abstract concepts is completely valid, but there is another defense, or rather another form of this defense, that may be more persuasive.

This second defense is that the concept of perfect competition has defeated its newer rivals in the decisive area: the day-to-day work of the economic theorist. Since the 1930’s, when the rival doctrines of imperfect and monopolistic competition were in their heyday, economists have increasingly reverted to the use of the concept of perfect competition as their standard model for analysis. Today the concept of perfect competition is being used more widely by the profession in its theoretical work than at any time in the past. The vitality of the concept is strongly spoken for by this triumph.

Of course, this is not counsel of complacency. I have cited areas in which much work must be done before important aspects of the definition of competition can be clarified. My fundamental thesis, in fact, is that hardly any important improvement in general economic theory can fail to affect the concept of competition. But it has proved to be a tough and resilient concept, and it will stay with us in recognizable form for a long time to come. (pp. 266–67)
In reality, the expectation is for some sort of imperfect competition, such as monopoly, duopoly, or oligopoly. In these cases, there is no need to assume full information and thus to assume away the possibility of marketing. States Kirzner in this regard: “It follows that, since perfect competition precludes selling effort, where advertising or other selling effort is in fact engaged in, this must be attributed to the monopolistic elements in the market structure” (1973, p. 164).

However, while imperfect competition is far more realistic than its “perfect” counterpart regarding such things as size of firm, homogeneity of goods, entry costs, etc., it is not—or, rather, need not be—as far as information is concerned. That is, it is still possible to combine the assumption of complete information with imperfect competition. Say what you will about monopolistic competition, it remains an equilibrium model for the neoclassicals. The imperfectly competitive model is an end-state theory, not one of process, and disequilibriums. As such, it continues to be compatible with the assumption of full information. Thus, while advertising may be compatible with imperfect competition, this is not necessarily the case. It is still possible for advertising to be ruled out of court by the assumptions, not only of perfect competition, but of imperfect competition as well, in any of its varieties.

A better tack may be the one taken by Stigler (1961). This economist posits not full knowledge of everything under the sun, as with perfect competition, but, rather, of entire probability distributions. In this more sophisticated vein, however, there is no information available concerning individual events, except for the fact that they belong to a given probability distribution.

Under these assumptions, there is now room for advertising in the neoclassical world, but only of the informational variety. Suppose you move to a new city and want to purchase a home. You will be very interested in ascertaining prices, quantities available, location, etc., of specific houses. Each day of search is expected to bring you lower prices, ceteris paribus, for a dwelling of a given quality, but, to put this in Stiglerian terminology, at a decreasing rate (for example, the marginal benefit curve declines with time). On the other hand, the money costs of staying, temporarily, in a motel are constant, while the inconvenience of living out of suitcases increases as time goes on (the marginal cost curve is an increasing function of time). Eventually, the rising marginal costs meet the falling marginal gains, and you end your search and finally make a purchase. You are willing to buy information through advertising, or from brokers, since in this case you save search time (by shifting the marginal benefit curve to the left). You gain less new information every day, which results in lower marginal savings, since, with the aid of your informational mentor, you

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14That is, nothing whatsoever is known about any given observation or occurrence, but everything is known about the universe of which it is only one small sample.
start out with more knowledge. If you had full information, and in perfect
competition, the marginal benefit curve would be coincident with the $Y$
axis, and your search time would be zero.

This is indeed an improvement on perfect competition, but the Stigler
search model has drawbacks of its own. The weakness is that it covers only
“name, rank, and serial number” kinds of information. Advertising of this sort
would impart knowledge about when the house was last roofed, the capacity
of the air conditioner, or the warranty on the boiler. But this does not even
begin to scratch the surface of the full-bodied, robust advertising we see all
around us every day, replete with Michael Jordan and Bugs Bunny, and super-
models hawking everything from tractors to underwear to diamonds.

Ludwig von Mises had this to say about that type of marketing:

The consumer is not omniscient. He does not know where he can obtain
at the cheapest price what he is looking for. Very often he does not even
know what kind of commodity or service is suitable to remove most effi-
caciously the particular uneasiness he wants to remove. At best he is famil-
iar with the market conditions of the immediate past and arranges his
plans on the basis of this information. To convey to him information about
the actual state of the market is the task of business propaganda.

Business propaganda must be obtrusive and blatant. It is its aim to attract
the attention of slow people, to rouse latent wishes, to entice men to sub-
stitute innovation for inert clinging to traditional routine. In order to suc-
ceed, advertising must be adjusted to the mentality of the people courted.
It must suit their tastes and speak their idiom. Advertising is shrill, noisy,
coarse, puffing, because the public does not react to dignified allusions. It
is the bad taste of the public that forces the advertisers to display bad taste
in their publicity campaigns. The art of advertising has evolved into a
branch of applied psychology, a sister discipline of pedagogy.

Like all things designed to suit the taste of the masses, advertising is repel-
ment to people of delicate feeling. This abhorrence influences the appraisal
of business propaganda. Advertising and all other methods of business
propaganda are condemned as one of the most outrageous outgrowths of
unlimited competition. It should be forbidden. The consumers should be
instructed by impartial experts; the public schools, the “nonpartisan”
press, and cooperatives should perform this task. (1966, p. 320; emphasis
added)

The point is, Stigler cannot account for anything “shrill, noisy, or coarse.”
Yet, this describes most real-world advertising. Therefore, the search model
cannot explain this aspect of economic reality. Moreover, while Stigler’s con-
tribution is at least relevant for those goods and services which the consumer
is already aware of, it does not at all apply to those commodities about which
“often he does not even know.” Yet, before the advent of Mozart, or rap music,
or the hula hoop, or the horseless carriage, or the personal computer, or
email, which of us was walking about the shopping mall of the day, searching
for these items? No one, of course. But this only indicates the paucity of the neoclassical explanation of this phenomenon, as compared to the Austrian explanation.

Let us put this in other words. The weakness of the Stiglerian–University of Chicago perspective on this matter is that it applies only to goods and services for which the consumer already has a demand; namely, it is limited to that which the buyer already knows about prior to being subjected to a marketing campaign. This search model can function reasonably well with regard to items such as houses, cars, and TV sets, which are already fully well known to the potential buyer. But unless the customer is in the act of shopping, already intending to purchase, holding off only until he determines the best deal, the Stigler model is helpless to account for his behavior. As such, it cannot take into account advertising, the purpose of which is not merely to inform, but to motivate.

Kirzner (1973) explains:

What I wish to point out is simply that to treat all informational aspects of advertising exclusively as providing a separate distinct service (“information”) fails utterly to perceive the crucially important role of the entrepreneur as one who brings available opportunities to the awareness of the consumer. (p. 155)

But consider now the case of the man who has no inkling that a certain commodity exists. We may, of course, imagine his demand curve for this commodity once its existence has become known to him. But if we wish to discuss the commodity in its unknown state we are simply unable to talk of the consumer’s demand for it. It is not that his demand curve coincides with the price axis; that he would buy none of it at any given price. It is rather that the very notion of demand has no place under these circumstances. It is nonsense to discuss the upper limit of the price this consumer is willing to pay for this unknown commodity; it is nonsense to discuss the quantity he would be prepared to purchase at a given price. These discussions refer to the eagerness with which a consumer wished to pursue perceived opportunities. With no opportunities perceived the notion of consumer demand has no meaning. (p. 158)

**PERFECT COMPETITION AS A NORMATIVE STANDARD**

Perfect competition is defended as a normative standard on the grounds of the model’s optimality conditions. That is, the optimality conditions provide standards by which to gauge the performance of real-world firms and markets, and thereby to assist in the development and enforcement of governmental economic policies; for example, antitrust.

The vitality of the competitive concept in its normative role has been remarkable. One might have expected that, as economic analysis became more precise and as the range of problems to which it was applied widened, a growing list of disparities between the competitive allocation
of resources and the maximum-output allocation would develop. Yet to date there have been only two major criticisms of the norm. . . . The first is that the competitive individual ignores external economies and diseconomies, which—rightly or wrongly—most economists are still content to treat as an exception to be dealt with in individual cases. The second, and more recent, criticism is that the competitive system will not provide the right amount (and possibly not the right types) of economic progress, and this is still an undocumented charge. The time may well come when the competitive concept suitable to positive analysis is not suitable to normative analysis, but it is still in the future. (Stigler 1965, p. 266)

Because perfect competition is a normative standard, as well as a positive one, neoclassicals’ defenses of perfect competition as a positive model and as a normative standard become conflated. Real-world behavior is compared to perfectly competitive “behavior” with reality found wanting, thereby justifying the potential desirability of ubiquitous governmental intervention in the real world, subject only to the outcome of a cost-benefit study in each particular proposed intervention. Therefore, the comparison of perfect competition to the ideal-gas and frictionless-system models is a disanalogy. Unlike an ideal gas or a frictionless system, which are strictly positive models, perfect competition is a normative standard as well; for example, it serves as the linchpin of antitrust legislation. To the extent that a firm deviates from the strictures of this model, it is liable to become enmeshed in the machinations of the Justice Department. In contrast, no one is indicted for failure to adhere to the niceties of the ideal gas.

**Unacknowledged Problems with Perfect Competition**

The neoclassicals rationalize and justify the use of the highly unrealistic perfect competition model on the ground that it is useful for predictions and as a standard of behavior and that the benefits of the uses outweigh the costs of unrealistic assumptions. However, other costs of this model go unacknowledged. First, perfect competition is applied more widely than is appropriate, in situations where the reality is so different from the assumptions that not only is it not useful, save for the purpose of making the analysis mathematically tractable, but the conclusions reached are positively misleading. There is no better example to illustrate this claim than the billions of dollars that have been wasted both prosecuting and defending against antitrust lawsuits, and the vast harm supposedly antimonopolistic laws have done to the structure of the economy.16

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