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Economics of the 21st Century
Part 4

Monopolistic Competition and the Determination of Prices and Wages

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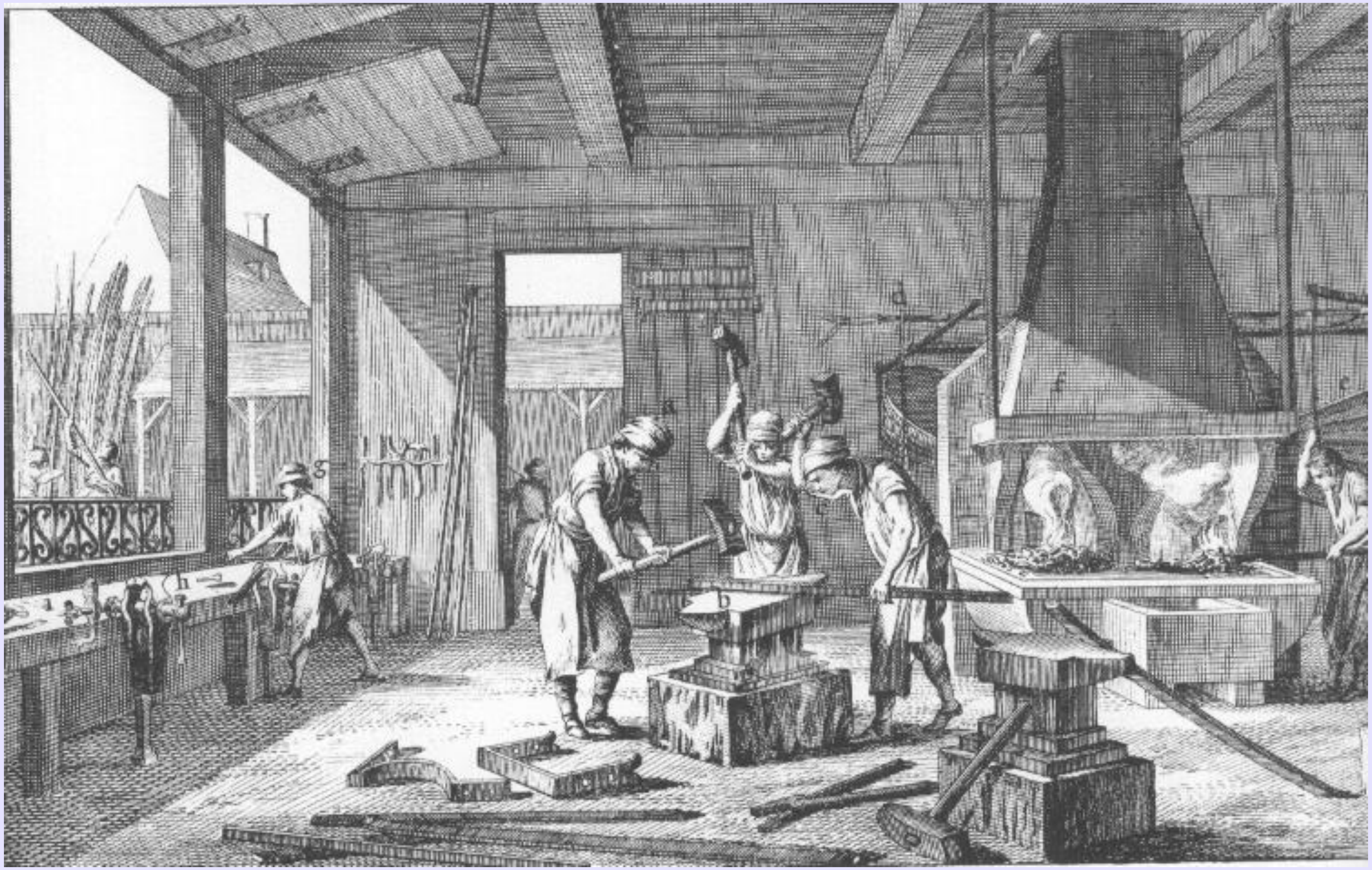
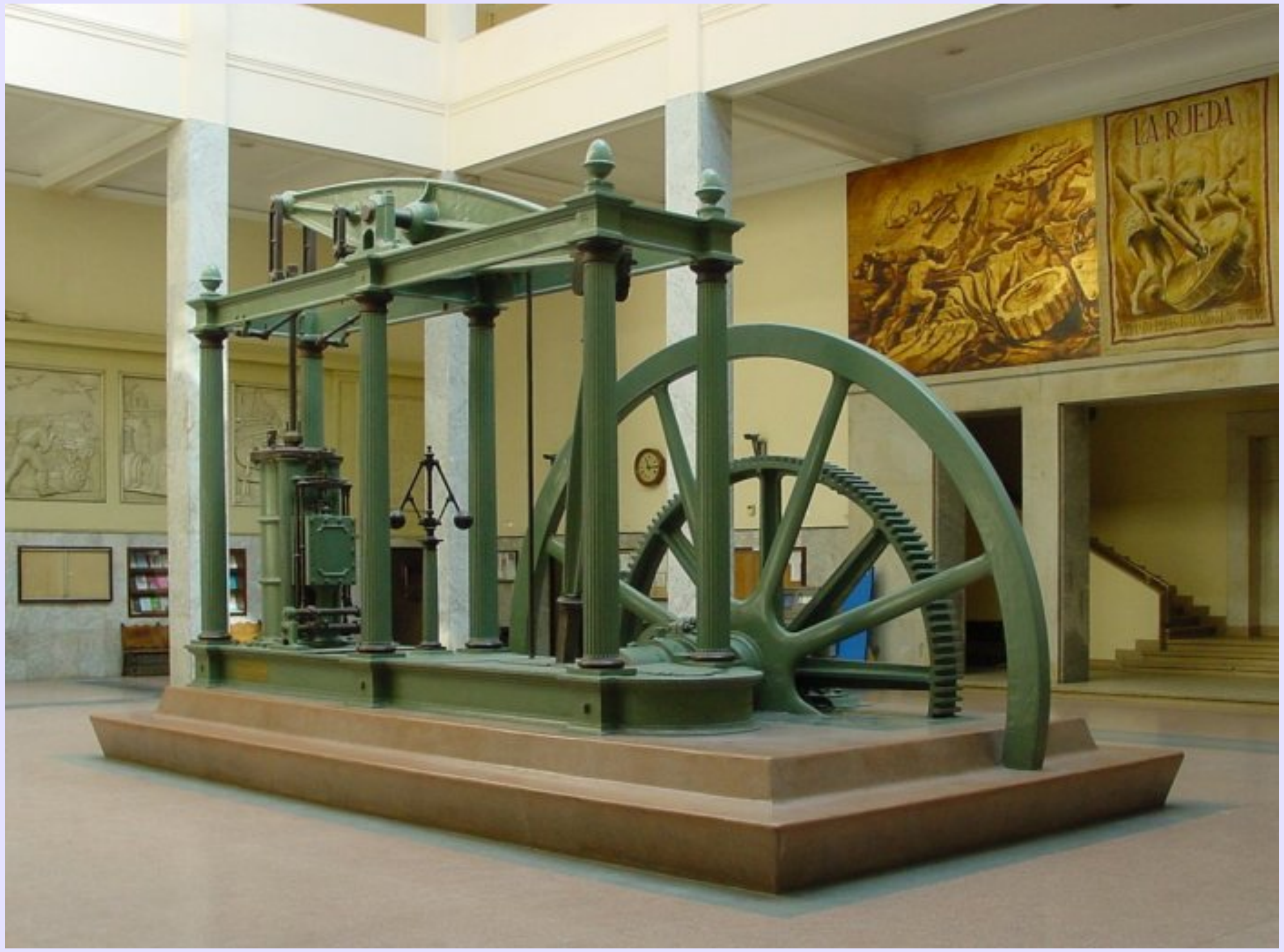


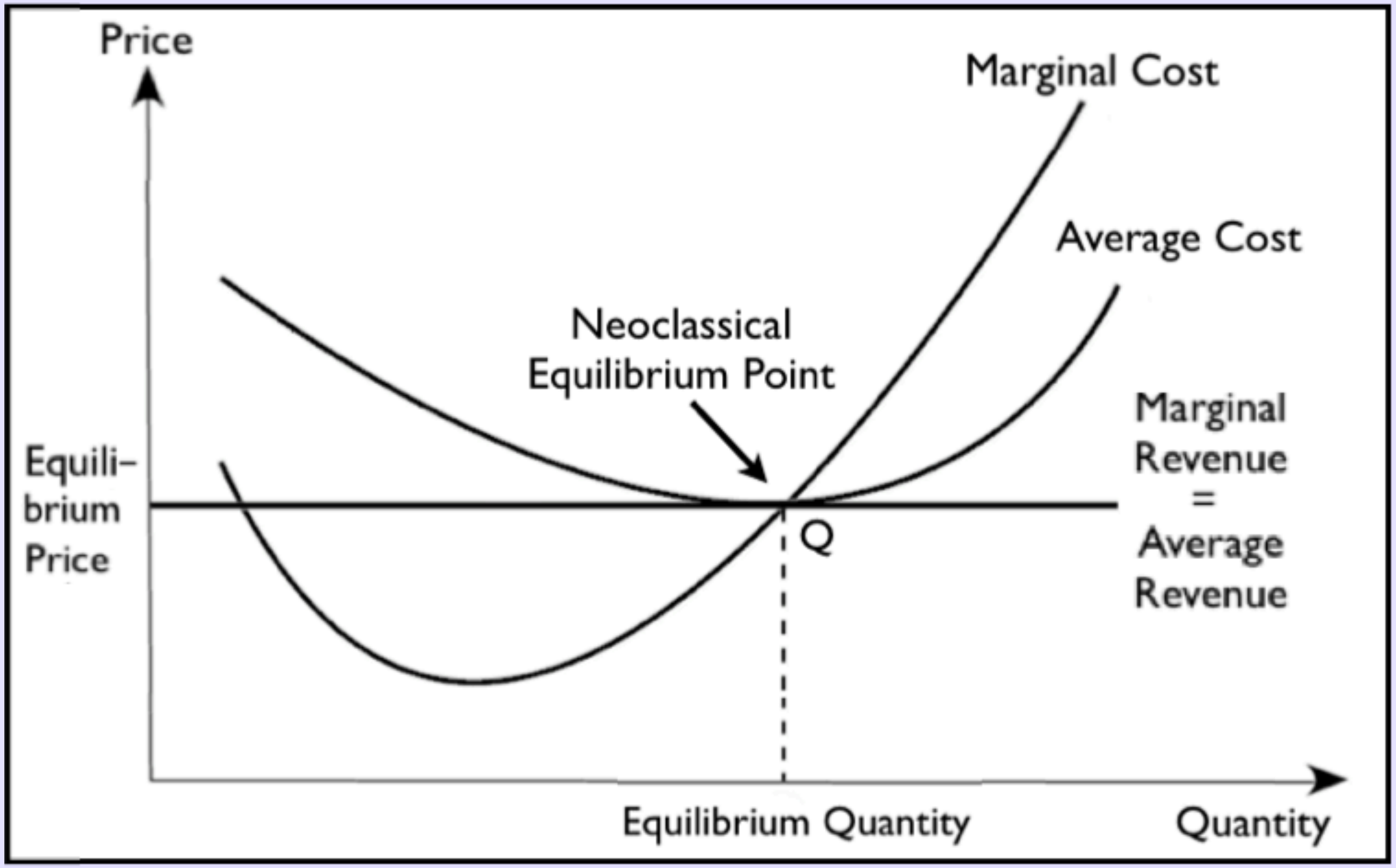
- In pre-industrial societies, the primary production of goods and services took place in workshops, which tended to cluster in streets near central squares in the markets towns.
- In this mode of production, the craftsmen most of the time not only produced all the goods, but they also sold them directly to the public from their workshops. In other words, the functions of production and distribution were often combined in the same economic unit.



- After the industrial revolution, the way the goods and services were produced changed dramatically. Replacing the workshops, industrial units took over production in most sectors.
- This spurred the rise of new social classes: industrial workers, owners of capital (productive and financial), and a rising number of middle class service workers and managers, needed to turn the wheels of the complex mix of private and public institutions that developed in industrial society.
- However, while the former nobility slowly lost its political power, its wealth turned many of its members into an influential rentier class, part of the precursor to the modern financial sector.

- A byproduct of industrialization was the growth of large metropolitan cities.
- This created the need for new infrastructures, although civic leaders were slow to understand the necessity that this put on the need for social planning.
- In this planning vacuum, early urban development was ad-hoc, in particular in North America where much of the needed infrastructures were developed by private capitalists in fierce competition with each other.
- Due to the often high economic stakes involved in constructing urban and inter-urban infrastructures, these processes were prone to corrupt civic government.

- We saw that Marx' cost formula was constant capital (depreciation of machines plus materials used up) and variable capital (wage expenditures).
- The cost elements subtracted from selling prices obtain surplus value, and the ratio between surplus value and variable costs gives the rate of exploitation.
- Note that the rate of exploitation is *not* the same as the rate of profit; the latter is the ratio of surplus value to the value of the employed capital.
- Cost of capital also include outside financing, or the opportunity costs of employing own capital in the specific enterprise.

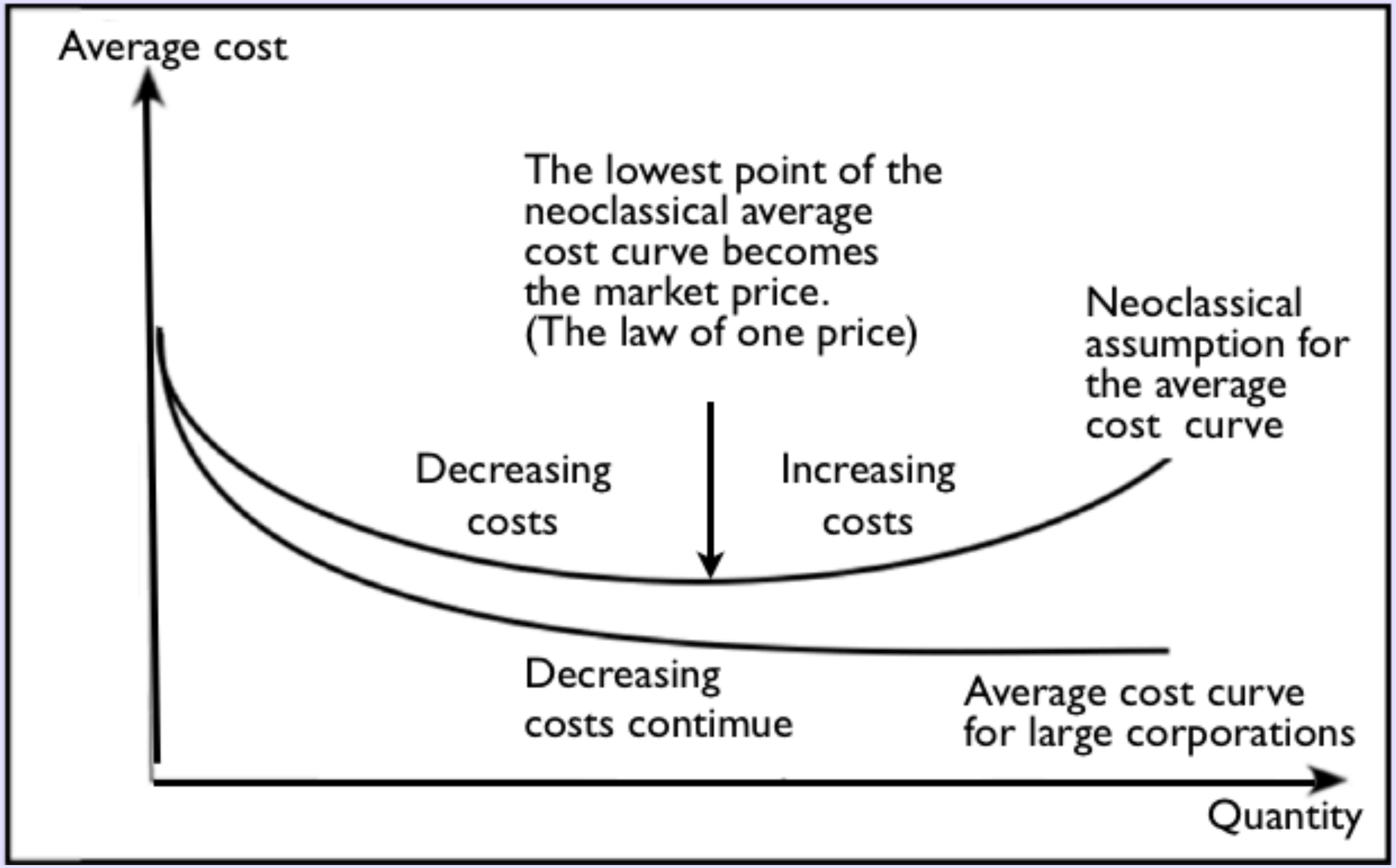


- A novelty of neoclassical economics was marginality. Instead of focusing on average values, the focus was on incremental values, or changes at the margin.
- Assuming perfect markets and information, consumers supposedly obey the law of one price, defined as the last price before they substitute to other options.
- Cost functions, including capitalists' normal profits, also develop under perfect conditions. Therefore, the market price is also all sellers' supply prices.
- Under conditions of perfect competition, no other price is possible since rational market participants with infinite knowledge adjust immediately to all changes.

- After metropolitan cities became the economic nexus of the newly industrialized nations, distribution structures separated from production; necessitated by a combination of rising specialization of products and distance in the new urban areas.
- Retail stores for specific lines of products spread into all urban districts; and department stores that sold a wide variety of product arose at central locations.
- Linking producers and final retail sellers, chains of wholesalers arose. Along with these changes, selling at fixed prices—or menu prices—became a new norm, at first adopted by the departments stores.

- Costs obviously influence final prices, but Marx' attempt to link the labour theory of value cost formula directly to final market prices did not produce satisfactory results.
- Explaining prices by neoclassical marginal changes and incremental value properties in a supply-demand framework sounded more convincing: don't we all become less likely to buy a product when its price go up and vice versa when it goes down?
- However, the neoclassical notions derive from assumption of perfect markets, and ignore the influences social relations have on the formation of prices and profits.
- It denies the reality of capitalist economies in which ubiquitous social power relations connect to the economy's tendency to concentrate wealth, and allowing its owners to acquire positions that wield control over over economic & political structures.

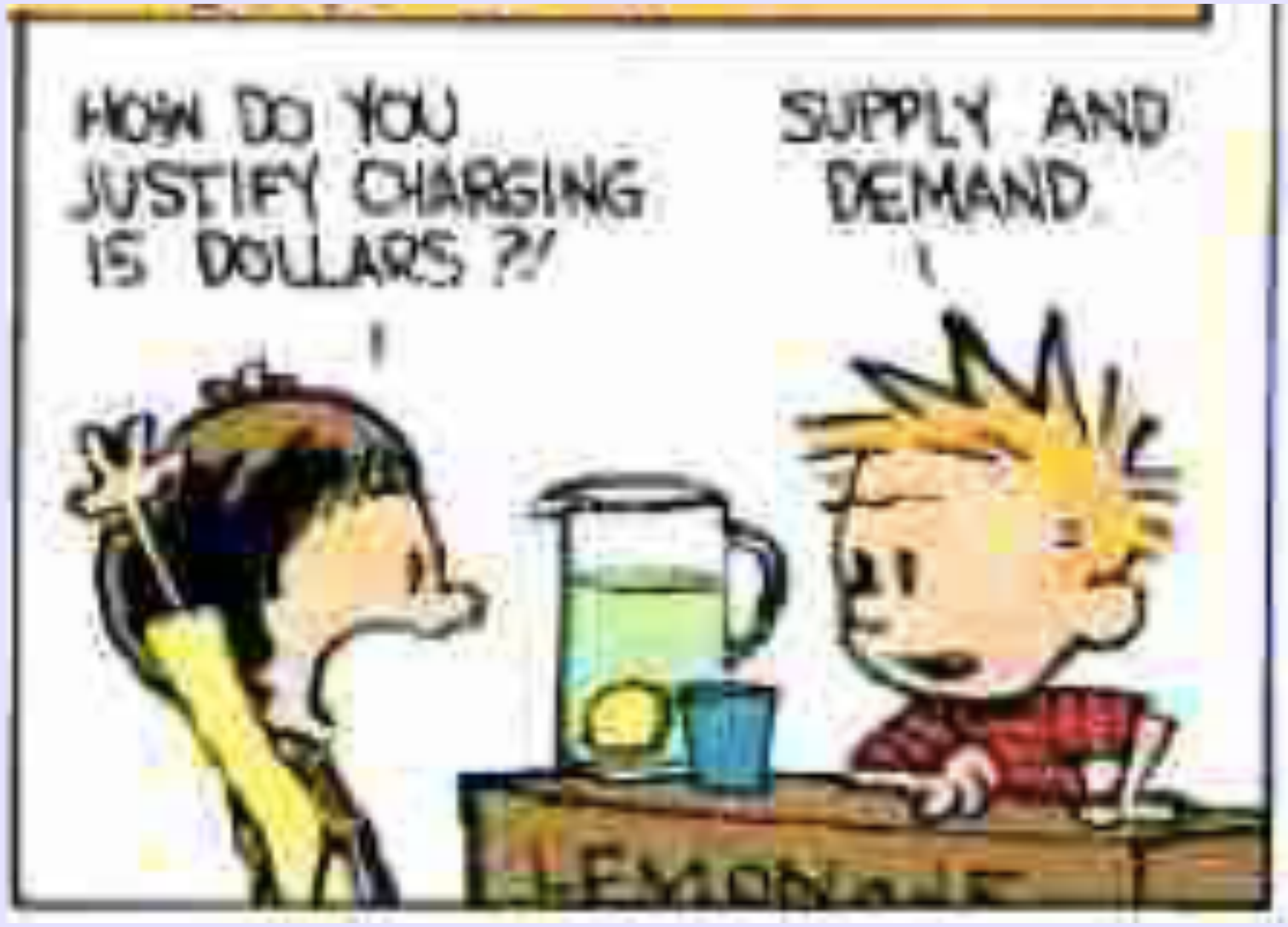


- A key neoclassical assumption—inherited from the classical economists study of agrarian economics—is that average costs at some point invariably will shift from decreasing to increasing costs, at a point that determines the market price.
- In the mid-1920s, a young Italian economist, Piero Sraffa, pointed out that this was however not so given in industrial markets.
- Large corporations are generally able to add to capacity whenever needed and maintain the advantage of economies of scale. The implication is that corporations with dominant positions often can stretch decreasing costs almost infinitely.

- By the 1930s, a number of economists reacted to the inconsistencies in neoclassical economics and developed alternative theories.
- An alternative price theory that arose was the theory of monopolistic competition.
- At Cambridge Joan Robinson took up Sraffa's notion that large corporations are able to maintain decreasing costs and connected it to creation of market power.
- At Harvard, Edward Chamberlin focused on product differentiation: the fact that products can have characteristics, some created by marketing and branding, that separate them from competitors and thereby prevent direct price comparisons.

- In markets dominated by monopolistic competition among corporate firms, market prices do not converge toward the neoclassical competitive market expectation, but towards the power prices set by dominant corporations
- Under such conditions, firms calculate their expected average costs for the next planning period, and then set a mark-up price in consideration of current competitive pressures arising from other dominant firms.
- The mark-up is the price which—in consideration of competitors’ possible moves and counter-moves—is expected to maximize profits.

- In monopolistic competitive markets, elaborate marketing schemes develop branding power, which creates barriers to entry in the given market segments that normally only other large corporations have any hope of surmounting.
- While of course some differentiation characteristics are natural, the effects of constructed branding (including embedded in packaging) are an increasingly important determinant of perceptions of product differentiation.
- When branding is an important factor of competition, constant flurries of marketing activities become necessary in order to keep the attained market positions.



- In monopolistic competitive markets, supply-demand forces and marginality are still active, but not converging on mythical equilibrium prices-quantity relations.
- Instead, supply-demand reactions and monopolistic pricing power are created by the prevalent state of market power relations (which include ability to influence the political structures in which markets embed).
- Often power pricing opportunities arise due to accidental events, in which case social norms and individual conformity to such norms will determine how price reactivity plays out (an example: after a plane crash that closed SFO airport some hotels price gouged stranded passengers, while others offered them discounts*).

*https://sanfrancisco.cbslocal.com/2013/07/08/hotel-rates-reportely-jump-in-hours-following-sfo-crash/

- A main feature of modern markets is the degree of price elasticity that products have. An inelastic product is a product that consumers find it difficult to substitute with other products if its price go up.
- Product inelasticities are often created by socio-economic relations. For instance, in a culture where people's daily commute is car-based, and alternatives poorly developed, the price of gasoline becomes highly inelastic.
- The economic function of product branding enhances inelasticities by creating perceived needs for engaging in the specific consumption that the product give rise to, in many cases by connecting to social status and peer acceptance perceptions.

- Joan Robinson pointed out that market power is not only favouring large corporations in consumers' markets, but also in labour markets.
- Permanent unemployment assures that labour markets always are buyers' markets and in the average situation forces workers to accept wages well below their productivity contributions.
- After globalization gave access to a large pool of low-cost labour in the developing world, the firms' price power in labour market became even stronger.
- As a result, the economy's productivity gains have in the last couple of decades almost all been reaped by the class that owns or controls capital.

- The mark-up prices—the monopolistic profits that firms can get away with—are determined by the degree of monopolistic competition in their fields of operation.
- This invalidates the assumption that profits, held in check by competition, will just be enough to replace used-up capital and expand according to a prevailing rate of growth.
- Instead, monopolistic profits lead to excess accumulation of capital, although this tendency can be held back by countervailing forces, e.g during 1950s-60s).
- The tendency for the economy to lead to excess accumulate has accelerated after globalization, and caused excess liquidity to flow into financial markets, where it intensify the extraction of profits by financial means from the real economy.

- Rising monopolistic profits, combined with the ability of the capital class (including the upper tiers of corporate CEOs, business professionals and captured politicians) to capture almost all productivity gains, has kicked top incomes into the stratosphere.
- The part of excess incomes not accumulating as savings in financial paper has given rise to orgiastic consumption of wealth-trophy products, which not only represents an enormous waste of societal resources but also leaves large ecological footprints.
- The rising economic inequalities has also intensified political consequences. A rising tide of money contributions harness political institutions to protection of the economic elite's low social contributions, while broader social goals are abandoned.

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See you next time

Mike Check! Economics students meets in front of their lecture hall with Occupy Boston in order to protest against Harvard University's intellectual imperialism in its economics programs, Nov 2011.