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THE NATURE OF EQUILIBRIUM IN MONOPOLISTIC COMPETITION: REPLY TO MR. DEMSETZ

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In an article of the above title in the *Journal of Political Economy* for February, 1959, Mr. Harold Demsetz discusses critically the description of equilibrium in *Monopolistic Competition* (8th ed.; Cambridge, Mass., 1962) with a long quotation from page 147 and an accompanying diagram. He maintains that excess capacity is "not a necessary implication" of the assumptions underlying the model in which I discuss selling costs. But he has misunderstood the nature of the analysis in question. I have received letters from time to time involving the same misunderstanding and therefore submit this short note of clarification.

The first drawing in his article (a reproduction of Figure 24, page 148, of *Monopolistic Competition*) does not deal with *how to find* the equilibrium in question, but with certain features of that equilibrium once it is found. The process of finding the equilibrium is given not in the diagram but in words, on pages 146 and 147, from which Demsetz gives a long quotation. Equilibrium, whatever it may be, involves "that combination of product, price, and selling expenditure for which its total profits are a maximum." Demsetz interprets the diagram, and the analysis, as applying *only* to the point Q', without recognizing that this output is by definition the equilibrium one. On page 22 of his article he says, for instance, "Since the firm is free to vary price and selling costs simultaneously neither FF' nor cc' presents a 'cost expansion plan' that is relevant for outputs different from Q', nor does dd' present a relevant sales expansion path for selling quantities other than Q'." (They are perfectly good "expansion plans" of course if their assumptions are met.) Demsetz regards this as a "deficiency" and substitutes "locus" curves, of which he presents several in the subsequent development of his article. This is of course *another* perfectly legitimate way to present the variables involved in the problem. But it is no more "correct" than the presentation in *Monopolistic Competition* which he is criticizing. (The cc' curves, also the dd' curves which are drawn at this point, have reference only to the single firm with all of the variables of others held constant, *or* to the single firm in the "large group" case. In other words, oligopolistic forces are not involved at this point in the argument.)

Incidentally, it is curious that the conclusion which Demsetz would like to establish—"that excess capacity is not a necessary implication"—is already admitted on page 161 of *Monopolistic Competition*, where it is pointed out that the output may be "either larger or smaller than the scale . . . which would be established under pure competition." In the matter of "efficiency," however, Demsetz fails to point out that the curve of average production costs could not be identified with "pure competition" so long as the selling costs are present.

The solutions involving "locus curves" pose a number of special problems, some of which Demsetz discusses, and I have discussed them elsewhere. The interested reader should consult Essay No. 8 in my *Towards a More General Theory of Value* (New York, 1957) and references there given. He should also consult references given in the last footnote to my own Appendix F (*Monopolistic*

Competition, 8th. ed.) where reference is made to the earlier article by Buchanan, also to one of considerable interest by Hans Brems.

The problems of "locus curves" lead to unsuspected complications (see, for example, *Towards a More General Theory of Value*, pp. 158 ff.). Without going into detail here, there seems to be some reason to believe that Demsetz, with his *mutatis mutandis* revenue curves, may not be wholly aware of these problems.