

## Part III: Competition law as a form of embedding economic relationships in social ones?

### The concept of perfect competition as the law of economics: addressing the homonymy problem

OLES ANDRIYCHUK\*

*ESRC Centre for Competition Policy, University of East Anglia*

#### Abstract

*The rapid expansion of economic analysis is visible in many areas of law. In some of them – in antitrust in particular – economic reasoning is already perceived as the dominant discourse. This article is an attempt to contemplate a reverse analysis. Instead of addressing the legal domain from the perspective of economics, it tries to explore the economic discipline through the lens of a lawyer. The analysis is directed at one of the main principles of neoclassical economics – the concept of perfect competition: partly to explore its constitutive role in economic reasoning, but also in order to articulate the misconception with which some economists approach legal regulation of economic relations. It attempts to explain why economic analysis is bound to address broader societal problems in a purely pragmatic way, quantifying the whole spectrum of societal values, reducing them to the common economic denominator of efficiency. This feature of economics is embedded in its epistemology and should not be perceived as its normative claim. In other words, the fact that welfare economics reduces the social interests to cost–benefit calculus does not automatically characterise it as being irresponsive to the social embeddedness problem.*

#### Introduction

Social institutions have always played a significant role in the market process. However, this role has not always been recognised. Many thinkers have tried to develop an algorithm for reconciling laissez-faire principles of market economy with broader societal needs. The issue has been addressed particularly by economists, lawyers and political scientists. All three disciplines were later influenced by sociology which, despite developing its apparatus relatively recently (compared to the three older counterparts), often provides guiding principles for other disciplines in this respect. Economic sociology perceives the social aspects of economic relations as its core subject area. Polanyi is considered among the most influential thinkers in this field. He *methodologically* criticises the dominant early twentieth-century view on the natural spontaneity of the market process, conversely considering the societal reaction to laissez-faire as a spontaneous response to excessive liberalism.<sup>1</sup> On the *normative* side, he insists upon the necessity of restricting survival-of-the-

---

\* Post-Doctoral Research Fellow. I am very grateful to the ESRC Centre for Competition Policy, University of East Anglia, Norwich, for enabling constant interdisciplinary dialogues between its members and, in particular, to Andreas Stephan for his comments as well as to the anonymous referees for providing valuable suggestions to the structure and content of this article. The usual disclaimer applies.

1 K Polanyi, *The Great Transformation* (New York: Octagon Books 1980), pp. 46–8.

fittest principles of economic selection with a range of institutional limits. He thereby redirects the objectives of economic activity towards more socially significant goals.

This article does not address the *normative* dimension of his concerns, concentrating mostly on the *methodological* part of the embeddedness problem. Polanyi's *normative* argument is now widely accepted by liberal democracies as a redistributive principle of social cohesion, thereby shifting the discussion away from the matter of principle (i.e. either/or) to the matter of scale (i.e. how much market freedom should be reserved versus how significant the social concerns are). The issue therefore becomes more dependent upon the context of its application, providing wider scope for empirical studies and inductive argumentation, and forcing a purely theoretical analysis to be either ideologically prescriptive or historically descriptive.

The task of this article is different. Being written by a competition lawyer, it naturally inclines towards developing two main narratives: the competition-centred and the law-centred. Both can often be approached interdependently, though sometimes they require separate treatment. Inasmuch as the competition-centred narrative should be based upon some normative claims – which go beyond the established borders of the topic – it will only be highlighted for the sake of the consistency of the main argument. It will be presumed that the competitive process is an important element of liberal democracy, which should be reduced neither to the epistemological concept of perfect competition nor to the normative goal of consumer welfare. Instead, the article concentrates mostly on the latter, law-centred, aspect of the problem. Remaining within the realm of theory, it does not address any issues related to the positive law of economic regulation. Its task is to explore from a legal mindset two important aspects of the embeddedness problem: (i) the principles of economic reasoning which predetermine the way in which economics addresses important societal problems (and in particular the market process) and other disciplines (and in particular the law); and (ii) the issue of the interdisciplinary interactions between the legal and economic discourses.

Two other issues remain to be clarified. First, in analysing the economic reasoning, the article takes an approach which is external to economics itself. Its task is not to provide an economic explanation of social problems, but to explore the phenomenon of economic thinking itself. It is made primarily in response to the reverse exercise, which economics is frequently doing with the domain of law. That is, rationalising legal discourse by its cost-benefit calculus, supplemented with the psychological studies on the behaviour of individual agents. Secondly, as will be argued, one of the main components of economic reasoning is the concept of *perfect competition*. This notion should not be confused with the *competitive process*, which is among the primary concerns of competition *law* and is also called “competition”.

The homonymy of the concept of *competition* demands that particular attention be paid to its categorisation. The terminological situation is even more complicated because the different meanings of competition are often used interchangeably – partly because they are closely connected, but also because different disciplines are not always aware of the terminological specificities of the word in other subject areas. The term *perfect competition* reflects a stable hypothetical state, whereas competition in the sense of the *competitive process* espouses the dynamism of market agents. Those two concepts are substantially different, though they are often mistakenly considered as synonyms. The economic analysis of competition is centred on the theory of equilibrium, a theoretical model of universal nature that enables us to understand economic relationships in a relatively coherent, logically correct and predominantly mathematical way. The importance of equilibrium in economic thinking is paramount. A majority of economic schools accept it as their main operational principle and even those who reject it still remain within its rationale. By pointing out the

problematic aspects of the economic method, they are predominantly set to *improve* the model rather than to *disprove* it. They add to the system more variables, unknowns and subjectivities, but are still considering equilibrium as the starting point and benchmark of economic analysis.

The concept of perfect competition is a main parameter of the equilibrium model. But the terms *perfect* and *competition* are easily misunderstood by social scientists relying on the same concepts in different areas. The term competition in this respect is taken as a hypothetical point at which demand fully meets supply. It is a theoretical parameter that should not be considered as reality. In a real situation, this important methodological tool transforms itself into a utopian dream, a certain reverse communism, where all the actors live a happy and long economic life. Under conditions of perfect competition there is no competition in the dynamic sense of the term. The same holds true for the term perfect: its perfectness should again be taken as an internal value for the purposes of modelling and not as a value judgment on the absolute quality of competition. Therefore, in the dynamic sense, the term perfect competition is neither perfect nor competition. However, for the purposes of equilibrium modelling the term maintains both *perfectness* and *competitiveness* reflecting the situation in abstract logical thinking and not the situation in the real market.<sup>2</sup>

Another homonymy should be highlighted as well. The main principle of welfare economics is based on the central role of free competition (“free” in the equilibrium sense of the term) in the process of maximisation of societal welfare. This role is of natural, mechanical essence. The adjective *free* is used in equilibrium economics in its technical, economic sense. It should not be perceived as an ideological statement against big government and in favour of economic freedom of market participants. Freedom in the equilibrium sense of the term has a different meaning. It is a mechanism of price determination, which implies that suppliers and consumers are not restrained in their choices and react on the situation in the markets by changing their respective supply and demand. Freedom in equilibrium economics primarily has an applied or operational character and is not of a substantive nature. It is pursued for the sake of the equilibrium and not as an ethical standard. The economic equilibrium is not hostile to freedom in its ideological sense but these aspects of freedom go beyond its scope.

The article proceeds as follows: it begins with explanation of the problem of general equilibrium, specifying the context in which the term is used and clarifying its role and significance for economic reasoning. The next section explains why the concept of perfect competition is the central part of economic thinking, followed by an analysis of attempts to modify its main premises. The article seeks to classify the main critical approaches to the concept of perfect competition into three main groups, and in the following section reverts to the third (external) one, which explores the principles of perfect competition from the institutional perspective. In its third part, the article addresses the issue of interdisciplinarity, describing different approaches to the relationship between economics and law. It argues for the necessity of maintaining epistemological borders between the disciplines.

### The principle of general equilibrium as the archetype of economic reasoning

The idea of economic equilibrium constitutes the main conceptual narrative of economics. Its dominant apparatus is based on advanced mathematics; its methodological framework is a situation in which the hypothetical supply and demand curves intersect (market clearing

2 The term perfect competition faces in this respect the same problems as the term ideal law. The latter is often misunderstood as being the best and perfect law: (“ideally we would live forever”), whereas from the perspective of legal theory, idealism also encompasses the philosophical foundation of a phenomenon, reflecting its ideal as opposed to material side.

equilibrium). In game theoretic literature, the principle is applicable to a situation where the agents do not deviate from their strategies, having taken into consideration the expected behaviour of their counteragents (Nash equilibrium).

In spite of the intuitive simplicity of the principle itself, its application in economics is very complex and not always unequivocally accepted by different economic sub-disciplines. The principle is applicable in static as well as in dynamic modelling. It plays a bigger role in macro- than in micro-economic analysis. Some fields of the latter – particularly industrial organisation and game theory – are often sceptical as to the universality of equilibrium analysis. Industrial organisation is interested in the structure and strategic conduct of firms. It supplements the basic premises of equilibrium with “real-world” parameters of asymmetrical information, barriers to entry and transaction costs. Behavioural economics concentrates primarily on psychological factors of the individual decision-making process. Approaching their subjects primarily from the bottom-up inductive perspective, both industrial organisation and behavioural economics are capable of overcoming the generalist presumptions of equilibrium.

However, as soon as the observed peculiarities of economic conduct are re-systematised, the proposed substitution may often have a shape of another, more advanced, equilibrium. The more factors included in it, the less universal its functionality becomes, which usually requires another approximation. In general, the opponents of equilibrium economics suggest that its analysis does not leave any room for market subjectivity, unpredictability and the entrepreneurial desire to maximise profits. However, the behaviour of entrepreneurs is taken as a dynamic aspect of equilibrium. It implies that the comprehensive modelling is a perpetual movement from one disequilibrium situation to another. The process itself constitutes an equilibrium which in real-life situations is an unachievable benchmark. The equilibrium is not static in this respect, because the process of adjustment of supply to demand has its natural centre of gravity in equilibrium, but the process itself is predetermined by disequilibrium conditions. A state of equilibrium in this respect is a theoretical, conditional point where profits achieve the level zero.<sup>3</sup> As no entrepreneur is interested in minimising their profits, they reduce their interests in this market, increasing in turn the demand and opening further possibilities for competition, which creates preconditions for new disequilibria. The term “equilibrium” is also used in economics in several other contexts (for instance, the concept of “multiple equilibria” and “non-unique equilibria” to model situations with more than one potential outcome).

Nevertheless, it is possible to argue that, although the principle of equilibrium itself is not always considered to be the main economic instrument of a particular type of economic analysis, it is still a fundamental tool of general economic *reasoning*. However critical some branches of economic theory might be of the principle of economic equilibrium, it can seldom be abandoned by them outright. It should be pointed out, therefore, that this article is limited to the analysis of the concept of equilibrium only in its basic sense. It addresses the more advanced or complicated models of equilibrium solely for apagogical purposes; trying to demonstrate that in spite of their criticism of the basic principles of equilibrium, they are epistemologically embedded into the principle itself. As Kaldor shows, many attempts to disprove the premises of the general equilibrium lead to the thickening of its fundamental premises, making them more impenetrable.<sup>4</sup>

3 “Profit” in economics is surplus gains over and above costs and profits needed to make the activity worthwhile, known as the difference between normal and super-normal profits. In this respect, it is different from an accountant’s understanding of profit.

4 N Kaldor, “The irrelevance of equilibrium economics” (1972) 82 *Economic Journal* 1237, p. 1239.

This article presumes, therefore, that the notion of equilibrium constitutes the *archetype* of economic reasoning, which is extrapolated to the vast majority of the modes of economic analyses. Kaldor further explains in this respect that the notion of the general economic equilibrium, as originally formulated by Walras, was developed by the mathematical economists “with ever-increasing elegance, exactness, and logical precision”.<sup>5</sup> From this purest abstract neoclassical perspective, equilibrium could be considered in terms similar to “Newton’s theory of forces”<sup>6</sup> or “a Euclidean line or point”.<sup>7</sup> Comparing the cognitive role of equilibrium in economic analysis to the role of a constitution in legal theory, the role of ideology in political studies or the role of grammar in linguistics would not overstate its position of natural logical benchmark for economics to collate all relevant factors. Economic thinking by its nature tends to apply mathematical and statistical methods. This *naturalness* means that the equilibrium rationale had been implicitly applicable in economics even before the institutional development of the theory of equilibrium economics as such.

In spite of the extensive *internal* criticism of the methodological purism of the general equilibrium economics – some of the most common types thereof will be addressed by this article – and in spite of the *external* criticism which the article itself puts forward, the concept of equilibrium is treated with due respect. Unlike the criticism from the angle of economics, the opposition as developed in this article strives neither to improve nor disprove the main premises of equilibrium economics. Its task is different. It primarily aims to *understand* the specificity of economic reasoning, perceiving equilibrium analysis as the cognitive economic tool. The secondary task of the article is to demonstrate that the helpful revelations which are possible with equilibrium analysis cannot overcome the disciplinary boundaries of economics. This article acknowledges how equilibrium analysis can be expanded to jurisprudence as well as to broader societal issues, but it is critical of the *exclusivity* of universalising economic modelling. The final task of the article is, therefore, to demonstrate the disciplinary specificity of legal discourse, which *can* be reduced to the principles of economic reasoning, yet does not *have to* undergo such reductionist contemplations.

### THE CONCEPT OF PERFECT COMPETITION

The idea of perfect competition reflects the equilibrium situation. Competition achieves its perfect level at the hypothetical point when demand fully meets supply. In this imaginary situation, competition taken in its literal, societal sense does not exist at all, because there is no possibility of pursuing individual interests without destroying the equilibrium. Competition in this sense is a purely theoretical situation. Unlike the Smithian concept of competition, which is essentially one of business behaviour that McNulty associated with the verb “to compete”, the concept of perfect competition is deprived of any behavioural content and focuses entirely on its effects. These two definitions of competition are incompatible, to the extent that “[c]ompetition came to mean, with the mathematical economists, a hypothetically realized situation in which business rivalry, or competition in the Smithian sense, was ruled out by definition”.<sup>8</sup> McNulty’s point is developed in the Hayekian tradition, stating that “‘perfect’ competition does indeed mean the absence of all competitive

5 Kaldor, “The irrelevance”, n. 4 above.

6 O Budzinski, “Monoculture versus diversity in competition economics” (2008) 32 *Cambridge Journal of Economics* 295, p. 297.

7 M Friedman, *Capitalism and Freedom* (Chicago: Chicago UP 1962), p. 120.

8 P J McNulty, “A note on the history of perfect competition” (1967) 75 *Journal of Political Economy* 395, p. 398.

activities”.<sup>9</sup> Kirzner concretises this point, claiming that under perfect equilibrium conditions, “the act of choice consists in nothing more than computing the solution *already implicit* in the data”,<sup>10</sup> which entails a mechanical nature of the decision process.

The equilibrium-based model “not only allowed for very important insights and advances in economic theory, it also changed the meaning of the term competition in comparison to classical economics”.<sup>11</sup> Such a conflation of two different terms significantly limits the meaning of competition under the traditional narrative.<sup>12</sup> This change was not aimed at creating a revolutionary trend by its neoclassical authors. Their re-interpretation of the phenomenon of competition does not emerge from an opposition to classical views, but rather as an attempt to better understand competition through a more advanced apparatus. This is the reason why the neoclassical equilibrium-based perception of competition does not reject classical views, but simply considers them underdeveloped and attempts to *improve* rather than *disprove* the concept of competition as present in classical economic literature. This *improvement*, however, created significant discrepancies between these concepts. While the classical understanding of competition concentrates primarily on the phenomenon of the competitive interactions of market agents, its neoclassical perception constitutes rather an important *theoretical premise* of economic reasoning with no direct implications for the competitive process.

In order to avoid any confusion, therefore, the concept of perfect competition should be perceived solely as a theoretical tool for the harmonisation of demand and supply. From this perspective there is no ethical or political value in competition, because it is an ethically neutral condition. The competitive process is not seen as a societal value, but merely as the actions of individuals which should ultimately correspond with the equilibrium conditions. The competitive process is then reduced to an applied means to reach equilibrium. On the normative side, the model of perfect competition implies that it is in the common interest to maintain the system in which demand always meets supply. The competitive process is, therefore, supported only as a tool that leads to a reduction in the prices and increase in the quality of products.

The theoretical significance of the concept of perfect competition is undisputable. It is particularly relevant for the development of a specific economic *language*, which enables us to address economic topics in the most uniform manner. The model of perfect competition essentially provides the common denominator necessary for economic reasoning. The difficulties begin when the theoretical, mechanical concept of competition substitutes its ethical counterpart. Apart from its static meaning, relevant for the mathematised methodology of economic analysis, the concept of competition also holds significant ethical, normative and substantive value.

Its ethical relevance is not limited to such areas as culture, law, politics or sport; it also plays a pivotal role in economic life. Economic theory itself provides one of the most

9 F A von Hayek, “The meaning of competition” in F A von Hayek, *Individualism and Economic Order* (Chicago: Chicago UP 1958), p. 96.

10 I M Kirzner, *How Markets Work: Disequilibrium, entrepreneurship and discovery* (London: Institute of Economic Affairs 2000), p. 31 (original emphasis).

11 Budzinski, “Monoculture”, n. 6 above, p. 298.

12 N Giocoli, “Competition versus property rights: American antitrust law, the Freiburg School, and the early years of European competition policy” (2009) 5 *Journal of Competition Law and Economics* 747, p. 760.



significant contributions to the ethical value of competition.<sup>13</sup> The concept of perfect competition and the ethical perception of this phenomenon, therefore, are situated in two different dimensions. Theoretically, they are irrelevant to each other and should be treated as two different areas which have two specific meanings, theoretical apparatus and normative importance.

The following sections explore the essence of competition taken as a universal cognitive tool of economics, leaving aside the dynamic aspects of the phenomenon of competition. An assumption is made that for a better understanding of the concept of perfect competition it would be useful to explore the historical evolution of this economic principle. By analysing the criticism of the notion of perfect competition which was developed by the economists, it will be shown that both the proponents and critics of the concept inevitably apply the equilibrium-based rationale in the development of their argumentation.

### IMPERFECT AND MONOPOLISTIC COMPETITION

Those who are sceptical about the relevance of the concept of perfect competition exercise rather an *apagogical* criticism (proving their argument by demonstrating the weaknesses of the contrary thesis).<sup>14</sup> The economic opponents of the concept refer to its hypothetical nature, introducing as an alternative the theory of *imperfect* competition. In a revisited version of "The economics of imperfect competition",<sup>15</sup> Robinson poetically describes the rationalising monopolist as "the best pilot to find a channel between the Scylla of competitive inefficiency and the Charybdis of monopolistic exploitation".<sup>16</sup> As observed by Kaldor, "[o]n the one hand it is increasingly recognised that abstract mathematical models lead nowhere. On the other hand it is also recognised that 'econometrics' leads nowhere",<sup>17</sup> implying that neither equilibrium-based abstract presumptions (despite their generalist convenience) nor inductive statistical data (despite their refined econometric elegance) are capable of providing the ultimate economic certainty.

Critics of the concept of economic equilibrium also point out that the diversity of human relations, their complexity and peculiarity, make it impossible to rely on equilibrium propositions and conclusions.<sup>18</sup> However, these negative aspects of the methodology of equilibration are internalised by the equilibrium itself. It counterbalances the *unknown unknowns* which are present on one side with the *unknown unknowns* present on the other, reducing them to a common denominator and hence making the *unknowns known*.<sup>19</sup> The

13 It is beyond the limits of this article to develop further the normative argument for the competitive process. Its elaboration can be found elsewhere (e.g. O Andriychuk, "Rediscovering the spirit of competition: on the normative value of the competitive process" (2010) 6 *Competition Law Journal* 581).

14 M C Marcuzzo, "The 'first' imperfect competition revolution" in W J Samuels, J E Biddle and J B Davis (eds), *A Companion to the History of Economic Thought* (Oxford: Blackwell 2003), p. 294, (original emphasis): "Like most intellectual 'revolutions' imperfect competition was more a reaction against rather than an endorsement of an unified research program; in fact, there was a greater consensus on the reasons for abandoning perfect competition than on how to represent the working of 'imperfect' competition."

15 J Robinson, *The Economics of Imperfect Competition* (London: Macmillan and Co. 1933).

16 J Robinson, "Imperfect competition revisited" (1953) *Economic Journal* 579, p. 581.

17 Kaldor, "The irrelevance", n. 4 above, p. 1240.

18 C Thomasberger, "The two utopias of economics: human freedom and the mechanism of competition", available at [www.f3.htw-berlin.de/Professoren/Thomasberger/pdf/Theorie3.pdf](http://www.f3.htw-berlin.de/Professoren/Thomasberger/pdf/Theorie3.pdf) (last accessed 4 February 2011), p. 6: "The Equilibrium Model or the utopia of the self-regulating system has the character of an ideal-type construct, a hypotheses, which does not tell us anything about economic reality."

19 I M Kirzner, "Entrepreneurial discovery and the competitive market process: an Austrian approach" (1997) 35 *Journal of Economic Literature* 60, p. 64: "In the neoclassical world, decision makers know what they are ignorant about. One is never surprised."

universality of equilibrium means that it can include within its modelling the full complexity of the system. In other words, it reduces the peculiarities of all social interests (including such non-economic issues as human rights and redistributive policy) to economically significant factors, which enable their comparison and weighing. However, this modelling is performed in an inductive way, implementing the factors *rationally*. Critics of this method suggest that *rationalisation* is not the best way to address *irrational* aspects of market forces and that sometimes even a tiny mistake in the calculation of the model's parameters can undermine the credibility of the model as a whole.

The ideas of marginalists on the subjective and relative aspects of utility are taken by equilibrium economics with due acceptance. However, they assume (perhaps for the sake of the methodological effectiveness of the model of equilibrium) that any value has its aggregate utility. This utility is reflected in prices and therefore can be measured objectively, while acknowledging the inevitability of subjective, non-rational elements. A conceptual remedy is based on the method of successive approximation, developed by Pareto, the task of which is to bring theoretical abstractions nearer to practical realities by including in the models more nuanced techniques of dealing with the subjectivity problem. The problem has been addressed, but has not yet been eliminated altogether. Complexity and the introduction of nuances, particularities and reservations often deviate from abstract thinking, universality and flexibility, which are all more congenial to stable propositions. This can be seen as a major economic dilemma. For instance, the purely economic perception of rights would, for the sake of clarity and predictability, not take into account their extra-economic aspects. This enables their more coherent treatment, calculating their pros and cons in a mathematical balancing exercise. This reductionist view can infringe upon the societal potential of the rights, however, since their legitimacy goes beyond cost-benefit analysis. But as soon as all the peculiarities of the rights are included in the equilibrium, it complicates the orderliness of the model and can paralyse its functioning entirely.

The method of equilibrium as a central method of economic analysis is characterised by a variety of approaches. Many important economic concepts are developed within its framework. For instance, the theory of monopolistic competition, introduced by Chamberlin, addresses the issue of perfect competition and puts forward that each individual company holds a de facto monopoly over its own products. According to Eucken's description of this theory, "[t]he goods offered by each individual firm must be looked upon as separate kinds of goods. Each individual producer has a 'monopoly' for his products. Each trader, farmer, or businessman sells *his* goods as a monopolist."<sup>20</sup> Each economic sector therefore is characterised by the range of small monopolies that have full control over their products and services.

The main argument of the theory of monopolistic competition is that the classical dichotomy between competition and monopoly is incorrect. Arguably, these two features of the economic process co-exist within each market as long as each market agent is simultaneously monopolist and competitor.<sup>21</sup> In terms of methodology, Chamberlin emphasises the monopolistic part of the analysis. This does not eliminate the competitive part, but would do if the analysis were taken the other way around. The core of Chamberlin's theory is not its criticism of the idea of perfect competition from the perspective of limited knowledge. Monopolistic competition should not be perceived as a

20 W Eucken, *The Foundations of Economics: History and theory in the analysis of economic reality* (Chicago: Chicago UP 1951), p. 141, (original emphasis).

21 E H Chamberlin, "Monopolistic competition revisited" (1951) 18 *Economica, New Series* 343, pp. 346–7: "Each seller has a local monopoly based upon his location yet he is surrounded by competitors. Hence, the paradoxical expression 'monopolistic competition'."



part of the theory of imperfect competition, but as “a *general* theory, designed to replace that of generalised pure competition”.<sup>22</sup> (The term “pure competition” is one of the synonyms of “perfect competition”.)

Different groups have reacted critically to the ideas developed by the alternative approaches to the concept of perfect competition. According to Marcuzzo, “[t]he first competition revolution was a reaction against the lack of realism of the perfect competition assumption but, ironically, was attacked for its inability to stand up to the test of its predictions”.<sup>23</sup> Eucken, on the other hand, criticises the concept of monopolistic competition itself for blurring the differences between competition and monopoly, suggesting that the theory has been more inspired by political circumstances than by a genuine scientific endeavour.<sup>24</sup> The Chicago School perceives the concept of monopolistic competition as a set of purely theoretical insights that can lead in real life to “output restriction, higher prices, and an uneconomical utilization of resources”.<sup>25</sup> In terms of policy implications, the model of monopolistic competition which influenced antitrust policy during the New Deal era “was far more complicated and made it far more difficult to examine a particular business practice”<sup>26</sup> than its neoclassical welfare-maximisation alternative. The development of the ideas of imperfect and monopolistic competition demonstrates that an economic algorithm embracing *known unknowns* creates significant complications. Alternative visions still address the problem of competition from the *intra-disciplinary* perspective of economic “mechanics”, neglecting the ethical and normative value of the competitive process, perceiving it as a mere means to welfare. Such criticism can be classified in the three categories set out in the following section.

### The concept of perfect competition: three perspectives of criticism

The methodological criticisms of the concept of perfect competition can be separated into three main groups: internal, dynamic and external. The first two belong to the area of economics, while the third one does not. None directly reflect the ideological dimension of the regulation of competition. Each can simultaneously embrace a libertarian and a regulatory perception of the relationship between state and market. They are of an epistemological rather than a prescriptive nature.

The first (*internal*) perspective acknowledges the methodology of equilibrium modelling, but highlights the necessity of putting a stronger emphasis on *known unknowns*. It submits that the model should internalise many subjective factors in order to maintain its theoretical credibility. These insights are represented by the concept of *imperfect competition* – which again refers to the situation where the absolute parameters of equilibrium models obtain – and have nothing to do with value judgments about the ethical value of competition.

The second (*dynamic*) line of criticism is also developed within economic theory, but rejects the role that the equilibrium model assigns to competition. It insists upon the dynamic qualities of the competitive process, refers to the subjective interests of market participants and stresses the important role played by competition in evolution, innovation

22 Chamberlin, “Monopolistic competition revisited”, n. 21 above, p. 343 (original emphasis).

23 Marcuzzo, “The ‘first’ imperfect competition revolution”, n. 14 above, p. 304.

24 Eucken, *The Foundations of Economics*, n. 20 above, p. 146: “It is in the interests of economic pressure-groups to confuse the distinction between competition and monopoly. The effects of monopolies are shown to be harmless and the special problems of economic constitutional law which the existence of such powerful private bodies creates, are concealed.”

25 G W Stocking, “The rule of reason, workable competition, and the legality of trade association activities” (1954) 21 *University of Chicago Law Review* 527, p. 536.

26 H J Hovenkamp, “Antitrust policy after Chicago” (1985) 84 *Michigan Law Review* 213, p. 224.

and progress (the Schumpeterian thesis of creative destruction can illustrate this approach, Hayekian competition as a discovery procedure which provides the link between the first to the second, but can technically be perceived from the third perspective as well). But this second criterion is just as economic as the first. It emphasises the importance of the competitive process, but considers as its main criteria economic parameters such as growth, wealth, welfare, well-being or utility.

The third (*external*) dimension of criticism encompasses the views of other disciplines about the phenomenon of competition. It does not contest the methodological essentiality of equilibrium modelling, acknowledging and respecting its paramount nature for the economic theory, but submits that competition is not an exclusive area of economics, and introduces its own narratives and proposals concerning the role of the competitive process in society.

Although the external method of criticism does not recognise the *normative* power of the equilibrium principle with respect to competition, it fully acknowledges the *methodological* intradisciplinary sovereignty of this principle for economics in general. It accepts that equilibrium serves the role of the epistemological *Grundnorm*, and this internal economic standard is acknowledged and respected. It is economics which is not accepted per se as a dominant apparatus, not the validity of its main internal disciplinary premises. This dissociation is the only way to bypass economic reasoning while addressing ethical problems, because any substantive economic disagreement with the notion of equilibrium requires implementation of this rationale as a prerequisite for such a disagreement (acquiring the form of the discussion on the existence of God, in which even the critics have to accept his existence first as a methodological postulate against which they develop counter-arguments).

### COMPETITION AND THE ROLE OF INSTITUTIONS

While the equilibrium approach to competition is aimed at exploring the economic perception of this phenomenon from an internal perspective, the institutional approach provides an insight into how economic scholarship perceives the role of government and other social mechanisms in the process of regulation of competition. This is therefore a perspective external to the phenomenon of perfect competition. The term *institutional* is used in a broader sense, encompassing both institutions *sensu stricto* (rules of the game) and organisations (actors of the game). The institutional perspective does not entail a regulatory response to market problems. It explores the role of institutions in this situation and the proposed normative solutions range from libertarianism to interventionism.

The history of economic thought explores this dimension from the very beginning of the conceptualisation of competition. According to Hovenkamp, "Institutionalism was one of the most important intellectual achievements of the first great law & economics movement and, with marginalism, supplied one of the greatest critiques of classical economics".<sup>27</sup> These ideas took their contemporary shape with the evolution of the cameralist theories,<sup>28</sup> developed mostly within the German – but also French, Dutch, Italian and British – tradition of public administration. Unlike classical economic analysis, this approach tends to adopt an external perspective on competition, concentrating on the institutions which administrate the competitive process more than on the phenomenon of

27 H J Hovenkamp, "The first great law and economics movement" (1990) 42 *Stanford Law Review* 993, p. 1013.

28 D J Gerber, *Law and Competition in Twentieth Century Europe: Protecting Prometheus* (Oxford: OUP 2001), p. 81: "[Cameralism] viewed economic conduct primarily from the perspective of its value to the state."

competition itself.

This external vision of competition also played an important role in developing inter-institutional relations in respect of reconciling conflicts of interests between different economic values. In its broader economic sense, this approach presupposes a mixed economy with active governmental programmes. It is being developed within the framework of many economic schools and contexts, and in particular within the Keynesian tradition. It often uses as an instrument the rationale of imperfect competition in order to justify the regulatory influence of government. However, the regulation of competition represents only one of the many aspects of proactive economic schools. The concept of “externalities” plays a significant role in this respect. It assumes the imperfectness of market transactions and the necessity of regulatory corrections. This approach was dominant in many jurisdictions. It was one of the preconditions for the development of modern law and economics, which emerged as a reaction to the conceptual justification of interventionist theories and policies with Coase’s “The problem of social cost”.<sup>29</sup> Following Horwitz, Coase’s article represents “a brilliant, theoretical counterattack on the left-wing (interventionist) implications of welfare economics”;<sup>30</sup> “internalise externalities” became a famous slogan.

Institutional scepticism towards the ability of the markets to self-correct impelled the institutional economists to pay more specific attention to other social institutions (Hovenkamp lists such institutional prerequisites of the markets as “ideology, technology, history, habit, previous investment, and lack of information or difficulty in communication”)<sup>31</sup> that influence the market process. This was done in both more general (old institutional tradition)<sup>32</sup> and more mathematical (new institutional tradition) terms.<sup>33</sup> For the analysis of competition, this has both negative and positive implications. The negative consequence of the broader view lies in the fact that the process of competition is not taken as a universal remedy to achieve efficiency. Competition taken in its equilibrium sense remains an important but no longer *the* exclusive method, because explanation of the market processes can be found outside of the equilibrium. On the other hand, unlike market-centred neoclassical views, the regulatory approach does not necessarily need a robust economic justification to promote the ethical aspects of competition, the rivalry process as such. It can potentially protect it as a public value in its own societal right. This possibility is limited, however. Indeed, in spite of its ability to perceive competition from the outside, the institutional approach still belongs to *economics* and shares the discipline’s natural inclination towards robust statistically significant evidence. This approach can accept the necessary connection between economics and other social sciences and recognise that not everything can be reduced to the parameters of economic modelling. It can also tolerate a less strict economy-centricity and the bigger role of induction, unpredictability and experiments, but it cannot abandon altogether the intrinsic limits of the discipline and

29 R H Coase, “The problem of social costs” (1960) 3 *Journal of Law and Economics* 1.

30 M J Horwitz, “Law and economics: science or politics?” (1980) 8 *Hofstra Law Review* 905, p. 906.

31 Hovenkamp, “The first great law and economics movement”, n. 27 above, p. 1013.

32 W H Hamilton, “The institutional approach to economic theory” (1919) 9 *American Economic Review* 309, p. 311: “‘Institutional economics’ alone meets the demand for a generalized description of the economic order. Its claim is to explain the nature and extent of order amid economic phenomena . . . in relation to human well-being. . . . Such an explanation cannot properly be answered in formulas . . . Its quest must go beyond sale and purchase to the peculiarities of the economic system.”

33 R H Coase, “The new institutional economics” (1998) 88 *American Economic Review* 72: “[Old institutional economists] were men of great intellectual stature, but they were anti-theoretical, and without a theory to bind together their collection of facts, they had very little that they were able to pass on.”

perceive social values from an internal perspective.

Therefore, the institutional approach to economics is primarily interested in interpreting the role of institutions and does not necessarily justify deviation from the internal economic reasoning for the sake of value arguments, which these institutions internally adhere to. Institutional economics is interested in knowing more about these values, yet it is less interested in promoting them through economic reasoning. For instance, the areas of economics dealing with social institutions like the law or constitutions (*law and economics* and *constitutional economics* respectively) contribute significantly to the understanding of how law and constitutional theory influence economic processes. These areas are important in order to understand the functioning of these institutions. However, they do not explore the relevant institutions from the perspectives of the natural narratives of *law* and *constitutional theory*. On the contrary, instead of *institutionalising* economic areas, they *economise* social areas. Apart from understanding the role of law and constitutions in economic life, this approach expands the limits of economics from the analysis of the market to the analysis of other social forms. Therefore, the terms “law and economics” or “constitutional economics” can only mean “*law* and its role in *economic* reasoning” (how law *externally* influences economic analysis) or “*law* and how *economics* can help to understand it better” (how law *internally* is understood by economics) – or even “*law* and how *economics* is better at understanding the law and what the law really is”. These various approaches remain economics-based at the epistemological level.

The intellectual legacy of Polanyi represents one of the institutionalist traditions. His external examination of economic relations from the perspective of broader societal needs constitutes a significant methodological contribution to the problem of correlating the purity of abstract economic modelling with the necessity to involve non-quantifiable social values. This article does not address (and does not share) Polanyi’s main *normative* premise underpinning his objection to the invisible hand as the universal tool for explanation and justification of self-interested behaviour of market agents. However, it does, to a large extent, agree with Polanyi’s *methodological* scepticism relating to the ability of abstract economic models to explain the entire complexity of human interactions by reducing them to economically significant variables. In order to articulate properly the main methodological claim which this article develops, it is necessary to explore the epistemic relations between the different disciplines.

### The role of economics in legal reasoning

The issue of interdisciplinarity is of paramount importance in social theory. At least three disciplinary discourses – economics, law and political theory – address the problems of embeddedness of social values in economic policy. The interactions between them illustrate the fruitfulness of interdisciplinary research. The problem of homonymy, however, is often apparent as well.<sup>34</sup> Stigler considers that the main problem lies in the substantive goals of each discipline and in their apparatus, submitting that “[t]he difference between a discipline that seeks to explain economic life (and, indeed, all rational behaviour) and a discipline that seeks to achieve justice in regulating all aspects of human behaviour is profound”,<sup>35</sup> as well as suggesting that economics and law speak different languages. Kelsen on the other hand

34 P Nicolaidis, “An essay on economics and competition law of the European Community” (2000) 27 *Legal Issues of Economic Integration* 7, p. 7: “Economists and lawyers do not often see eye to eye. They are divided by the boundaries of their respective disciplines . . . Lawyers, for example, bemoan the ‘pollution’ of their discipline by economists who favour the introduction of cost–benefit criteria in legal decisions, while economists find incomprehensible court rulings that appear to disregard obvious, in their eyes, economic facts.”

35 G J Stigler, “Law or economics?” (1992) 35 *Journal of Law and Economics* 455, p. 463.

observes that “[t]he sociology of law [and in the present context the economic analysis of law] cannot draw a line between its subject – law – and the other social phenomena”.<sup>36</sup> In their mutual attempts to internalise each other’s arguments, law was originally more successful than economics, since the pre-modern culture was based on dogmas. Conversely, the age of rationality is characterised by the pervasive application of economic methods to other disciplines. Antitrust is merely an example, even if a particularly explicit one, of a much more general trend. Economics has been successfully applied to many other areas. Gauthier, for example, critically explores at least three important epistemic influences of economics on moral theory (its cognitive alma mater)<sup>37</sup> and philosophy in general:

[t]he first is that value is utility – a measure of subjective, individual preference. The second is that rationality is maximization. . . . The third is that interests are non-tuistic [a person is not interested in the interests of another person].<sup>38</sup>

Although the centre of gravity of law and economics is primarily concerned with private law adjudication, it does not prevent its application to public law.<sup>39</sup> The economic analysis of the political decision-making process is reflected in public choice theory constitutional economics,<sup>40</sup> and more generally in social choice.<sup>41</sup> Today, one can find studies of economics of just about *every* reasonable area of human practice (economics of education, religion, happiness, football, recycling, art and so on).<sup>42</sup> The ability of economics to address legal, political and ethical questions reflects the universal symbols and interests with which it usually operates.

In legal scholarship the role of economic analysis is usually limited to its positive part.<sup>43</sup> It is hard to deny that economics *can* indeed explain in its *intra-disciplinary* way the phenomenon of law, but in addition the economic analysis often proposes the normative guidelines for the legal field.<sup>44</sup> Monti puts a legitimacy question: “whether the use of economics is legitimate and . . . how economics is used”.<sup>45</sup> This concern is substantiated

36 H Kelsen, “The pure theory of law and analytical jurisprudence” (1941) 55 *Harvard Law Review* 44, p. 53.

37 I Lianos, “Lost in translation? Towards a theory of economic transplants” (2009) 62 *Current Legal Problems* 346, p. 351.

38 D Gauthier, “Thomas Hobbes: moral theorist” (1979) 76 *Journal of Philosophy* 547.

39 F I Michelman, “Constitutions, statutes, and the theory of efficient adjudication” (1980) 9 *Journal of Legal Studies* 431.

40 J M Buchanan and G Tullock, *The Calculus of Consent: Logical foundations of constitutional democracy* (Ann Arbor: University of Michigan Press 1962).

41 K J Arrow, *Social Choice and Individual Values* (New Haven: Yale UP 1951).

42 F Parisi, “Positive, normative and functional schools in law and economics” (2004) 18 *European Journal of Law and Economics* 259, p. 261: “[T]he cohesiveness of economic techniques makes it possible for economics to move successfully into another field, such as law, and dominate it intellectually.”

43 H J Hovenkamp, “Positivism in law and economics” (1990) 78 *California Law Review* 815, p. 816: “A positive economic analysis says simply that, given a certain set of premises, A, B, and C, some conclusion D will follow.”

44 D Wolf, “Competition policy objectives” in C Ehlermann and L L Laudati (eds), *The Objectives of Competition Policy. European competition law annual 1997* (Oxford: Hart 1998), p. 24: “[E]conomists have learned to be advocates of the interests of their clients, just as lawyers have learned to do so.”

45 G Monti, “EC competition law: the dominance of economic analysis?” in R Zäch, A Heinemann, A Kellerhals (eds), *The Development of Competition Law: Global perspective* (Cheltenham: Edward Elgar 2010), p. 4.

46 J N Keynes, *The Scope and Method of Political Economy* (London: Macmillan and Co. 1897), p. 8: “[T]he general tendency of popular economics is towards rash generalizations and fallacious arguments post hoc ergo propter hoc . . . leading to confusion of thought and the selection of false propositions as self-evident postulates; and where deductive reasoning is employed its results are often applied without regard to the conditions requisite for their valid application. To this it must be added that the sharp distinction drawn by opposing schools, and their narrow dogmatism.”

and explained by some economists as well.<sup>46</sup> Law and economics enthusiasts suggest that economics can “teach” the law to be more pragmatic and respond to societal needs more rapidly and effectively. Some suggest that only economic reasoning reflects genuine relations between people.<sup>47</sup> More moderate authors usually acknowledge the important connections between law and economics,<sup>48</sup> suggesting that economics is indeed a useful tool for assessing evidence. At the same time, they submit that economic analysis of law “cannot and should not serve as a general basis of legal decision making”.<sup>49</sup> The sceptics make methodological observations about the mutual epistemic incompatibility of the disciplines.<sup>50</sup> In technical areas of law like antitrust, economics always plays a pivotal role. Yet, until recently, it merely explained *competition*, while nowadays it often seeks to explain competition law. *Mutatis mutandis*, criminology is of paramount importance to criminal law, but it does not pretend to be its only source of interpretation or guide for its development. As some authors show, the line between positive and normative economic analysis in present-day European antitrust is blurred.<sup>51</sup> This trend is exacerbated by the dominance of the welfare-oriented approach, which jeopardises the other important aspects of competition law. Even if the universality of cost–benefit analysis were to enable its perception as pure objective science, it could not guide the law.<sup>52</sup>

### Conclusion

[I]f we compare the conditions of to-day with those of thirty years ago, we see an increase of economic methods and economic influence in some parts of the work of government.<sup>53</sup>

This statement of the former president of Yale University sounds topical today, though it was made in 1899. The role of economics in legal reasoning can be supported or opposed, but it cannot be ignored. The main task of this article was to explore the basic premises of economic reasoning, making an attempt to understand *how economists think*. After describing the main logical apparatus of economics, it reverted to the issue of interdisciplinarity. The conclusion of the article is that effective interdisciplinary research should be distinguished from a *fusion* of economic and legal methodologies. Each discipline is characterised by established analytical schemes which can be neither merged into, nor supplemented by, each other. True interdisciplinarity means understanding the *language* of the other discipline

47 Horwitz, “Law and economics”, n. 30 above: “Like . . . Marxism, law-and-economics treats law as ‘superstructure’, merely reflecting what is ‘real’ in the ‘base’ of economic rationality.”

48 H J Hovenkamp, “The antitrust movement and the rise of industrial organisation” (1989) 68 *Texas Law Review* 105: “Even though they spoke different languages, economists and lawyers derived their ideas from each other.”

49 E Engle, “Law and economics: theoretical puffery, exaggerated claims and counterfactual models” (2009) 2 *Journal of Jurisprudence* 29.

50 G Teubner, “The two faces of Janus: rethinking legal pluralism” (1992) 13 *Cardozo Law Review* 1443, p. 1455: “The lawyers observe economic action under the code legal/illegal and misread economic processes and structures as sources of law. Conversely, clever economic actors misread legal norms under the economic code as bargaining chips, as new opportunities for profit-making. Again, we have a symbiosis of mutual distortion.”

51 Monti, “EC Competition Law”, n. 45 above, pp. 4–5: “[The Commissioner’s statement that the aim of competition enforcement is to protect competition in the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources. An effect-based approach, grounded in solid economics, ensures that citizens enjoy the benefits of a competitive, dynamic market economy] blurs the line between positive and normative economic analysis.”

52 H Kelsen, *General Theory of Law and State* (New York: Russell & Russell 1973), p. xiv: “One of the most difficult tasks of a general theory of law is that of determining the specific reality of its subject and of showing the difference which exists between legal and natural reality.”

53 A T Hadley, “The relation between economics and politics” (1899) 8 *Yale Law Journal* 194, p. 205.



rather than developing an uncritical Esperanto.

The epistemic border between disciplines implies that “law produces by itself all the distinctions and concepts that it uses, and the unity of law is nothing but the fact of this self-production”.<sup>54</sup> This implies that law cannot be explained by non-legal apparatus and the other way around, “[p]articulars are legally relevant only inasmuch as they can be brought within juridical categories”.<sup>55</sup> In Kelsen’s sense, purely legal silos (analytical jurisprudence) recognise the importance and validity of external views on law (sociological jurisprudence in general),<sup>56</sup> suggesting that both stand side by side but “neither can replace the other because each deals with completely different problems”.<sup>57</sup> The origins of this approach can be traced – as Paulson shows<sup>58</sup> – back at least to Jellinek.<sup>59</sup> Kelsen’s critics also see these similarities.<sup>60</sup> This explains the position of legal positivism, liberating it from misinterpretation by its critics who perceive legal positivism as a claim “that law must be strictly severed from morality . . . [and economic analysis, which denies] the possibility of any bridge between the obligation to obey law and other moral obligations”.<sup>61</sup>

Even the tenants of a purist *intra*-disciplinary interpretation of law do not reject the importance of economic knowledge. They claim merely that the law *can* be defined by economics, but that the ensuing definitions can serve *only* as theoretical modelling with no normative implications, arriving essentially at Frost’s “good fences make good neighbours” conclusion.<sup>62</sup>

If these observations are correct, this may reveal one of the main methodological discrepancies between the economic and legal analyses of the broader societal problems. While the former tends to operate within the benchmark of efficiency, addressing the issues of the most effective generation and/or allocation of limited resources, the latter is more dogmatic and therefore less flexible in respect to the inductive discoveries and the specificities of regulated context. While the former tends to be utilitarian, the latter holds important deontological elements. This might be the reason why for economists the idea of competition is usually perceived as a state of the ultimate equilibrium, while lawyers tend to understand better the dynamic aspects of the competitive interactions, disentangling the outcomes of such interactions from the competitive process itself.

For lawyers, the independent support of the competitive process may be fairly reasonable, provided the provisions of positive law enable/require such support. For most

54 R Nobles and D Schiff, “Introduction” in N Luhmann, *Law as Social System* (Oxford: OUP 2004), p. 6.

55 E J Weinrib, “Legal formalism: on the immanent rationality of law” (1988) 97 *Yale Law Journal* 949, p. 976.

56 J M Balkin and S V Levinson, “Law and the humanities: an uneasy relationship” (2006) 18 *Yale Journal of Law & the Humanities* 155, pp. 161–2: “An externalist attitude . . . studies law as a social phenomenon, much as an anthropologist might study the ancient beliefs of the Mayan religion without adhering to them . . . In like fashion, literary critics might be interested in the rhetorical operations of law; historians might be interested in the development of law in its social and political context, and so on.”

57 Kelsen, “The pure theory of law”, n. 36 above, p. 52.

58 S L Paulson, “Hans Kelsen’s earliest legal theory: critical constructivism” (1996) 59 *Modern Law Review* 787, pp. 798–800.

59 G Jellinek, *System der subjektiven öffentlichen Rechte* (Tübingen: J C B Mohr 1905).

60 C Schmitt, *Political Theology: Four chapters on the concept of sovereignty* (Cambridge, MA: MIT Press 1985), p. 18 (original emphasis): “To obtain in unadulterated purity a system of ascriptions to norms and a last uniform basic norm, all sociological elements have been left out of the juristic concept. The old contrast between is and ought, between causal and normative considerations, has been transferred to the contrast of sociology and jurisprudence, with greater emphasis and rigor that had already been done by George Jellinek and Kistakowski, but with the same unproved certainty.”

61 L L Fuller, “Positivism and fidelity to law: a reply to Professor Hart” (1958) 71 *Harvard Law Review* 630, p. 656.

62 P F Hubbard, “Sociology of law: one view from the lawyer’s side of the fence” (1976) 7 *Rutgers Law Journal* 458.

economists, the very idea of such support of the competitive process independently of the outcomes, which can be calculated within the equilibrium model of perfect competition, may well appear to be nonsensical. This explains the scepticism with which mainstream economics addresses the independent normative value of the competitive process.