Associate Professor Steve Keen
Email s.keen@uws.edu.au
Ph: 61 2 4620 3016 Fax: 61 2 4620 3727
30th April 2004

David Card
Co-editor, *American Economic Review*

Dear David,

Thank you for your letter of April 4 covering the single referee's report on our paper "Aggregation fallacies in the theory of the firm" (Ms. 20040083).

Unfortunately your referee has failed to come to grips with the main point of the paper and has as a result given you quite misleading advice. He says that "the main point is that the comparison depends on the aggregation of cost curves". This is in fact a minor though necessary preliminary.

The main point is that the accepted profit maximization rule of equating marginal revenue and marginal cost is false. True profit maximization requires that marginal revenue exceed marginal cost by a specific ratio. Our paper shows that the correct rule is not

$$MC = MR$$

but

$MR - MC = \frac{n-1}{n} \cdot (P - MC)$ (where n is the number of firms in the industry).

The section that your referee then describes as having "some novelty" but "not a sufficient contribution for publication" is simply one application of this quite substantial revision to accepted economic belief.

This innovation has not been published previously and is of substantial general interest, which befits publication in a general purpose journal like the *AER* rather than the *JIO* as you recommend.

The fallacious formula that we correct forms the basis for instruction in economics, and is also taken for granted by research that presumes the equality of marginal cost and price in general equilibrium modelling, etc. Our paper shows that profit maximization is incompatible with the equivalence of marginal cost and price in individual markets and in general equilibrium.

If these points were not clear to you in the original manuscript then I would like the opportunity to revise the paper to make them more explicit. An obvious starting point would be to revise the title of the paper to "Equating marginal cost and marginal revenue does not maximize profit".

Yours sincerely,