Competitive Markets and Price Regulation (Summary of Chapter 4 in Microeconomic Policy: A New Perspective 2nd Edn)

Chapter · July 2008

CITATIONS
0

READS
103

2 authors:

Clement Allan Tisdell
The University of Queensland
1,995 PUBLICATIONS **12,089** CITATIONS
SEE PROFILE

Keith Hartley
The University of York
225 PUBLICATIONS **2,743** CITATIONS
SEE PROFILE

Competitive Markets and Price Regulation

Chapter 4 in Clem Tisdell and Keith Hartley (2008), *Microeconomic Policy: A New Perspective*, Edward Elgar, Cheltenham UK and Northampton, MA, USA

4.1 Introduction

Spillovers or externalities can result in a social (Kaldor-Hicks) welfare loss, even under perfectly competitive conditions, and as pointed out in Chapter 2, may call for government intervention in markets. But actual government intervention in competitive markets is not limited to correcting market operations to allow for externalities. There is considerable government interference in competitive markets even when externalities do not occur. *The purpose of this chapter is to consider how and why governments interfere in competitive markets even when externalities are absent and to outline the economic effects that such intervention has*. Government policies to maintain, to limit, or to stabilize product or factor prices, and government regulation of prices in international markets are examined.

Before considering the effects of such intervention, it is worthwhile to digress and clarify the meaning of different types of market competition. This is because this chapter concentrates on government intervention in perfectly competitive and purely competitive markets; intervention which in the absence of externalities is liable to result in a Kaldor-Hicks social welfare loss.

Defining the state of competition in an industry and in markets generally is not as straightforward as it may appear at first sight. It is likely to depend on the ease of entry of new firms into the industry, the number of producers in the industry, and the ease with which other products can be substituted for those of the industry. An industry tends to be more competitive the easier entry is into it, the larger the number of producers are in the industry, and the more nearly other products substitute for those of the industry.

Defining Competition

Two broad approaches to defining the state of competition in an industry are found in the economics literature. One approach defines competition in an industry by reference to its structure and the other defines it by reference to the performance of the industry. The traditional approach is the structural one. The state of competition in an industry is defined by the number of producers in an industry, conditions of entry into the industry, the degree or absence of collusion between market participants, and the degree to which their products are identical or differentiated. Thus a purely competitive industry is one in which there are many sellers and buyers (so many that the supplies or purchases of any individual do not influence the price of the commodity), commodities are homogeneous, and therefore perfect substitutes, and entry and exit in the long run is easy. Markets for fish and vegetables are

usually of this type. In a perfectly competitive market, these characteristics are satisfied, but in addition, traders in the market have perfect knowledge of the relevant economic variables.

At the other end of the competition spectrum is pure monopoly. This is characterized by a single seller of a product with no close substitutes and the absence of possible entry by other firms. Posts and telecommunications in many countries used to be a state monopoly. Often inventors of new products, such as a new medicine or a veterinary product, can obtain a patent from the state which gives them an exclusive right to the inventions' use for a limited number of years. This legally established monopoly is often justified on the grounds that it provides an incentive for research and development effort.

Oligopoly is a market situation in which there are few sellers. The supply of motor fuel, cement in some regions, air travel, and man-made fibres is oligopolistic. A monopsony is said to exist when there is a single buyer of a commodity and an oligopsony arises when there are few buyers of a commodity. With the growth of supermarket chains, the retail trade has increasingly become concentrated in the hands of a few companies in some countries, and their suppliers may be faced with an oligopsonistic market in which larger retail chains exercise considerable market power (Smith, 2006). Each of these circumstances has implications, or likely implications, for the degree of competition in an industry. This chapter concentrates on purely competitive and perfectly competitive markets, but other market structures will be considered in later chapters.

Stock Characteristics of Perfect Competition and of Monopoly

It is useful now to summarize the 'stock' characteristics of perfect competition and monopoly and compare these using Table 4.1. Assuming that market participants have perfect knowledge, the structural characteristics stated in the top part of this table give rise to the performance characteristics mentioned in the lower part of the table. In assessing markets, some economists and lawyers have concentrated on the structural characteristics of industries but others have been more concerned about the performance characteristics of markets.

Performance Definitions of Competition Compared to Structural Characteristics

Differences in the performance and structural approaches to assessing economic competition in an industry are summarized in Figure 4.1. Performance definitions of competition pay little attention to market structure but concentrate on the question of whether the performance of an industry is similar to that which might be expected under pure competition. If there is little divergence between the price charged for a product and the marginal cost of producing it, an industry might be regarded as workably competitive by this approach. This may be given further support if long-term profits in the industry are not excessive, if technological progress and innovation occur at a socially desirable rate, and if avoidable waste and inefficiency do not occur in the running of businesses in the industry. Given this approach, it is feasible for an industry which is structurally oligopolistic to be workably competitive. If it is shown that an industry is workably competitive (despite its structure), this is sometimes used to argue that the market situation is socially acceptable.

There are possibly no markets in practice which are perfectly competitive and few are purely competitive. The degree of perfection of knowledge and mobility of resources required for

the operation of perfect competition is so great that it can only be approached. But the perfectly competitive model provides an ideal or a benchmark as a basis for welfare judgements and comparison. The model is useful in a similar way to Euclidean geometry. Both refer to limiting cases but both have applications to the actual world because the degree of approximation is sufficiently close for some purposes.

There has been a political shift in favour of market systems and economic liberalism in the last few decades (see Chapter 10). This means that there is less government regulation of the operation of economies than was common in the 1950s and 1960s and most of the 1970s. However, the speed at which different countries have moved to deregulate the operation of their economies and open them to international competition has varied in timing and in extent. Australia, for example, started on this path in the second half of the 1970s (King, 1997; Tisdell, 2005) whereas India delayed this switch in policy until the beginning of the 1990s. China embarked gradually on such a course beginning in 1979. Then it began to move from a centralized relatively closed economic system towards a market system increasingly open to the outside world. As a result of such changes, there is less government regulation of purely competitive markets than used to be the case. For example, in Australia, milk prices are no longer regulated by governments and entry into mille production is no longer controlled by governments (Edwards, 2003).

Many markets for agricultural products and for fish either satisfy or nearly satisfy the conditions required for pure competition. Nevertheless, in many countries, there is still considerable government interference in the operations of these markets. In Japan, for example, rice production is heavily subsidized. In the EU, Japan and USA, imports of many competing agricultural products are restricted. While capital movements and foreign exchange markets were commonly controlled by most governments in the past, this is not usually the case now. In several countries, minimum wages for work are specified, for example, in the UK by the Low Pay Commission and in Australia (in 2007) by the Australian Fair Pay Commission, which replaced the Australian Industrial Relations Commission in 2006. Local governments also limit market competition by restricting the purposes for which land can be used. The regulations, for example, often restrict the type of business that can be conducted in a particular area.

Table of Contents of Chapter 4

List of Figures and Tables for Chapter 4