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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 milke 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

4. Competitive Markets and Price Regulation	61
4.1. Introduction	61
<i>Defining competition</i>	61
<i>Stock characteristics of perfect competition and of monopoly</i>	62
<i>Performance definition of competition compared to structural characteristics</i>	62
4.2. Why does the State Regulate Competitive Markets?	64
<i>Information failure (due to externalities or spillovers)</i>	65

	<i>Pressures from producers for government enforcement of cartel-like arrangements</i>	65
	<i>Stabilization of incomes and prices in an industry</i>	67
	<i>Pressure from participants on the competitive side of a market to regulate prices on its less competitive side</i>	68
4.3.	Price Regulation in Product Markets: Some Examples	68
	<i>Maximum prices – rent of dwellings</i>	68
	<i>Public intervention in the provision of education generally</i>	71
	<i>Subsidies for university education and regulation of fees</i>	72
	<i>Europe’s common market agricultural policy (CAP) and the support of farm incomes</i>	76
4.4.	Price Regulation in Factor Markets: Some Examples	80
	<i>Minimum wage rates</i>	80
	<i>Regulated rates of interest, dividends and profits</i>	81
4.5.	Price Regulation in International Markets: Some Examples	82
	<i>Fixed exchange rates</i>	83
	<i>Tariffs and quotas on imports</i>	85
	<i>Imperfect competition modifies predictions about the effects of tariffs</i>	86
	<i>Import quotas</i>	88
4.6.	Concluding Comments	89
	Reading and References	89
	Questions for Review and Discussion	89

List of Figures and Tables for Chapter 4

<i>Figure 4.1</i>	Some of the different factors taken into account in structural and performance definitions of competition	63
<i>Figure 4.2</i>	Illustrations of the incentive for individual suppliers to break an agreement limiting their supplies even though restriction is, in their collective interest. For this example, the higher the agreed price in a cartel, such as OPEC, the greater is the incentive of individual suppliers to undercut the price and/or exceed their supply quotas.	66
<i>Figure 4.3</i>	Excess demand results from decreeing a maximum price for a commodity less than its equilibrium price. Means other than price alone are then used to allocate supplies to buyers. In the above case, a rent ceiling of P_1 results in the demand for housing space for renting exceeding the available supply by $X_3 - X_1$. The deadweight or Kaldor-Hicks loss of rent control is shown by the hatched triangle.	69
<i>Figure 4.4</i>	An illustration of some economic consequences of the government providing the disadvantaged with a rental subsidy.	70

<i>Figure 4.5</i>	Regulation of university fees results in ‘excess’ demand for university places and political pressure for expansion of such places.	73
<i>Figure 4.6</i>	Free public hospital services typically result in excess demand for public hospital places and queuing occurs as indicated by waiting lists for admissions	74
<i>Figure 4.7</i>	An illustration of economic consequences of public subsidies for medical consultations.	75
<i>Figure 4.8</i>	An illustration of the economic consequences of the EU’s Common Agricultural Policy based on pre-1992 policies. After 2003, CAP changed substantially and there were also some reforms in the preceding decade.	77
<i>Figure 4.9</i>	A hypothetical relationship between environmental quality and the level of agricultural output given the amount of resources available in agriculture. Adjustments in the level of agriculture production (and in techniques used in agriculture) may be required to bring about a socially acceptable outcome. The reforms of 2003 to the Common Agricultural Policy were intended to take this into account.	79
<i>Figure 4.10</i>	A minimum wage rate in excess of the equilibrium wage rate leads to involuntary unemployment if markets are competitive. In this case, a minimum wage rate of w_3 for women results in the involuntary unemployment of $L_3 - L_1$ of women and in fewer women (L_1) being employed than in the absence of intervention (L_2).	80
<i>Figure 4.11</i>	Controls on the maximum rate of interest lead to a shortage of available funds if the maximum rate is less than the equilibrium one. In this case, a ceiling on the rate of interest r_1 of results in an excess demand for funds of $K_3 - K_1$ and in less loanable funds being supplied than in a free market.	82
<i>Figure 4.12</i>	A foreign exchange market in which equilibrium occurs when the US dollar costs 50p. Suppose, however, that the Bank of England fixes the exchange rate at 40p to the dollar. The pound is then overvalued in relation to the dollar and the demand for dollars for foreign exchange purposes exceeds their supply by $X_3 - X_1$. Some mechanism (such as priorities for different purposes for which foreign exchange is required) is needed to ration out the reduced supply of dollars.	83
<i>Figure 4.13</i>	Stabilization of the exchange rate by the use of (buffer stock) reserves of foreign currency. In this case, a buffer stock system enables the exchange rate to be stabilized at the fixed exchange rate of P_2 . In the absence of intervention the exchange rate fluctuates between P_1 and P_3 .	84
<i>Figure 4.14</i>	An example of the effect of a tariff on imports, assuming perfect competition in the domestic industry. The tariff raises the price of yarn in the domestic market, expands its local production, reduces imports and increases the surplus earned by domestic suppliers. In contrast, as discussed below, domestic production may fall when a tariff or import quota is imposed if the domestic industry is	85

imperfectly competitive. In the above case, imports fall after imposition of the tariff by $(X_2 - X_1) + (X_4 - X_3)$, local production rises by $X_2 - X_1$, and the surplus of domestic suppliers rises by the hatched area. But if this gain in producers' surplus is offset against the loss in consumers' surplus, the net social loss (in the Kaldor-Hicks sense) from the imposition of the tariff amounts to the flecked area.

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| <i>Figure 4.15</i> | A diagram to illustrate the impact on the behaviour of a domestic monopolist of tariffs on the import of competitive products. Depending upon the circumstances discussed above, the tariff can lead either to an increase or a decrease in the monopolist's level of output whereas under perfect competition an increase in the tariff on a product can normally be expected to result in an increase in its level of domestic production. | 87 |
| <i>Figure 4.16</i> | Relationship between various economic magnitudes and the level of a tariff on a product assuming that domestic supply of the product is in the hands of a monopoly. Specifically, assuming the monopoly-type situation shown in Figure 4.16, general relationships for the following are shown as a function of the level of tariff imposed on the imports of X: the level of imports of X, the profit of the domestic monopolist, the quantity of output of X produced by the monopolist, and the level of employment in the production of X. | 88 |
| <i>Table 4.1</i> | 'Stock' characteristics of perfect competition and monopoly | 63 |