

Government intervention in market

Government



The Market Structures The complete economic activities are handled in four different market structures, namely perfect competition, monopolistic competition, oligopoly and monopoly. The nature and degree of competition varies among the all the above-mentioned four markets. In summarized manner we can describe that as the number of sellers increases, each firms' ability to charge high prices reduces. If number of buyers increases then buyers practice to purchase the goods at his choice price diminishes. The sellers have to face price competitions if the product is homogeneous and price and non-price competition exist if goods are differentiable.

A large number of buyers and sellers make competition perfect. A homogeneous good with a number of sellers put the market in competition but a homogeneous good in a few sellers and a number of buyers leads the competition in another directions and put sellers in relatively good position. The complete knowledge of buyers and sellers regarding market price and goods encourage fair competition on the other hand incomplete knowledge of product, alluring misleading advertisements and forced differentiation of the goods break the pure competition. Production of a good by a particular producer or a few producers put the economy in their hands (monopoly) but if only a few buyers or a union of the buyers is controlling (monopsony) the market then market becomes non-competitive. All of the above there are some peculiar goods, which are non-excludable (can be consumed by any one without paying the cost) and non-rivalrous (no one has exclusive right over its consumption), that are not produced by any profit making companies such as military service to protect the nation.

MarketFailureCauses From the above discussion it is very clear that except

perfect competition rest three market structures are not fulfilling the optimal criteria of economy i. e.

high over all economic growth, full employment and fair distribution of income among the different parts of the society. The reasons for such market failure or non-attainment of the Pareto optimality (efficiency in exchange/consumption, efficiency in production and overall Pareto efficiency) are as follows: 1. Imperfect Market: Whenever the market is imperfect as under monopoly, monopolistic competition or oligopoly, the perfect market will fail to achieve the Pareto optimal conditions. 2.

Externalities: If the prices in a market do not reflect the true marginal costs and/or marginal benefits associated with the goods and services traded in the market then there must be present of some externality. If the productivity of an individual affects the benefits of the others is called the production externalities and if the consumption levels of others affect the welfare of the individuals then consumption externalities occur. 3.

Public Goods: Because public goods are non-excludable and non-rivalrous, they are not sold in a free market like private goods. Therefore, they cannot be provided by private firms. 4. Increasing returns to scale: There are increasing return to scale or decreasing costs due to technical externalities that lead to market failure under perfect competition. When there are increasing returns to scale in a perfect competitive market, they lead either to monopoly or to losses. 5. Asymmetric or Incomplete information: In the real world, there is asymmetric or incomplete information due to ignorance and uncertainty on the part of buyers and sellers of goods.

Thus they are unable to equate social and private benefits and costs. Type of Government Intervention At this stage Government intervention comes into effect and Government try to provide the following benefits: 1. Control non-competitive behavior of the firms. a. Taxation of monopoly profits (the Windfall Tax) . Regulation of oligopolies/cartel behavior c. Policies to introduce competition into markets (de-regulation) 2.

Using Tax or subsidies or by environmental policies combat externalities. 3. Provide public goods. a. Direct provision of public goods (military services) b. Price controls for the recently privatized utilities 4. Provide information and assure information flow by various law and policies.

5. Government changes the income distribution by society by imposing income tax and inheritance taxes etc. Why corn/ soybean or wheat like agricultural commodity market do not need government intervention: The agriculture commodity market for corn/wheat/soybean like commodities fulfill the conditions of perfect competitive market as a) Many small producers b) Homogeneous product c) Many buyers d) Free entry and exit e) All the producer's face the same cost as they have equal access to the same technology. In the perfect competitive market a seller/producer has to simply determine how many units to produce and sell at the current equilibrium price. If a perfectly competitive firm earns short run economic profit, new firms enter in the long run and market supply increases hence the price decreases. As the price falls each firm's economic profit diminishes. To restore the economic profit, existing firms make every effort to become more efficient, but their success encourages further entry in the market.

Due to this continuous entry in the market in the long run each firm get a normal profit. If firms face the economic loss in the perfect competitive market and they are optimally efficient with current available technology then this environment compels some (weaker) firms to leave the market in the long run. As some firms exit, the market supply decreases and price increases. The process continues in the long run till each surviving firms earn a normal profit. The graph below demonstrates the longrun equilibrium in a perfectly competitive market, where profit equals zero: [pic] We observe that the following is the case for a perfectly competitive market in long-run equilibrium

- Profit (π) = 0 because $P = ATC$.
- $P = MR = MC = ATC$.
- The firm is producing the quantity where ATC is at its minimum point.

Technological Efficiency: At given cost of production (resources used) if the output produced is maximized then it is called technological efficiency. From the above diagram it is clear that the firm is technologically efficient as it is producing the output at the lowest point of its cost curve (ATC). It is natural as

- i) All profit maximizing firms want to increase their profit by minimizing the cost of production; as in the perfect competition they cannot raise the prices of homogeneous product.
- ii) As in long run profit equals to zero for a perfectly competitive firm, hence, if the firm does not choose to minimize the production-cost, ATC will increase and profit would be less than zero.

Allocative Efficiency: It occurs when resources are allocated to the production of goods in such a manner that society is a well off as possible.

Marginal social cost (MSC) captures the opportunity cost of using another input in the production of a good, where opportunity cost refers to the best

alternative use of an input. If more of a good is demanded in the market, additional inputs (e.

g. labor, electricity, etc.) are required to produce additional output of that good. We can measure the cost of added production by looking at the marginal cost (MC) of producing one more unit of the good. The rule to achieve allocative efficiency is that the additional benefits received by consumers from consumption of a good equal to the incremental costs of producing another unit of that good. $MSB = MSC$ To achieve allocative efficiency in the use of productive inputs, marginal social benefit must equal marginal social cost for a good or service. If marginal social benefit is greater than marginal social cost ($MSB > MSC$) then the benefits attained by consumers from the consumption of another unit of the good or service exceeds the opportunity cost of the allocation of additional inputs into the production of that good.

In other words, when $MSB > MSC$, society wants more of the good produced and uses the market to signal that desire. How does the market convey this information? Since price (P) equals marginal social benefit (MSB) and marginal cost equals marginal social cost (MSC), we have the condition that: $P = MSB = MSC = MC$; or $P = MC$ So the Pareto optimality conditions fulfilled. Hence the agriculture commodity markets for corn/wheat/soybean like commodities need not any government intervention. Local Cable TV or local gas company need government intervention: The local cable TV or local gas company in many countries works as a monopolist. The required conditions to be a monopolist are: 1. There is one seller or producer of a homogeneous product. 2.

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There is no close substitution of the product available 3. There is perfect competition in the factor market so that it can minimize the cost of the production 4. There are many buyers of the product but none of them can influence the price of the product. 5. There is no threat of entry or exit. Given above assumptions, the price, output and profit under monopoly are determined by the forces of demand and supply. The monopolist has complete control over the supply of the product.

He is also a price maker who can set the price to his maximum advantages. But he cannot fix the price and output simultaneously. Either he can fix the price and leave the output to be determined by the consumer demand at that price or he can fix the output to be produced and leave the price to be determined by the consumer demand for the product. Thus whatever price he fixes, whatever output he decides to produce are determined by the condition of demand. [pic]We observe that the following is the case for a perfectly competitive market in long-run equilibrium

- Profit (π) ≥ 0
- because $P \geq ATC$.
- $P \geq MR = MC$
- The firm does not produce the quantity where ATC is at its minimum point.

Technological Efficiency: Although each firm in monopoly want to reduce its cost of production to maximize the profit yet the industry/ market does not produce the output at the minimum point of ATC so the monopoly market is technologically not efficient.

Allocative Efficiency: As we have already discussed that the condition to attain allocative efficiency is $P = MSB = MSC = MC$; or $P = MC$ But as P is greater than MC in the case of monopoly so it is inefficient on allocation basis, which is called deadweight welfare loss (social cost). We may say that

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the monopoly leads to misallocation and underutilization of resources and reduction in consumer's welfare. Government may impose regulations to control a monopoly: For industries where the average total cost curve displays tremendous economies of scale, the government may decide that having a single provider is desirable. Using the measures of productive and allocative efficiency, regulators know that when left alone, a profit maximizing monopoly produces less of the good or service than is desired by society and at too high of a cost. Regulated monopolies agree to adhere to government oversight in order to sustain their monopoly status. 1.

Forbidding the formation of monopolies (e.

g. , antitrust laws) 2. Forbidding monopolistic behavior (like predatory pricing) 3. Ensuring standards of provision. 4. Ensuring competition exists (e. g.

deregulation) 5. Imposition of a lump-sum tax on a monopolist (shifts AC upwards), and supernormal profits are taken as tax. Governments may also regulate MC/AC pricing for monopolies. Effects of MC/AC regulating pricing by government intervention : Marginal Cost Pricing : Regulators set price where marginal cost equals demand. This is the most efficient solution as allocative efficiency is achieved: $P = MC$ and therefore $MSB = MSC$. But the firm is losing money, as total revenues are less than total costs (see the figure given below). In the long run, if this condition prevails, the firm will shut down and cease to operate, not especially a desirable outcome if the monopoly provides an essential good or service such as electricity or water.

It is sometimes called optimal price regulation. It does not work with natural monopolies (they will not earn a profit, and would exit the industry). See the following figure. Average Total Cost Pricing : For natural monopolies, the regulator can force monopolies to charge the price where ATC crosses Demand. At this price economic profit will be zero, although there will be normal accounting profits. Sometimes called non-optimal price regulation. This is a more efficient outcome than no regulation at all.

Price still exceeds marginal cost and therefore, marginal social benefits exceed marginal social costs. With average cost pricing, allocative and productive efficiency are not achieved. The firm earns accounting profits but no economic profits. Smaller deadweight loss than unregulated monopoly. See the diagram given below. [pic]