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Deregulation Does Not Imply Competition

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It is interesting to observe California's electricity supply debacle and large US air carriers attempting to gobble up one another. Both problems are a result of deregulation. However, many economists and legislators believe that deregulation implies that imperfect markets will become perfect. For instance, in the early eighties, one of my microeconomics professor asked on a test what would deregulation do to the airline industry. In my answer, I indicated that, in the long run, the major carriers would initially lower prices, operate on the most profitable routes, displace less profitable carriers, and finally raise prices. He indicated that my answer was incorrect. He stated that based on theory the market would become highly competitive.

However, my intuition and experience in the chemical industry indicated that even under deregulation barriers to entry would exist. For instance, the cost of purchasing a fleet of airlines would dissuade new entrants. Likewise, the cost of building new power plants is a dissuading, and delaying, factor for any new entrant. Moreover, new entrants know that they may not be able to capitalize on their investment value, since the established firms can temporarily lower their offer prices. Additionally, the established firms can buy out the new entrants, and close older facilities. Thus, they are able to maintain or decrease supply.

Competition exists where there are many sellers and many buyers. Monopoly exists where there is one seller and many buyers. Competition and monopoly are extremes within the spectrum of exchange. Often, however, the economy is a mixture of both. Therefore, the recent tendency of firms to consolidate should be a cause for some concern. We have seen consolidation in the petroleum, airline and in other industries. In the electricity industry we see facilities been taken off line for maintenance overhaul and, consolidation will follow. The result of consolidation and off line facilities is a reduction in supply.

It is critical to understand how a reduction in supply affects the price for goods or service in imperfect markets. In imperfect markets, the demand for goods and service is inelastic, meaning that the slope of the demand curve is steep. Inelastic demand means that there are no good substitutes for the firm's products or services. Thus, a small reduction in supply causes a large upward price movement. As a result, firms that reduce supplies through consolidation, or by taking facilities off line, can reap windfall profits.

Industries or firms that can produce larger outputs with ever decreasing-cost per unit are not truly competitive, even when deregulated. For example, if firms in a decreasing-cost industry had similar cost functions, with declining average cost, the firm that achieved an output lead would be able to produce at a lower cost. Thus, the industry will, more likely than not, remain an oligopoly (few sellers) or a single dominant firm will emerge. Economists call a single dominant firm a monopolist. A single firm can set prices above free-entry cost or produce wastefully.

Moreover, if the market or industry for products or services has an inelasticity of demand, the dominant firms in the industry will have high incentives to collude. Restricting output would significantly increase their profits. Thus, in the past, government would regulate industries with decreasing-cost functions. Regulation allows the monopolist to cover the cost of production and normal profits.

Congress should reevaluate the need for re-regulating firms with decreasing-cost functions and inelastic market demand, particularly if the firms are subject to output contractions and unreasonable price increases. Otherwise, these firms in a deregulated market will charge as much as the market can bear.

Under regulation, the regulators would require decreasing-cost firms to equate price with average cost. However, under deregulation the monopolist price is directly above the intersection of the firm's marginal revenue and marginal cost, higher than the regulated price. Accordingly, society can achieve ideal output by providing permanent government subsidy to the decreasing-cost producer. The firm will then equate price to its marginal cost and supply will increase.

Opponents of regulation, however, argue that if society allows prices and profits to rise, it will provide incentives for new entrants. In addition, new entrants will increase supply and prices will fall. This is indeed correct in competitive markets where barriers to entry are insignificant. However, barriers to entry are often insurmountable in industries that require large investment. As a result, these industries are unlikely to have many sellers. Rather, they will have many buyers and few sellers. Another argument against regulation is that regulated firms are less interested in achieving technological advances that may reduce their average cost. This argument is somewhat mute because it is also applicable to unregulated decreasing-cost firms.

The monopolist fixes price such that marginal revenue equals marginal cost, leading to a curtailment in supply. Thus, there is a redistribution of income towards the monopolist and away from the consumers. Such redistribution causes public concern. Clearly, it should also cause legislative concerns, since legislators represent the public.

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