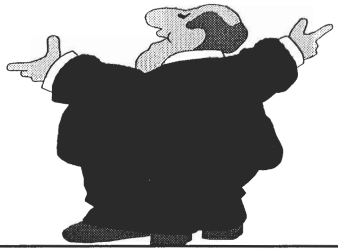
Competition in the real world



Profit maximizing:

- Firms are not just concerned with short run profit
- They are also concerned with long run profit
- Most firm want good reputations

ex: help environment

- such expenditures on reputation may increase long run profit, but they reduce short run profit

The Hall of Shame

Corporate scandals are busting out all over, in a wide range of industries. Here are some of the most famous -- or infamous.

COMPANY	INDUSTRY
Enron	Energy
WorldCom	Telecom
Xerox	Business equipment
ImClone Systems	Drugs
Global Crossing	Telecom
Tyco	Manufacturing
Rite Aid	Retail
Adelphia	Cable
Qwest	Telecom
Peregrine Systems	Software

Asymmetric information

Agents on one side of the market have much more information than those on the other side

Adverse selection:

In a market where buyers cannot accurately gauge the quality of the product that they are buying, it is likely that the marketplace will contain generally poor quality products. Adverse selection was first noted by Nobel Laureate George Akerlof in 1970.

Monitoring problem:

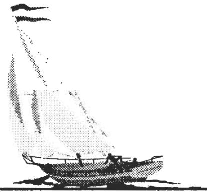
- Employees' incentives differ from the owner's incentives
- Most U.S. CEO's are very well paid
- Are multimillion dollar salaries to high?
- Most are not pure salaries, they include stock options and bonuses for performance

Lazy monopolist:

•X-inefficiency - firms operating far less efficiently than they could

•They don't make large profits

•Instead their costs rise because of inefficiency



Competition limits the lazy monopolist:

•If all firms in an industry are lazy, competitive pressures don't reduce their profits

•if a new efficient firm enters into the industry or the industry is opened to international

•competition, massive restructuring is necessary

•Corporate takeover- Managers don't like takeovers. A takeover may mean losing their jobs

Real world competition:

•Perfect competition is unlikely in the real word

•Perfect competition assumes individual accept a competitive industry structure

•Self seeking individuals don't like competition for themselves

ex: price supports

Competition:

•Pure monopolies are as rare as perfect competition

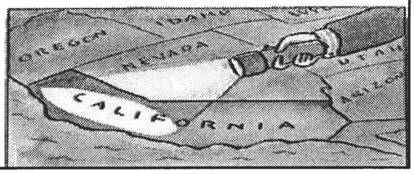
•for a monopoly to exist firms must be prevented from entering

•even if the monopolist has a patent potential competitors get around the obstacle by developing a slightly different product

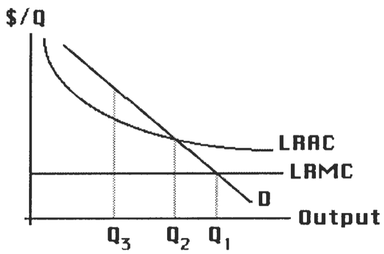
ex:computers

Natural Monopoly

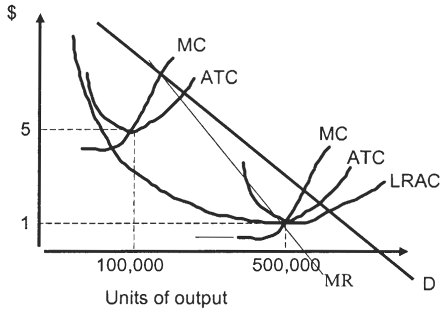
An industry that realizes such large economies of scale in producing its product that single-firm production of that good or service is most efficient



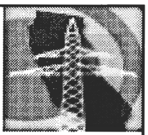
Economies of scale must be realized at a scale that is close to total demand in the market



Increasing firm outpu t from 100,000 to 500,000 units low ers avera ge costs from $5 to $1.

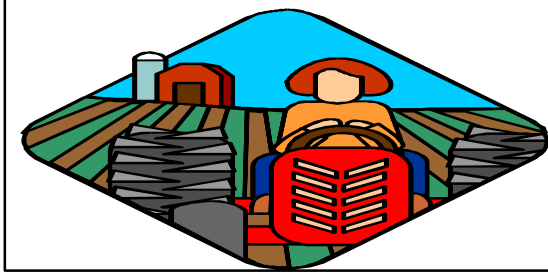


There are several ways to regulate natural monopoly.



- The government sets a monopoly's price equal to marginal cost.
- The government enforces a price ceiling equal to marginal cost, and subsidizes production.
- The government sets a monopoly's price to cover average cost per unit.

Agricultural Markets



The nature of agricultural markets

•Neither the United States nor any other country allows the market unhindered, to control agricultural prices and output

Good/bad paradox:

•The phenomenon of doing poorly because you're doing well

•Enormous increases in productivity has reduced agriculture's importance

•200 years ago, 97% of labor was engaged in farming

•Today less than 3% of the U.S. labor force is engaged in farming

A way around the good/bad paradox

- Limit the production of all farmers
- The difficulty of organizing privately to limit supply can be avoided by organizing through the government
- Suppliers can organize and get the government to establish programs to limit production or hold price high

Price floor(above equilibrium)

- Some producers are helped, some are hurt
- Consumers pay more for less
- Gov’t must prevent the surplus from being resold

Pay farmers not to grow:

- JFK’s acreage control programs early 1960s
- Farmers may pretend they have an interest in growing the good in order to get the subsidy
- Farmers get a higher price if they produce
- If farmers don’t produce they still get paid and can use their land to produce other goods
- Consumers pay more for less
- Higher taxes

Subsidizing the sale of the good:

•Suppliers are paid $5 to supply 200 bushels of wheat. The gov't turns around and sells that quantity for what ever it can get($1)

•Farmers are paid more

•Consumers pay less

•Taxes increase

Buying up and storing, giving away or destroying the good:

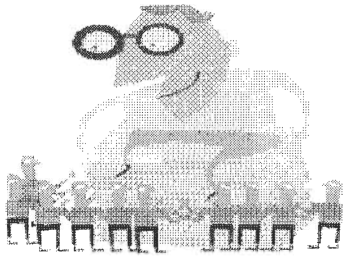
•The gov't can buy up all the excess supply at the support price

•Gov't must pay $5 per bushel

•What to do with the surplus

1. Give it away
2. Destroy it

The Distribution of Income and Wealth



The Distribution of Economic Income and Components in the U.S., 1995

HH	TOTAL INCOME	WAGES AND SALARIES	PROPERTY INCOME	TRANSFER INCOME
Bottom 5th	3.1	5.9	1.0	27.9
Second 5th	8.6	12.0	3.9	26.2
Third 5th	14.0	19.9	8.4	18.6
Fourth 5th	24.2	27.1	16.5	13.7
Top 5th	50.1	35.1	70.2	13.6
Top 1%	12.6	2.9	29.8	1.4

(Percentages)

The Distribution of Income, 1947-1993

HH	1947	1960	1972	1984	1993
Bottom 5th	5.0	4.8	5.2	4.7	4.4
Second 5th	11.8	12.2	11.5	11.0	10.6
Third 5th	17.0	17.8	17.5	17.0	16.5
Fourth 5th	23.1	24.0	24.3	24.4	24.0
Top 5th	43.0	41.3	41.5	42.9	44.6
Top 5%	17.2	15.9	15.3	16.0	17.6

(Percentages)

Economic Income

The amount a household can spend during a given time period without increasing or decreasing its net assets

Money Income

Excludes noncash transfer payments and capital gains income,

Income measure used by the Census Bureau

Distribution of Money Income of Households, 1992

	All HH	Black HH	White HH	Hispanic HH	1-person HH
$0- 5,000	4.6	11.8	3.6	6.6	8.4
5-10,000	10.0	18.7	8.9	13.8	24.0
10-15,000	9.5	12.2	9.1	12.6	16.5
15-25,000	16.8	18.3	16.7	20.8	20.9
25-35,000	14.8	13.2	15.1	16.8	13.5
35-50,000	17.1	12.8	17.7	14.5	9.6
50-75,000	16.1	8.8	17.0	10.5	4.8
75,000 +	11.0	4.2	11.9	5.0	2.3

(Percentages)

Poverty is very difficult to define.

The official poverty line is the income level that distinguishes the poor from the nonpoor.

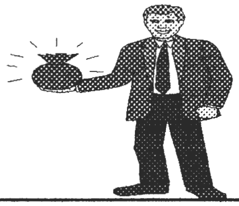
It is set at three times the cost of the Department of Agriculture's minimum food budget.

The Distribution of Wealth: Percent of Assets Held by Families, 1989

	TOP 1%	TOP 10%
STOCKS	44.6	82.7
BONDS	65.2	93.5
BUSINESS ASSETS	67.7	93.0
PRINCIPAL RESIDENCE	8.4	37.7
OTHER REAL ESTATE	43.0	82.1
TOTAL ASSETS	32.8	64.4

Prosperity and Happiness

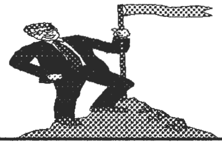
- More income or wealth makes most people happier
- On average, additional income means more to the poor than the rich



Do extra dollars Mean More to the poor than the rich?

•People favoring greater equality might argue that extra dollars mean more to the poor because necessities generate more utils

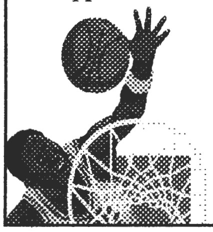
•Defenders of our current system could respond that income must mean more to the well-to-do because most of them worked hard for it



Contribution Standard:

•Advocates- a contribution standard recognizes that income incentives encourage work effort

•Opponents- wonder how well markets measure productivity



Needs Standard:

•"From each according to ability, to each according to needs." Louis Blanc

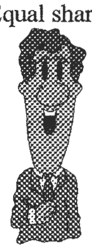
•Assessing needs is imprecise

•lack of production incentives

Equality Standard:

•Divide national income by population, then mail each family a check for its share.

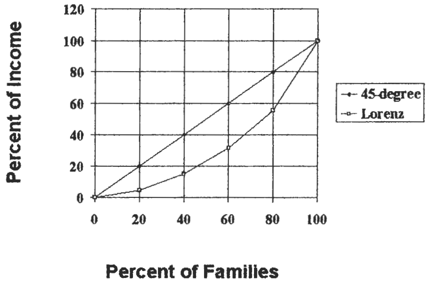
•Equal sharing of income erodes personal incentives for productivity



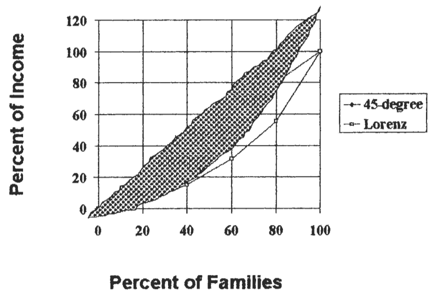
Two ways to describe the degree of inequality in a distribution:

- **Lorenz curve- shows the cumulative percentage distribution of income in a society**
- **Gini coefficient- A/(A+B)**
- **Zero implies perfect equality**
- **One implies perfect inequality**

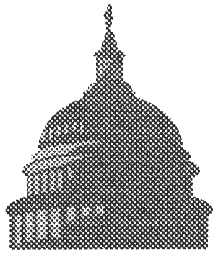
Lorenz Curve for Money Income in the U.S., 1993



A Gini coefficient is the ratio of the shaded area to the total triangle to the right of the 45-degree line.

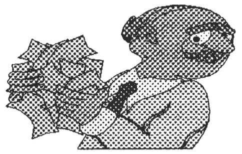


The Redistribution Debate



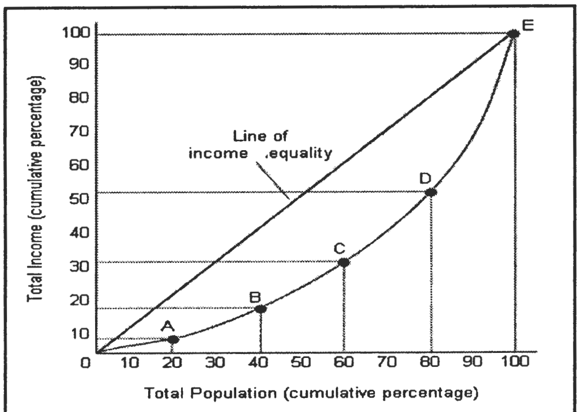
Arguments against Redistribution

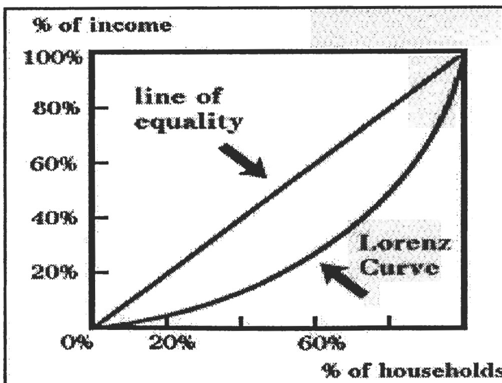
- The market, when left to operate on its own, is fair.
- Tax and transfer programs interfere with the basic incentives provided by the market.
- Redistribution does not help the poor out of poverty.



Arguments in favor of Redistribution

- A society as wealthy as the U.S. has a moral obligation to provide all members with basic necessities.
- Many people (children, those who are ill) are left out through no fault of their own.





A Lorenz Curve illustrates inequality