Commentary

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Perfect Competition: From Riches...

To begin our thought experiment, let us imagine a city. The city has multiple neighborhoods and boroughs, each with its own distinct flavor and style. Do you have something in mind? For myself, I picture my capital city of Atlanta, a city bustling with activity, but lousy with urban sprawl and all the accompanying ailments—traffic, low air quality, etc. (but that is beyond the scope of this paper).

While the cities we each imagine may be vastly different, in the face of a natural disaster, perhaps all cities will share remarkably more characteristics than under normal circumstances. Inside the city in your head there are myriad stores and shops and vendors and sellers of all kinds, from convenience stores to bodegas to big box stores that carry everything you could ever want and more. Let us assume that there is considerable overlap in inventory between these stores (each store sells identical products), and we begin to see that no seller has a significant advantage over another, and that no individual seller has the power to influence price to a large degree. Following this logic through to its conclusion, we see that each seller will be forced to charge very similar prices, or be at risk for losing most of its customers.

We also see that the output of each firm will be a quantity for which marginal cost is equal to this market price.[3] Sound familiar? If you have taken an introductory economics course, it should! This is sounding more and more like the market structure of perfect competition. For argument's sake, let us go ahead and assume that the city we have imagined is indeed perfectly competitive. Also for argument's sake, let us assume that we are examining a particular market—

Notice how the monopolist charges a higher price than the competitive market and produces less output. Why? Is the monopolist "evil"? Are they "price gouging"? By no means! The monopolist here is simply responding to the incentives provided by the market. Notice how the monopolist isn't able to charge whatever price and sell whatever quantity they want. No, they are forced to select a price/quantity-combination on the demand curve. The market still places guardrails around even the monopolist, preventing this toothless tyrant from grinding consumers under its heel.

The first key observation I wish to make is that there is no "price gouging" going on here. What we see in this illustration is not a seller preying on the consumers by needlessly raising the price, but rather the amoral actions of a profit-maximizing firm attempting to achieve its goal. Here we have a producer/seller, who is providing a desirable good to consumers (albeit a smaller subset of the original market) at or below their respective willingness to pay. Nobody is being forced to participate in market activity that would harm them economically. While it is true that the new price of bottled water (to return to our example good) is higher than prior to the monopolizing event, what is also true is that no buyer is now paying a price above what she or he is willing to pay. Further, from an allocative standpoint, those buyers who get to consume the water are the ones who value it the most (i.e., those who have the highest willingness to pay).

The second key point that I feel needs mentioning is the welfare effects of a monopoly. It's no secret that a monopoly charges a price greater than a competitive market—this is to be expected and is not necessarily a bad thing in and of itself. But we cannot neglect that the monopoly also restricts output to lower than competitive levels, generating an amount of welfare loss, known also as "deadweight loss" (as shaded in Figure 4).

This welfare loss is a concern for many economists because of its meaning: inefficiency. The existence of welfare loss is a clear signal that resources are not being efficiently allocated, and that production and consumption are occurring at a suboptimal level—specifically, at a level below that which is collectively best for the buyers and sellers. This is because there are some units that the

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