The economics of imperfect competition

This book takes a new approach to traditional price theory and to the analysis of imperfect competition. It represents a breakthrough in the development of a "new" microeconomic theory. Increasingly, it has been recognized that the perfectly competitive paradigm is inappropriate to the explanation of pricing behavior in many "real life" markets characterized by a significant separation between producers and consumers. The spatial perspective adopted by the authors provides a natural separation of markets, but provides as well a powerful analogy for apparently nonspatial issues such as product differentiation, pricing over time, problems of storage and transportation, and the economics of intraindustry trade and of the multinational enterprise.

A major concern of *The Economics of Imperfect Competition: A Spatial Approach* is to make these analogies explicit by applying this spatial analysis to a wide variety of nonspatial problems. In addition, the analysis and results presented in this book are shown to carry significant policy implications with respect, for example, to the Robinson-Patman legislation, antimerger policies, and antidumping legislation. In particular, the authors have addressed issues that are of increasing concern to specialists, researchers, policy makers, and students in the areas of price theory, industrial organization, international trade, and regional and urban economics.

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The economics of imperfect competition

A spatial approach

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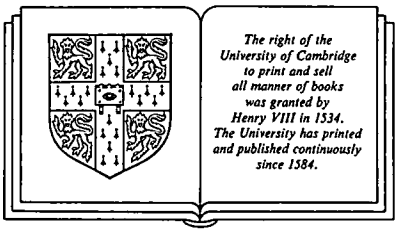

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Preface

Microeconomic theory has undergone a quiet revolution in recent years. In particular, developments in the economics of imperfect competition and in what by some has been termed "new industrial organization" are responses to the deficiencies of the competitive paradigm in explaining the workings of modern economic markets. These developments take explicit account of the fact that individual buyers and sellers are not atomistic. The actions of any one economic agent will have noticeable effects on the economic environment for other agents and so can be expected to call forth reactions. The nature of these expected reactions, or "conjectural variations," will be of vital importance to price setting and efficiency in imperfectly competitive markets.

A central feature of the analysis to be presented in this book is the power that individual sellers have to set prices. This power rests in the ability of the seller to assign its customers to separate markets. In other words, an alternative subtitle to this book could have been "the economics of differentiated markets." What is needed is a convenient, powerful, and yet realistic analogy for market separation.

It has become apparent that "space" or "distance" can provide such an analogy. A spatial framework opens up entirely new ways of viewing long-standing problems in microeconomics. For example, the pricing of services and, more generally, of differentiated products and the pricing of electric power, amusement park privileges, and many other products, even though not distance-related per se, can be analyzed from a spatial perspective. Nor should it be thought that we address purely theoretical issues. Firms in private-enterprise nations have been increasingly subjected to legislation improperly rooted on a perfectly competitive paradigm. The recognition of market differentiation brings with it the need to develop significant insights into oligopoly market structures. Simply put, the spatial framework provides policymakers with a more adequate foundation on which to base legislative judgments.

We shall show that modern firms can be expected to price heterogeneously over the differentiated markets they serve. If reasoned statements are to be made explaining why this heterogeneity exists, and how it might change over time, a general theoretical framework is needed. This frame-

work is readily formulated on the presumption that firms sell to spatially separated and distinct markets, each typically subject to different demands and competitive influences.

"Space" and "distance," in other words, are merely labels for a variety of economic phenomena. As noted earlier, one illustration relates to product differentiation, where individual product variants can be viewed as if located along a spectrum of consumer desires, with each variant having a well-defined "market area." The spatial framework allows investigation of the effects of new product variants and comparisons of product varieties in a number of different market structures. As another example, it is well recognized that demands for many products and services are limited not only by the price of the good or the fee that is charged but also by other costs of acquisition, such as waiting time or storage costs. This is particularly true in evaluating service activities, including private medical-care alternatives. The spatial analogy then sheds new light on the positive relation between fees and the number of medical practitioners.

Analysis of the impacts of mergers and antitrust regulation is made more tractable and realistic once the imperfectly competitive environment of firms is taken into account. Similarly, the efficiency and welfare implications of such topics as the bundling of goods (so-called tying contracts), bank charges on checking accounts, wage discrimination by sex and education, quantity discounts, and nonlinear price schedules charged by telephone companies are amenable to spatial analysis.

The reader of this book will find that the spatial framework sheds light on a number of important international trade issues. Tariff barriers have many of the properties of transport costs, but it will emerge that an ad valorem tax acts somewhat differently than a specific tax. International-trade theorists are becoming particularly concerned with two phenomena that do not fit easily into "traditional" theories: the emergence of the multinational enterprise and the increasing proportion of trade flow that is accounted for by intraindustry trade. Spatial microeconomic analysis provides insights into why companies and industries change orientation from chiefly export-based operations to strict emphasis on local markets, or even dealing in both markets, with intraindustry trade going both ways.

The topics indicated earlier by no means compose a complete list of the applications discussed in this book. We also hope that readers will identify applications that have never occurred to us or to others who have specialized in spatial microeconomics. Indeed, we would venture to suggest that the applications are limited only by imagination.

One final comment is worth making in this preface. The very concept of an economic space requires rejection of many of the principles derived

in the theory of perfect competition. This book must, accordingly, center part of its attention on the following question: If perfect competition does not (cannot) characterize an economy of differentiated markets, then what is left of microeconomic theory? Perhaps most important, the reader will find that the long-existing intrinsic contradiction – between a macroeconomics based on aggregating business investment and foreign-sector activities along with the consumer and government sectors, and a microeconomics predicated on individual atomistic firms behaving as robots – will no longer apply to a microeconomics founded on both time and space. In a nutshell, the fundamental objective of this book is much deeper than simply recording the basic framework of *spatial* microeconomic analysis.

The authors owe an intellectual debt to far too many of their fellow economists for them to be named individually. Many of Dr. Greenhut's former students have contributed directly and indirectly to improving our exposition. In particular, we would like to thank Bruce Benson for his advice on the later chapters. Our colleagues in Texas, Leicester, and Florida have all provided unstinting advice and support, and our families have borne uncomplainingly the pressures that writing a book of this type inevitably imposes.

November 30, 1985

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