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New Joint Center Monograph Claims That Regulators Are Misled by Simplified Economics

REGULATION MISLED BY MISREAD THEORY: PERFECT COMPETITION AND COMPETITION-IMPOSED PRICE DISCRIMINATION

By William J. Baumol

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In a new monograph based on last year's AEI–Brookings Joint Center Distinguished Lecture, Professor William Baumol shows how some elementary economic principles may not apply in many competitive markets. For example, economics students are taught that competition drives prices down and that in competitive markets all consumers will pay the same price for identical products. Professor Baumol argues that competitive markets, in reality, often do not work that way. Simple application of these principles, generally taken as conventional wisdom, can lead regulators to wrongly conclude that a firm has market power when, in fact, it does not. This finding has enormous implications for how officials should assess and regulate a market's competitiveness.

The monograph *Regulation Misled by Misread Theory: Perfect Competition and Competition-Imposed Price Discrimination* (AEI Press, March 2006) focuses mainly on instances in which firms can charge different prices to different groups of consumers. Basic economics suggests that only monopolies can engage in such discriminatory pricing because, supposedly, in a competitive market any firm's attempt to increase prices will be undercut by a competitor. Professor Baumol counters that price discrimination is likely to be a standard feature in many markets in which firms compete vigorously.

A conventional test for competitive markets, for example, might conclude that airlines have market power because of the large range of ticket prices on each flight. Baumol's theory suggests just the opposite. Because people cannot resell their tickets, airlines can find themselves in a situation where they must charge different prices to different consumers just to survive. (If people could resell their tickets easily, one would expect that the tickets might eventually go for a single price—i.e., there would be a conventional

market.) Professor Baumol shows that effective competition does not necessarily impose uniform prices. More provocatively, competitive pressures can force all firms to adopt discriminatory prices if consumers cannot easily resell a product.

This radically different picture of competitive markets helps explain the actual near ubiquity of discriminatory pricing and suggests that regulators should only sparingly use discriminatory pricing as a justification for market intervention.

William J. Baumol is the Harold Price Professor of Entrepreneurship and Economics and the academic director of the Berkley Center for Entrepreneurial Studies at New York University. He is also professor emeritus and a senior economist at Princeton University.

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