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Optimal Export Policy for a New-Product Monopoly: Comment

Walter Block

The author

Professor Walter Block, Economics and Finance Department, University of Central Arkansas, Conway, Ar 72035, USA.

Abstract

A comment on Bagwell s proposition that export subsidies are welfare enhancing under certain conditions.

Bagwell (1991) seeks to defend the proposition that export subsidies are welfare enhancing under certain conditions. As implied by the title of his paper, he limits his argument to those cases where one, there is a monopoly, and two, a new product is being introduced.

Why should this be so? This is because foreign consumers may be unaware of the product s quality (1156) [1], and they will judge its quality by the price demanded. Therefore, a firm in possession of a high-quality product may need to distort its price, lest consumers mistakenly infer that the product s quality is low (1156). The export subsidy, presumably, will enable this firm to overcome this need, holding fast to a lower non distorted price.

There are many difficulties with this claim.

1. *Generalisability*. If this argument is correct, it covers far more territory than the author seems to realise. Why should only foreign buyers act in the way described by Bagwell? Surely, this should apply to the domestic variety as well.

Nor should only new products merit such treatment; old ones - albeit to a lesser degree - can also be expected to operate in this manner. For one thing, information is always less than perfect. Even people who are (partially) familiar with a good can, if Bagwell is correct, resort to judging quality by price. For another, there is always a learning curve; as time goes on, more and more people acquaint themselves with a new service, but 100% of them are never fully knowledgeable about anything, except perhaps in the rarest of cases. All too often, moreover, there are pockets of individuals woefully ignorant of integral aspects of modern civilisation.[2]

Further, it is not clear why the big guns of anti monopoly theory have to be brought to bear in this case.[3] Consumers who use price as a proxy for the quality of a good can do so whether the supplier is a monopolist or not. Then, too, there is no reason to restrict the Bagwell thesis to final consumer goods markets. This can occur, if it occurs at all, in labour markets, capital goods markets, real estate markets, land markets, loanable fund markets, insurance markets, etc.

Bagwell s title offers us a policy, alright, but not one for export; domestic sales cannot be ruled out. Nor one for new products; old ones satisfy his criterion as well. Nor must it be monopolistic, nor limited to consumer goods. If the referents of the thesis are as inclusive as all this, then the public policy prescription offered by Bagwell - government subsidies - will amount to the socialisation of an exceedingly large part of the economy, not the relatively modest portion of it he implicitly advocates.

2. *Externalities*. Using price as an index of quality gives rise to an informational externality, (1156) according to our author. He posits that the diseconomy is engendered by the low quality product, and impacts negatively upon the firm which creates the high quality one. However, assuming that the Bagwell s main thesis is logically coherent[4], one might as well assert the very opposite: namely, that the perpetrator is the high quality firm, and the victim its counterpart at the other end of the quality continuum. For let us assume that people really do judge quality by price, but only at the high end of the spectrum. That is, they know full well that the Lada is not a luxury car, but are a bit confused about the relative merits, say, of the Mercedes vs the Jaguar. This being the case, automobile dealers at the high end of the continuum can raise their prices, without as much fear of loss of business to the Ladas of the world as would otherwise obtain. In other words, using price as an index of quality tends to reduce the elasticity of demand for good cars. But this renders these products more impervious to competition from the lower end of the scale. Thus, if there is any case for a subsidy on grounds of externalities[5], it is in precisely the opposite direction from the one supported by Bagwell.[6]

3. *Economic welfare*. Bagwell states of his article that conditions are given under which a specific export subsidy for a new-product monopolist raises export-country welfare (1157). There is little doubt that the firm, monopolist or not, exporter or not, new product owner or not, which receives a subsidy will register an increase in economic welfare. If this is true, however, it is no less true that this subsidy can only be financed by an increase in taxes[7] which will *decrease* the welfare of those forced to pay for it. Our author, of course, implicitly assumes that the former will outweigh the latter, but this cannot be shown without violating the strictures against interpersonal comparisons of utility (Rothbard, 1977), or in the absence of an actual payment from the former to the latter, out of the supposed differential. If this exists, paradoxically, it undermines the case for resort to the compulsory tax-subsidy system. For if efficiencies can truly be garnered in this way, it is at least theoretically possible to finance this voluntarily, through the stock market.

It will of course be objected that the transactions costs of any such private matter will be overwhelming. This market failure is supposed to justify, in a value free manner, Bagwell s public policy recommendation. But government action, too, is not a free good. This author ignores the possibility, nay, the likelihood, that government action will have higher transaction costs than the market alternative.[8]

4. *Infant industry argument.* Bagwell s suggestion is eerily reminiscent of the case for subsidising the initial investment for a colony, in order to promote exports, or at least import substitution. It fails, too, on much the same grounds.

First of all, there is no intrinsic time limit for the subsidy. It can occur as long as the distortion or the price signalling takes place: well into the indefinite future. Second, there is the point that if the recipient of the subsidy succeeds, it, and not the long suffering taxpayers, will enjoy the proceeds. Third, *every* new firm, at least at the outset, is an infant. This plan, then, is really a disguised call for the subsidisation of all new businesses.

5. *Bankruptcy.* The strategy of discerning quality based on price is not a survival oriented one. This is perhaps hard to see in consumer markets, where competition is somewhat attenuated - there cannot be too many households which have gone bankrupt as a result of this alone - but it is readily apparent in factor markets. Some entrepreneurs have a natural talent for discriminating between high and low quality; others invest in this skill, or hire those who have it. Of course, if they cannot tell the difference between good and bad jewellry, or between potentially productive and non productive oil wells, for example, it will be exceedingly difficult for them to hire those who can. Perhaps they ought to seek another line of work, for bankruptcy must be ever looming for investors of this sort. If this is so, then the *last* thing a firm in possession of a high-quality product may need (do is) to distort its price, lest consumers mistakenly infer that the products quality is low (1156).

Thus, Bagwell is worrying about something which, by its very nature, is continually being weeded out of the marketplace. He talks of certain pricing protocols as being of second order importance (1157). It is difficult to resist the notion that this applies to his total concern in this regard.

Footnotes

1. Unless otherwise noted, all page citations are to this one article, Bagwell (1991).

2. The movie The Gods must be crazy depicts a group of people who have only recently discovered Coca Cola, perhaps the best well known product on the planet.

3. For an alternative view which holds that monopoly is solely due to government grants of exclusive privilege, see Rothbard (1962), Armentano (1972, 1982), Block (1977, 1994).

4. An assumption we call into question below.

5. For a dissenting analysis of externalities, one which denies that the case for *any* subsidies on this ground has been successfully made, see Hoppe (1993); Block (1989, 1993); Hummell (1990).

6. States Bagwell: Since the subsidy benefits a low quality producer most, the subsidy causes low quality exports to be selected more often than is optimal for the exporting country (1157). If so, how can he maintain that the informational externality lies in the direction he claims?

7. Assuming no inflation or government borrowing which merely complicates the analysis without changing any of the essential elements of it.

8. Even putting the matter in this way is inaccurate, in that it implies that there is an objective way to compare these costs. There is not, given the theoretical impermissibility of interpersonal comparisons of utility.

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