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## Indirect taxation, public pricing and price cap regulation: A synthesis

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## **Indirect Taxation, Public Pricing and Price Cap Regulation: A Synthesis**

*Edilio Valentini*

**Abstract**

This paper provides a unified vision of a number of results that appeared in three separate streams of literature. The author emphasizes the strong parallelism between the results obtained in a number of papers that analyzed the relationships between price cap regulation, welfare maximization, welfare improvements, distributional preferences and poverty reduction and those originating from the well-established theories of optimal indirect taxation and tax reforms, as well as public pricing.

**JEL** D6 L5

**Keywords** Price cap regulation; indirect taxation; public pricing

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# 1 Introduction

It is well known that the theory of commodity taxation has a straightforward counterpart in the theory of monopoly pricing. The optimal second-best rules proposed by Ramsey (1927) and Boiteux (1956) represent the most obvious and celebrated example of this correspondence. Both the original Ramsey problem and the Boiteux's application to monopolistic markets deal with how prices should depart from marginal costs in order to maximize social welfare subject to a constraint which is given by the tax revenue in the Ramsey setup and by the firm's profit in the Boiteux analysis. Therefore, it is not surprising that any extension to the original Ramsey-Boiteux problem can be interpreted in terms of both indirect taxation and public pricing. Indeed, Feldstein (1972) extended the Ramsey-Boiteux pricing rule and proposed the optimal structure of public pricing for the case when the social welfare function accounts for distributional concerns; in the same spirit, Diamond (1975) developed the analysis of Diamond and Mirrlees (1971) to derive a many-person Ramsey tax rule which enables to take into account the trade-off between efficiency and equity objectives. Successively, Ahamad and Stern (1984) and Ross (1984) proposed, independently but almost contemporaneously, an identical method to infer social welfare weights from, respectively, the observed commodity taxes and regulated prices. Subsequent contributions on welfare improving and poverty reducing marginal price and tax reforms confirmed how the economics of indirect commodity taxation is closely related to the economics of public pricing (Yitzhaki and Slemrod, 1991; Mayshar and Yitzhaki, 1995; Makdissi and Wodon, 2002; Liberati, 2003; Duclos, Makdissi and Wodon, 2008 among the others).

In contrast, it is less acknowledged that this parallelism exists also with respect to a number of properties that characterize some analyses on price cap regulation. Indeed, we will show that the link between price cap mechanisms and optimal pricing/taxation goes beyond the well-known adjustment process of capped prices towards Ramsey-Boiteux prices which has been firstly shown by Vogelsang and Finsinger (1979) and further analyzed by Bradley and Price (1988), Brennan (1989) and others. Notably, Iozzi, Poritz and Valentini (2002) generalize the Brennan's analysis showing how the price cap formula can be opportunely adapted to the regulator's preferences in order to take into account possible distributional aims.

Therefore, under their characterization, also Feldstein prices represent a feasible goal that can be achieved through price cap regulation. Moreover, Valentini (2006) adapts the inverting procedure proposed by Ross (1984) to derive an operational rule that can be used to infer the regulator's social welfare weights over different groups of consumers. Finally, Makdissi and Wodon (2007) extend the analysis on welfare improving and poverty reducing marginal price reforms to the case where the social planner relies on price cap regulation showing under what conditions the results obtained in the former setting apply also to the latter.

Even if this stream of literature deals with the normative properties of price cap regulation, we do not intend to provide an exhaustive survey of the contributions analyzing price cap from a this point of view. In fact, most of the normative studies on price cap are concerned with productive efficiency, a perspective which is out of the scope this survey. Moreover, the majority of the papers that, especially during the 80's and the 90's, studied price caps also from a social welfare perspective (Bradley and Price, 1988; Neu, 1993; Cowan, 1995, among the others) refer, explicitly or implicitly, to the Ramsey-Boiteux pricing rule as the benchmark for their welfare evaluations. Therefore, in those papers the normative analysis is neither based on ethical judgments on the utilitarian welfare function featuring Ramsey prices, nor on the distributional consequences of implementing these prices. In contrast, these are issues characterizing the papers reviewed in this survey.

Other surveys dealing with some of the topics analyzed in this paper have been published in the past. For instance, Sappington (2002) and Armstrong and Sappington (2005) review the theory of price cap regulation, while Vogelsang (2002) and Sappington and Weisman (2010) assess how price cap has performed in the practice of regulation. Surveys on commodity tax reforms are Lambert (1993), Ray (1997) and Santoro (2007). However, to the best of our knowledge, no paper has ever attempted to give a unified vision of the literature reviewed in this survey.

Table 1 presents a synthesis of the main contributions reviewed in the following sections indicating the main correspondences between the papers reviewed in Section 2 (columns A and B) and those reviewed in Section 3 (column C). Indeed, in Section 2 we first analyze the "classic" second best problems of Ramsey (1927) and Boiteux (1956), then we generalize them in order to take distributional concerns into account.

In addition Section 2 reviews some further extensions in the literature of both indirect taxation and public/monopoly pricing, establishing the main characteristics of the inverse optimum problem and the poverty reducing problem. Then, in Section 3, we review those papers that, in the context of price cap regulation, showed results that are conceptually analogous to those analyzed in Section 2. Finally, Section 4 concludes and points out some possible future researches in this area.

**Table 1**

|  | (A)                         | (B)                       | (C)                                |
|--|-----------------------------|---------------------------|------------------------------------|
|  | Indirect taxation           | Public Pricing            | Price cap regulation               |
| <i>“Classic” second best problems</i>                    | Ramsey (1927)               | Boiteux (1956)            | Vogelsang and Finsinger (1979)     |
| <i>Second best problems with distributional concerns</i> | Diamond and Mirrlees (1971) | Feldstein (1972)          | Iozzi, Poritz and Valentini (2002) |
| <i>Inverse optimum problems</i>                          | Ahamad and Stern (1984)     | Ross (1984)               | Valentini (2006)                   |
| <i>Poverty reducing problems</i>                         | Makdissi and Wodon (2002)   | Makdissi and Wodon (2007) | Makdissi and Wodon (2007)          |

## 2 A short tour of indirect taxation and public pricing

### 2.1 Optimal indirect taxation vs. optimal pricing

Let consider the following individualistic social welfare function

$$W(\mathbf{p}, \mathbf{y}) = W[v^1(\mathbf{p}, y_1), \dots, v^H(\mathbf{p}, y_H)] \quad (1)$$

where  $\mathbf{p}$  is the price vector faced by any of the  $H$  households,  $\mathbf{y}$  is the vector of the households' incomes,  $v^h(\mathbf{p}, y_h)$  is the indirect utility function of household  $h$  ( $h=1, \dots, H$ ), with  $y_h$  which is the income of household  $h$ . Now, if we assume that  $\mathbf{p} = \mathbf{s} + \mathbf{t}$ , where  $\mathbf{s}$  is the vector of producers' prices and  $\mathbf{t}$  the vector of specific taxes, we can formulate the optimal taxation problem as

$$\begin{aligned} & \max_{\mathbf{t}} W(\mathbf{p}, \mathbf{y}) \\ & \text{s. t. } T(\mathbf{t}) \geq \bar{T} \end{aligned} \quad (2)$$

where  $\bar{T}$  is the constraint on the tax revenue  $T(\mathbf{t}) = \sum_{i=1}^I t_i q_i(\mathbf{p})$ ,  $I$  is the number of goods and  $q_i(\mathbf{p}) = \sum_{h=1}^H q_i^h(\mathbf{p})$  is the aggregate demand function of good  $i$  ( $i = 1, \dots, I$ ) which is

assumed to be continuous, differentiable and downward sloping. Let  $\mathbf{t}^* = (t_1^*, \dots, t_M^*)$  be a tax rates' vector that solves this problem;  $\mathbf{t}^*$  is implicitly given by the  $I + 1$  conditions

$$\begin{cases} T(\mathbf{t}^*) = \bar{T} \\ \left. \frac{\partial W}{\partial t_i} \right|_{\mathbf{t}^*} + \lambda \left. \frac{\partial T}{\partial t_i} \right|_{\mathbf{t}^*} = 0 \end{cases} \quad \text{for } i = 1, \dots, I \quad (3)$$

where  $\lambda$  is the Lagrange multiplier. We further assume that this vector exists and is unique for any level of tax revenue  $\bar{T}$  in (2).

The optimal taxation problem is essentially equivalent to the following maximization problem

$$\begin{aligned} & \max_{\mathbf{p}} W(\mathbf{p}, \mathbf{y}) \\ & \text{s. t. } \Pi(\mathbf{p}) \geq \bar{\Pi} \end{aligned} \quad (4)$$

where the main difference is in the nature of the constraint that in (4) represents a minimum level of profits,  $\bar{\Pi}$ , that must be guaranteed to a multi-product monopolist that produces  $I$  goods in order to maximize profits given by  $\Pi(\mathbf{p}) = \sum_i p_i q_i(\mathbf{p}) - c(\mathbf{q}(\mathbf{p}))$ .

We let  $\mathbf{q}(\mathbf{p})$  be the  $I$ -dimensional vector whose element  $i$  is the market demand function  $q_i(\mathbf{p})$ , and  $c(\mathbf{q})$  denoting production costs which are assumed to be continuously differentiable in  $q_i$ , for any  $i = 1, \dots, I$ . Now the price vector  $\mathbf{p}^* = (p_1^*, \dots, p_M^*)$  that solves problem (4) is implicitly given by the  $I + 1$  conditions

$$\begin{cases} \Pi(\mathbf{p}^*) = \bar{\Pi} \\ \left. \frac{\partial W}{\partial p_i} \right|_{\mathbf{p}^*} + \mu \left. \frac{\partial \Pi}{\partial p_i} \right|_{\mathbf{p}^*} = 0 \end{cases} \quad \text{for } i = 1, \dots, I \quad (5)$$

where  $\mu$  is the Lagrange multiplier.

It is straightforward to show that conditions defined in (3) are exactly equivalent to those defined in (5) as long as we limit problem (2) to the case of constant return to scale. Indeed, under constant return to scale  $s$  is constant and we can interpret the problem of selecting a tax structure as equivalent to choosing a structure of consumer prices (Sandmo, 1976).

## 2.2 The Ramsey-Boiteux condition

To provide a convenient interpretation of (3) and (5), we consider the further assumptions that *i*) for any given pair of goods  $i, j=1, \dots, I$ ,  $i \neq j$ , there is no demand cross elasticity and *ii*)  $W(\mathbf{p}, \mathbf{y})$  is defined as the simple sum the quasi-linear indirect utility functions of the  $H$  individuals purchasing the  $I$  goods, that is

$$W(\mathbf{p}, \mathbf{y}) = \sum_{h=1}^H v_h(\mathbf{p}, y_h) = \sum_{h=1}^H u_h(\mathbf{p}) + y_h \quad (6)$$

Quasi-linear indirect utility function implies that the Roy's identity takes the form  $\partial v_h / \partial p_i = -q_{ih}$ , for any  $h=1, \dots, H$ , and any  $i=1, \dots, I$  (see for instance Varian, 1992 or Mas Colell et al., 1995) so that

$$-q_i(\mathbf{p}^*) = \left. \frac{\partial W(\mathbf{p}, \mathbf{y})}{\partial p_i} \right|_{\mathbf{p}^*} \quad (7)$$

Under these assumptions the first order conditions defined by both (3) and (5) imply the well-known Ramsey-Boiteux condition

$$\frac{p_i^* - c_i}{p_j^* - c_j} = \frac{\eta_j}{\eta_i} \quad \forall i, j = 1, \dots, I, i \neq j \quad (8)$$

where  $\eta_i$  and  $\eta_j$  are the demand elasticity of good  $i$  w.r.t.  $p_i$  and the demand elasticity of good  $j$  w.r.t.  $p_j$ , respectively, and  $p_i^* - c_i$  ( $i=1, \dots, I$ ) can be seen as the optimal departure from marginal costs either in terms of taxation (i.e.  $t_i^* = p_i^* - c_i$  when we limit problem (2) to the case of constant return to scale) or in terms of monopoly pricing.

Condition (8) provides an operational rule telling us that when the demand elasticity of one good is higher than the demand elasticity of another good, the distance from the marginal cost should be less for the former than for the latter.

In Section 3.1 we will show how the Ramsey-Boiteux condition defined in (8) can be satisfied by a multi-product monopolist that maximizes its profits subject to a Laspeyres-type tariff-basket price cap constraint.

### 2.3 Distributional issues

Several authors (see Atkinson and Stiglitz, 1972 and Feldstein, 1972 among the others), however, noticed that the Ramsey-Boiteux condition may imply conflict between allocative efficiency and distributional objectives. Typically, commodities with low price elasticity are necessities while those with high elasticity are luxuries. Then condition (8) might imply that necessities should be taxed at higher rates than luxuries which may result undesirable from the distributional point of view since, typically, necessities represent a large share of expenditure for lower income consumers. This undesirable result, however, depends on the characterization of the social welfare function given in (6): the choice of a simple sum of quasi-linear indirect utility functions implies that the social welfare weight attached to any household is always the same or, equivalently, that the consumer side of the economy can be treated as if there were just one representative household.

Therefore, in order to extend the analysis to a many person economy and combine distributional concerns with allocative purposes, we follow Diamond and Mirrlees (1971) and go back to the more general individualistic social welfare function defined in (1). Differentiating (1) w.r.t.  $p_i$  we obtain

$$\frac{\partial W(\mathbf{p}, \mathbf{y})}{\partial p_i} = \sum_{h=1}^H \frac{\partial W}{\partial v_h} \frac{\partial v_h}{\partial p_i} \quad (9)$$

where, by the Roy's identity,  $\frac{\partial v_h}{\partial p_i} = -q_{i,h} \alpha_h$ , for any  $h= 1, \dots, H$ , and any  $i= 1, \dots, I$  and

$\alpha_h = \frac{\partial v_h}{\partial y_h}$  is the marginal utility of income of consumer  $h$ . Therefore, we can rewrite (9)

as



$$\frac{\partial W(\mathbf{p}, \mathbf{y})}{\partial p_i} = -\sum_{h=1}^H \beta_h q_{i,h} \quad (9')$$

where  $\beta_h = \frac{\partial W}{\partial v_h} \alpha_h$  is the marginal social utility of income, or social welfare weight, referred to consumer  $h$ . By comparing (9') to (7) we can note that  $\beta_h$  is equal to one as long as  $W(\mathbf{p}, \mathbf{y})$  is defined as in (6). We can use (9') to rewrite conditions (3) and (5), respectively, as follow:

$$\begin{cases} T(\mathbf{t}^*) = \bar{T} \\ -\sum_{h=1}^H \beta_h q_{i,h}(\mathbf{t}^*) + \lambda \frac{\partial T}{\partial t_i^*} = 0 \end{cases} \quad \text{for } i=1, \dots, I \quad (10)$$

and

$$\begin{cases} \Pi(\mathbf{p}^*) = \bar{\Pi} \\ -\sum_{h=1}^H \beta_h q_{i,h}(\mathbf{p}^*) + \mu \frac{\partial \Pi}{\partial p_i^*} = 0 \end{cases} \quad \text{for } i=1, \dots, I \quad (11)$$

## 2.4 The Feldstein optimal structure of public prices

The many household optimal taxation problem derived by Diamond and Mirrlees (1971) is formally equivalent to the less general framework used by Feldstein (1972) who tackles with an optimal public pricing problem in a multi-product context where the social planner aims at maximizing a welfare function expressed as weighted sum of the households' consumer surpluses. Formally, we can define (1) as  $W(\mathbf{p}; \mathbf{y}) = \sum_h S_h(\mathbf{p}) \cdot u'(y_h)$  and restate (11) as

$$\begin{cases} \Pi(\hat{\mathbf{p}}) = \bar{\Pi} \\ \sum_h \frac{\partial S_h}{\partial \hat{p}_i} u'(y_h) + \mu \frac{\partial \Pi}{\partial \hat{p}_i} = 0 \end{cases} \quad \text{for } i=1, \dots, I \quad (11')$$

where  $S_h(\mathbf{p})$  is the consumer surplus of household  $h$ , with  $\frac{\partial S_h(\mathbf{p})}{\partial p_i} = -q_{i,h}(p_i)$ ,  $\mathbf{y}$  is the  $H$ -dimensional vector of households' income,  $y_h$  is household's  $h$  income, and  $u'(y_h)$  is the marginal social utility due to a small increase in the income of household  $h$ . Under standard assumptions on the shape of  $u(y_h)$  ( $u' > 0$  and  $u'' < 0$ ), the use of  $u'$  as welfare

weights implies that society values more a marginal increase in utility by a low-income household than an equal increase for a high-income household. To make easier the comparison between the Ramsey-Boiteux conditions and those derived under Feldstein's (and Diamond and Mirrlees') model it is useful to define

$$R_i = \frac{\sum_{h=1}^H q_{i,h}(\mathbf{p}) \cdot u'(y_h)}{\sum_{i=1}^H q_{i,h}(\mathbf{p})} \quad \text{for any } i = 1, \dots, I \quad (12)$$

as the distributional characteristic of the good  $i$ .  $R_i$  is a weighted average of the marginal social utilities, where each household's marginal social utility is weighted by the quantity of good  $i$  consumed by that household. The conventional welfare assumption that  $u''(y) < 0$  implies that the value of  $R_i$  will be greater for goods that take a larger share of the budget of households with lower income (necessities) than for goods that take a larger share of the budget of high income households (luxuries).

In particular, when  $\eta_i$  denotes the own-price elasticity of good  $i$  and  $\frac{\partial q_i}{\partial p_j} = 0$  for any

$i, j = 1, \dots, I$  and  $i \neq j$ , we can get

$$\frac{\frac{\hat{p}_i - c_i}{\hat{p}_i}}{\frac{\hat{p}_j - c_j}{\hat{p}_j}} = \frac{\eta_j (R_i - \mu)}{\eta_i (R_j - \mu)} \quad \text{for any } i, j = 1, \dots, I, i \neq j \quad (13)$$

which corresponds to Feldstein's equation (9) (see Feldstein, 1972, p 34) and can be easily compared to the Ramsey-Boiteux condition defined above by (8). Also condition (13) provides an operational rule telling us how we must depart from the Ramsey-Boiteux condition when  $R_i \neq R_j$ , that is when goods differ for their distributional characteristics.

Also this condition can be satisfied in a regulatory framework by a multi-product monopolist that maximizes its profits subject to a tariff-basket price cap constraint. Indeed, as it will be clarified in Section 3.2, a generalization of price cap regulation can ensure the convergence to second-best prices for almost any social welfare function. Therefore both the convergence to Feldstien's prices and the

convergence to Ramsey-Boiteux prices can be achieved by ad hoc characterizations of a more general price cap formula.

## 2.5 Marginal commodity tax and price reforms

Feldstein (1976) and most of the following literature shifted the emphasis from optimal commodity tax design to marginal commodity tax reforms. Marginal commodity tax reforms have been investigated by Ahamad and Stern (1984) as a viable approach to evaluate empirically a tax system. This approach consists in a specification of the economy and its initial equilibrium, together with a social welfare function and its welfare weights, aimed at verifying if social welfare improvements can be obtained by marginal tax variations.

From conditions (3) we get

$$\lambda = -\frac{\frac{\partial W}{\partial t_i}}{\frac{\partial T}{\partial t_i}} = -\frac{\frac{\partial W}{\partial t_j}}{\frac{\partial T}{\partial t_j}} \quad \text{for any } i, j = 1, \dots, I \text{ and } i \neq j \quad (14)$$

which implies that, when neither  $\frac{\partial T}{\partial t_i}$  nor  $\frac{\partial T}{\partial t_j}$  are equal to zero, a sufficient condition

for a marginal commodity tax reform to be welfare improving is that the following holds for at least a pair of goods

$$-\frac{\frac{\partial W}{\partial t_i}}{\frac{\partial T}{\partial t_i}} \neq -\frac{\frac{\partial W}{\partial t_j}}{\frac{\partial T}{\partial t_j}} \quad i, j = 1, \dots, I (i \neq j). \quad (15)$$

More specifically,  $-\frac{\partial W}{\partial t_i} / \frac{\partial T}{\partial t_i} \geq -\frac{\partial W}{\partial t_j} / \frac{\partial T}{\partial t_j}$  would mean that the marginal social

cost of taxing commodity  $i$  (i.e. the welfare loss caused by a marginal increase in  $t_i$  relative to the corresponding gain caused in the tax revenue) is greater than the marginal social cost of taxing commodity  $j$ , implying that we could increase social welfare without reducing the tax revenue (or, alternatively, increase the tax revenue without reducing the social welfare) by increasing  $t_j$  and decreasing  $t_i$ .

For an exhaustive and updated survey of the existing literature on marginal commodity tax reforms we refer to Santoro (2007) who also stresses the related theoretical limitations and implementation issues. Here, instead, we are interested in showing how easily we can replicate the Ahamad and Stern's idea of marginal tax reforms to a pricing context characterized by multi-product monopoly (Coady, 2006).

As a matter of fact, condition (5) implies

$$\mu = -\frac{\frac{\partial W}{\partial p_i}}{\frac{\partial \Pi}{\partial p_i}} = -\frac{\frac{\partial W}{\partial p_j}}{\frac{\partial \Pi}{\partial p_j}} \quad \text{for any } i, j = 1, \dots, I \text{ and } i \neq j. \quad (16)$$

Therefore, the sufficient condition for a welfare improving marginal price reform is

$$\frac{\frac{\partial W}{\partial p_i}}{\frac{\partial \Pi}{\partial p_i}} \neq \frac{\frac{\partial W}{\partial p_j}}{\frac{\partial \Pi}{\partial p_j}} \quad i, j = 1, \dots, I \text{ (} i \neq j \text{)}. \quad (17)$$

which implies that, as long as  $-\frac{\partial W}{\partial p_i} / \frac{\partial \Pi}{\partial p_i} \geq -\frac{\partial W}{\partial p_j} / \frac{\partial \Pi}{\partial p_j}$ , we could increase social welfare without reducing profits (or, alternatively, increase profits without reducing the social welfare) by increasing  $p_j$  and decreasing  $p_i$ .

## 2.6 The inverse optimum problem

It could be argued that the existence of social welfare improvements depends on the social welfare function that has been chosen at first. Even if the initial equilibrium taxes and/or prices admit welfare improvements for a specific social welfare function it is still possible that those taxes and/or prices are an optimum for another social welfare function. Under this respect one could evaluate a tax system from a different perspective aimed at finding out "*whether there is a set of value judgements [i.e. a set of welfare weights] under which, given the model of the economy, the initial state of affairs would be deemed as optimum. That is the inverse optimum problem. The value judgements may then be used in a number of ways. One might infer that these are*

*indeed the value judgements of the government and use them in appraising other decisions. Or if the computed value judgements were seen as objectionable, then they could be employed to criticise the existing state of affairs. in the sense that it could be seen as optimum only with respect to disagreeable values” (Ahamad and Stern, 1984, p. 259).*

Almost contemporaneously, but independently, both Ahamad and Stern (1984) and Ross (1984) proposed an easy procedure to extract social welfare weights from the existing tax and price structure, respectively. For an optimal indirect taxation problem, we can compact the system of  $I$  equations reported in the second line of (10) in the following way

$$\boldsymbol{\beta}'\mathbf{Q} = \lambda\mathbf{T}' \quad (18)$$

where  $\boldsymbol{\beta}'$ ,  $\mathbf{Q}$  and  $\mathbf{T}'$  are, respectively, the transpose of the  $(H \times 1)$  vector of social welfare weights with  $h$ th element  $\beta_h$ , the  $(H \times I)$  consumption matrix with  $h$ ith element  $q_{i,h}$ , and the transpose of the  $(I \times 1)$  vector with  $i$ th element  $\frac{\partial T}{\partial t_i^*}$ . The inverse optimum problem (IOP) consists in finding out the vector  $\boldsymbol{\beta}$  that satisfies (18). When  $I=H$ , the solution of the IOP is

$$\boldsymbol{\beta}' = \mathbf{T}'\mathbf{Q}^{-1} \quad (19)$$

where  $\mathbf{Q}^{-1}$  is the inverse of  $\mathbf{Q}$  and, as in Ahmad and Stern (1984), we conveniently set  $\lambda=1$ . The IOP of an equivalent optimal public pricing problem can be easily defined along the same lines in terms of finding out the vector  $\boldsymbol{\beta}$  that satisfies  $\boldsymbol{\beta}'\mathbf{Q} = \lambda\boldsymbol{\Pi}'$ , where  $\boldsymbol{\Pi}'$  is the transpose of the  $(I \times 1)$  vector with  $\frac{\partial \Pi}{\partial p_i^*}$  being the  $i$ th element. The solution in this case is

$$\boldsymbol{\beta}' = \boldsymbol{\Pi}'\mathbf{Q}^{-1} \quad (19')$$

In section 3.3 we will see how to set the inverse optimum problem in a context of price cap regulation.

## 2.7 Welfare improving and poverty reducing marginal price reforms

Ahamad and Stern (1984) recognise that their theory of marginal commodity tax reforms relies on specific, and possibly controversial, social welfare functions. For this reason they suggest also an alternative approach aimed at discovering possible Pareto-improving tax reforms. Even if the Paretian approach avoids normative value judgements, it is nonetheless of little practical importance since it would require that no household is negatively affected by the reform. On this motivation Mayshar and Yitzhaki (1995) generalize Yitzhaki and Slemrod (1991) and propose an intermediate approach based on the Daltonian principle. According to this principle, a tax reform improves social welfare if, given a prior social ranking of households, it redistributes from high-ranking to low-ranking households (let say from a rich to a poor), without reverting the initial ranking. To put this idea in a formal way, assume that the only information on the social welfare function is that, for any pair of households  $h, k = 1, \dots, H$  ( $h \neq k$ )  $\beta_h \geq \beta_k$  whenever  $y_h \leq y_k$ . Therefore, we can define a marginal increase in welfare as a positive weighted sum of variations of equivalent income, that is

$$dW = \sum_{h=1}^H \beta_h dy_h \geq 0 \quad (20)$$

where  $dy_h$  is the variation of equivalent income of household  $h$ , that is the variation of income that in terms of household's  $h$  utility is equivalent to the variation of prices. We can rewrite (20) as

$$\sum_{h=1}^H \beta_h dy_h = \sum_{h=1}^{H-1} \left[ (\beta_h - \beta_{h+1}) \sum_{k=1}^h dy_k \right] + \beta_H \sum_{k=1}^H dy_k \geq 0 \quad (20')$$

and since  $\beta_H \geq 0$  and  $\beta_h \geq \beta_{h-1}$ , then a sufficient condition for a marginal increase in welfare is  $\sum_{k=1}^h dy_k \geq 0$  for any  $k=1, \dots, H$ . Of course this framework applies to both a commodity tax and a public monopoly context since the variation of prices causing an equivalent variation  $dy_h$  to household  $h$  can be due to both tax and pricing policy.

Within this stream of literature some scholars have extended the analysis even further by considering marginal indirect tax and pricing reforms as a possible poverty-reducing instrument (see, for instance, Yitzhaki and Slemrod, 1991, Makdissi and Wodon, 2002 and Liberati, 2003) in a framework that can also include higher order classes of ethical judgments than the Daltonian principle used in Mayshar and Yitzhaki (1995) (see also Duclos, Makdissi and Wodon, 2008).

We follow most of this literature and define  $f(y)$  as the density function of income  $y \in [0, y^{\max}]$ ,  $\mathbf{p}^R$  as a  $(1 \times I)$  vector of reference prices that can be used to assess the consumers' welfare in the presence of prices' variations,  $y^E(y, \mathbf{p}, \mathbf{p}^R)$  as the equivalent income function that, for any level of  $y$ , provides consumers who face the reference prices  $\mathbf{p}^R$  with the same level of utility that they would yield if they faced  $\mathbf{p}$ , i.e.

$$v(y^E(y, \mathbf{p}, \mathbf{p}^R), \mathbf{p}^R) \equiv v(y, \mathbf{p}). \quad (21)$$

We still consider a setting where  $H$  households consume  $I$  goods but, for expositional reasons, we refer only to price variations. Indeed, when prices are under the direct control of the social planner, the results obtained for the impact on poverty and social welfare of balanced budget marginal price reforms are similar to that for the impact of indirect tax reforms (Makdissi and Wodon, 2007).

Consider first the standard problem of a social planner aiming at increasing welfare. We deal with the classes of welfare indices  $\Omega^s$  defined by utilitarian social welfare functions

$$U = \int_0^{y^{\max}} u(y^E(y, \mathbf{p}, \mathbf{p}^R)) f(y) dy \quad (22)$$

such that  $U \in \Omega^s$  ( $s=1,2,\dots$ ). The class  $\Omega^s$  is defined as

$$\Omega^s = \left\{ U \mid u(y^E) \in C^s(\infty), (-1)^{i+1} u^{(i)}(y^E) \geq 0 \text{ for } i = 1, 2, \dots, s \right\}. \quad (23)$$

where  $C^s(\infty)$  is the set of continuous function that are  $s$ -time differentiable over  $\mathbb{R}_+$ . Within this framework we can give a specific normative interpretation to every class  $\Omega^s$ . First of all, for any  $s \geq 1$ , social welfare indices are Paretian, that is they weakly increase (i.e.  $u^{(i)}(y^E) \geq 0$ ) when an individual's income increases, and obey to symmetry

(or anonymity) axiom, that is interchanging any two individuals' incomes does not modify the social welfare indices. Moreover, when  $s \geq 2$ , social welfare indices are concave and respect the Daltonian principle of transfer. When  $s \geq 3$ , social welfare increases if, provided that the variance of the distribution does not increase, an adverse Daltonian transfer in the upper part of the distribution is accompanied by a beneficial Daltonian transfer within the lower part of the distribution. Further interpretations for higher classes of welfare indices are also possible (see Fishburn and Willig, 1984) but are not discussed here.

A very similar setting can be used for the case of a social planner whose task is to reduce poverty. As a matter of fact, a poverty index can be thought as a social welfare index censored at a poverty line (Duclos and Makdissi, 2004), hence we can express poverty indices as

$$P(z) = \int_0^{y^{\max}} \psi(y^E(y, \mathbf{p}, \mathbf{p}^R), z) f(y) dy \quad (22')$$

where  $P(z)$  is an additive poverty index,  $z$  is the poverty line that, for the sake of convenience, is assumed to be defined in the equivalent income space, and  $\psi(y^E(y, \mathbf{p}, \mathbf{p}^R), z)$  is the contribution to total poverty of a consumer with an equivalent income  $y^E \leq z$ . We consider the classes of poverty indices  $P(z) \in \Psi^s$  defined as

$$\Psi^s(z) = \left\{ P(z) \left| \begin{array}{l} \psi(y^E, z) = 0 \text{ if } y > z, \psi(y, z) \in \hat{C}^s(z), \\ (-1)^i \psi^{(i)}(y^E, z) \geq 0 \text{ for } i = 0, 1, \dots, s \\ \psi^{(i)}(z, z) = 0 \text{ for } i = 0, 1, \dots, s-2 \text{ when } s \geq 2 \end{array} \right. \right\} \quad (23')$$

where  $\hat{C}^s(z)$  is the set of functions that are  $s$ -time piecewise differentiable over  $[0, z]$  with respect of  $y^E$  and the normative meaning of classes  $\Psi^s(z)$  is basically the same of  $\Omega^s$ . A fundamental instrument to compare alternative distributions of incomes in terms of poverty indices of classes  $\Psi^s(z)$  is the stochastic dominance curve (see, for instance, Davidson and Duclos, 2000) that, when  $\mathbf{p} = \mathbf{p}^R$ , can be written as

$$D^s(z) = \frac{1}{(s-1)!} \int_0^z [z-y]^{s-1} f(y) dy. \quad (24)$$



It is possible to show (see Duclos and Makdissi, 2004) that, for any  $U \in \Omega^s$ , a sufficient condition for  $U_b - U_a \geq 0$ , that is for improving welfare by moving from the relative density functions  $f_a$  to  $f_b$ , is

$$\begin{aligned} D_a^s(y) - D_b^s(y) &\geq 0 \text{ for any } y \in [0, y^{\max}] \\ \text{and, if } s &\geq 3, \\ D_a^s(y^{\max}) - D_b^s(y^{\max}) &\geq 0 \text{ for any } i \in \{2, \dots, s-1\}. \end{aligned} \quad (25)$$

Analogously, for any  $z \in [0, z^+]$  and any  $P(z) \in \Psi^s$ , a sufficient and necessary condition for  $P_b(z) - P_a(z) \leq 0$ , that is for reducing poverty by moving from the relative density functions  $f_a$  to  $f_b$ , is

$$D_a^s(y) - D_b^s(y) \geq 0 \text{ for any } y \leq z^+. \quad (25')$$

However, when we want to assess how a given income distribution is affected by a marginal price reform we need to consider how stochastic dominance curves are affected by such reforms and deal with normalized consumption dominance curves which are defined as

$$\overline{CD}_k^s(z) = H \frac{CD_k^s(z)}{q_k(\mathbf{p})} \quad (26)$$

where  $CD_k^s(z) = \frac{\partial D^s(z)}{\partial p_k}$  is the consumption dominance curve of good  $k$  ( $k=1, \dots, I$ ), and  $\frac{q_k(\mathbf{p})}{H}$  is the normalizing factor which is the reciprocal of the average consumption of that good.

The impact on the stochastic dominance curve of a marginal price reform that keeps the firm's profit constant is, by definition,

$$dD^s(z) = \sum_{i=1}^I CD_i^s(z) dp_i \quad (27)$$

that, in the simpler case of a marginal price reform that decreases the price of good  $i$  and increases the price of good  $j$ , can be shown (Makdissi and Wodon, 2007) to be equal to

$$dD^s(z) = \left[ \overline{CD}_i^s(z) - \gamma \overline{CD}_j^s(z) \right] \frac{q_i(\mathbf{p})}{H} dp_i \quad (27')$$

where  $\gamma = -\frac{dp_i q_j(\mathbf{p})}{dp_j q_i(\mathbf{p})}$ .

By (25) and (27') we can show that, for any  $U \in \Omega^s$ ,

$$\begin{aligned} \overline{CD}_i^s(y) - \gamma \overline{CD}_j^s(y) &\geq 0 \text{ for any } y \in [0, y^{\max}] \\ \text{and, if } s &\geq 3, \\ \overline{CD}_i^\sigma(y^{\max}) - \overline{CD}_j^\sigma(y^{\max}) &\geq 0 \text{ for any } \sigma \in \{2, \dots, s-1\}. \end{aligned} \tag{28}$$

is a sufficient condition for increasing  $U$  when we marginally decreases the price of good  $i$  and increases the price of good  $j$  in order to keep the firm's profit constant.

Similarly, by (25') and (27') we can show that, for any  $P(z) \in \Psi^s$ ,

$$\overline{CD}_i^s(y) - \gamma \overline{CD}_j^s(y) \geq 0 \text{ for any } y \in [0, z^+] \tag{28'}$$

is a necessary and sufficient condition for increasing  $P(z)$  when we marginally decreases the price of good  $i$  and increases the price of good  $j$  in order to keep the firm's profit constant.

In Section 3.4 we will see how Makdissi and Wodon (2007) extend these results to the context where the social planner has not prices under her direct control and she has to rely on price cap regulation.

### **3 Price cap regulation: allocative, distributional and poverty issues**

Price cap is a regulatory instrument typically used to control the dynamic of prices in utility markets which are characterized by some degree of market power. If the regulated market is a multi-product monopoly and the regulator is a benevolent social welfare maximizer, her objective can be still represented as the problem we have outlined in (4). The regulator's possibility of solving that maximization problem depends greatly on her knowledge of demand and cost functions. In fact, almost any form of regulation is characterized by asymmetric information where the less informed part is supposed to be the regulator who cannot directly observe either some firm's behaviour - usually the level of effort put to reduce costs - or the realisation of some

stochastic parameter generally regarding the structure of cost and/or demand. On the other hand, the regulated firm knows these parameters but does not have incentives to truthfully report them and behave in accordance with the regulator's wishes.

Price cap regulation represents a useful instrument which is easy to implement and allows to bypass the regulatory problems due to asymmetric information. As a matter of fact, price cap is a non-Bayesian regulatory instrument in the sense that the regulator can implement and enforce the contract with no need of having prior information - even in probabilistic terms - on the unobservable parameters of the problem. In fact, price cap regulation belongs to fixed-price contracts (i.e. the regulated firm has no chance to affect the cap on its prices) that always guarantee productive efficiency because the firm is residual claimant of any possible gain due to its effort of reducing costs. Moreover, in multi period contexts price cap regulation can be designed as a routine that allows to enforce socially efficient prices (at least in the long run).

### 3.1 The Vogelsang and Finsinger mechanism

Vogelsang and Finsinger (1979) first highlighted that a Laspeyres-type price cap can be structured as an incentive mechanism which enforces the use of Ramsey-Boiteux prices by a multiproduct monopolist.

Suppose the regulatory maximization problem is that defined in (4) where the welfare function is defined as the simple sum the quasi-linear indirect utility functions of  $H$  individuals purchasing  $I$  goods and, therefore, (6) and (7) apply. Let  $\mathbf{p}^t$  be the  $I$ -dimensional vector of market prices at time  $t$ , where  $t = 0, \dots, \infty$  and assume the regulated monopolist myopically maximises its profits  $\Pi(\mathbf{p}^t) = \sum_i p_i^t q_i(\mathbf{p}^t) - c(\mathbf{q}(\mathbf{p}^t))$  in each period of time  $t$ , where  $c(\mathbf{q}(\mathbf{p}^t))$  is the cost function at period  $t$  when the firm fixes a vector of prices  $\mathbf{p}^t$  and sells the corresponding vector of quantities  $\mathbf{q}(\mathbf{p}^t)$ . The cost function has the same properties discussed in section 2 for the single period case and it is also assumed to show decreasing ray average cost, that is  $c(\lambda \mathbf{q}) \leq \lambda c(\mathbf{q})$  for any  $\lambda \geq 1$ . Both cost and demand functions are supposed to be stable over time while myopia implies that the regulated firm does not maximise any discounted flow of future

profits, disregarding the effects that its choice at any time  $t$  may have on the problem it has to face in the subsequent periods. The regulator does not know neither the demand functions nor the cost function. Nevertheless, in any period  $t$ , the regulator can observe both the total cost which has been realised by the firm in the previous period and the corresponding vector of sold quantities  $\mathbf{q}(\mathbf{p}^{t-1})$ .

Within this framework, Vogelsang and Finsinger (1979) suggest a sequential mechanism, or algorithm, built on a price constraint just exploiting the regulator's capacity to observe the realisations of the previous period. Then, the regulatory constraint requires that the vector of prices chosen by the firm at any period  $t$  must satisfy the following inequality:

$$\mathbf{q}(\mathbf{p}^{t-1}) \cdot \mathbf{p}^t - c(\mathbf{q}(\mathbf{p}^{t-1})) \leq 0. \quad (29)$$

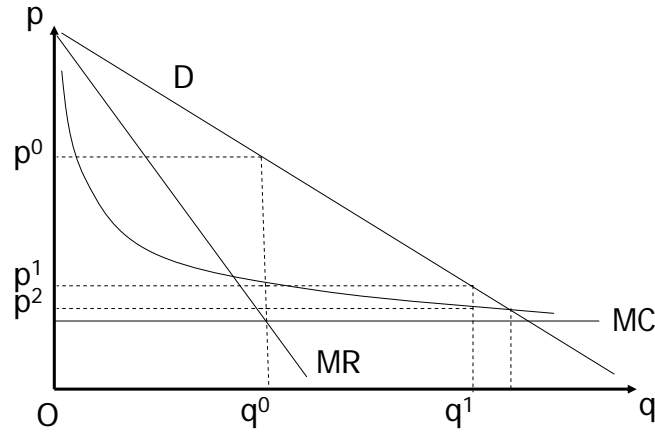
In words, the pseudo-revenue given by multiplying the previous period's vector of quantities by the current vector of prices cannot exceed the total cost occurred to the firm at time  $t-1$ . Then, suppose that  $t=1$  is the period of time when the mechanism is implemented for the first time. If we start with positive profit at  $t=0$ , (29) requires that  $\mathbf{p}^1$  cannot be equal to  $\mathbf{p}^0$  and, in general,  $\mathbf{p}^t$  cannot be equal to  $\mathbf{p}^{t-1}$  until the zero profit contingency takes place. Furthermore, positive profit at  $t=0$  and decreasing ray average cost causes (29) to induce  $\Pi^t \geq 0$  for any subsequent period. Indeed, as prices go down, profits tendency to decrease is partially balanced by the assumption of decreasing average cost. As a matter of fact, as prices go down, quantities go up and decreasing average cost assures that unit costs go down. Under the above assumptions, it can be also shown that, whenever  $\Pi^{t-1}$  is positive, (29) guarantees  $W(\mathbf{p}^t) \geq W(\mathbf{p}^{t-1})$  and the sequence of the price vector  $\{\mathbf{p}^t\}$  converges to a long run stationary equilibrium where social welfare is maximized under the  $\bar{\Pi}=0$  constraint.

Here we provide a graphical intuition of these results for the simpler single product case. When  $I=1$ , the constraint (29) becomes  $q(p^{t-1}) \cdot p^t - c(q(p^{t-1})) \leq 0$  which implies

$$p^t \leq \frac{c(q(p^{t-1}))}{q(p^{t-1})} \quad (29')$$

that is the price chosen by the firm at time  $t$  cannot be higher than the average costs at time  $t-1$ . The assumption of decreasing (ray) average cost implies the following figure:

Figure 1



Let  $t=1$  be the first period when the price cap (29') comes into force and be  $p^0$  and  $q^0$  the profit maximizing price and quantity pair: then, according to (29'),  $p^1$  is the highest level of price – equal to the firm's average costs at time 0 – that the firm will charge at time 1 and  $q^1$  will be the corresponding level of quantity that will be produced and supplied. Given  $q^1$ ,  $p^2$  is the highest level of price – equal to the firm's average costs at time 1 – that the firm will charge at time 2 and so on till the stationary point where average costs and demand cross each other. This converging process depends on the assumption of decreasing average costs. Indeed, under increasing (ray) average costs either the process converges to second best prices with profits and losses following each other in a hog cycle or, if the average cost curve is steeper than the demand curve (in absolute terms) the process does not converge and some further steps must be added to the basic regulatory algorithm consisting in the regulator imposing (29) whenever firm's profits were positive in the previous period (see the flow chart II at figure 8, p. 169 of Vogelsang and Finsinger, 1979).

The price cap formula proposed by Vogelsang and Finsinger (1979) has some similarity with the *RPI-X* price cap first introduced in 1984 for regulating British Telecom (Littlechild, 1983) and then adopted in many other markets and countries (OECD, 2000). The *RPI-X* constraint is a limit over the increase of a Laspeyres price index, that is

$$\frac{\mathbf{p}^t \cdot \mathbf{q}(\mathbf{p}^{t-1})}{\mathbf{p}^{t-1} \cdot \mathbf{q}(\mathbf{p}^{t-1})} \leq \frac{RPI^t}{RPI^{t-1}} - X \quad (30)$$

where  $RPI^t$  is the retail price index at period  $t$  and  $X$  is an exogenous adjustment factor aimed at inducing productivity improvements over time. This formula can be rewritten, and it is usually presented, as a  $RPI-X$  threshold to a weighted average of the prices' changes over time

$$\sum_{i=1}^I \frac{p_i^t}{p_i^{t-1}} \cdot \frac{p_i^{t-1} \cdot q_i(\mathbf{p}^{t-1})}{\mathbf{p}^{t-1} \cdot \mathbf{q}(\mathbf{p}^{t-1})} \leq \frac{RPI^t}{RPI^{t-1}} - X \quad (30')$$

where the weights are the firm's revenue shares calculated at period  $t-1$ . This  $RPI-X$  is essentially similar to the V-F mechanism given in (29) that can be rewritten as

$$\mathbf{p}^t \cdot \mathbf{q}(\mathbf{p}^{t-1}) - c(\mathbf{q}(\mathbf{p}^{t-1})) \leq 0 = \mathbf{p}^{t-1} \cdot \mathbf{q}(\mathbf{p}^{t-1}) - c(\mathbf{q}(\mathbf{p}^{t-1})) - \Pi(\mathbf{p}^{t-1})$$

in order to obtain

$$\frac{\mathbf{p}^t \cdot \mathbf{q}(\mathbf{p}^{t-1})}{\mathbf{p}^{t-1} \cdot \mathbf{q}(\mathbf{p}^{t-1})} \leq 1 - \frac{\Pi(\mathbf{p}^{t-1})}{\mathbf{p}^{t-1} \cdot \mathbf{q}(\mathbf{p}^{t-1})} \quad (31)$$

Indeed, if we allow for an inflationary element in costs, (31) is the same as the tariff basket  $RPI-X$  approach with  $X$  varying from period to period according to the size of profits (see also Bradley and Price, 1988). The Laspeyres type price caps' property of converging towards Ramsey-Boiteux prices is also showed by Brennan (1989) for a further simplified version of (31) where the second term on the right-hand side is set equal to zero.

### 3.2 Distributional issues of RPI-X regulation and the Generalized Price Cap

As we have seen in section 2.3, there may exist some possible adverse distributional effects of Ramsey-Boiteux prices since they entail higher mark-ups on those goods with lower demand elasticity which, in turn, often represent a large share of low-income consumers' expenditures. There have been a number of papers (see, for instance, Hancock and Waddams Price, 1995 and Waddams Price and Hancock, 1998) that have questioned the desirability of the so-called process of tariff re-balancing

undertaken by many price capped utilities. This process has entailed a sharp rise in the price of items with low price elasticity and a decrease in the price of items whose demand is more sensitive to price changes with a largely documented regressive effect.

This widespread concern led Oftel (the former regulator of the telecommunications industry in the UK) to modify in 1997 the *RPI-X* formula that had been used since 1984 to regulate the prices set by British Telecom. Basically, Oftel shifted from a typical Laspeyres type price cap as in (30') to a new price cap formula where different weights were chosen for price changes of the different goods included in the regulated bundle. These weights were no longer the revenue shares for the previous period but the shares of total revenues accruing to the regulated firm only from those consumers who are in the first eight deciles of total expenditure in telecommunications services. This new price cap formula implied that a stricter control was placed on the prices of the goods that make up a large share of the typical bill of low-consumption customers. Formally, indicating by  $\tilde{q}_i$  the quantity of good  $i$  purchased by consumers who are in the first eight deciles of total expenditure in telecommunications services, the price cap formula adopted by Oftel can be approximated by the following:

$$\sum_{i=1}^I \frac{p_i^t}{p_i^{t-1}} \frac{p_i^{t-1} \tilde{q}_i^{t-1}}{\sum_{j=i}^I p_j^{t-1} \tilde{q}_j^{t-1}} \leq RPI - X . \quad (32)$$

It is straightforward to show that, if  $\partial W / \partial p_i^{t-1} = \tilde{q}_i^{t-1}$  for some specification of  $W(\mathbf{p}, \mathbf{y})$ , (32) can be related to the generalized price cap (GPC) formula proposed by Iozzi, Poritz and Valentini (2002). For the simplified case of  $RPI=1$  and  $X=0$ , the GPC can be written as

$$\sum_{i=1}^I \frac{p_i^t}{p_i^{t-1}} \frac{p_i^{t-1} \frac{\partial W}{\partial p_i^{t-1}}}{\sum_{j=i}^I p_j^{t-1} \frac{\partial W}{\partial p_j^{t-1}}} \leq 1 \quad (33)$$

When the regulator knows her preferences, she can attach a value to any  $\partial W / \partial p_i^{t-1}$  and implement (33). Moreover, if the regulator can observe the prices set by

the firm in the previous and current periods, she is able to check whether the firm is complying with (33) and enforce it.

Iozzi, Poritz and Valentini (2002) prove that, if the social welfare function  $W(\mathbf{p}, \mathbf{y})$  is quasi-convex and under the other hypotheses we have already discussed in 3.1, the application of a GPC like (33) to a multi-product monopolist may guarantee that social welfare does not decrease over time. To show this point it is convenient to rewrite the GPC as

$$\sum_{i=1}^I p_i^t \cdot \frac{\partial W(\mathbf{p}^{t-1})}{\partial p_i} \geq \sum_{i=1}^I p_i^{t-1} \cdot \frac{\partial W(\mathbf{p}^{t-1})}{\partial p_i} \quad (33')$$

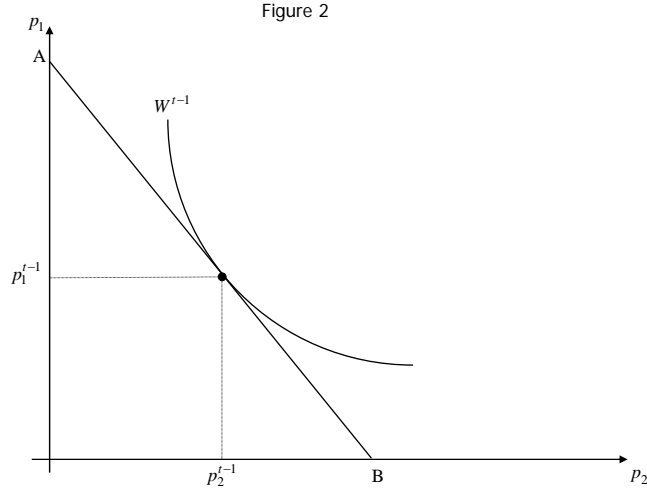
where the direction of the inequality is simply due the negative values of the derivatives of the welfare functions. From (33') it must be

$$\sum_{i=1}^I (p_i^t - p_i^{t-1}) \cdot \frac{\partial W(\mathbf{p}^{t-1})}{\partial p_i} \geq 0$$

which, since we are assuming that  $W(\mathbf{p})$  is quasi-convex and strictly decreasing in prices, implies  $W(\mathbf{p}^t) \geq W(\mathbf{p}^{t-1})$ , that is social welfare is monotonically non-decreasing in time.

In Figure 2 we can see this result in graphical terms. Let  $W^{t-1}$  be the iso-welfare curve going through the price vector  $\mathbf{p}^{t-1}$ . By totally differentiating  $W(\cdot)$ , it is straightforward to show that the slope of  $W^{t-1}$  at  $\mathbf{p}^{t-1}$  is  $-\frac{\partial W / \partial p_1^{t-1}}{\partial W / \partial p_2^{t-1}}$ . Note, from (33'), that this is also the slope of the GPC constraint imposed on the firm at time  $t$ . As the prices set by the firm at time  $t-1$  satisfy the GPC constraint at time  $t$  as an equality, the tangent to  $W^{t-1}$  at  $\mathbf{p}^{t-1}$  and the GPC constraint at time  $t$  are actually the same line. Thus, the GPC restricts the set of feasible prices for the firm at time  $t$  to those on (or below) a line tangent to the iso-welfare curve going through the prices set at time  $t-1$ . Because of the quasi-convexity of the welfare function, the GPC constraint never lies above the iso-welfare line at  $t-1$ . Thus, it cannot happen that a vector of prices selected by the firm at time  $t$  and satisfying the GPC constraint reduces social welfare.

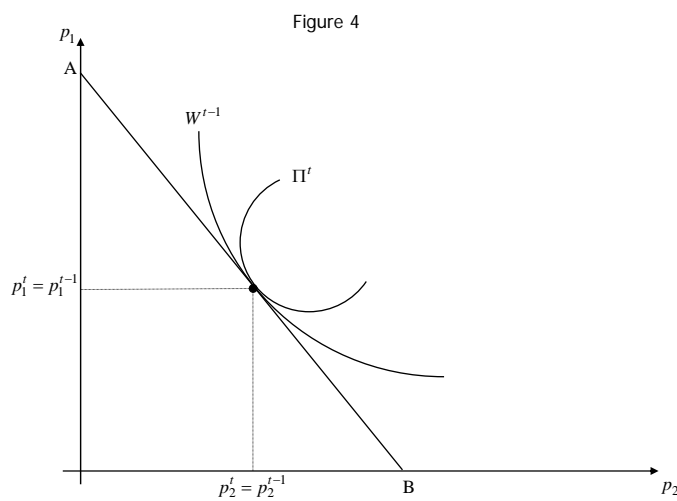
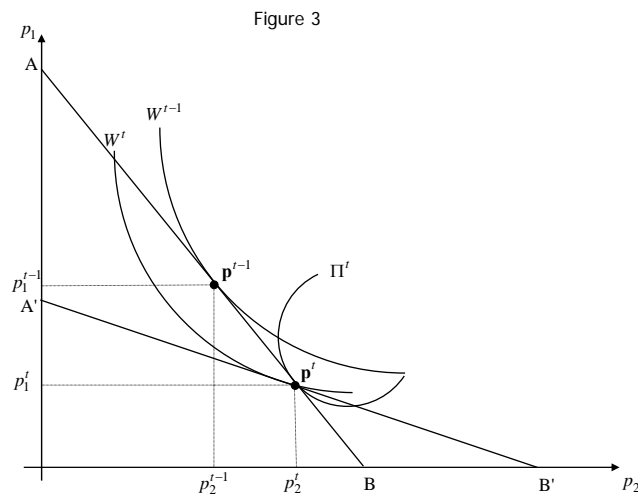




Moreover, Iozzi Poritz and Valentini (2002) show that, under the GPC, the sequence of prices chosen by a regulated firm that maximizes profits in each period  $t$  converges to a price vector which respects the allocative optimum conditions defined in the second line of (5). In other terms, when the regulated firm faces a constraint as in (33), the only long run equilibrium is such that the firm chooses the price vector which maximizes social welfare, given that the firm obtains a specified amount of profits in equilibrium. Here we provide a *heuristic* argument of this sequence convergence, mainly based on graphical interpretation, while for a more rigorous proof we refer the interested readers to the original paper (see Proposition 2 of Iozzi, Poritz and Valentini, 2002, p. 102).

First of all, it must be noted that the price vector  $\mathbf{p}^*$ , coming as the result of the maximization of social welfare given a constraint on the minimum profit level, can also be obtained as the solution to the dual problem of maximizing firm's profits under a constraint of a minimum level of welfare. Note also that the GPC can be seen as a linear approximation of the constraint on the welfare when this is fixed at the level  $W(\mathbf{p}^{t-1})$ . In a two-goods case (see again Figure 2) this observation implies that in any period the GPC can be seen as the line tangent to the iso-welfare contour at the prices set in the previous period. Therefore, in any period  $t$ , the regulated monopolist chooses its optimal price vector  $\mathbf{p}^t$  such that the upper contour set  $\Pi(\mathbf{p}^t)$  is tangent to the GPC

constraint. Since the GPC corresponds to the slope of the welfare function at  $\mathbf{p}^{t-1}$  prices, two alternative possibilities can occur. The first possibility is that  $\mathbf{p}^t$  is not equal to  $\mathbf{p}^{t-1}$  as it is illustrated in Figure 3. Therefore, the GPC constraint at time  $t+1$  (the line  $A'B'$ ) is different from the GPC constraint at time  $t$  (the line  $AB$ ), implying that the process of convergence is not finished yet and the level of social welfare is still increasing over time.



The second possibility, instead, is that  $\mathbf{p}^t$  is equal to  $\mathbf{p}^{t-1}$  which implies that the GPC will not move in the following period (i.e. the convergence is concluded) and the iso-profit and the iso-welfare are tangent to each other at  $\mathbf{p}^t$ , which is exactly what the constrained welfare maximisation requires. This alternative situation is illustrated in Figure 4.

Iozzi, Poritz and Valentini (2002) provide a description of the properties of price cap regulatory schemes under very general hypothesis on the structure of the regulator's preferences. Their result then can be interpreted as a generalisation of Vogelsang and Finsinger (1979) and Brennan (1989) where the convergence to Ramsey-Boiteux prices is optimal as long as the welfare function is strictly utilitarian (i.e. when it is an un-weighted sum of the individuals' welfare).

Since the only restriction on the welfare function which is required in Iozzi, Poritz and Valentini (2002) is quasi-convexity, we can assert that the GPC is able to guarantee a long run equilibrium with optimal prices for almost *any* welfare function; hence, when the welfare function is strictly utilitarian and consumers have quasi-linear preferences,  $\frac{\partial W}{\partial p_i} = -q_i$ , for all  $i = 1, \dots, I$ , and the GPC simply takes the form of the Laspeyres-type price cap studied by Brennan (1989).

Similarly, the GPC can be accommodated to provide a specification which is suitable for the case of distributionally weighted utilitarian preferences. Indeed, when the regulator's preferences can be represented by the following welfare function  $W(\mathbf{p}; \mathbf{y}) = \sum_h S_h(\mathbf{p}) \cdot u'(y_h)$ , we can show that the GPC defined by (33') can guarantee the convergence of the prices set by the regulated firm to the optimal prices as defined by condition (11'), provided that the (33') takes the following characterization

$$\sum_{i=1}^I p_i^t \cdot \tilde{q}_i^{t-1} \leq \sum_{i=1}^I p_i^{t-1} \cdot \tilde{q}_i^{t-1} \quad (34)$$

where,

$$\tilde{q}_i^{t-1} = R_i^{t-1} q_i^{t-1} = \sum_{h=1}^H q_i^h(\mathbf{p}) \cdot u'(y^h) \quad (35)$$

with  $R_i^{t-1}$  which is the distributional characteristic of the good  $i$  at time  $t$  as it is defined in (12). Then  $\tilde{q}_i^{t-1}$  is an adjusted measure of the aggregate consumption of good

$i$  at time  $t-1$ , which entails that the quantities consumed by each individual are adjusted using the marginal social utility of income of that individual.

By the same arguments used for the case of Laspeyres-type price cap we can prove that, when the GPC takes the form (32), social welfare can never decrease in time, and the sequence of price vectors  $\{\mathbf{p}^t\}$  which come as the solution of the firm's maximization problem converges to a unique vector which satisfies the first order conditions of problem (4) for the special case when, as in Feldstein (1972),  $W(\mathbf{p}; \mathbf{y}) = \sum_h S_h(\mathbf{p}) \cdot u'(y_h)$ . Indeed,  $\sum_h S_h(\mathbf{p}) \cdot u'(y_h)$  is a strictly decreasing function in prices which respects the required properties of continuously differentiability and quasi-convexity. Moreover, the constraint in (34) is identical to the GPC that has been defined in (33') since, from (35) and from the fact that  $\frac{\partial S_h(\mathbf{p})}{\partial p_i} = -q_{i,h}(p_i)$ , we have

$$\frac{\partial W(\mathbf{p}^{t-1})}{\partial p_i} = -\tilde{q}_i^{t-1}.$$

It is straightforward to see that  $\tilde{q}_i^{t-1} = \tilde{q}_i^{t-1}$ , that is the specification of the GPC given in (32) as representation of the price cap formula implemented by Oftel in 1997 is equal to the specification given in (34), as long as the social welfare weights (that in the case of  $W(\mathbf{p}; \mathbf{y}) = \sum_h S_h(\mathbf{p}) \cdot u'(y_h)$  are the social marginal utility of income,  $u'(y_h)$ ) are one for households belonging to the first eight deciles of expenditure, and zero otherwise.

### 3.3 Uncovering social welfare weights under price cap regulation

Valentini (2006) extends the analysis of Iozzi, Poritz and Valentini (2002) and explores the possibility of adapting the framework suggested by Ross (1984) in order to detect the implicit welfare weights of a regulator who is implementing a GPC. Since in Ross (1984) prices are directly chosen by the regulator, they exactly reveal the regulator's preferences over consumers, and the strategy of inverting a "generic" Ramsey formula with potentially diverse welfare weights may be usefully followed. Under price cap regulation, instead, the observed prices might be not optimal since they eventually

converge to the second best in the long run. However, if we assume that the regulator's maximization problem is given as in (4), that is,

$$\begin{aligned} & \max_{\mathbf{p}} W(\mathbf{p}, \mathbf{y}) \\ & \text{s. t. } \Pi(\mathbf{p}) \geq \bar{\Pi} \end{aligned}$$

and the price cap rule is given by

$$\sum_{i=1}^I \frac{p_i^t}{p_i^{t-1}} \frac{p_i^{t-1} \Phi_i^t}{\sum_{j=i}^I p_j^{t-1} \Phi_j^t} \leq 1 \quad (36)$$

we can try to get information on  $W(\mathbf{p}, \mathbf{y})$  at any time  $t$  by simply observing the vector  $\Phi$  of the weights used in (36). Indeed, the price cap rule defined in (36) has the same properties of a the Iozzi, Poritz and Valentini's GPC defined by (33) as long as

$$\Phi_i^t = \frac{\partial W}{\partial p_i^{t-1}} \quad \text{for any } i=1, \dots, I. \quad (37)$$

We can adapt (9') to the present context by rewriting it as

$$\frac{\partial W}{\partial p_i^{t-1}} = - \sum_{h=1}^H \beta_h q_{i,h}^{t-1} \quad (38)$$

where  $q_{i,h}^{t-1}$  is the quantity of good  $i$  consumed by consumer  $h$  at time  $t-1$  and  $\beta_h = \frac{\partial W}{\partial v_h} \alpha_h$  is again the marginal social utility of income (that is the social welfare weight) of consumer  $h$ . Therefore, as long as at any time  $t$  we can observe the weight  $\Phi_i^t$  and the quantities of good  $i$  consumed by each consumer  $h=1, \dots, H$  at time  $t-1$ , (38) allows to uncover  $\beta_h$ , conditional on all the other  $\beta_k$  ( $k=1, \dots, h-1, h+1, \dots, H$ ). More precisely, we can write the system of  $I$  equations given by (38) as

$$\mathbf{W}^t = \mathbf{Q}^t \cdot \boldsymbol{\beta} \quad (39)$$

where  $\mathbf{W}^t$  is the  $(I \times 1)$  vector whose  $i^{\text{th}}$  element is  $\frac{\partial W}{\partial p_i^{t-1}}$ ,  $\mathbf{Q}^t$  is the  $(I \times H)$  non-singular matrix whose  $i, h^{\text{th}}$  element is  $q_{i,h}^t$  and  $\boldsymbol{\beta}$  is the  $(H \times 1)$  vector of social welfare weights whose  $h^{\text{th}}$  element is  $\beta_h$ .

In this framework, the inverse optimum problem (IOP) consists in finding out the vector  $\beta$  that satisfies (39). When  $I=H$ , the solution of the IOP problem is

$$\beta = \mathbf{Q}^{-1} \cdot \mathbf{W}^t \quad (40)$$

where  $\mathbf{Q}^{-1}$  is the inverse of  $\mathbf{Q}^t$ .

### 3.4 Welfare improving and poverty reducing marginal price cap reforms

We can extend the analysis on welfare improving and poverty reducing marginal price reforms to the case where the social planner has not prices under her direct control and she relies on price cap regulation (Makdissi and Wodon, 2007). Let us assume, as usual, that the regulated monopolist chooses  $\mathbf{p}$  in order to maximize its profit  $\Pi$  given a static version of price cap (see, for instance, Armstrong and Vickers, 1991 and 1993) which is given by

$$\sum_{i=1}^I \omega_i p_i \leq \bar{p}. \quad (41)$$

where the regulator's choice of  $\omega_i$  reflects her social preferences. For instance, when the weights  $\omega_i$  are set equal to the realized quantities (i.e.  $\omega_i=q_i$  for any  $i=1, \dots, I$ ), then the profit maximization problem yields to Ramsey-Boiteux prices that imply a regulator who aims to maximize a strictly (i.e. unweighted) utilitarian social welfare function<sup>1</sup>. Given (41), the first order conditions of the monopolist's problem are

$$v \omega_i = q_i(\mathbf{p}) + \sum_{j=1}^I (p_j - c_j) \frac{\partial q_j(\mathbf{p})}{\partial p_j} \quad (i=1, \dots, I) \quad (42)$$

where  $v$  is the Lagrange multiplier.

In this setting we define a marginal price cap reform as a reform that affects the weights of two prices in the price cap basket by increasing  $\omega_i$  and decreasing  $\omega_j$  in such a way that  $d\omega_i = -d\omega_j$ . However, differently from the case of direct price reform, where just the prices of two goods change, any  $d\omega_i$  may imply that the regulated firm

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<sup>1</sup> Even if it is not realistic to assume that the regulator can anticipate the realized quantities, this simplified static version with fixed weights (i.e. not endogenously determined as they are in a dynamic setting), allows Makdissi and Wodon (2007) to highlight the possibility of relying on stochastic dominance conditions to reform price cap regulation.

adjusts its whole price structure and changes all prices. As a matter of fact, by totally differentiating the set of equations given by (42), we get that, for any  $i=1, \dots, I$ ,

$$vd\omega_i = \sum_{j=1}^I \left[ \frac{\partial q_i(\mathbf{p})}{\partial p_j} + \left( 1 - \sum_{k=1}^I \frac{\partial c_j}{\partial q_k} \frac{\partial q_k(\mathbf{p})}{\partial p_j} \right) \frac{\partial q_j(\mathbf{p})}{\partial p_i} + (p_j - c_j) \frac{\partial^2 q_j(\mathbf{p})}{\partial p_i \partial p_j} \right] dp_j \quad (43)$$

We know from section 2.7 (see eq. (27)) that the impact on the stochastic dominance curve of a marginal change of prices is given by

$$dD^s(z) = \sum_{i=1}^I CD_i^s(z) dp_i. \quad (44)$$

In the present setting we can rewrite (44) as

$$dD^s(z) = \sum_{h=1}^I CD_h^s(z) \frac{\partial p_h}{\partial \omega_i} d\omega_i + \sum_{h=1}^I CD_h^s(z) \frac{\partial p_h}{\partial \omega_j} d\omega_j \quad (45)$$

that, taking into account that  $d\omega_i = -d\omega_j$ , becomes

$$dD^s(z) = \sum_{h=1}^I CD_h^s(z) \left( \frac{\partial p_h}{\partial \omega_i} - \frac{\partial p_h}{\partial \omega_j} \right) d\omega_i \quad (45')$$

Equation (45') allows to identify the sufficient condition for a marginal price cap reform being welfare improving for any welfare index  $U \in \Omega^s$ , namely

$$\sum_{h=1}^I CD_h^s(y) \left( \frac{\partial p_h}{\partial \omega_i} - \frac{\partial p_h}{\partial \omega_j} \right) \leq 0 \text{ for any } y \in [0, y^{\max}]$$

and, if  $s \geq 3$ ,

$$\sum_{h=1}^I CD_h^\sigma(y^{\max}) \left( \frac{\partial p_h}{\partial \omega_i} - \frac{\partial p_h}{\partial \omega_j} \right) \leq 0 \text{ for any } \sigma \in \{2, \dots, s-1\} \quad (46)$$

and the necessary and sufficient condition for a marginal price cap reform being poverty reducing for any poverty index  $P(z) \in \Psi^s$ , namely

$$\sum_{h=1}^I CD_h^s(y) \left( \frac{\partial p_h}{\partial \omega_i} - \frac{\partial p_h}{\partial \omega_j} \right) \leq 0 \text{ for any } y \in [0, z^+]. \quad (46')$$

The main difference between the conditions implied by (46) and (46') and those obtained in the case of marginal price reforms [i.e. (28) and (28')] is that the former

relies on  $CD$  curves of all goods while the latter on only  $\overline{CD}_i^s$  and  $\overline{CD}_j^s$ . This is due to the effect of cross-price elasticities in (43). In fact, if we assume that the cross-price elasticities of goods are zero, (43) can be written as

$$vd\omega_i = \left[ 2 \frac{\partial q_i(\mathbf{p})}{\partial p_i} - \frac{\partial c_i}{\partial q_i} \left( \frac{\partial q_i(\mathbf{p})}{\partial p_i} \right)^2 + (p_i - c_i) \frac{\partial^2 q_i(\mathbf{p})}{\partial p_i^2} \right] dp_j, \quad (i=1, \dots, I)$$

(46) and (46') become

$$CD_i^s(y) \frac{\partial p_i}{\partial \omega_i} - CD_j^s(y) \frac{\partial p_j}{\partial \omega_j} \leq 0 \text{ for any } y \in [0, y^{\max}]$$

and, if  $s \geq 3$ ,

$$CD_i^\sigma(y^{\max}) \frac{\partial p_i}{\partial \omega_i} - CD_j^\sigma(y^{\max}) \frac{\partial p_j}{\partial \omega_j} \leq 0 \text{ for any } \sigma \in \{2, \dots, s-1\}$$

(47)

and

$$CD_i^s(y) \frac{\partial p_i}{\partial \omega_i} - CD_j^s(y) \frac{\partial p_j}{\partial \omega_j} \leq 0 \text{ for any } y \in [0, z^+]$$

(47')

respectively.

## 4 Conclusion

This paper provided a unified vision of a number of results that appeared in three separate streams of literature. We have seen that there exists a strong parallelism between many normative properties that characterize the theory of indirect taxation and public pricing and the underlying theory of price cap regulation. Along this parallelism further areas of future research are still possible. First of all, as it is recognized also by Makdissi and Wodon (2007), the stochastic dominance approach should be further adapted to a dynamic price cap setting where there is asymmetric information between the regulator and the private firm. Moreover, while the theoretical contributions on marginal tax and public pricing reforms stimulated an enormous amount of empirical investigations, the empirical literature devoted little attention to the assessment of price cap regulation in terms of welfare consequences,



distributional implication and poverty reducing. We hope that this gap will be filled in the near future.

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