This thesis examines the regulation of a vertically differentiated market by Minimum Quality Standards (MQS) and commodity taxation. The research problem is: Does there exist a simple regulatory mechanism or policy instrument that would improve the overall efficiency and social welfare of a vertically differentiated product market? It is divided into three sub-problems: 1. What causes market inefficiencies in a vertically differentiated market? 2. How can Minimum Quality Standards affect the market outcome and the social welfare? 3. How can different taxation schemes affect the market outcome and the social welfare?

In order to answer the research problems, a literature study and analysis of the reviewed theories was carried out. Main sources include Crampes – Hollander (1995) for a basic duopoly model and implications of a MQS, Ecchia et al. (2001) for a broad review of MQS literature, and Cremer – Thisse (1994) for a study of ad valorem taxation under vertically differentiation.

It was shown that in a vertically differentiated duopoly firms do not offer an optimal mix of product qualities as they try to relax the price competition and increase their profits by differentiating their products as much as possible. In the unregulated equilibrium, the lower quality is too low and high quality too high. A sufficiently low MQS may be welfare improving as it reduces the quality dispersion of the differentiated products, thus forcing a harder price competition. Similarly, a small ad valorem tax is welfare improving, but a large tax may begin to decrease the social welfare, in which case, if tax revenue requirements are high enough, a unit tax may actually be preferable. Thus, MQSs and taxation both reduce the quality difference, taxation by lowering and MQSs by increasing both qualities. Therefore I speculate on a solution using both instruments simultaneously; a MQS to raise one and taxation to decrease the other quality.

This study contributes to existing knowledge by providing a combined analysis of MQS and commodity taxation, by showing formal proofs for the results and third, by proposing a hypothesis for a combined use of MQS and taxes for achieving the first-best optimum.

Avainsanat-Nyckelord-Keywords
vertical product differentiation
minimum quality standards
commodity taxation
social welfare

Muita tietoja-Övriga uppgifter-Additional information