

BS2243 – Lecture 3

Structure – Conduct – Performance - II

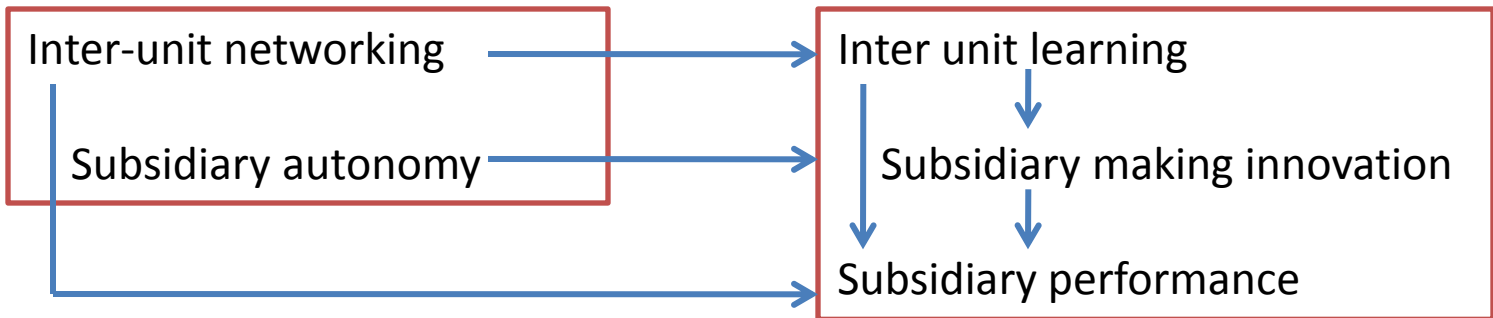
Spring 2010

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Thinking about SCP

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|------------------------------|----------------------------|----------------------|
| 1. Government influence | 5. Resource sharing | 9. Legal conditions |
| 2. Quality of infrastructure | 6. Corporate governance | 10. Economic freedom |
| 3. Global competition | 7. Economic development | 11. Other |
| 4. Technological change | 8. Costs of doing business | |

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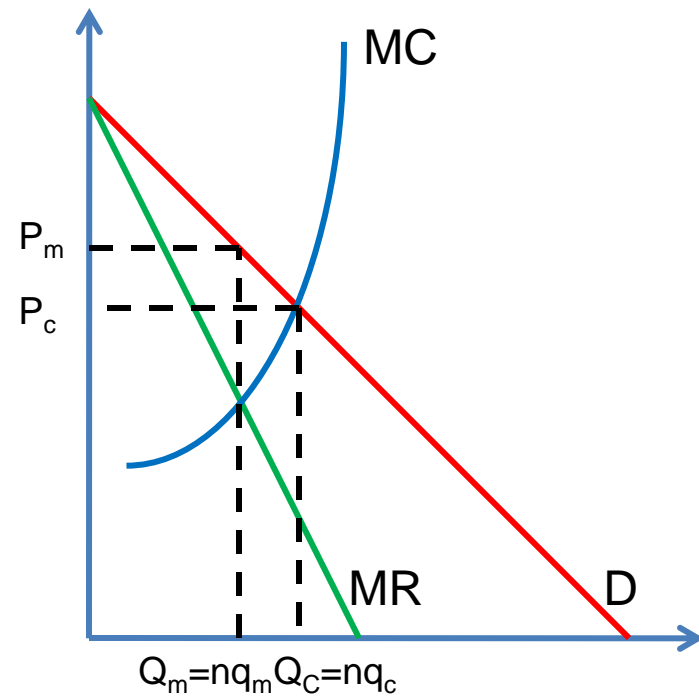
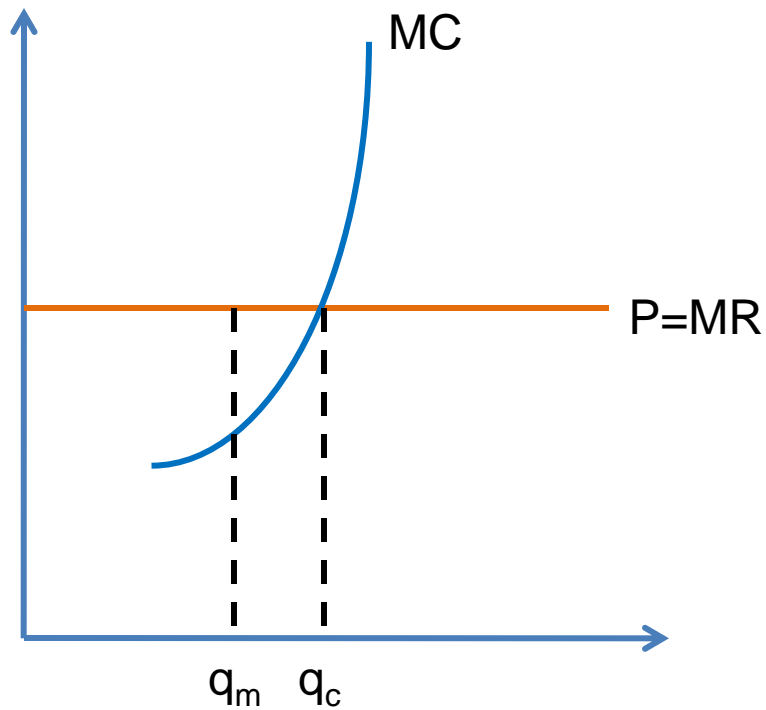
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|-----------------------|-------------------------|-------------------------|
| 1. Age of operations | 5. Type of market | 9. Marketing adaptation |
| 2. Parent nationality | 6. Proportion of expats | 10. Product adaptation |
| 3. Size of operations | 7. Physical distance HQ | 11. Price adaptation |
| 4. Type of product | 8. Cultural distance HQ | |

Cartels – why are they formed?

- Each individual firm takes into consideration the marginal gains/losses from changing its output level, but ignores the impact on the other firms
- A cartel is able to internalise this externality, and hence produce less in equilibrium
- However, the externality provides an incentive to cheat on cartel partners

Cartels – graphical view



Cartel formation – necessary conditions

- Ability to raise price above competitive levels without facing competition from non-members
 - Elasticity of demand
 - Market share of the cartel members
 - Barriers to entry
- The expected penalty should not be high
- The cost of enforcement should not be high
 - Number of cartel members (more likely in concentrated industries)
 - Geographic spread of the cartel members

Types of collusion

- Types:
 - Explicit (e.g., OPEC)
 - Tacit (price fixing)
- Some alleged cases of price fixing
 - Six South African airlines are being investigated for allegedly colluding to hike fares for local flights during the football World Cup in June (<http://news.bbc.co.uk>)
 - United Parcel Service Inc, the world's largest package-delivery service, said on Wednesday it has been contacted by the European Commission, which is probing price fixing in the shipping business (www.reuters.com)
 - Italy's financial police have raided the offices of the country's five main pasta makers as part of a price-fixing investigation, judicial sources say (<http://news.bbc.co.uk>)

What does the law say?

- Competition law prohibits almost any attempt to fix prices - for example, **you cannot**:
 - **agree prices** with your competitors, eg you can't agree to work from a shared minimum price list
 - **share markets** or limit production to raise prices, eg if two contracts are put out to tender you can't agree that you'll bid for one and let your competitor bid for the other
 - impose minimum prices on different **distributors** such as shops
 - agree with your competitors what **purchase** price you will offer your suppliers
 - cut prices below cost in order to force a smaller or weaker competitor out of the market
- The law doesn't just cover formal agreements. It also includes other activities with a **price-fixing effect**. For example, you shouldn't discuss your pricing plans with your competitors. If you then all 'happen' to raise your prices, you are fixing prices
- The law is enforced by the OFT, which can impose a **fine** of up to 10 per cent of your turnover. It can also apply for company directors to be disqualified

Source: <http://www.businesslink.gov.uk>

Enforcing a cartel agreement

Necessary conditions	OPEC
There are few firms in the market	✓
Prices do not fluctuate independently	Demand can fluctuate significantly
Prices are widely known	✓
All cartel members sell identical products at the same point in the distribution chain	There are multiple modes of distribution, and each member has its own distribution network

Conduct – taking a step back

- Collusion is a strategic decision aimed at reducing competitive pressures
- Strategic decisions are taken by firms' management
- Why do firms take many bad strategic decisions?
 - E.g., mergers and acquisitions
 - “Agency” conflict

Implications of agency conflict

- There should be mechanisms to align the interests of the managers and the shareholders
 - Employee ownership of shares
 - Family owned firms
- Problems with entrenchment