ECONOMICS U$A

PROGRAM #7

OLIGOPOLIES: WHAT EVER HAPPENED TO PRICE COMPETITION?

AUDIO PROGRAM TRANSCRIPT

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MUSIC PLAYS)

Announcer: Funding for this program was provided by Annenberg Learner.

FRANK STASIO: This program was originally recorded in 1985. Though times have changed, the basic economic principles presented here remain as relevant today as they were when this series was produced. Also, please note that individuals interviewed on this program may no longer hold the same titles they held when this program was recorded.

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FRANK STASIO: Economics U$A, one of a series of programs designed to explore twentieth-century micro and macroeconomic principles. The subject of this edition is Oligopoly. Our guests are Doctor Thomas Kratinaker, Law Professor at Georgetown University and Nariman Behravesh, a Vice President at Wharton Econometrics. I'm Frank Stasio.

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FRANK STASIO: Commercials, the mark of fierce competition, one company after another touting the praises of its products in breathless efforts to gain your business. But, in fact, advertising is used many times to avoid competition. It's true that firms work hard to get your business but they'd rather not engage in head to head competition where the consumer's decision to buy is based on price alone. So, in the car industry for instance manufacturers offer various packages of options and styles to make price comparisons practically impossible. Think about how much easier the choice would be if cars were like hamburger. Look in the paper for the grade that suited you and see which dealer had the best price. There was time when the choice was almost that simple.

RICHARD STROUT: "They were lovely little cars. They were seven feet high and they were as angular as uh, as an awning I would say, and uh, they would take you anywhere."

FRANK STASIO: Richard Strout of the *Christian Science Monitor* is talking about the Model T developed by Henry Ford. Durable and inexpensive, the Model T was a huge success leaving the competition in the dust. It got you from here to there and working people could afford it and that was enough to make most buyers ignore the no-frill styling and a few minor inconveniences. Ford himself was convinced that cars sold on performance not gadgets. Richard Strout.

RICHARD STROUT: "He said why should he go to the trouble of providing a self-starter after all. And uh, why should he have uh, uh, a rear-view mirror in the car. The joke was at the time, why have a rear mirror in a Ford car because whatever was behind you would pass you soon anyway."

FRANK STASIO: So, why aren't we all driving updated versions of the Model T?

THOMAS KRATINAKER: "The reason we're not driving Model T's today is that's what people don't want."

FRANK STASIO: Doctor Thomas Kratinaker is a Law Professor at Georgetown University. He said that businesses would prefer to differentiate their products in ways other than price. In the early days of the auto industry, General Motors saw that it couldn't build a car like Ford and charge any less so it began to build different kinds of cars and successfully convinced the American public that owning a GM car was a step up in status.

THOMAS KRATINAKER: "Product differentiation is…it is a very important part of competition. Sometimes it arises as a result of…of consumer confusion. That is, consumers being misled into thinking that this product is really very different from that product. Other times product differentiation is a phenomenon of adding frills that people want."

FRANK STASIO: By the 1960s, there were only four firms that made up the U.S. auto Industry. Because there was so few competitors, that industry was said to be an oligopoly. Firms in an oligopoly generally are able to take advantage of economies of scale and by capturing a large share of the market they keep production costs down. Such industries usually have heavy start-up costs that act as barriers of entry to new companies. Businesses that make up an oligopoly diligently avoid price competition. In the first place because there are so few other firms in the same field, it's likely that each competitor would cut its price to meet its rivals. So lowering the price just lowers the profits for everybody else. Unless of course, the price cut is the result of a reduction in costs. But even then, it's usually just a matter of time before the competition acquires the same cost advantage. As we've heard, companies try to differentiate their products from their competitors to capture business without lowering prices. Advertising is the frontline in the battle for product recognition and differentiation. There are other ways to avoid lowering prices. Companies that willfully join to fix prices have formed an illegal arrangement called a cartel.

THOMAS KRATINAKER: "If the firms get together and explicitly agree on price and…and divide up markets by say, having a monthly meeting in a hotel room in the Adirondacks, that might be described as a cartel. All that is...is a…that's quite simply a monopoly in the sense that those people who are getting together are really acting as though they all control all these firms together."

JULIAN GRANGER: "Saturday night I was coming in on the late shift of the Knoxville News Sentinel. I um, went to my box and I pulled all the…all the news releases and so forth and there was the weekly or bi-weekly uh, news release of the uh, Tennessee Valley Authority."

FRANK STASIO: One of the most celebrated cases of illegal price fixing was a scandal in Nineteen Fifty-nine involving some of the major suppliers of the Tennessee Valley Authority. Julian Granger was the reporter with the Knoxville News Sentinel who broke the story.

JULIAN GRANGER: "And I got around to the second page and low and behold this uh, thing jumped out on…at me. On this bidding, Allis Chalmers's, General Electric, and Pennsylvania Transformer quoted identical prices of a hundred and twelve thousand seven hundred and twelve dollars."

FRANK STASIO: Soon after the news broke, Congress announced that it would hold hearings to investigate. Then the Justice Department launched a probe of its own and built a case that eventually led executives of the big suppliers like General Electric, Westinghouse, and Allis Chalmers to confess their part in the conspiracy.

ROBERT BICKS: "They used some names uh, registered under false names, called each other uh, at home rather than at the office, uh, used unmarked envelopes."

FRANK STASIO: Former Assistant Attorney General Robert Bicks who head the Justice Department investigation.

ROBERT BICKS: "As identical bids became suspect, developed a rather com…complex formula known colloquially as phase the moon whereby they overlaid detection. The bids were just bad, uh, subject to a formula which enabled a rotating low bidder so that everybody ended up with the agreed upon percentage of the business. The theory being that detection would be …impossible."

FRANK STASIO: TVA suppliers had formed a cartel. There was no doubt about the purpose of their elaborate scheme. Each supplier would be guaranteed a fair share of the market without dropping prices.

ROBERT BICKS: "I guess the upside was uh, raising the prices and what was thought to be a comparatively easier, comfortable, more predictable life for the executives. You really didn't have to worry how much business you were gonna have at your end. You agreed on that in January."

FRANK STASIO: Firm price-fixing arrangements can be very difficult to prove if the participants take pains not to document their agreements. Why don't corporate executives just divvy up the market while on a hunting trip or playing a round of golf. No written records, no recording devices, and as long as nobody admitted their role, who could prove collusion. Well, it turns out that the greatest obstacle to price-fixing is not the government but the firms themselves. Law Professor Thomas Kratinaker.

THOMAS KRATINAKER: "An oligopoly or cartel will be inherently unstable because it's in…well, its got an incentive to try to maximize profits. That incentive can cut either way. On the one hand, they would like to get together and agree on price, engage in tacit price coordination if they can't get together without being caught by the FBI agents, but on the other hand, they want a large market share, and once you have all gotten together and raised price from say ten dollars to fifteen dollars and maybe you're one of four firms, you're getting a quarter of that business, you're gonna go home every night thinking, gee, if I just drop price to thirteen fifty, I'd still be way above the competitive price and I could get all of that business. And the second thought you're gonna have is, and my other three competitors just had the same thought before they went to bed last night. So you're constantly worried about whether your competitors are cheating and if they're not, why don't you get out there and cheat."

FRANK STASIO: Because price discipline is so hard to manage and because joining a cartel is so risky, formal non-price competition usually takes another form. Firms in an oligopoly often set prices through tacit coordination.

THOMAS KRATINAKER: "In…in that fashion what happens is you never get together and discuss things on the phone. What you do is you read each other's literature and you learn to send signals by your behavior. Uh, you raise your price with the expectation that the other guy will raise his price. Uh, if the other guy cuts his price, you immediately cut your price to show him not to do that anymore."

FRANK STASIO: This kind of unspoken agreement is perfectly legal. The industry tacitly selects a price leader, then follows the behavior of that firm. Until the steel industry fell prey to foreign competition, U.S. Steel was considered the price leader in that business.

THOMAS KRATINAKER: Those people with long political memories, in any event, will remember President Kennedy haranguing the president of U.S. Steel, when the steel industry raised it prices, because President Kennedy knew that the steel…that the price increase was due exclusively to the behavior of…of U.S. Steel. If you could get Steel's president to change it's…his mind, then all the steel companies would roll their prices back."

FRANK STASIO: If it seems odd that a firm can be its own worst enemy in its drive to reduce competition, it is perhaps more ironic that the government is often a cartel's best friend. While it is true that generally the government tries to break up concentrated corporate power, there are times when the government sees an advantage in restricting competition. Given the billions of dollars spent each year in the travel industry, you wouldn't think the airlines would need the government to help them make money. But there was a time when air travel was a novelty more suited to adventurers than vacationers. Clearly, commercial air travel would mean enormous benefits for the economy. The government wanted to make sure that the United States was able to develop a vigorous airline industry, so the airlines were regulated. The government dictated fairs and routes leaving airline executives free of the uncertainties of competition. Airlines were competing not on the basis of fairs, they were all the same. Instead, they would promote their service, better meals, cheerier flight attendants, convenient arrival times, movies, champagne and skies were never friendlier or more expensive, but the cost of providing amenities didn't matter. The airlines would simply include them in their next fair increase request submitted to the Civil Aeronautics Board which regulated the industry. So, service improved and fairs continued to climb. But for travelers who could only afford the cost of getting from one place to another without the extras, there was no service at all. Alfred Kahn was Chairman of the Civil Aeronautics Board in the Carter Administration.

ALFRED KAHN: "Fundamentally, economic regulation in airlines as in trucking and communications and many other fields was a comprehensive scheme for the suppression of competition. In all its forty-year history, the Civil Aeronautics Board had not permitted a single new carrier to come in. They prevented new competitive entry. They were keeping the Freddie Lakers of the world out. They prevented price competition. That may have served some purpose when it was first set up in the '30s, and they thought that this was an infant industry and you needed protection in order to develop reliable continuous service. But by the '60s and '70s it was clear that it had all the evils of monopoly and cartelization and protection, and in a world of stagflation of wage-price spirals of inadequate productivity, it was clear to almost all disinterested observers that we wanted the benefits of competition and that meant deregulation."

FRANK STASIO: Kahn and many others by the mid-1970s believed the time had come to end regulation in the airline industry. As in the decision to end Bell Telephone's monopoly on long-distance service, the government felt that the public interest was no longer served by restricting competition. In 1978 the airline industry was de-regulated and airline executives who once hovered high above the competitive fray now found themselves in the trenches slugging it out for a piece of the action.

ALFRED KAHN: "De-regulation has done almost all the things we said it was gonna do. Competition is obviously intensified and that's what we wanted it to do. You have more carriers in individual markets and they're competing with one another. Um, as a result of that uh, prices are much…with some exceptions, which you know and I know uh, prices on average are much better attuned to costs, which is what competition does. That means they've gone down on the long routes. They've gone down on the dense routes where you have the advantages you can use big planes and pack them full. They've gone down on vacation routes. Uh, they've gone down on off peak much more than on-peak, partly because…mainly because you have many more discount seats available off peak than on-peak. All that, I could go on at length, is economically desirable. The result is that passengers have a much wider range of choices. You go in uh, to People Express where the seats are narrower. They've taken out all those seats. They put many more seats in planes, much less leg-room, you carry your own baggage, you bring a sandwich, and you can fly places for nineteen dollars that used to cost you ninety-nine dollars."

FRANK STASIO: Alfred Kahn's glowing assessment of the effective de-regulation comes from the point of view of a consumer. For the airlines, it was a much different story. Airline executives would be forced to learn a whole new style of management. The smaller leaner airlines which were already in the habit of cost conscious management marched ahead steadily in the transition from regulation to competition, while the big national carriers stumbled, and in some cases fell.

HOWARD PUTNAM: "With all of our financial difficulties, we couldn't generate the revenue. And with all the innovations that we tried, we just couldn't get enough revenue and cash from the till."

NEWS REPORTER: "Braniff's passengers were just as surprised as Braniff's employees. Hundreds of them have been stranded. In some cases flights already in the air were told to turn around and come back."

FRANK STASIO: Proponents of de-regulation had argued for a long time that some carriers would have gone out of business if it wasn't for the government, that the government was, in effect, subsidizing their inefficiency. The collapse of Braniff shortly after de-regulation seemed to prove their point. Braniff Chairman, Howard Putnam.

HOWARD PUTNAM: "Well, I think under de-regulation uh, it was probably inevitable, although no one wanted to admit it that somebody's gonna fail. In the free enterprise system if you believe in it and I do, the strong and the well-managed are gonna succeed. The weak and the poorly managed probably are gonna fail and probably ought to. So no one knew who it was going to be. Uh, de-regulation did not cause the demise of Braniff. I still believe in de-regulation. De-regulation simply gave the management of Braniff at that time the opportunity to expand it. They gave them the opportunity to succeed and the opportunity to fail."

FRANK STASIO: The airlines were not the only ones squeezed in the transition. Small towns and sparsely populated regions which had never been profitable markets for the large carriers now found themselves cut off. Albert Rosenthal, the Mayor of Meridian, Mississippi.

ALBERT ROSENTHAL: “You’d have to promise me that if we would upgrade our main runway to accommodate their 727s, they were gonna sell their DC-9s and we’d have 727 service non-stop from Atlanta to Dallas ninety days after de-regulation took effect. Delta advised us that under de-regulation essential air service they were gonna leave Meridian. We’d spent five million dollars. I told Senator Stennis I felt it would be a disaster to our part of the country, that we were the economic poorest in the country and we were beginning to grow, but economics required transportation as well as a workforce and an education for the workforce, and that without airline transportation, we would have it even more difficult to overcome our economic drawbacks.”

FRANK STASIO: Towns like Meridian, Mississippi may be heard in the short run, but in many cases when larger carriers pulled out, small commuter airlines took their place. Their scaled down operations made it possible to offer air service to local travelers and still make money. Again, this seems to bear out the predictions made by de-regulation proponents that without the government the airline industry would seek its own level of efficiency and profitability, and that in the end the consumer is the winner when the marketplace and not the government or business sets the price for a product. We have heard the ways that businesses try to control the market in industries made up of only a few firms. But what about companies with lots of competitors? Have the developed ways to avoid price competition? To find the answer, we talked to Nariman Behravesh, a Vice President for Wharton Econometrics. Nariman, is there any way that smaller firms who face more competition than automakers or steel makers can have any real influence on their markets?

NARIMAN BEHRAVESH: “The one way that firms can control the market is by selling a product that’s slightly different from other products. This is called monopolistic competition, and in effect, it’s a weak kind of monopoly. Weak in the sense that the product is only slightly different and there are other substitutes, but monopoly in the sense that it is different enough so that the producer really is facing the market himself or herself. And so from that point of view these kinds of firms like, let's say the designer jean manufacturers or the toothpaste manufacturers or detergent manufacturers can, in fact, create something of a monopoly situation."

FRANK STASIO: Now I noticed in those examples you were talking about industries where there are many competitors unlike say the car industry or the steel industry. Is the one of the characteristics of monopolistic competition?

NARIMAN BEHRAVESH: "That's exactly right in the sense that a monopolistic competition is characterized by a lot of different producers and, in fact, it could be the four or five gas stations around a neighborhood could be monopolistic competitors."

FRANK STASIO: Can they get together in any way to control the output of their product?

NARIMAN BEHRAVESH: "Typically they don't because the way they try to control the market is through product differentiation rather than through any kind of collusion. Uh, in fact, what they do is they try to define their product in such a way that it is as…as monopolistic as possible and then what they try to do is limit the output to the extent that they can to maximize their profits."

FRANK STASIO: Well, Nariman, what are the limits then for firms in monopolistic competition in controlling their market?

NARIMAN BEHRAVESH: "The limits uh, to how much a monopolistic competitor can control output and raise prices are dictated by the availability of substitutes. Uh, this brings in a term that we refer to as cross price elasticity. If that's fairly high for a product, in other words, there are available substitutes, then the firm in question doesn't have too much power to limit output and raise prices, because people would quickly switch into other products. If that cross price elasticity is low, then the firm has somewhat more leeway to limit its output and raise prices."

FRANK STASIO: So we have monopoly, oligopoly, and we have monopolistic competition. Let's compare and contrast those in terms of their control over the market, their control of output and the kinds of prices they can command?

NARIMAN BEHRAVESH: "Well, it's useful to look at these examples in a kind of spectrum where on the one hand you have perfect competition and at the other extreme you have monopoly and somewhere in between you have a monopolistic competition and oligopoly. A monopolistic competition is probably the closest to perfect competition. In those markets prices are maybe a little bit higher than perfectly competitive markets and output is just a little bit lower. Moving up the scale a little bit, you go to oligopoly where prices are a little bit higher and output is a little bit lower, and then finally you get to monopoly where, in fact, prices are much higher and outputs quite a bit lower than the perfectly competitive case.

FRANK STASIO: Now a review of the main points in our discussion of oligopoly. An oligopoly is an industry made up of very few competitors. Firms in an oligopoly avoid price competition because of the likelihood that their competitors will drop their prices as soon as one firm lowers its price. The result would be lower profits for all the companies. These firms avoid price competition by product differentiation. That is, distinguishing their product from that of a competitor in ways that make price comparisons difficult. This is usually done through advertising. Businesses in an oligopoly may also form an illegal relationship called a cartel in which executives in each of the firms explicitly agree on what prices to charge and how much of the market each will control. Cartels are difficult to form and maintain not only because they're illegal but also because individual firms within a cartel often yield to the temptation to break with the group and reap higher profits on their own. There is a less formal arrangement in which companies tacitly agree to follow the direction of a price leader. Because there is no explicit collusion among the corporate executives, this practice is no illegal. Sometimes it is the government and not the companies in an industry that creates an oligopoly. The government may choose to regulate an industry like the airline business to foster its growth in the early stages. When it's apparent that government assistance is no longer necessary, the government may move to end regulation. De-regulation of the airline industry showed how an oligopoly can keep prices artificially high, but while forcing airlines to face direct competition may have lowered some fairs, it also reduced service for some less profitable markets. Still, the government's position in general has been to let the marketplace decide how goods and services should be allocated unless there is greater public benefit in regulating the industry. Industry is where the relatively large number of competitors who are able to distinguish their products from a rivals are said to practice monopolistic competition. This is a weak form of monopoly in which product differentiation is the main tool in avoiding price competition. Product differentiation is usually achieved through advertising. The control over prices by a firm in monopolistic competition is limited, however, by the degree to which consumers are likely to switch to slightly different product made by a competitor. The measure of consumer's willingness and ability to switch from one product to another is called cross price elasticity. American industry has faced varying degrees of competition from perfect competition in which the producer has no control over price to the progressively less competitive markets of monopolistic competition in oligopoly. And finally, industries where there is no competition called monopolies.

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FRANK STASIO: You've been listening to Economics U$A, one of a series of programs on micro and macroeconomic principles. Our guests have been Doctor Thomas Kratinaker, Law Professor at Georgetown University, and Nariman Behravesh, Vice President for Wharton Econometrics. Economics U$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

(MUSIC ENDS)

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