ECONOMICS U$A
21st Century Edition

PROGRAM #7

OLIGOPOLIES:
WHAT EVER HAPPENED TO PRICE COMPETITION?

AIRSCRIPT

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Final Transcript

Annenberg Learner (Logo and Music)
NARRATOR: FUNDING FOR THIS PROGRAM IS PROVIDED BY ANNENBERG LEARNER

(EFC LOGO appears on screen)

DAVID SCHOUMACHER: Henry Ford's Model T seemed like the perfect car. It never wore out, never went out of style. How could it be beat? The TVA and other electric companies bought hundreds of millions of dollars worth of equipment every year. What lengths would the manufacturers of this equipment go to to make sure that the price was right? For forty years, regulation protected the airline industry from the hazards of competition. Have 25 years of deregulation been an improvement?

While the role of large companies has diminished in the U.S. over the past century, some crucial industries are still dominated by a few powerful companies, which have grown with the economy and rewritten the rules of competition for their markets. What are the economic and legal rules these companies live by? What has big business done for and to the consumer in key markets such as autos, utilities and airlines? Whatever ever happened to price competition for these goods and services? With the help of economic analysts Richard Gill and Nariman Behravesh, we'll examine these questions on this 21st Century edition of Economics U$A. I'm David Schoumacher.

(MUSIC PLAYS – OPENING TITLES)

PART I

DAVID SCHOUMACHER: There's no business bigger than the auto business…. If you shopped for a car recently, this is a familiar sight. Looks like real competition…a variety of products at a variety of prices…. But is what you see what you get?

It was when you bought one of Henry Ford's Model T's. Henry Ford didn't invent the car and he didn't invent the assembly line, but he brought the two together and gave America its first mass produced and mass purchased car. Ford was an inventor and mechanic by trade and… no effort was spared to improve the car…and to improve the process by which it was built. The Tin Lizzie looked like the same car year after year, but Ford's mechanical genius made it run better each year than the year before. His industrial genius made it cheaper to build and to buy. He paid the highest wages in industry…$5 a day. He made a car that his workers and other working people could afford to buy. Ford's vision was to produce the perfect car…inexpensive and durable…. Looks didn't count. Ford said that the customer could get a Model T in any color he wanted "as long as it was black!" Richard Strout of the Christian Science Monitor owned a Model T and remembers….

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

DAVID SCHOUMACHER: It seemed as though Ford had devised the perfect competitive product. It took a beating, but it never wore out…. It kept getting cheaper and it was never out of style. Henry Ford had American drivers eating out of his hand. Model Ts weren't the only cars on the road back then. Americans also were driving Pierce Arrows and Stutz Bearcats and Duesenbergs as well as the Chevrolets, Oldsmobiles, Buicks, and Cadillacs built by Ford's number one competitor, General Motors, headed then by Alfred P. Sloan.

According to Alfred Sloan, the primary object of the corporation is to make money, not just to make motor cars. Sloan realized he couldn't sell his cars cheaper than Ford, so he gambled that people wanted more from their cars than a ride and that they'd pay more for the color, variety and options that they could get only from GM. Henry Ford may have known cars, but Alfred Sloan knew people and he knew the twenties.

(MUSIC becomes JAZZ MUSIC/SINGING)
AUDIO: "Are you having any fun, what ya getting' outta livin'? What good is what you've got if you're not having any fun? Are you having any laughs? Are you gettin' any lessons? If other people do something new, you have a little fun!"

DAVID SCHOUMACHER: To link his cars with the national mood, Sloan made advertising as much a GM product as the Chevy. Professor Leo Ribuffo of George Washington University has written about the car and the era.

LEO RIBUFFO: "…Shrewd, in some sense manipulative advertising, suggesting that an automobile represents your status and your personality….'It's not just a way to get around' aided the appeal, and of course, the possibility that you could trade in your old car and buy a Chevy on time made it much more possible for GM to challenge Ford."

RICHARD STROUT: "They had better looks and convenience, yes. What more is there in life than those two things?"

LEO RIBUFFO: "William Knutzen, who headed the Chevrolet division, who had worked for Ford, recognized that there was a stigma, as he put it, in using cheap goods that look cheap. There would be an opportunity to sell the Chevrolet by making it look a little classier than the Model T. The Chevy wouldn't look cheap as the Model T was beginning to do. The Chevy would make you proud, make you stand out!"

DAVID SCHOUMACHER: For a while Henry Ford stood his ground with the Model T. The man whose name meant efficiency around the world couldn't believe that Americans would choose GM's style over Ford's substance.

RICHARD STROUT: "He said, 'Why should he go to the trouble of providing a self-starter, after all? Why should he have 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!"

DAVID SCHOUMACHER: What was passing the Ford was the Chevy. By the time the Depression started in 1929, Sloan and GM had overtaken Ford. The Model T was history. Ford brought out a new car. The Model A that offered colors and options and colors like the GM did, but it was too late…. Ford had to settle for second place. Then for third place behind the new company of former GM executive Walter Chrysler.

DAVID SCHOUMACHER: We live in a world of change but not all that much has changed in the auto industry since general Motors pushed Ford from command. GM is still in first and consumers still watch the advertising and choose among cars that vary more in color and cachet than in costs. When economists talk about supply and demand they're usually talking about price competition. But the battle between General Motors and Ford wasn't over who had the lowest price. We asked economic analyst Richard Gill if that holds for the rest of the economy.

(MUSIC PLAYS – COMMENT & ANALYSIS I)

RICHARD GILL: What you have in the case of the American automobile industry, especially in recent years, is competition between a relatively small number of firms. We don't have a monopoly --- which means a single firm in control of that industry. We don't have pure competition, which means thousands of firms selling identical products. We have a few firms in control --- what economists call an <u>OLIGOPOLY</u>.

Now, in general, oligopolistic firms like to avoid price competition. People can get hurt that way. And this automobile story brings out two ways firms can avoid price competition:

1) by fiddling around in various ways with the special features and gadgetry associated with their product --- what economists call PRODUCT DIFFERENTIATION;
And 2) by ADVERTISING and trying to convince consumers that their special version of this product is necessary for their survival or at least for their personal or social success. Now this kind of competition raises all sorts of problems for the economic analyst. When you have PRODUCT DIFFERENTIATION, for example, each firm does have a monopoly of its particular product. Only General Motors can sell a Cadillac, only Ford a Lincoln Continental, or whatever the latest brand names happen to be. As monopolists in this limited sense, it can be argued that their prices, costs and profits may be all too high. Still, these companies are subject to competition and … after all, consumers do seem to like having such a wide variety of choices available to them.

In a sense, that's exactly how GM was able to overcome Ford's early advantage.
Or, take advertising. Obviously, businesses use advertising to convince consumers that their products have special qualities, different "personalities," really, trying in this way to increase consumer demand for them. Of course, when my competitor also does this, he is trying to increase the demand for his product at the expense of mine. How much advertising is self-canceling like this? How much contributes useful information about the products involved? Clearly, these aren't easy questions to answer, though it must be said that there are other ways of avoiding price competition that are far more dubious than those we have been discussing.

PART II

DAVID SCHOUMACHER: It could have been a novel: a newspaper reporter, a crusading senator and federal prosecutors teaming up to solve the biggest crime in dollar amounts ever committed, and put the powerful criminals behind bars. The scene of the crime was here in Philadelphia, but the story started in Knoxville, Tennessee. The Tennessee Valley Authority was a national symbol of progress, bringing electricity to millions who had lived without light…General Electric, one of its primary suppliers and one of the nation's industrial giants…. In 1959, Julian Granger was a reporter with the Knoxville News-Sentinel….

JULIAN GRANGER: "It was Saturday, Saturday night. I was coming in on the late shift of the Knoxville News-Sentinel. I went to my box and I pulled out all the news releases and so forth, and there was the weekly, or the bi-weekly news release of the Tennessee Valley Authority. And I went through it…the rainfall in the valley…. It was mundane stuff. And I got around to the second page and low and behold this thing jumped out at me…. On this bidding, Allis-Chalmers, General Electric, and Pennsylvania Transformer quoted identical prices of $112,712."

DAVID SCHOUMACHER: "Close parenthesis…and that was it?"

JULIAN GRANGER: "So I went back to my desk and thought about it for a while, and then I called Red Wagner…. I told him, I seem to recall telling, 'I can't believe this Red, you know – how could you have identical bids?' And he began to unload to me. He says, 'A real story is down in Chatanooga, where the head of purchasing is Paul Fahey.' So I did. So I went down there and Paul Fahey had a stack…it was on ruled paper…but he had case after case after case after case of identical bidding on contracts. Now these are sealed bids. They come in a sealed envelope…But the biggest and the most interesting things were the electrical contracts from big firms like General Electric, Westinghouse, Allis-Chalmers…I don't think anybody really knew what the hell we had!"

DAVID SCHOUMACHER: The TVA wasn't usually front-page news, but… Tennessee happened to be the home state of Senator Estes Kefauver. Kefauver had made his name nationally with televised hearings investigating organized crime. Adopting a coonskin cap as his trademark, he had waged two popular but unsuccessful campaigns for president. Then, in 1959, Kefauver took on a new crusade against a different kind of organized crime…anti-trust violators.

JULIAN GRANGER: “Kefauver announced that he was going to hold hearings in Knoxville. The word I heard was that the Justice Department decided, ‘well they better get moving.’ ”

DAVID SCHOUMACHER: Robert Bicks was the Assistant Attorney General who oversaw the Justice Department’s investigation of TVA’s identical bids.

ROBERT BICKS: “We came across, quite by accident, a very small company in the industry, and an official that was known to somebody in the Anti-trust Division, who told the story with regard to one particular product in a meeting, after its company had been subpoenaed to produce data. Building on that, when he told the story about conspiracy in a series of meetings there, the first one or two cases were put together.”

DAVID SCHOUMACHER: The first few confessions prompted more executives to come forward, executives from big firms like GE, Westinghouse and Allis-Chalmers. Soon, prosecutors began to unveil the intricate design of the conspiracy.

ROBERT BICKS: “They used assumed names, registered under false names, called each other at home rather than at the office, used unmarked envelopes. As identical bids became suspect, they developed a rather complex formula known colloquially as Phases of the Moon, whereby, to avoid detection, the bids were disparate, 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 well nigh impossible.”

DAVID SCHOUMACHER: “What was it, in the simplest terms, that the conspirators were conspiring to do?”

ROBERT BICKS: “Trying to raise the prices at which their products were sold, and make sure that each of them got what it believed to be a fair share of the market. In other words, they rigged the bid.”

DAVID SCHOUMACHER: It’s hard to understand. The electric equipment industry was an oligopoly…The executives knew that their companies could control the industry without elaborate and illegal arrangements. Why would they risk losing their jobs and going to jail? We asked Edwin Rome, a Philadelphia lawyer, who argued the conspirators’ case in court.

EDWIN ROME: “They were driven to do what they did by reason of being devoted to the company…If this was what the company wanted them to do, they thereupon did it, just as they drove a car with somber colors and wore dark colored striped ties and appropriate clothes to the office and so on… This, too, was another way in which, in their understanding of it, the corporate mentality worked.”

DAVID SCHOUMACHER: “What do you think was in the minds of these captains of industry? Why would they be motivated to take these shortcuts?”

ROBERT BICKS: “I guess the up-side was 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 going to have at year end…You’d agree on that in January.”

DAVID SCHOUMACHER: The verdicts sent a message. Competition is the economy’s most basic value. Businesses and executives who try to short circuit competition with conspiracies and agreements would not be dealt with lightly. We asked our economic analyst Richard Gill why executives from these firms would want to risk fines and jail sentences trying to fix prices?

(MUSIC PLAYS – COMMENT & ANALYSIS II)

RICHARD GILL: Well, the electrical industry case was fairly extreme, but if businessmen do engage in illegal price-fixing from time to time, it's probably because setting prices in an industry dominated by a few firms is inherently difficult. Say you have these five or six big firms. I set a nice comfortable price and then you come along and set a price just under mine and take away all my business. Suddenly we are in a "price war" and, of course, as far as the producers are concerned, it's ruinous to everyone. In fact, economists have sometimes argued that in the few firm --- the oligopoly situation --- companies will have to cling to whatever their current price is. Suppose a company is selling electrical transformers for $100,000 a piece, (it is selling this quantity…at this price…). Before it raised that price, it would have to consider, "What would my rivals do?" What if they left their transformers at the going price? Then I would be underbid! My sales would drop off sharply. On the other hand, if I try to cut my price and underbid my rivals, that could lead to a price war. All prices would plummet downward…with little gain in sales volume for anybody. Of course, ologopolists do change their prices, particularly during inflationary periods. But they have to do it carefully, gingerly one might say. And this raises a kind of philosophic problem. If firms gingerly meet together and fix these prices, then they are in violation of the anti-trust laws and can be fined, and their executives thrown in jail. If, on the other hand, they gingerly form a tacit understanding that firm "A" will be the "price leader" and that it will set prices for the whole industry, taking the interests of its rivals into account, then we often get similar economic results… Yet it's all perfectly legal! Of course, there is still another way to bring order into the oligopolistic price process --- Have the government set prices for you!

PART III

DAVID SCHOUMACHER: The airline industry has been deregulated since 1978. And it's true that under deregulation fares have come down but at what price? Long lines, uncomfortable seats, unequal prices, delays, safety issues . . .is this laundry list of complaints justified? Has deregulation been a success? What people may forget is that the airline industry is an oligopoly dominated by just a few big carriers.

But it was an oligopoly with a difference. For its first fifty years, a federal agency, the Civil Aeronautics Board, not the market, set the fares and routes.

ALFRED KAHN: "…with one minor exception. The Civil Aeronautics Board had not permitted one single new competitor to come in, to compete with the domestic lines, and price competition was strictly prohibited."

HERB KELLERHER: "Southwest airlines had to go through an agony of lawsuits and administrative proceedings in order to get started for three and a half years because the incumbents didn't want us to be able to compete. During that time I got a little depressed about the system, thinking the system might fail. I mean all we wanted to do was offer more flights at lower fares with a better quality of service and it didn't seem to me that that was too inimical to the well being of, of America."

ALFRED KAHN: "Consumerists and anti-trust people were beginning to realize that this was a cartel to protect the industry from competition and the final demonstration of this was who was it that was in favor of regulation? Easy, the airlines and their unions."

HERB KELLERHER: "You would walk into a Congressman's office and his eyes would get real big and he'd say, 'aren't you the smallest carrier in America?' 'Yeah.' ' How many airplanes do you have?' 'Oh, we've got 10'. 'And you want the industry to be deregulated? You are going to get wiped out.' I said, 'we don't think so. But, give us a chance to be wiped out. Give us that chance, to be wiped out.' "

DAVID SCHOUMACHER: So deregulation it was, and President Carter appointed Professor Kahn as Chief Deregulator. At first, airline deregulation was a game with only winners. There were lower fares for passengers, high profits for well-established airlines, and new airlines for ambitious entrepreneurs. Then, in the mid-eighties, there started to be losers, too: TWA, Pan-Am, Eastern, People's Express, Braniff.

NEWSCAST – Sync:
Braniff International Airlines tonight is out of business…

DAVID SCHOUMACHER: In the era of deregulation, big airlines were inviting targets for competitors with low fares, low costs, and flashy advertising.

HERB KELLERHER: "You had Western, which flew in the west. You had Eastern, which flew in the east and you know east was east and west was west and never the planes would meet. They simply did not compete with one another and it was ordained that way. So, you can get confused by thinking that less carriers means less competition. Actually, since deregulation, the number of competitive routes has increased enormously as compared to what it was prior to deregulation, and it's having carriers flying against one another on a given route that produces competition, not how many carriers there are volumetrically in the United States of America."

ALFRED KAHN: "Where would fares be today if we had not deregulated?"

CLIFFORD WINSTON: "What deregulation did was effectively replace the reduction in fares that had been generated by technical change, because technical change had been slowing by the time deregulation came in as the industry became more mature, and what it did was lower fares through competition."

ALFRED KAHN: "Probably, the principle source of dissatisfaction generally regarded by the public as a failure, because the public doesn't understand economics, is that traveling experience is much less pleasant."

CLIFFORD WINSTON: "For airline deregulation to work as efficiently as possible, you must have capacity at airports for new carriers and existing carriers to compete for entry to expand, plus you are able to make use of runway capacity and airspace capacity. This has not been done. There has been significant congestion at airports. What this does is prevent as much competition from developing at the airport, you have restrictions on gates. All these things impede the competitive process but they also impede the level of service, that is, with congestion there are delays, people then blame the carriers for this problem, but this is something that could be fixed if we had what was called peak load or congestion pricing at airports, or if we had efficient investment in runways. Improvements in air traffic control. In a sense the failure of public policy to keep up with that has undermined, really, the performance and benefits of deregulation."

ALFRED KAHN: "It was a success of deregulation, not a failure, that planes are 70 to 75% full and all that goes with that. We've given people of modest means a quality price option that they didn't have before."

DAVID SCHOUMACHER: The virtually unanimous opinion of economists, as well as the business community and people who believe in antitrust, is that airline deregulation has been a great success, encouraging competition and cutting rates about 40 percent. The familiar big-business pattern of oligopoly remains, but now it's the marketplace and not the government which decides who succeeds and who fails. The era of government guarantee of routes and of profits is history. We asked economic analyst Nariman Behravesh what this experience with airline deregulation has taught us.

(MUSIC PLAYS – COMMENT & ANALYSIS III)

NARIMAN BEHRAVESH: By many measures, airline deregulation has been a huge success. Compared with twenty years ago, airfares are virtually flat -----

Look at the red line in the graph – and when you adjust for inflation – the fact that most other prices have risen – ticket prices have fallen by almost half – you can see that shown by the blue line. Two other measures of success: three times as many passengers are flying now than in the early 1980s, and the airline industry employs twice as many people.

Many of the concerns that were voiced in the early days of de-regulation have not materialized. Setting aside the risk of terrorism, airline safety has actually improved – not deteriorated, as many had feared. Moreover, while a number of airlines have gone out of business, the industry has not become dominated by a few large carriers. Quite the contrary, the smaller upstart airlines such as Southwest, JetBlue and AirTran are doing well, while the large airlines such as United and USAir are in trouble.

Probably the single biggest complaint about flying these days is congestion. Flying on an airplane feels no better than a glorified bus ride. However packed airplanes and over-crowded airports are not symptoms of the failure of de-regulation, rather, they are the consequence of its success.

The problem is that the federal, state and local governments in the U.S. have not upgraded and expanded airports and air traffic control systems to meet the spectacular increase in demand triggered by deregulation.

DAVID SCHOUMACHER: This 21st Century edition of Economics U$A has been a guided tour of some of America's 20th Century oligopolies, a region of big business, non-price competition, and price-makers…a kind of twilight zone of our economy where the usual rules of competition work a little differently. There's not much price competition here, because, as every good oligopolist knows, that only leads to uncertainty and lower profits…much safer to fight over style and convenience. I'm David Schoumacher.

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