RESTRICTIVE BUSINESS PRACTICES, TRANSNATIONAL CORPORATIONS, AND DEVELOPMENT

DIMENSIONS OF
INTERNATIONAL BUSINESS

Restrictive Business Practices, Transnational Corporations, and Development

A Survey

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INTRODUCTION

Problems of development in what is normally called the Third World have been a subject matter of concern of the social sciences, especially of economics, for over two decades now.[1] Between the late 1950s and the current time, as Chapter 2 attempts to show, the emphasis seems to have shifted from purely economic considerations of underdevelopment to a paradigm that includes other, extra-economic considerations of a social, political, and cultural nature. The recent emergence of development studies as a new social science discipline stems precisely from the methodological premise that development is a complex process that can only be adequately understood, analyzed, and alleviated by a cross-disciplinary approach instead of a wholly unidisciplinary one.[2]

We do not wish to challenge the above proposition. However, it remains true that an assessment of certain economic phenomena that pose problems to developing countries can offer us greater insights into problems of development, including the formulation of appropriate policies aimed at improving socioeconomic conditions in such countries.

One such phenomenon is restrictive business practices. This study is concerned mainly with surveying aspects of restrictive business practices as they relate to problems of development in the Third World. Restrictive business practices are not confined to developing countries; however, limited work seems to have been conducted in terms of relating the concept of restrictive business practices to problems of development. The existing evidence of restrictive business practices in the development process is quite fragmentary.

This study is not concerned with restrictive business practices in a general sense. We are specifically concerned with restrictive business practices that involve transnational corporations.[3] Restrictive business practices may involve national firms as well, but these do not concern us in this study.

We justify the emphasis of this study on the following grounds:

- No systematic attempt exists in terms of relating restrictive business practices of transnational corporations to problems of development in the Third World; this remains so in spite of increasing interest in transnational corporations.
- Transnational corporations are an important feature in the economic life of most economies of the Third World—through production, trade, or both.
- Transnational corporations, as we will show, generally operate under market conditions that potentially give rise to forms of restrictive business practices.

The survey attempts to show the following:

- Restrictive business practices involving transnational corporations appear widespread insofar as they relate to economies of the Third World.
- Such practices tend to hamper the development process of many Third World economies.
- As a result, restrictive business practices involving transnational corporations can be considered important in the study of underdevelopment.

The outline of this study is as follows: Chapter 1 deals with definition of terms, the concepts of oligopoly and monopoly and their relevance to the study of restrictive business practices, dynamic aspects of competition, market concentration and the real world, and market power and the law. Chapter 2 is concerned with surveying the literature on development for the purpose of illustrating the analytical neglect of restrictive business practices legislation in selected countries. The chapter attempts to show that most legislation fails to include adequate controls over transnational corporations and their activities as these affect developing countries. Chapter 3 examines aspects of control. Chapter 4 looks at the activities of transnational corporations in developing countries. The argument here is that a large number of important transnational corporations tend to operate in grossly imperfect markets. Further, Chapter 4 attempts to show the importance of transnational corporations in the economies of developing countries. Chapter 5 examines the available evidence of restrictive business practices of transnational corporations in developing countries. Chapter 6 represents an attempt to discuss some of the problems of restrictive business practices and development. Chapter 7 looks at some policy aspects of the problem. The book ends with a brief conclusion that summarizes the entire study and indicates its implications for future research.

1 THE PROBLEM

This chapter looks at the general problem of restrictive business practices. It focuses on the definition of terms, the concepts of oligopoly and monopoly and restrictive business practices, business concentration and the real world, and market power and the law.

DEFINITION OF TERMS

Restrictive business practices are variously defined. Most of the definitions concern the questions of market dominance by one firm and collusiveness involving two or more firms, and their consequences for competition.[1] The concept therefore relates to market asymmetry and is relevant to the study of imperfect rather than perfect markets. In this study, restrictive business practices are regarded as attempts by firms to "restrain competition, limit access to markets, or foster monopolistic control."[2] The concept is essentially a legal one, although its explanation is to be found in the behavior of firms. As Chapter 3 shows, restrictive business practices are regulated under the national laws of many countries. Clearly, this would seem to necessitate strategic considerations by firms—hence, the relevance of collusiveness and other types of behavior, such as those relating to pricing, output, and marketing. Evidence suggests that a collusive strategy frequently involves one or more of the following considerations: aspects of price fixing, product-sharing arrangements, control over promotion and distribution channels, market allocation arrangements, mergers and takeovers, and other attempts at market control. These aspects of collusive behavior are prominent in most legal complaints involving the use of restrictive business practices. They are, for example, well documented in various official reports on competition policy in Europe and North America.[3]

An exception to the rule of collusiveness would exist, in principle, where there is only one firm dominating an industry. An extreme case in point is the pure monopolist. In such a case, it makes little sense to adopt a collusive strategy with another firm or firms. The dominant firm is able to "restrain competition, limit access to markets, or foster (greater) monopolistic control" on its own, so that it can continue to reap abnormal profits. One way of doing so would be by discriminatory pricing. There are surely others. Under perfect competition, for example, free market entry will persist, and higher product prices will tend to induce potential firms to enter the market in order to maximize profits. In the final equilibrium state, abnormal profits will cease to exist, with competitive forces resulting in a corresponding increase in supply, which brings about a reduction of prices.

Thus, market domination, which is often regarded as synonymous with market control, has come to be regarded as "the position occupied either by a single enterprise or by a group of enterprises between which no effective competition exists."[4]

THE CONCEPTS OF OLIGOPOLY AND MONOPOLY AND RESTRICTIVE BUSINESS PRACTICES

It follows that the theory of the firm is a useful starting point for the study of restrictive business practices. Firms operate in different markets. The type of market relevant here, however, is, as we just saw, the imperfect market. The normal assumptions of perfect competition, such as an unlimited number of buyers and sellers, perfect information, perfect factor mobility, freedom of market entry, parametric market prices, and product homogeneity, mean that individual firms are unable to influence market prices and conduct. A firm or group of firms likewise is unable to adopt a strategy for market control since the assumptions preclude forms of market control. This Marshallian notion of the firm has not been without criticism, as evidenced by Sraffa's criticism in the 1920s and Chamberlain's and Robinson's in 1933. Essentially, their argument was that the real market situation was characterized by forms of market imperfection. Sraffa argued, for instance, that "it is necessary to abandon the path of free competition and turn in the opposite direction, namely towards monopoly."[5] Robinson contended that perfect competition was, in fact, "a special case" rather than the typical one.[6] And Chamberlain's position was that "both monopolistic and competitive forces combine in the determination of most prices, and therefore a hybrid theory affords a more illuminating approach to the study of the price system than does a theory of perfect competition supplemented by a theory of monopoly."[7]

The study of firms in imperfect markets can be classified broadly as follows: monopolistic competition, oligopoly, and monopoly. In a nutshell, the Chamberlain model of monopolistic competition differs from perfect competition in that the typical firm produces differentiated products instead of homogeneous ones. Substitutes are therefore imperfect, the implication being that some element of "monopoly" is associated with the differentiated product. The demand curve facing the firm is therefore downward-sloping instead of horizontal. Provision is also made for selling expenditure. However, the presence of a large group of firms in the industry and free market access by new firms operate to ensure competitiveness. In other words, each firm produces a small part of the market output, but it has some overall influence on prices. Because of product differentiation, the firm is also unable to determine the rules of the market game. Competitiveness here ensures that in the final equilibrium state, abnormal profits are ruled out. In this state, marginal costs are equal to marginal revenue, but average revenue or price is higher than both of these, given the downward-sloping nature of the firm's demand curve already mentioned.[8] The Robinson model is essentially similar.

The above paradigm is not strictly relevant for our purposes, despite its usefulness in other respects. What is needed is a concept of gross market imperfection, such as oligopoly or monopoly. Most forms of restrictive business practices legislation, for example, regard a significant share of the market by a single firm to be consistent with market dominance or statutory monopoly. This, of course, varies—in the United Kingdom, it is 25 percent; in the United States, it is 90 percent. In France, "manifest concentration of economic power" is the criterion, while in the Federal Republic of Germany, market domination is defined in terms of "absence of substantial competition."[9] Surely, then, the Robinson-Chamberlain firm type fails to satisfy this criterion. Often, the collusive practices referred to in the preceding section involve firms that, as a group, are able to command a large share of the market so that jointly they can influence prices, profits, and conditions of market entry.

Most textbook models of the firm operating in imperfect markets do not discuss restrictive business practices in any comprehensive sense. However, some of the models can be extended to incorporate this consideration more seriously.

The case of pure monopoly is well treated in economic theory, and we do well by starting here. Strictly speaking, the pure monopolist is the sole producer of a product. The firm is not only a firm but also the industry. Product competition is nonexistent. The "pure monopolist" has complete market power and is able to take the whole of all consumers' incomes at whatever level the firm's output is set.[10]

The case of the pure monopolist is quite unrealistic on a number of counts. For example, products compete with each other for limited consumers' income, and so there is in fact a limit to a firm's power to fix prices. Also, for our present purpose, the pure monopolist does not represent the real-world case of market dominance, even though it does pose, in principle, some of the price and output problems one tends to encounter in situations of market dominance.

More practical models of monopoly deal with cases in which a firm controls the supply of a particular product for which there are no close substitutes (although substitutes do exist) or a large share of the market for a particular product, as in the case of statutory monopolies referred to earlier. The profit-maximizing monopolist here can be operating under conditions in which marginal costs are rising, falling, or constant. In competitive situations, they are rising. The point to bear in mind is that whether pure monopolist or not, the profit-maximizing monopolist will tend to earn abnormal profits in the long run—he is able to charge high prices for his products given the absence of close substitutes, and therefore of competition, and produces to the point where his marginal costs are equal to marginal revenue. The degree of monopoly profits depends on the shape of the average revenue or demand curve. The more inelastic the curve, the greater the scope for monopoly profits.

In principle, two types of restrictive business practices can be identified in the above situation. One is that the monopolist is able to restrict output in an effort to earn high monopoly profits. Also, he is able to engage in discrimination in different markets characterized by varying price elasticities of demand, with respect to either prices or output, and is therefore able not only to maximize profits but also to keep out potential competitors. For example, by charging arbitrarily low prices, sometimes referred to as limit pricing, he is able to keep out competitors in an effort to maximize long-run profits.

Given his market power, the monopolist is not necessarily forced by competitive pressures to produce at the lowest point possible along the firm's cost curve. If, however, one assumes for the sake of argument that costs of production are indeed the lowest possible, the monopolist is still able to charge relatively high product prices to consumers. In other words, low-cost output does not necessarily benefit consumers in the form of low product prices.

The assumption that the monopolist is not operating at the lowest point on the average revenue curve means that the critique against the monopolist—namely, resource misallocation—holds. Further, high monopoly profits will tend to introduce distortions in the factor markets and therefore in the functional distribution of income. The reduction of income inequality is often regarded as a social objective in the preference function of most governments. Under assumptions of an open economy, other consequences can follow—for example, lack of international competitiveness and therefore reduced welfare for a particular economy.[11]

The problem with monopoly models, however, is that while the marketplace of modern industrial societies tends to be characterized by big business, such business is not the type one finds in monopoly theory. Rather, it tends to be of an oligopolistic nature—that is, a number of large firms coexist in a market rather than there being just one single firm. In theory, however, it is possible for a group of large firms to constitute the textbook type of monopolist simply by adopting "collusive market strategies" so that, functionally, the effect in terms of pricing and output that can be obtained is the same as if the group were a single firm. Still, the situation is not strictly analogous, as a prisoner's dilemma can develop in a collusive arrangement whereby the whole "deal," or part of it, collapses. Alternatively, one may opt for a diluted concept of monopoly, such as the one found in legislation—namely, market-dominating enterprises—where, as we saw, a sizable share of the market is the main criterion. But it should be noted that in this case, some competition would exist in the product market since there are also competing firms, albeit large ones. Even so, the dominant firm is able to exert some control over the market, in terms of prices and output, though to a lesser extent than if it had complete control of the market. In this situation, the dominant firm may be operating in an oligopolistic market. The concept of oligopoly brings us closer to home.

The basic oligopoly/duopoly model used in economics was first developed by Cournot.[12] Essentially, the Cournot model results in determinate solutions for price and output, usually under very strict assumptions. For example, one central assumption is that Firm 1 would conjecture about how its rival, Firm 2, would vary output in response to Firm 1's market decisions. This conjectural variation in Cournot's model is zero. In other words, Firm 1 decides what level of output to produce on the assumption that the rival firm would not vary output in response to this.[13] If data are available on costs and on the average revenue curves of each firm, it is possible to derive Firm 2's profit-maximizing responses to any output set by Firm 1, assuming a conjectural variation of zero for Firm 2—in other words, Firm 2's reaction function. Given this response symmetry, it is also possible to obtain Firm 1's profit-maximizing or reaction function. This is shown in Figure 1.1. Firm 1 initially produces output y, Firm 2's reaction function results in output x, Firm 1 opts for output y_2 (its own reaction function), and Firm 2 responds to x_2. The process continues until equilibrium is reached at point A, where both reaction functions intersect.

The Cournot model is in many respects an uninteresting one for the analysis of restrictive business practices. In particular, it assumes a state of "independence" in the sense that Firm 1's actions do not influence Firm 2's output decisions. This does not seem quite realistic. As Chamberlain argues, interdependence rather than independence is a feature of oligopolistic behavior. Thus, according to Chamberlain, "If each sees his maximum

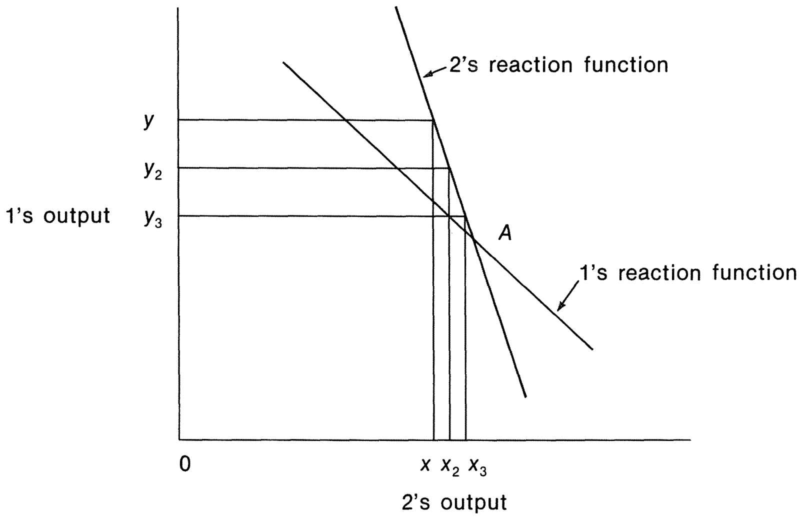

FIGURE 1.1. Oligopolistic Reaction: An Illustration

profit position rationally and intelligently, he will realize that when there are only two or a few sellers his own move has considerable effect upon his competitors and that it makes it idle to suppose that they will accept without retaliation the losses he forces upon them."[14] According to the Chamberlain position, it is possible for a joint profit-maximizing price to be reached in these circumstances. Once this price has been attained, a firm will be unable to reduce price since it will assume that others will respond and profits will be adversely affected, and price competition will thereby be eliminated. In effect, although sellers are legally distinct, the equilibrium situation will be as if "there were a monopolistic agreement between them," in the manner mentioned earlier. In other words, this amounts to a form of collusive pricing behavior found in many empirical investigations of monopoly type of market practices. Such behavior can be open or tacit.

However, Chamberlain's position regarding joint profit-maximization prices will apply only where all firms have identical costs and revenue properties. It is possible, for instance, for technological and learning-by-doing economies to result in different cost profiles among firms. Also, different demand curves might be the result of product differentiation, sales promotion, and the like. In this case, different firms will want different profit-maximizing prices. Nevertheless, in the interest of long-run stability, agreements concerning market behavior are, in principle, possible. For example, markets could be allocated to different producers so that prices reflect individual producer's cost and demand considerations. Brand-name pooling is also possible so that more established firms "compensate" less established firms in terms of having assured market outlets for their products. In this way, high profits are assured for less established firms. In like manner, joint promotional efforts could be made that discriminate positively in favor of less established firms, again following a welfare compensation principle. The agreements here will take a different form from the pure-pricing type suggested by Chamberlain. In either case, competition will tend to be restricted first among the "given group" of agreeing firms and second against outsiders. In the latter case, different entry-forestalling strategies that keep out potential entrants are possible—for instance, predatory pricing or freezing distributional channels.[15] However, as Stigler has shown, problems arise in enforcing agreements of the type just described.[16]

Another development in oligopoly behavior refers to von Stackelberg's leader-follower model.[17] Here, the dominant firm A assumes a leadership role, meaning that other firms treat A's output or price as given and proceed to establish their market conduct on that basis. In this case, a determinate stable equilibrium is reached. If two leading firms choose to lead independently of each other, an unstable equilibrium with adverse consequences for the profit prospects of both will result. A price war, for instance, is possible in these circumstances. Likewise, if both leading firms choose to follow, we are back to the Cournot solution, since each firm is likely to take the other's output as given.

From this model, a dominant firm price-leadership situation can be depicted.[18] One large firm and a number of smaller firms are assumed. Let us assume that the dominant firm is able to estimate the sales of other competing firms in the industry under different market prices. With this assumption, the dominant firm is able to arrive at its own anticipated demand curve by deducting the other firms' sales from the anticipated industry's demand curve. Assuming further that there is information as to how its production costs are likely to vary with output, the dominant firm can select the price that maximizes its own profits. Other firms follow this price in an effort to maximize their profits or to enhance survivability.

Figure 1.2 demonstrates the case of dominant price leadership. *DD′* is the industry demand curve, and *SS′* is the small firms' supply curve. When market price is 0*C* where *SS′* intersects *DD′*, small firms will be able to satisfy available demand. This is the price at which the dominant firm's demand curve cuts the vertical axis. At price 0*S* the small firms' supply will be zero so that the dominant firm's *dD*'s are the same as the industry's demand curve, when price is below 0*S* and output beyond 0*Y*. At price 0*B*, the small

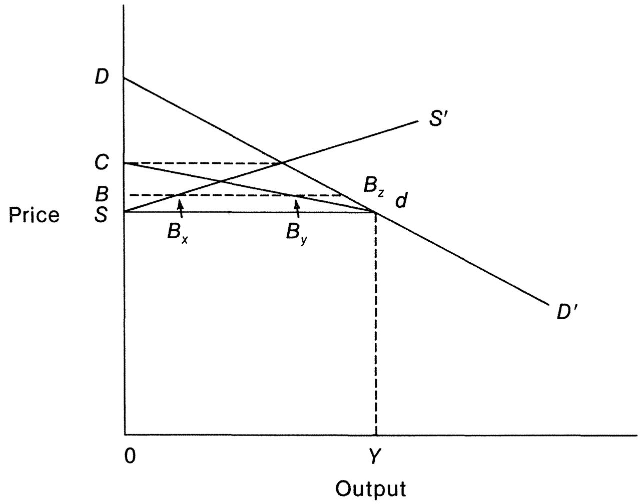

FIGURE 1.2. Price Leadership Model