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Risk, Challenges & Success of Predatory Pricing in a Free Market Economy

Dr. Gangambika C. Savagaon
Asso. Professor & Head, Dept. of Economics, Vidyavardhini's A.V. College of Arts, K.M. College of Commerce & E.S.A College of Science, Vasai Road, Dist-Palghar, (M.S.) India

Prof. Sairam Iyer
Assistant Professor

Abstract

Study reveals that regardless of the presence of a competition law to monitor and regulate the behaviour of firms, predatory pricing is not a viable means for achieving sustainable growth and market position for any firm, whether a monopoly or otherwise. The extent of this concept reaches only to the theoretical boundaries and does not translate to a reality in the long run. The market pricing process and the interlinked system of preferences and prices ensure that predatory and limit pricing is nothing more than a temporary distortion of market driven prices, with no lasting consequences on the market competition structure.

Key words: predatory, pricing, dominant-firm, preference, challenges

1-Introduction:

It is observed that sometimes "Predatory Pricing" is followed in markets of different areas & different products. Predatory pricing means an illegal act of setting prices low to attempt to eliminate rival firms from business. Limit pricing is undertaken in a competitive market with the objective of undercutting all other firms and capturing their market shares by selling at a loss till the competitors are driven out of the market. The mainstream theory explains how the smaller firms with a smaller profit margin not having sufficient reserves to endure losses, are forced to exit the market. This allows the dominant firm to not only takes over their market share, but also their resources from the input markets at an undervalued price following the shutdown of their business venture. Repetition of such operations in the market shall create a monopoly in the free market as per mainstream theory. Following this very reasoning, Professor Richard Wolff explains this as the natural conclusion of any free market system. Once the dominant firm can thus acquire monopoly over a market, and raise its prices to monopoly premium rates it recovers its profits due to lack of competitors.

2-Research Methodology:

Among the Austrian school of economists, this concept has been studied in detail by Thomas Woods Jr, who has commented on the potential for exploitation by following this strategy. In this paper researcher attempts to capture the logical fallacy identified by Woods Jr. and explain why such a practice is unlikely to succeed in any free market. It elaborates risk, challenges & success of predatory pricing in a free market economy.

Objectives of the study-

1-To understand the meaning of predatory pricing
2-To explain losses of dominant Firm

practicing predatory pricing

3-To elaborate consumer preference & their response to predatory pricing

4- To discuss sustainability & challenges of dominant Firm

5- To explain the effects of predatory pricing on input and related markets & to comment on empirical evidence

The study is based on secondary data collected from reference books, journals & articles.

3-Meaning of Predatory Pricing:

Indian Competition Act 2002 defines the term "Predatory Pricing" under section 4, explanation (ii) (b). It states that Predatory Pricing means sale of goods and provision of service at a price which is below production cost, with a view to reduce competition or eliminate potential competitors. The production and provision cost used for such diagnosis is determined by the Act, based on industrial standards. Thus, the legal definition includes the concept of Limit Pricing. In general economic literature, predatory pricing is a policy of supplying commodities at a loss so as to deter new entrants from the market. The firm, a monopolist, uses its market position and profit reserves as a buffer to bear losses in the short run to eliminate the risk of new entrants into the market by price cutting. After the entrants have been successfully barred from the market, the monopolist again raises the prices to monopoly premium levels to recover the losses incurred and make profit through its monopoly position. Limit pricing is a related concept, with the exception being that the firm is not a monopolist, but a dominant firm.

4-Losses of Dominant Firm:

By all lengths of reasoning, in any free market, the strategy of limit pricing or predatory pricing is self destructive. The concept relies heavily on the financial reserves that provide a buffer to the dominant firm to incur losses. However, the aspect of economies of scale is ignored in this reasoning. A dominant firm generally holds a large segment of the market, from which economies of scale arises. If the firm follows the theory of predatory or limits pricing, and begins to operate at loss, the firm incurs loss on every unit output sold. Thus, compared to smaller firms, the dominant firm's losses also scale up. The firm holding the larger market share will sell more at the unprofitable price and face more losses than its smaller competitors. Thus, the financial buffer of the dominant firm would get depleted at least the same rate as its competitors.

5-Consumer Preference:

Another ignored factor is the consumer preference which determines sales. Demand is not solely determined by price considerations. There are other heterogeneous factors that determine demand, which causes the consumer preference to be relatively sticky. Thus, on implementation of predatory pricing, the firm will be the first to be affected. The longer the delay in shifting of preference, then less effective the business policy will be. This delay is even more where sales approach makes every product distinct and heterogeneous to the consumers. The effect of predatory pricing will spread across the market in a manner similar to Cantillon effects, thus impacting the competing firms at a later point in time.

6-Consumer Response to Predatory Pricing:

Consumer behavioral patterns reveal that consumers attempt to plan their

consumption in a way so as to improve their intertemporal savings and maximize their utility along their intertemporal budget line. Following this, consumers would raise their consumption during periods of low prices. This demand surge is not for immediate consumption, but for delayed future consumption. Thus, the higher demand under predatory prices may actually substitute the consumption in the future, under higher prices. The abrupt price decrease under predatory prices would thus raise demand and increase the unprofitable sales. Under subsequent higher prices, the demand may be lower due to higher prices & past purchases for future consumption.

7-Sustainability & challenges of Dominant Firm:

To further elaborate the flaw in the concept, the researcher assumes that the dominant firm succeeds in its attempt and attains monopoly in that market. Then, it is essential to look at the cause of its monopoly power. This monopoly did not arise out of efficiency, innovation or government sanction; it arose due to an unprofitable strategy of the firm. The firm shall abandon this strategy as a monopolist to recover from the losses. For this purpose, it shall adopt higher prices and attempt to earn supernormal profits. Thus, the barrier that ensured the existence of monopoly would be lost. The high prices and potential for supernormal profits would attract new entrants. These new firms would be able to enter the market, leading to lower prices and division of profits between the firms. Thus, the previous monopolist would not only lose its monopoly, but may also incur loss due to lower profits for reimbursing its losses.

Thus, any instances of predatory pricing undertaken in a free market shall be a only temporary distortion of market price, which will exist as long as the freedom to enter and exit is not blocked. The aforementioned self equilibration will be even more effective in case of innovation introduced by any of the new entrants. In both of the cases, the dominant firm shall either end up in the same situation, as before undertaking predatory pricing; or will be even more vulnerable due to an unreimbursed portion of its financial buffer. This effect is further amplified for firms that operate within an extensive chain store model of business structure, since the lower prices are even more damaging when the financial reserves are divided between various branches, each incurring losses on sales.

8-Effects of predatory pricing on Input and Related Markets:

Another risk such firms face is from the input markets. As the smaller firms facing predatory pricing close down, they sell their assets and reserves in the input market. The sudden inflow of assets in the input markets would reduce its prices, which would attract the investment of potential firms. That industry would become attractive to firms due to low investment required. This would increase the number of potential entrants and may also result in a growth in the competitors' scale of business. Economist Don Boudreaux elaborates on the implications of predatory prices on other interrelated markets. No market can operate independently, unaffected by the operations of the markets of inputs and related commodities. Even in a hypothetical case of successful predatory pricing, the act would have adverse effects on not only the consumers, but also on the suppliers in the input markets. As the degree of monopoly increases in the output

market, the degree of monopsony increases for the input markets. This reduces the bargaining power held by the suppliers of the input markets. Due to the risk of lower sales and profits, the suppliers at this stage of the production chain have incentive to prepare preventive agreements, as a means to arrest the success of predatory pricing. This can be achieved by establishing a minimum or maximum price in the agreement. Minimum price directly curtails the possibility and extent of predatory pricing. Setting a maximum price negates the possibility of a price surge in the recovery phase of predatory pricing. This reduces the profit potential available from predatory pricing. Since predatory pricing at any stage of the production chain can disrupt the price system across all stages, all participants have an incentive and self interest in preventing such practices.

Considering all these obstacles and risks present in this, economist George Reisman states that the supernormal profit premium earned even in case of success would be extremely limited compared to the resources invested for the position. Thus, the net benefit to the firm from this practice would be undesirable when compared as a cost to benefit analysis. Perhaps owing to these practical difficulties, Dominick Armentano of Hartford University was unable to find even a single example of successful predatory pricing in his study. George Stigler also notes that the theory has fallen into disfavour among professional economists. In spite of the mentioned irrationality in the decision to apply predatory pricing, economists Aneeda and Turner argue that business irrationality is a strong cause to such actions, which necessitates the creation of provision in competition law. But for a dominant firm with sufficient acumen to become a market leader, it is unlikely to adopt such inefficient and ineffective policy. These challenges & risks restrict the firm from opting predatory pricing.

9-Empirical Evidence:

The researcher was unable to find any case under Competition Act 2002 where the verdict found any party guilty of predatory policy with the intention of creating a monopoly. In almost all cases, the accused was cleared of such charges for predatory pricing. The case law MCX stock exchange vs NSE of 2011 determined that predatory prices are a subset of unfair prices. The element of unfairness in price must be studied on a case by case basis. No specific definition is provided in the Act regarding unfair price. Another case of 2013 added that the firm's plan to recover its lost profits is a requisite condition for determining predatory pricing.

10-Conclusion:

With this, it can be concluded that regardless of the presence of a competition law to monitor and regulate the behaviour of firms, predatory pricing is not a viable means for achieving sustainable growth and market position for any firm, whether a monopoly or otherwise. The extent of this concept reaches only to the theoretical boundaries and does not translate to a reality in the long run. The market pricing process and the interlinked system of preferences and prices ensure that predatory and limit pricing is nothing more than a temporary distortion of market driven prices, with no lasting consequences on the market competition structure.

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