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Raising Rivals' Costs

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Synonyms

Non-price predation

Definition

It is a strategy aiming to increase the cost of an entity's competitors in order to disadvantage and even exclude them from the market.

Raising Rivals' Costs: How It Works!

The original cases that founded the raising rivals' cost (RRC) theory relate to famous monopolization cases faced by the US Federal Trade Commission (e.g., Alcoa, Dupont de Nemours, Kellogg, and Standard Oil) where firms interfere in input or upstream markets in ways that reduce rivals' profits. In most cases, the premise of the RRC theory goes as follows: the predatory firm increases their competitors' costs by developing exclusive relationships with strategic suppliers, such as input overbuying, naked exclusion – where the supplier is committed not to sell inputs to competitors – and controlling the whole supply chain in order to prevent rivals from accessing consumption markets (Granitz and Klein *1996*; Carlton and Perloff *1998*; Scheffman and Higgins *2003*; Scheffman and Higgins, *2015*). It is worthy to notice that the RRC strategy differs from price predation, because to be profitable, it does not require initial investments that need to be recovered (Scheffman *1992*).

In order to present the RRC mechanisms and main results, let us consider the following market structure (Salop and Scheffman *1983*; Church and Ware *2000*): a dominant firm (or group of firms), denoted D , a group of fringe rivals, denoted F , and a perfectly elastic supply for D . The marginal (and average) cost for the dominant firm c_d is lower than the marginal cost of the fringe firms, but this firm cannot produce beyond a given quantity, q_d . Moreover, assume the marginal (and

average) costs for the fringe of competitive firms, denoted c_f , to be constant, but without any production constraint. The equilibrium price and quantity, respectively, denoted c_f and q^* , are presented in Fig. 1.

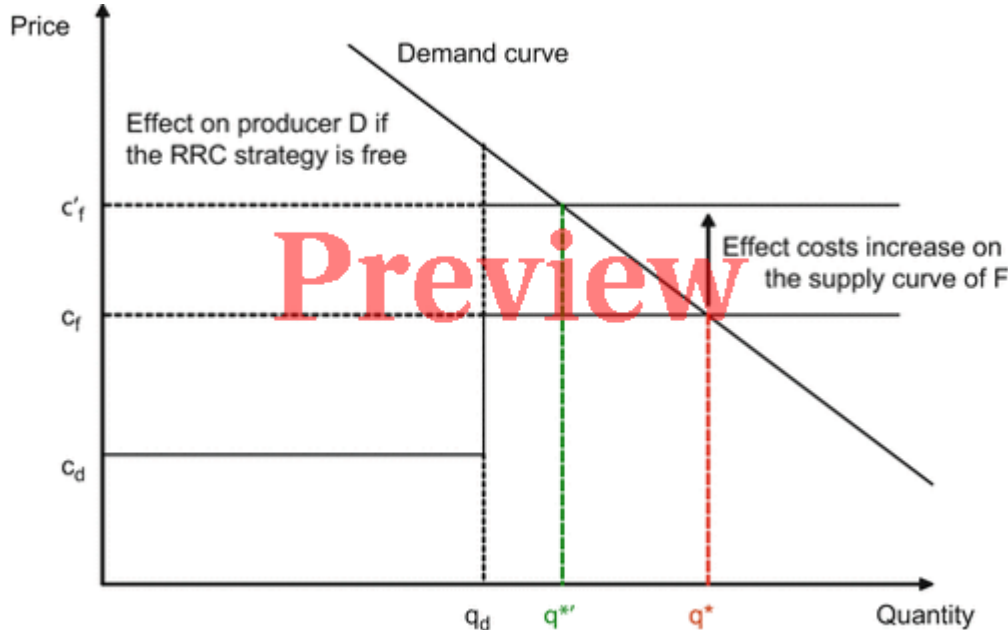


Fig. 1

Raising the costs of a competitive fringe (Inspired from Church and Ware [2000](#), 629)

At equilibrium, the dominant firm is considered as inframarginal since its price is above average cost, despite a competitive market, which allows it benefiting from inframarginal rents. Now assume that the dominant firm is able to increase the costs incurred by the fringe rivals. The equilibrium price will increase proportionally to the increase of the marginal cost of the fringe. However, the quantity produced by D will not change, while the quantity produced by F will decrease. In addition, assume that this cost is equally distributed across production units. The change in net profits of D can be written as $\Delta \pi_D = (\Delta c_f - \Delta c_d) q_D$. Hence, the profit of D increases if $\Delta c_f > \Delta c_d$. A sufficient condition for a profitable RRC strategy is that it increases the marginal cost of the fringe relatively more than it does for the dominant firm. Indeed, only an increase of the marginal cost of F leads to an increase of the equilibrium price. Consequently, any producer for which an increase of the market price is beyond the increase of its average cost will benefit from a RRC strategy. Moreover, two other basic results (Scheffman [1992](#); Church and Ware [2000](#)) can also be mentioned. First, an attempt to increase the dominant firm's costs does not influence the equilibrium price, although it can influence the profit of D. In other words, there is no strategic effect because the situation of F is not affected. Second, the demand has to be sufficiently inelastic in order to guarantee the profitability of the RRC strategy. Indeed, if the demand is highly elastic, the price will not increase despite a marginal cost increase of F. The fringe producers will rather exit the market.

Based on the seminal works of Director and Levi ([1956](#)), Nelson ([1957](#)), Williamson ([1968](#)), and Salop and Scheffman ([1983](#)), scholars examined the relevance of RRC strategies in various domains such as free trade agreements (Depken and Ford [1999](#)), advertising, lobbying for product and/or environmental-related standards (Hilke and Nelson [1984](#); Grolleau et al. [2007](#)), agro-food systems (Barjolle and Jeanneaux [2012](#)), pollution regulation (Sartzetakis [1997](#); Lyon [2003](#)), and stock exchange (Harris et al. [2014](#)). In general, these studies provide, explicitly or not, evidence to the relevance of using the RRC theory in analyzing specific organizations of the considered markets. Moreover, Normann ([2011](#)) recently provided experimental evidence in favor of the hypothesis that

vertically integrated firms have an incentive to foreclose the input market to raise its downstream rivals' costs. Nevertheless, several scholars developed arguments against the RRC theory, in particular regarding its "real" potential to analyze antitrust cases (e.g., Lopatka and Godek 1992; Coate and Kleit 1994). (Given the large literature, we only provide a general overview of the arguments against the RRC theory, without purporting to be exhaustive.) For instance, the RRC theory is often analyzed through its vertical aspects and consequently its contribution to the existing competition analyses can be considered rather weak (Brennan 1986). Indeed, a RRC strategy requires that the predator is assumed to look for a monopoly on a relevant input market, which makes it a particular case of preceding competition analyses. Similarly, Church and Ware (2000) argue that some RRC cases can be also analyzed through the lenses of other theories. Moreover, the required conditions for RRC strategies are so constraining that it turns unlikely to have a significant anti-competitive effects (Coate and Kleit 1994). In addition, the costs of excluding rivals could be also higher than the derived benefits. Furthermore, Boudreaux (1990) points out the fact that the RRC theory does not take into account competitors' counter-strategies. Interestingly, while S. Salop and D. Scheffman developed the RRC theory, they admit that their works have some limits (Scheffman and Higgins, 2015) mainly encompassing the following concerns:

1.

The theoretical ambiguity of the RRC effects, especially because a RRC situation does not necessarily correspond to an anti-competitive behavior

2.

The lack of a framework allowing to distinguish intentional RRC strategies and other types of competition that also alter rivals' situation

3.

The focus on particular market structures that may not reflect real-world settings

4.

The lack of an analysis regarding the whole effects in terms of well-being (Salop and Scheffman 1987; Scheffman and Higgins 2003)

Conclusion

We presented a general description of the RRC theory. We pointed out the necessary conditions for a profitable RRC strategy and the effects of its implementation, although such effects are often ambiguous. We believe that RRC theory offers promising insights in domains that were not initially considered or extensively studied such as environmental regulation or standards. RRC strategies are sometimes difficult to detect and can be justified by other issues such as environmental conservation or public health. Interestingly, these issues can also lead to "strange" coalitions, such as the one between Baptists and bootleggers described by Yandle (1983). Hence, given the multidimensional nature of RRC, the net welfare effect can remain ambiguous and makes it difficult to craft adequate remedies. Such a result can be discouraging for antitrust authorities.

Cross references

Norms and Standardization

ECOLABELS: Are They Environmental-Friendly?

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