STRUCTURE - CONDUCT - PERFORMANCE PARADIGM

The Simple SCP model/framework with and without feedbacks, its critique and modified framework with feedback

Industrial economics is a distinctive branch of economics which deals with the economic problems of firms and industries, and their relationship with society.

Subject matter of Industrial Economics

In industrial economics we study the

- policies of firms towards rivals and towards customers
- firms in industries that are competitive or less competitive

At a fundamental level there is no difference between industrial economics and microeconomics (or price theory).

Beyond this basic level, there are difference between microeconomics and industrial economics.

1. The focus of micro courses is usually on simple market structures-competition and monopoly, whereas focus of IE is on oligopoly market
2. IE is more concerned with policy questions than micro. (these questions concern government policy towards business, regulation and public ownership of business, etc)

In the USA, two school of thought long contested the analysis of industrial economics.

1. The structure conduct performance school- market structure determines the behavior of the firms in the market, and the behavior of firms determines the various aspect of market performance. An implication of this argument is that government should implement a relatively high level competition policy, intended to limit strategic behavior.
2. Chicago school-the argument of this school is that anything one firm can do can be done by any other equally efficient firm, unless some higher power intervenes. In this view, the main source of monopoly power is government interference in the market place. Government, by intent or ineptitude, can prevent some firms from completing, to the advantage of other firms. Beyond the prohibition of naked collusion , there is little that government can or should do to try to improve market performance, a laissez faire policy is recommended.

The Simple SCP model/framework with and without feedbacks

Structure, Conduct and Performance paradigm (SCP) is used as an analytical framework, to make relations amongst market structure, market conduct and market performance. It was developed in 1959 by Joe S. Bain Jr., who described it in his book "Industrial Organization".

The SCP paradigm was the brain child of the Harvard school of thought and popularized during 1940-60 with its empirical work involving the identification of correlations between industry structure and performance. This SCP hypothesis has lead to the implementation of most anti-trust legislation.

Some definitions

- Structure: those set of variables that are relatively stable over time and affect the behaviour of sellers and/or buyers. The way in which markets fail to follow *perfect competition* conditions, depends on:

- Number and size distribution of setters (supply concentration)-
- Number and size distribution of buyers (demand concentration)
- product differentiation and
- Market entrance barriers.

Also, the structure of the market will always be determined by the nature of the product and the technology available.

- Conduct: the way in which buyers and sellers behave, both amongst themselves, and amongst each other.

- Pricing behavior- if the sturcuture of a market is competitive then it determines its long run equilibrium where P=MC=LAC. On the other hand, if the structure of oligopolistic or monopolistic in nature then P>MC.
- Strategic behavior- in imperfectly competitive markets, established producers may be able to discourage the entry of new firms. On the other hand, there are a variety of ways in which established firms can raised the cost of actual or potential rivals.
- investment in research & development
- advertising levels,
- *collusions*-

- Performance: It is measured by comparing the results of firms along the industry in efficiency terms, and different ratios are used to assess different profitability levels.

- Profitability

- Efficiency or static efficiency or product efficiency-output to be produced in the least expensive way given the available set of technologies.
- Progressiveness or dynamic efficiency- it refers to the rate of technological progress or it refers to the improvement over time of products and production techniques.

The Simple SCP model/framework without feedbacks

The Structure-Conduct-Performance paradigm viewed its goal as one of establishing links between Market Structure and Market Performance.

The more concentrated was an industry ís market structure, the more market power would be exercised in the industry.

Logic behind SCP model

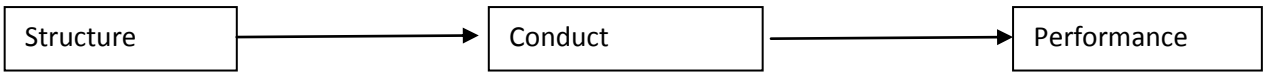
The SCP approach believed that an industry's performance - is success in producing benefits for consumers - depended critically on the conduct – the competitive behavior - of firms in the market.

- Firms would have the most market power and market outcomes would be worst for consumers when competition amongst firms was almost nonexistent, e.g. firms in the market were colluding.
- Of course, market power is nonexistent and market outcomes are best for consumers when firms are perfectly competition

In turn, firm conduct hinged upon market structure

- Collusion is more likely to occur when the number of firms in the industry is few, and there are barriers to entry into the market.
- On the other hand, when there are many firms in a market, and firms are free to enter, firms in the industry are more likely to compete with each other

Following its reasoning, an industry performance (which could be considered as the potential benefits to consumers and society as a whole) are determined by the conduct of the firms within the boundaries of this industry, which in turn depend on the structure of the market. We can represent this model by using following fig.



Thus, through an examination of the structure of markets and the organization of Örms, these economists though they could explain differences in market outcomes.

The Simple SCP model/framework with feedbacks

Structure and conduct are both determined in part, by demand conditions and technology. Sturcture affects conduct but conduct-strategic behavior- also affects structure. Structure and conduct interact to determine performance. Sales efforts- an element of conduct-also feed back and affect demand. Performance , in turn, feeds back on technology and structure. progressiveeness molds the available technology. Profitability, which determines how attractive it is to enter the market, has a dynamic effect on market structure.

Fig 1.2 (pp 7)

Implication

- The degree of market concentration is inversely related to the degree of competition. This is because market concentration encourages firms to collude.

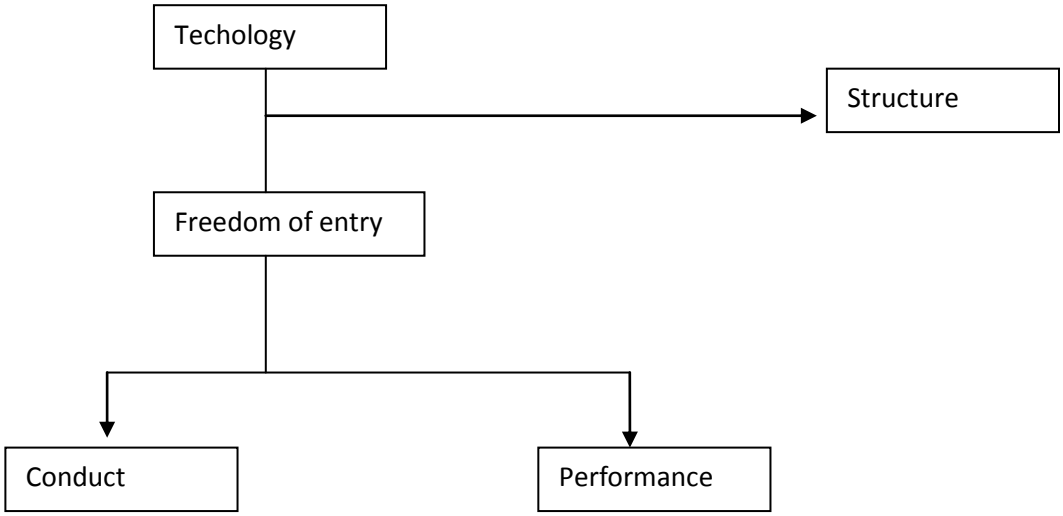
Harvard school recognizes market power as being dangerous, and establishes a relation between, the concentration ratio, and the harmful effects on *social welfare*.

Critique

1. The SCP school has emphasized the private exercise of market power as a source of poor market performance, but other economists have concluded that the main source of monopoly or anticompetitive is likely to be government interference in the marketplace.
2. The dynamic behaviors of buyers and sellers have an effect on the markets, making it harder to predict and establish fixed market structures.
3. A fundamental assumption behind the SCP Paradigm is that the effect of an increase in concentration should be the same in every industry
4. The main problem when using this methodology to analyze a market or an industry is the difficulty of defining the limits or boundaries of a given industry.

Modified framework with feedback

The Chicago School represents a view that is highly critical of intervention in the marketplace. They contend that the market will not allow rational, profit-maximizing firms to behave in ways that are detrimental to consumers. They believe that if a firm has a high market share, it is because that firm is a "superior economic performer." Thus, the conduct and performance of firms in a market determine the market's structure. Any correlation that exists between high concentration and economic profits is the result of large, successful firms being superior economic performers. Government intervention only succeeds in punishing superior firms for being efficient.



Technology and freedom of entry determining market structure, with freedom of entry guaranteeing optimal conduct and performance.
There is no assumption of complete and perfect knowledge, but otherwise the assumptions and results are those of the basic competitive model. It is admitted that relationships might be more complicated in the short run, but such departure from the competitive model are not expected to persist unless the government somehow blockades entry.