# Section 10: Cartels

For monopoly or price searching, there is a topic of “Cartel”.

Cartel refers to the phenomenon that although there is more than one producer in the market, they collude together to make decisions like a monopolist, such as reducing output together and making the price rise from a lower oligopolistic price to a higher monopolistic price.

Of course, it again makes the mistake of using the number of producers in the market to define monopoly. However, even if this mistake is put aside, cartel is regarded as only a myth in MSE, because the members in a cartel are motivated to cheat. One member promises to abide by the agreement on output reduction, but in fact he will increase output in secret. When the price rises due to the output reduction by other members, he will benefit from both price rise and output rise. One member will do so, while other members are not idiots and will do the same, so all just promise to reduce output and secretly increase output. As a result, the output in the market does fall at all, but rise, causing the price to fall. A cartel is doomed to fail.

There is such a fable. In a village there would be a wine party. Every villager was required to bring a bottle of wine and pour it into a large barrel. One was so tricky that he thought, “Why don’t I take a bottle of water? No one can know I mix a bottle of water in a large barrel of wine. I can take advantage of others by drinking their wines for paying just a bottle of water.” However, when he drank the wine from the barrel, he found all was just water! Obviously, everyone was as tricky as him, so all poured water instead of wine into the barrel. The logic of this fable is the same as the cause of fragility of cartel.

In reality, there is no cartel that can survive long. The OPEC (Organization of Petroleum Exporting Countries) in the following reading material seems to be the most successful cartel. However, according to the facts provided by reading material, the reason why the OPEC seemed to be successful to raise the price of petroleum by reducing output was due to political factor of fighting with Israel, the common enemy of these member countries (mainly of Middle East). They temporarily put aside the economic interest for political interest and acted in unity. However, which really caused such ideal result, the Middle East wars that cast an uncertain shadow on petroleum output and led to an increase in the price, or their strict abiding by the cartel agreement to reduce output? It is still a question.

After the disintegration of the Soviet Union, Russia, a country with tremendous petroleum resources but not a member of OPEC, has become a major supplier of petroleum in the international market, and OPEC’s influence on the price has been obviously weaken. Saudi Arabia, the largest member in OPEC, had to cut the output of petroleum the most in order to support the cartel, resulting in declining of the market share and monopolistic power.

> READING MATERIAL: THE OPEC [^1][^2]

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> Before 1960, international oil companies such as Royal Dutch Shell and Standard Oil of New Jersey were often accused of acting as a cartel aimed at keeping prices high. If so they failed – as became evident later on when the Organization of Petroleum Exporting Countries (OPEC) came into existence and really raised prices! In fact, it was the attempt of the major companies to cut oil prices that led the oil-exporting nations to establish the OPEC. (At what must have been a low point for intelligent foreign economic policy, the U.S. State Department actively encouraged formation of the OPEC cartel!)

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> Starting about 1960, the main OPEC nations solidified their control over pricing and production, in effect expropriating the private companies whose efforts had discovered and developed their oil resources. Thereafter private oil companies operating in OPEC countries received only what amounted to handling fees for extraction and marketing services. In 1973, for example, the Saudi Arabian government took all but about $0.60 of the $2.59 price per barrel.

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> The problem for the OPEC was and is to limit production. In fact, most OPEC members have not been holding back production. To the extent that the cartel has been viable, it is only because a few major producers, notably Saudi Arabia and Kuwait, have limited their own production.

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> The petroleum trade since formation of the OPEC has gone through several dramatic phases. After Egypt and Syria attacked Israel in 1973, the Arab countries dominating OPEC halted the previous rising trend of oil exports, aiming to influence the diplomatic policies of the Western nations. Oil prices moved sharply upward. By January 1974 the price more than quadrupled to $11.65 per barrel. During this period the cartel was extraordinarily successful. Presumably, agreement upon foreign policy issues (mainly, opposition to Israel) helped to limit the chiseling that would otherwise have tended to undercut the cartel.

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> For some years afterward OPEC’s power gradually weakened. Although the official price rose from $11.65 per barrel at the beginning of 1974 to $13.00 five years later (an increase of about 12%), the U.S. dollar depreciated about 38% over the same period. Thus, by January 1, 1979, the real price of OPEC crude oil was down from its peak.

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> But then, starting in 1979, another round of price increases was triggered by the revolution that paralyzed production in Iran. The official OPEC price rose ultimately to $34 per barrel in late 1981. But by 1985 maintaining these high prices required increasingly severe production cutbacks by the major OPEC producers – in particular, Saudi Arabia. Owing to OPEC cutbacks and rising non-OPEC production, the OPEC share of the world market, which had been 56% in 1973, fell to only 30% in 1985.

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> After 1985 Saudi Arabian production began to rise, along with the exports of other OPEC members. In consequence, despite a moderate upward trend in non-OPEC output, the OPEC fraction of the world market has recovered to about 40%in recent years. The price, still at about $28 per barrel in 1985, has since ranged between $15 and $25 per barrel – apart from a sharp temporary jump due to Iraq’s occupation of Kuwait and the first Gulf War in 1990–1991.

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> In some periods the cartel has been hugely successful, thanks in large part to the Middle East wars of 1973 and 1990–1991 and the Iranian revolution of 1979. In the interludes between these historical shocks, two factors worked against the cartel. First, consuming nations began to use oil more economically and shift toward substitute fuels. Second, the high prices encouraged non-OPEC oil exporters such as Britain, Russia, and Mexico to expand their production and exports.

In reality, there is a cartel that is much more successful than OPEC -- trade union! Trade union is a typical seller cartel in that it gathers a large number of workers to collectively negotiate wages and other welfare conditions with the management.

As analyzed above, cartel is just a myth, but why can trade union be successful? The answer lies in the fact that trade union has the legal power to exercise violence that only police and army can have in a nation. Trade union will threaten to go on strike if they cannot reach an agreement with the management. Once there is a strike, trade union will cordon off the workplace, and no one can cross the cordon to go to work no matter whether he is a member of a trade union, or whether he agrees with the strike, otherwise he will be subjected to violence such as beating. If trade union cannot exercise violence like other ordinary organizations, it is hard to imagine that they can maintain control over workers. Therefore, the essence of trade union is not cartel, but administrative monopoly!

As has been clearly analyzed, the entry threshold established by technology or brand cannot really eliminate competition, because technology or brand itself is something everyone can strive for. The real reason why a cartel cannot be successful is not that the members are motivated to cheat, but if there is no technology or brand as the entry threshold, a cartel agreement cannot establish a threshold out of thin air.

The self-interest of human determines that competition is everywhere, and the behavior of cheating is nothing more than the representation of self-interest under certain constraints. Only administrative monopoly, the threshold of which is established by government, can eliminate competition in the market. Therefore, the key to the success of trade union is not cartel, but administrative monopoly.

However, administrative monopoly can be protected by government for a long time, but it cannot eliminate the competition in the international market, so the cost is the competitiveness of the country in the world. In fact, those nations full of trade unions in all kinds of industries are all with weak international competitiveness. After 40 years of reform and opening up, China has become a nation with strong competitiveness in almost all manufacturing industry. One of the key reasons is the trade unions in China are not the “genuine” trade unions in western countries.

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[^1]: This reading material is an excerpt from “Price Theory and Its Application”, P247-248.

[^2]: The data on prices and production used here have been collected from several sources including International Economic Report of the President, Washington, DC: U.S. Government Printing Office, February 1974, pp. 110–111; Los Angeles Times (March 15, 1983), p. 1;M. A. Adelman, The Genie out of the Bottle: World Oil since 1970 (M.I.T. Press, 1995), especially Figure 6.1 (p. 144), A. F. Alhajji and David Huettner, “OPEC and Other Commodity Cartels: A Comparison,” Energy Policy,v.28 (2000), and Energy Information Administration, Monthly Energy Review (July 2003).