LECTURE 12.2

BENEFITS OF NON-MARKET TRANSACTIONS

BENEFITS OF USING SPOT MARKETS OR ‘BUYING’

Minimises costs if markets are competitive

- in the long run equilibrium of a competitive market, price is equal to the minimum of long run average cost
- get the advantage of any economies of scale and learning economies that might be available

Do not have to provide incentives or motivate employees

- incentives are provided in competitive markets
- this avoids agency costs and bureaucracy

BENEFITS OF NON MARKET TRANSACTIONS

Potential benefits

- minimise contracting costs
- take advantage of market power
- taxes and regulation

If the benefits of non market transactions exceed those of using the market, the firm may wish to vertically integrate.

- We will focus attention on contracting costs and market power.

BENEFITS OF NON MARKET TRANSACTIONS

Contracting costs: the costs of writing and enforcing contracts

- can be high for market transactions

Costs arise because contracts are incomplete:

- it is not possible to specify all contingencies
- it is difficult to measure performance in order to enforce contracts
- asymmetric information between contracting parties

There are several reasons non market transactions may involve lower contracting costs

- firm-specific assets
- costs of measuring quality
- externalities
- coordination problems

MARKET POWER

Vertical integration may allow the firm to exercise market power

- e.g. the firm may price discriminate

Example: A firm (DrugCo) that produces a patented compound called Painsolve used in the production of two drugs, a pain reliever and a cancer drug.

The cost of producing q grams of the compound is given by:

$$C(q) = 10q$$

The demand curve for each drug is given by:-

Cancer drug (no substitutes):

$$P = 200 - 10Q$$

Pain reliever (many subs.):

$$P = 100 - 5Q$$

MARKET POWER

Assume that there are no additional costs of producing each drug over the cost of producing Painsolve. That is, a drug manufacturer can use Painsolve to produce either the cancer drug or the pain reliever at zero marginal cost.

Also assume retail markets for both drugs are perfectly competitive. This means that the retail price of the pain reliever and cancer drug down to the manufacturers' MC, which in this case is the wholesale price charged by DrugCo for Painsolve.

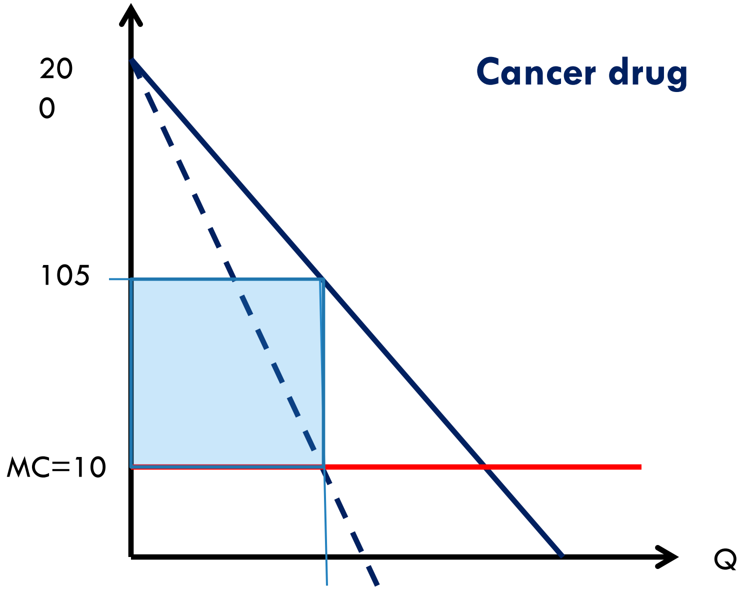
This means the demand curves that DrugCo faces for Painsolve is the same as the demand curves for the pain reliever & cancer drug.

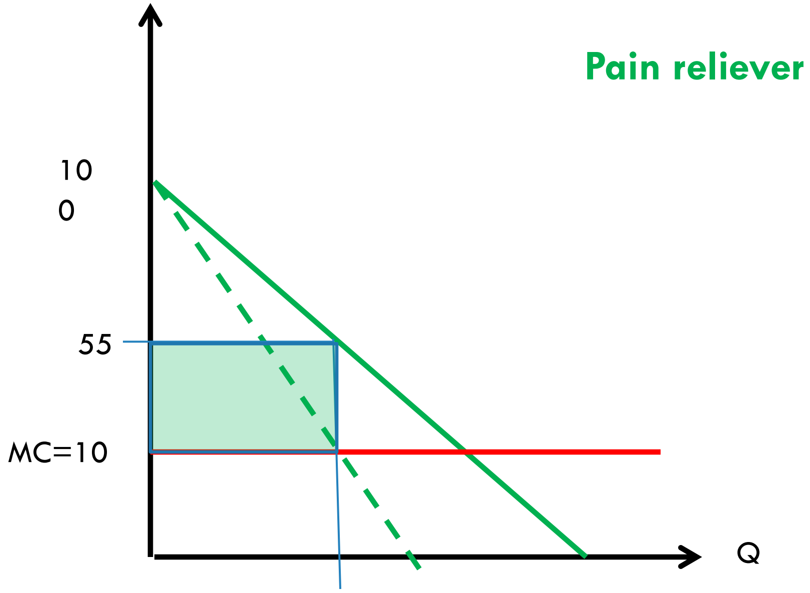
DrugCo would prefer to maximise profits by setting MR = MC in each market.

This would require them to set a price for the compound when it is sold to pain reliever manufacturers and cancer drug manufacturers. The profit maximising prices are $105 for the cancer drug and $55 for the pain reliever.

Can DrugCo set different prices in each market?

MARKET POWER





MARKET POWER

To prevent arbitrage, DrugCo could integrate forward (downstream) into the pain reliever market.

- sell the pain reliever at a price of $55 (in the retail market)
- sell the compound at a price of $105 (in the wholesale market)
- arbitrage is not possible (provided the pain reliever cannot be converted to the compound)

OTHER BENEFITS OF NON MARKET TRANSACTIONS

Quality Issues

- Quality might be difficult to observe and verify
- Once contract has been signed, the supplier might cut costs and curtail quality notwithstanding contract stipulations. (Reputation may be a solution.)

Avoiding externalities .

- Downstream firms such as distributors might try to free ride on the efforts of upstream manufacturers e.g. advertising, service, expertise, showroom space

Coordination

- If delicate coordination is required between successive production stages, this is difficult to achieve with market transactions