Loss Leading as an Exploitative Practice

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Growing market power of large retailers causes serious antitrust concerns
Buyer power against suppliers: most of existing literature
Seller power against small rivals: few research
This paper studies seller power to fills the gap
We find exercising seller power through loss leading
Widely adopted in retailing markets, see the UK Competition Commission (2008)

Leader products: staples like milk, bakery, wines, focused on Known-Value-Items

Used by 90% large retailers, with about 6% of total sales

Rarely adopted by small retailers
Inconsistency between Theory and Practice

Existing theory on loss leading

- Loss leading as an advertising strategy (Lah and Matutes 1994, Ellison 2005)
- Loss leading may arise as optimal cross-subsidizing strategy for a monopolist with multi-product (Bliss 1988)

Inconsistent with often-voiced antitrust concerns

- Small retailers profits are squeezed as unintended consequence of loss leading (Competition Commission 2008)
- Consumers face higher prices on non-leader items due to cross-subsidizing the leader products (Dobson 2000)

Conflict with antitrust interventions, German Cartel Office (2000)
Conflicting Views in Practice

- **Case Law: American Drugs vs. Wal-Mart in Arkansas (1993)**
  - Wal-Mart lost the initial trial in state court, however won on appeal in Supreme Court of Arkansas
  - The Supreme Court of Arkansas states:
    - "Loss leading is readily justifiable as a tool to foster competition rather than to eliminate rivals"

- **Statutes of Sales-Below-Cost in U.S.**
  - Banned in 22 states, and allowed in other states

- **National laws on below-cost selling in EU**
  - Banned in 6 countries, restricted in 7 countries, and allowed in Netherlands and UK
Dilemma: Predatory or not?

- Practitioners tend to tackle loss leading with predatory-pricing test
- But loss leading is persistent below-cost pricing
- Unlikely to establish recoupment and other feasibility condition for predation
- Following *Brooke* Case (1993), generally implausible to drive the rival out successfully
- Argued by Competition Commission (2008):
  - "Below-cost selling by large grocery retailers does not represent predatory behavior"
Our Findings

- Loss leading is not predatory
- But is exploitative when used by a large retailer with substantial market power
- Allows large retailer to exploit extra surplus from consumers
- And earn higher profit even than monopoly level
A typical setting where a large retailer \((L)\) provides broader ranges of products than a smaller rival \((S)\)

For instance, \(L\) offers beef and wine

While \(S\) offers wine only but with higher quality and/or lower price

Consumers have homogeneous valuations on beef and wine

But they differ in perceived costs of shopping

Some consumers incur less shopping cost than others and prefer multi-stop shopping
Example

- One-stop shoppers buy beef and wine from $L$
- While multi-stop shoppers buy beef from $L$ and wine from $S$
- Were rivals excluded, $L$ cannot screen consumers by their shopping costs
- It charges a monopoly retailer margin $r_B + r_W = 100$ from both products, for instance
Presence of rivals exerts a competitive pressure on $L$

Also opens a door for screening consumers by their shopping costs

Pricing wine below cost such that $r_W = -10$, while $r_B = 110$

Earn $r_B + r_W = 100$ from one-stop shoppers as before

While $r_B = 110$ from multi-stop shoppers

Retail margin even higher than monopoly level 100: A super-monopoly profit
Main Results

- Existence of more efficient $S$ provides a screen mechanism for $L$ to discriminate consumers
- $L$ extracts extra rents from multi-stop shoppers by adopting loss leading: earn super-monopoly profit
- $L$ will accommodate rather than exclude $S$
- But $S$ could be still hurt as a by-product of loss leading strategy
- Banning loss leading increases consumer surplus, small retailers profits and social welfare
Concluding Remarks

- **Contributions to the literature:**
  - Loss leading arises without efficiency justifications on advertising and cross-subsidizing
  - Possibility theorem of harmful impact on consumers and small rivals
  - Loss leading is exploitative rather than exclusionary

- **Limitation and further research**
  - Main results are achieved in a stylized framework where consumers have homogeneous valuations
  - Although robustness is checked for uniform distribution of heterogeneity
  - Extension to generalized distribution leaves to future works