

NEIO : Some Often Neglected Aspects of Specification and Inference

T.V.S. Ramamohan Rao

The New Empirical Industrial Organization (NEIO) approach maintains that the effect of market power of a firm on its conduct and performance can be adequately examined only by estimating a properly specified behavioural model. However, most of the tests of discretionary managerial behaviour are based on inappropriate reduced form specifications. It will be shown that a proper specification of the behavioural models of NEIO necessitates recognition of some often overlooked behavioural constraints. Appropriate estimation will be possible if the Systematic Two-step Estimation Procedure (STEP) outlined in this study is utilized.

1. NEIO Perspective 1/

Almost all the markets for industrial products can be categorized as differentiated oligopoly or monopolistic in nature. The firms in such markets exhibit two distinct characteristics : (a) large size due to the nature of the technology, and (b) product differentiation. Individual firms in such markets often have some market power, as reflected in the concentration of the market share and the inelasticity of demand, vis-a-vis their rivals. Further, (a) the distinct organizational designs of the individual firms, and (b) the advantages they derive from the firm specific monitoring and information, reinforce their relative market power within the industry. This gives rise to the possibility that the firms have more than normal profits.

Such a performance, or an anticipation thereof, may bring about a change in the conduct of the management 2/. This can take several manifestations so long as there is no take over threat. The managers may prefer to (a) distribute these funds to the various input suppliers according to their own preferences (increasing managerial perquisites, allowing managerial slack, appropriating stock options at the expense of the shareholders, etc.), (b) consolidate their market position (by increasing their market share through advertising, diversification, growth via capital expansion), and/or (c) view the market structure as a strategic variable open to their manipulation rather than as an exogenously determined state of nature (adopting entry preventive measures like limit pricing). The emergence of extensive interactions between the structure - conduct - performance of firms have been detailed in the New Empirical Industrial Organization (NEIO) literature. See, for instance, Jacquemin and DeJong (1977, pp. 159-178).