Profit maximization

The fear of destructive competition in the oligopoly market structure often leads the firms to collude to maximize joint profits. The profit maximization can be achieved by way of explicit collusive agreement or in the form of implicit cartel. Priceleadershipis another alternative cooperative method used to avoid tough competition in the oligopoly markets, especially followed in the tobacco industry. In case a dominant firm of the industry sets the price it is known as dominant price leadership. However, in the absence of the dominant firm, any one firm may set the price employing the Barometric Price Leadership.

The theory of oligopoly is defined by the way the firms view their interdependence with their rivals in the current demand-supply situation. The combined profits of all the firms in an industry get maximized when they act together as a monopolist. The profit maximizing is governed by the concept of homogeneity of products, where the elasticity of substitution is infinite. Most oligopolies are based on the struggle for survival especially since the mature markets offer limited growth potential, the companies grow by buying other companies (Oligopoly Watch, 2009).

Tobacco industry in US is characterized by a few market leaders who are willing to pay any price, whether it may be buying out, or eliminating a competitor in order to retain their market shelf space. Maintaining a stable market and profitable prices is the key to the friendly competition among the competitors in the tobacco industry, just like any other oligopoly. The high concentration of the financial power in the tobacco industry provides ample support for its survival and success. Data shows that the Marlboro, a billion dollar brand of Philip Morris, alone owns around 39% of the market share.

In a financial report analysing the tobacco industry, the Federal Trade Commission staff provided the industry's estimates of the cigarette consumption and the tobacco stock prices. According to an evaluation report presented by the Federal Trade Commerce staff, the tobacco industry claims greater elasticity of demand assuming that there will be decline in cigarette sales even in the absence of the price increases. The industry also presents an inaccurate estimate of the profits due to the inconsistent adjustments for inflation (1997).

The tobacco industry claims that the retail price of the cigarettes will soon reach $1. 50. The top leaders of the tobacco industry are in constant effort to lessen the competition by maintaining effective coordination amongst themselves and sharing the substantial increase in the industry profits. The expected rise in the price of cigarettes owing to inflation alone is not likely to deter the industry sales since inflation also increases consumer's income. The product-mix available in the cigarette industry includes the premium brands and some other discounted brands.

Any increase in the price of the cigarettes of the discounted brands would reduce the percentage difference in price between the premium brands and the discount brands making the premium brands a more attractive choice. As demonstrated by the FTC staff, the tobacco industry must be constantly checked against creation or reinforcement by mergers which could otherwise result in the market becoming even more concentrated. The excessive tacit concentration could lead to oligopolistic price coordination. The merger policy in such oligopolistic markets must aim to work against such tacit coordination.

The antitrust law aims to keep a check on such tacit coordination in the industry. The US FTC allowed the merger of R. J. Reynolds and the B&W, the second and third position leaders of the cigarette industry. R. J. Reynolds is the maker of brands such as Camel and Winston while the B&W sells Lucky Strike and Kool. The unanimous merger broke the antitrust law but resulted in the newly merged company to own 32 % of the US market. Policies such as the anti-trust law must prevail in the oligopolistic market structure so that no monopolistic firms emerge due to merger and acquisition.

Presence of a limited number of firms in the market does not give the firms the liberty to revise the prices of their products in an upwardly manner. This is so because the price rise will make the cigarettes manufactured by the competitors more attractive to the buyer. The decline in the cigarette consumption and the threat of various social policies like the antitrust law bear an adverse impact on the tobacco industry. The government has been taking various steps to curtail the tobacco consumption andsmokingin the society.

However, Schwartz (2002) asserts that the Regulation of tobacco products by the government actually tyrannize the tobacco industry for having the audacity to make products that people willingly buy. Schwartz explains this effort of the government as enslaving paternalism where individuals are protected against their own choices. While the oligopolies cannot directly dictate prices like a monopoly, they often turn into friendly competitors to maintain stable market prices in the interest of all the firms.

The few existing cigarette manufacturers and tobacco firms have been using non-price tools such as advertising and product quality for creating long lasting effect on the strategic behaviour ofthe rivalfirms. Government regulations prevent the tobacco companies from becoming large monopolistic firms so they cannot manipulate prices of their products as per their will and the high entry bar prevents newer companies from entering into the tobacco products market. This helps preserve the oligopolistic structure of the market as well as control the prices of the products for the consumer.

This is a beneficial situation except that lower priced tobacco products may lead to increased consumption and this is injurious to thehealthof the user.

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