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Import Parity Pricing: A Competitive Constraint or a Source of Market Power?

Geoff Parr



UNITED NATIONS
UNIVERSITY

UNU-WIDER

World Institute for Development
Economics Research



Development Policy Research Unit
School of Economics, University of Cape Town

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Import Parity Pricing:

A Competitive Constraint or a Source of Market Power?

Geoff Parr¹

Competition Commission of South Africa.

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Pricing tradable goods in the domestic market at import parity is evaluated to determine whether it can be characterized as a competitive constraint on pricing, or as a source of market power. The policy of import parity pricing (IPP) is also assessed in terms of the South African Competition Act. Because IPP depends on so many variables, its effects are uneven across sectors and it so is difficult to condemn outright or to address via a policy measure.

Introduction

In August 2005, Minister of Trade and Industry Mandisi Mpahlwa stated that ‘import parity pricing’ (IPP) is a problem in the SA economy. This followed several years of complaints from ‘downstream’ users of steel, aluminium and chemicals that their input costs were rising as a result of the policy of import parity pricing by the suppliers of those commodities. The Minister has promised a series of policy measures to deal with the problem posed by import parity pricing. These measures would possibly include amendments to the competition legislation, and reductions in tariff protection, amongst others. As yet, no further details have been released, although the Department of Trade and Industry is currently conducting a review of SA competition policy. This article seeks to revisit some of the issues and in particular, enquires whether IPP reflects market power or whether in fact it constrains pricing behaviour.

¹ Views expressed in this paper do not necessarily reflect those of the Competition Commission of SA. This paper was first presented at the biennial conference of the Economic Society of SA in Durban on 7-9 September 2005.

1. Import parity pricing defined.

Import parity pricing is a pricing policy adopted by suppliers of a good for their sales to domestic customers, according to which price is set at the opportunity cost of a unit of an imported substitute good. As such, price is set equal to the world price converted into rand, plus any transport, tariff and other costs the customer would bear if importing.

Conversely, export parity pricing is a pricing policy adopted by suppliers of a good for their sales to domestic customers, according to which price is set at the net proceeds per unit from export sales. As such, price is set equal to the world price, converted into rand, minus any transport, tariff (in the destination market) and any other costs the supplier would incur if exporting.

2. Determinants of IPP.

For non-tradable goods, the concept of IPP does not apply, since imports are impossible and therefore an import parity price cannot be determined. For example, many services (like haircuts) are non-tradable, as is fixed property. Not only is fixed property non-tradable by definition in the balance of payments, but in reality it is impossible to substitute imported land for domestic land. In contrast, it is actually possible to have a haircut while one is overseas, but the transaction is likely to be incidental.

But for real-world examples of tradable goods, the determinants of IPP are simply the components of the price as it has been built up. These might be listed (non-exhaustively) as the world price; the exchange rate; transport costs; insurance; and tariffs.

It is one thing to add up all the components of a price determined according to IPP. But how does that price change over time owing to changes in one or more of its constituent parts?

In respect of IPP, the nature of the good is influential:

- Goods with a low ratio of value to volume are more expensive to transport, which is another way of saying that transport costs comprise a higher portion of the total IPP price for such goods.
- The IPP price of low (value/volume) goods is therefore more sensitive to a given change in transport costs.

On the other hand, assuming that transport costs remain constant, low (value/volume) goods are affected less severely by:

- Changes in the world price (in foreign currency terms) of the good, because that represents a smaller part of the final price of a good priced at import parity than it does for high (value/volume) goods.

- Changes in the exchange rate, because that also mainly impacts on the world price (and any *ad valorem* tariff component: see below), which again is a smaller part of the final IPP price than it is for high (value/volume) goods.

The nature, level and rate of tariff protection applied are also influential in determining how the IPP price of a good is affected by a change in either the world price or the exchange rate.

If either a zero tariff or a specific tariff is applied (e.g. R1 per unit imported), then neither a change in the world price nor a change in the exchange rate will affect the tariff component of a price set according to IPP.

If instead, however, the tariff is applied on an *ad valorem* basis (e.g. 10% of the value of imports), then any change in the world price or the exchange rate will also affect the tariff component of the final IPP price.

3. Susceptibility to IPP.

One should remember that a price calculated according to the principle of import parity is a notional price. It does not necessarily reflect actual costs incurred by the supplier. In reality, a supplier's costs might be less than the import parity price. The suspicion that this is the case is often the ostensible reason why customers are unhappy about being charged an IPP price. Equally, however, an import parity price might be lower than the costs incurred by a domestic supplier, in which case customers might benefit from IPP if suppliers were constrained to price at or below IPP. This situation would, however, be unsustainable for domestic manufacturers over the long run. To illustrate the benefits of IPP for consumers the recent strength of the rand has allowed imports of many goods to become available in SA at reduced prices, sometimes at the expense of domestic suppliers.

Where pricing at import parity would allow domestic suppliers to cover their costs and earn economic profits, nevertheless it might not be possible for them to price at import parity if they face vigorous competition domestically. In that case, one would expect prices to be competed down to some level below import parity.

These considerations lead naturally to the question of what goods and market structures would be susceptible to import parity pricing? Some criteria are suggested below:

- Goods protected against imports by tariff and other trade barriers, for example high rates of tariff protection, high specific tariffs, and restrictive quotas.
- Goods protected from imports by high transport costs relative to the value of the good, that is, goods with a low ratio of value to volume.

- Goods produced in locations that are geographically remote from trading partners, for example SA in general.
- Goods produced in locations with poorly developed/maintained/managed transport infrastructure, for example SA rail. This factor would only serve to magnify the susceptibility to IPP of goods with a low ratio of value to volume.
- Goods produced in a domestic industry that is concentrated, as a result of which competition between domestic suppliers is either weak or non-existent.
- Goods produced in a domestic industry that has no intrinsic or initial comparative advantage and that must therefore be sheltered by IPP in order to be able to compete with imports.
- Goods that have a high imported content, as a result of which the final price is influenced by the world price of the good and the exchange rate. In the limit, goods that are entirely imported will of necessity be priced at the import price.
- Goods for which the domestic supply is inadequate to fulfill the entire domestic demand, so that the entire domestic output is priced at marginal cost, which in this case would be the (IPP) cost of the last unit imported.

Now that some criteria have been set out to identify goods that are likely to be priced at IPP, we can examine the central question of this paper, which asks whether pricing at IPP is a source of market power or a competitive constraint?

4. IPP: a competitive constraint or a source of market power?

One impression of pricing at import parity is that it simply involves pricing at “what the market will bear”. To some this implies profiteering, if it allows domestic suppliers to cover their costs and make economic profits, because of the price ‘wedge’ afforded by IPP. But is a local entrepreneur, observing high-priced imports in a particular line of business, wrong to react to that price signal by setting up shop and pricing just below the imported competition – especially if that entrepreneur creates job opportunities in the process of import substitution?

In certain instances, as noted in the criteria listed above, a domestic supplier might be less efficient than other world suppliers and might therefore be unable to supply the particular good unless protected by the wedge of transport and tariff costs in excess of the world price. In that case, there would be no economic profit for domestic customers to be upset about. They might complain about the inefficiency of domestic suppliers, but that’s as may be.

In the case where a domestic supplier is able to make economic profit by charging at import parity, one should enquire about the structure of the industry. If there were more

than one domestic supplier, then one would expect competition to keep prices below IPP, presuming IPP allowed for any economic profit at all. But in cases of imperfect competition (such as oligopoly or duopoly), prices might remain at IPP owing to tacit or explicit collusion, or due to price leadership, etc. In the case of a domestic monopoly, the supplier would price at IPP if it corresponded to the monopoly price, but note that the monopolist will charge less than IPP if IPP is higher than the monopolist's equilibrium price.

The discussion of terms such as monopoly, collusion and market power, indicate that competition law and policy might be involved here. Therefore the next section considers how the practice of import parity pricing is addressed in the SA Competition Act, if at all.

4.1 Treatment of IPP under the Competition Act.

The Competition Act, No. 89 of 1998, prohibits the fixing of prices by competitors, according to section 4(1)(b)(i):

4. Restrictive horizontal practices prohibited

(1) An agreement between, or concerted practice by, firms, or a decision by an association of firms, is prohibited if it is between parties in a horizontal relationship and if –

...

(b) it involves any of the following restrictive horizontal practices:

(i) directly or indirectly fixing a purchase or selling price or any other trading condition

Note that for competitors, fixing a price is prohibited regardless of whether those firms are large or small, and also regardless of what level they choose to fix the price at. Therefore firms may decide to fix prices at below cost, at above cost, or at import parity for that matter, but it is the *act* of fixing the price that is outlawed, rather than the *level* at which the price is fixed.

The Competition Act also prohibits 'excessive pricing'. The Act reads as follows:

8. Abuse of a dominant position.

It is prohibited for a dominant firm to –

(a) charge an excessive price to the detriment of consumers.

Note that the prohibition in this case applies to unilateral action by a *dominant* firm to set its price at a level that is excessive. The reasoning is that if a non-dominant firm were to set a very high price, then consumers would simply buy from someone else, whereas

there might not be much or any choice if a dominant firm charged an excessive price. Therefore the prohibition against excessive pricing is regarded as an abuse of a dominant position. Note that being dominant is not prohibited; rather, it is the abuse of that position that the Act prohibits.

It seems that there are two circumstances in which IPP can be anti-competitive in terms of the Act:

1. Suppliers collude to fix prices at IPP, in contravention of section 4(1)(b)(i) of the Act.
2. A dominant supplier sets its price at IPP and that is adjudged to be an excessive price, in contravention of section 8(a) of the Act.

However, it does not seem that there is necessarily any link between the Competition Act and the policy of pricing at IPP. After all, fixing a price is prohibited whether it is at IPP or not, and an excessive price may or may not correspond to a price at IPP (witness IPP in the clothing sector).

In respect of excessive pricing, the Commission must approach complaints according to guidance from the Act. To reiterate, the section reads as follows:

8. Abuse of a dominant position.

It is prohibited for a dominant firm to –

(a) charge an excessive price to the detriment of consumers.

The words ‘abuse of a dominant position’ indicate that the firm must be dominant within the ‘relevant market’ for its prices to be challenged for excessiveness. In section 7 of the Act, dominance is defined:

7. Dominant firms

A firm is dominant in a market if –

(a) it has at least 45% of that market;

(b) it has at least 35%, but less than 45%, of that market, unless it can show that it does not have market power; or

(c) it has less than 35%, but has market power.

Clearly, a firm is defined as dominant if it has a market share of 45% or more. But below that threshold, are two gray areas. Between 35-45% market share, a firm is presumed dominant unless it can show it is not, whereas below 35% market share, a firm is

presumed not to be dominant unless the Commission or the complainant can show that the firm has market power. Importantly, the market must be correctly defined before reliance can be placed on market shares to show dominance. Market shares might also have to be shown to be fairly stable, especially in dynamic industries in which competitors are constantly jostling for position, or in an industry characterized by rapid technology change – and so a firm is not dominant simply because it temporarily captures a high market share.

Section 7 begs the question of what is meant by market power. Market power is defined in section 1 of the Act (definitions and interpretation) as follows.

- (xiv) *‘market power’ means the power of a firm to control prices, or to exclude competition or to behave to an appreciable extent independently of its competitors, customers or suppliers.*

What about the case of a firm that is dominant within a very small market? Here, the *de minimis* threshold set from time to time in accordance with a provision in section 6 of the Act, is that only firms with an annual turnover or assets in excess of R5 million are subject to section 8(a).

Turning to the prohibition in section 8(a) itself, mention is made of an excessive price. But what exactly does the Act mean by the term ‘excessive price’? In economics, the term ‘excessive’ is normative or subjective, rather than positive or descriptive. A *positive* statement would be that the price is R10. But a *normative* statement would be that a price of R10 is too high. Economics can deal easily with positive statements and data, but often has no answers to normative or subjective questions such as “is a price too high?” or “is a price excessive?” The answer necessarily has an element of subjectivity and requires *judgment*.

Therefore, even where a case passes all the tests that one might set out in order to evaluate whether a price was excessive, a finding that a certain price is excessive will *always* be a matter of *judgment* rather than the result of some calculus.

Nevertheless, excessive pricing by a dominant firm is prohibited by the Act, and so one must make sense of that prohibition in order to apply the Act. ‘Excessive price’ is defined in the Act as follows.

- (ix) *‘excessive price’ means a price for a good or service which –*
 - (aa) *bears no reasonable relation to the economic value of that good or service; and*
 - (bb) *is higher than the value referred to in subparagraph(a).*

Now this definition does not clarify much, for the term ‘reasonable relation’ is also normative and would also be subject to judgment. Also, the term ‘economic value’ is not elsewhere defined in the Act and so it, too, must be interpreted.

What follows in the next two subsections, are illustrations of import parity pricing, both as a competitive constraint and as a source of market power.

4.2 IPP: a competitive constraint?

To the extent that the pattern of trade in most countries involves imports and exports, there are many goods that SA must import. These imports take place at the import price, equal to the world price plus transport and tariff costs. Of course, the prices charged for imports are the import prices, not the import *parity* prices, because there are no domestic goods ready to be priced at parity with the imports.

Nobody is too concerned about the prices of goods imported in the absence of a domestic alternative, although these goods are priced according to the same principles adopted in the calculation of IPP. Clearly, the absence of domestic producers of those goods means that there is no alternative to imports.

Turning to an example of a sector where there are domestic producers, consider briefly the SA clothing industry. Following the long-awaited expiry of the Multi-Fibre Agreement last year, and on the back of an undervalued Yuan, clothing exports by China have surged into the European and North American markets, threatening domestic industries there. South Africa has also been affected, and the situation here is exacerbated by the strong rand, which makes imports from China even cheaper.

In the case of clothing therefore, SA prices are being constrained by the prices of imports. In fact, prices of clothing from China are so low that SA suppliers are being swept aside. The reasons for the low prices surely include: the undervalued Yuan (despite a recent revaluation); the strength of the rand (which may or may not be overvalued, but it has certainly strengthened substantially in the last three years); the alleged under-invoicing of imports; bringing in imports under the wrong tariff lines; and Chinese comparative advantage in production of clothing and textiles.

Although consumers (and therefore retailers) are benefiting greatly from cheaper clothing, it seems that this will be at the expense of most of the local clothing industry. Therefore, IPP as a competitive constraint can go so far that it kills off a local industry.

Clearly, there will be ‘in-between’ examples of industries in which IPP constrains prices without leading to the demise of the sector. And while suppliers within those industries might complain bitterly about a strengthening rand causing their export prices to fall at the same time as they are faced with falling prices on imported substitutes for their products, nevertheless they will rarely complain about the prices of their imported inputs falling too.

4.3 IPP: a source of market power?

Given the discussion in section 4.1 about excessive pricing, it should be noted that there have been complaints to the Competition Commission about excessive pricing in the steel industry, with complainants such as Harmony Gold arguing that Iscor's pricing at import parity is tantamount to excessive pricing. These complaints have a long history (since 2002) and are now being dealt with by the Competition Tribunal. The respondent (now Mittal Steel) is being required to demonstrate that its prices are indeed based on 'economic value', whereas the complainant (Harmony) insists the prices are excessive because they bear no relation to economic value.

The issues in the steel cases have been somewhat blurred by subsequent, counterbalancing developments: the recovery of the rand since 2002, and the global rise in steel prices, based on surging demand. Disentangling these effects on local prices in an attempt to determine whether Iscor/Mittal prices are excessive or not, will be a very difficult and unenviable task for the Competition Tribunal (the case hearings continue in 2006). Therefore this case will not be discussed any further in this article, save to say that there is no clear link between excessive pricing and IPP – as borne out by developments in the clothing sector. Instead, the focus will be shifted onto another topical sector: automobiles.

Increasingly, patterns of trade are shifting towards intra-industry trade (also known as two-way trade or matched trade) and away from inter-industry trade (also known as net trade or Heckscher-Ohlin trade). This is on account of factors such as preference diversity, imperfect competition, product differentiation and the exploitation of economies of scale in different varieties or qualities of particular goods.

- Traditional net trade sees countries exporting certain goods and importing different goods, based on differences in comparative advantages between countries. For example, SA exports gold, platinum and coal, but doesn't import any. Similarly, SA imports many types of consumer electronics that aren't produced in the country at all.
- By contrast, two-way trade or intra-industry trade sees countries involved in the export as well as the import of similar goods. Thus, SA produces certain car models for the local and export markets, and imports other models.

Therefore we see local manufacturers specializing in the production of a few right-hand drive (RHD) model derivatives for local and export sales, and importing the balance of domestic sales in completely built-up form.

The trend towards intra-industry trade in the car market has also most certainly been driven by the Motor Industry Development Programme (MIDP), which allows for a tariff of 34% on cars and 27% on components (falling gradually each year), coupled with export rebates and duty drawbacks. For the manufacturer, the incentive is clearly to specialize in producing only one or a very few models, in order to reap economies of

scale, and then to export the surplus units of those models produced, thereby to earn rebates on tariff liabilities, raised in respect of the models that are imported.

In some cases, the prices of locally made vehicles are much higher in SA than they are in other countries to which they are exported, despite the extra cost involved in transporting such vehicles to overseas markets. This is because SA cars must be sold at competitive prices in foreign markets, prices that must include any costs of transport and tariff liability at destination. Therefore the net export proceeds (the export parity price or XPP) will be equal to the world price minus transport and tariff costs. But the same cars can be sold at IPP in SA, equal to the lowest RHD price worldwide, plus transport costs and the 34% tariff, as provided for by the MIDP.

Therefore it seems that in the case of motor vehicles, the net export proceeds from a sale to a foreigner can exceed the price charged to a local customers by up to as much as *twice* the value of transport costs plus both tariffs (SA and the destination country tariff).

This can be readily shown by setting out what is meant by import parity pricing and export parity pricing, and then by comparing them, presuming that (i) domestic prices are charged at IPP and (ii) export proceeds are equal to XPP.

The numbers used are of course for illustration purposes only, but it can be seen that

Box 1. The difference between export parity pricing and import parity pricing.				
IPP	=	World Price	=	Rand
			=	100
		plus transport cost <i>to here</i>	=	10
		plus tariff <i>here</i> (34% MIDP)	=	34
Thus, IPP			=	R144
XPP	=	World Price in rand	=	100
		minus transport cost <i>to there</i>	=	(10)
		minus tariff <i>there</i> (e.g. 10%)	=	(10)
Thus, XPP			=	R80
IPP minus XPP = R144 – R80 = R64 = transport cost times two plus two tariffs!				

whatever the numbers are, the magnitude of twice the transport cost plus both tariffs is going to be large.

Also note that the IPP minus XPP price wedge may be so large that IPP is above the monopoly equilibrium price. It is quite possible that for cars, this price level might have been reached in 2002, after the exchange rate depreciated to such an extent that the IPP price became higher than the profit-maximising monopoly price. It might also partly explain why prices were sticky downward once the rand appreciated thereafter.

Note that most participating manufacturers are relatively cost-neutral in relation to the MIDP, because their tariff liabilities are drawn down by rebates they earn on exports of cars or components. Now, if the tariff payable on vehicles according to the MIDP does not affect manufacturers' costs, then how is it that the tariff can inflate car prices? The answer is that prices are set by both supply and demand factors. Cost is not the only determinant of price: opportunity cost, demand and the availability of substitutes also come into play. The importance of opportunity cost is crucial, because it allows manufacturers to price at IPP rather than at cost-plus. This is how it works. For any particular brand, the manufacturer knows only too well that the consumer's opportunity cost is IPP: importing the vehicle directly from the lowest-cost producer of the relevant right-hand drive model, and paying transport costs and the 34% tariff on top of that.

In the way that is set out above, IPP – bolstered by the MIDP – seems likely to have been a source of market power for motor vehicle manufacturers in recent years in SA.

Conclusion.

This paper has shown that many factors contribute to the determination of a price charged at import parity, and these factors are in turn variables that can and do change over time. For example, the SA experience since the year 2000 has seen wildly fluctuating rates of exchange that have caused similar variations in import parity prices. In turn, these changes in import parity prices have had different effects in different sectors of the economy. Therefore, it is difficult to condemn the practice of IPP outright, and because it is a moving target, it would be difficult to devise a sensible policy instrument to tackle some of the negative effects that have been attributed to IPP.
