The Nature and Benefits of National Brand/ Private Label Competition


Robert L. Steiner
3112 Q St. N.W. Washington, DC 20007-3027
E-mail - rls.cjs@erols.com
1. OVERVIEW

In this paper I assert that social welfare in a consumer goods industry is generally maximized in categories in which a group of popular leading advertised brands (LNBs) receive strong competition from the private label brands (PLs) of the major chain retailers. In this industry structure, which I term the “mixed regimen”, the rivalry between the brands of firms at successive stages contains important competitive elements that are normally absent when all competition is among rival manufacturers’ brands or where, hypothetically, all competition would be among the private labels of rival retailers.

As prologue, it is helpful to have an idea of the relative importance of the private label sector and the recent trend in its market share. Although no statistical service estimates the overall private label market share, there are sufficient data for specific categories to conclude that PL’s share is substantial and has been growing. By far the best information is for food and non-food grocery store products sold in supermarkets, mass merchandisers and drug chains. For the 52 weeks ending 08-12-20, the PL dollar market share was 14.1%, up from 13.1% the prior year. (Private Label Magazine, 2000). Hoch, Montgomery and Park (2002) found that in 86% of the 225 categories sold in the above 3 types of retail outlets, “private label trended upward, on average about 1% per year during the period 1987-1994).” This upward trend in overall PL share in these categories continued from 1994-2000 for all three classes of retailers (Private Label Manufacturers Assn., 2001).

In apparel the PL dollar share was 36% in 2000 (NPD,2001). In athletic shoes in 1997-8 it was 33% share (Setlow, 1998,p.17). PL share estimates in hard goods categories are difficult to find.
In the U.K. from 1975-1997 private label market share grew from 16.4% to 30% (KPMG,1999). In Europe overall PL sales rose 28% from 1993-1998 (Euro Monitor,1999), and its market share in major Western European countries in 1998 was far above the U.S. level (Private Label Manufacturers Association, 2001 communication to author.)

A- Plan of the Paper

The following three Sections identify the key relationships between national brands (NBs) and PLs and describe how they have historically and contemporarily acted as incentives for large retailers to develop a strong PL program. The procedure is to cite to the writings of the economist or marketing scholar who it appears first described the relationship then to provide important subsequent research on that topic. It will be seen that most of these relationships, and the evidence for them, appeared in Neil Borden’s, The Economic Effects of Advertising (1942), a work that unfortunately is not familiar to most present-day economists.

Section V describes the competitive weapons that private labels and leading national brands use against each other, including the asymmetric effects that often tilt the battle in the national brand’s favor. The most potent weapons in the private label’s arsenal turn out to be quality improvement and the provision of favorable shelf space. Section VI lists numerous examples over the past 50 years of NB/PL competition in action and illustrates how PLs have succeeded in reducing the typically high margins of competing national brands, thereby lowering average consumer prices in the category.

Section VII Describes the dynamics of the mixed regimen and summarizes the author’s “informal dual-stage model” (See Steiner, 1993) which identifies the crucial consumer brand and store-switching behavior that largely determines the size of margins at both stages and the level of consumer prices in a
product category. This provides the mechanism to demonstrate why the mixed regimen structure is likely to be welfare-maximizing.

The article’s final section presents several antitrust issues arising out of NB/PL competition and warns that the rise and pervasiveness of category management has provided a framework in which price-fixing has sometimes replaced price competition.

11. THE REPUTATION PREMIUM AND COMPARATIVE QUALITY

In a 1928 article in The Economic Journal, Dorothea Braithwaite (1928), had noted the tendency for PLs and unadvertised manufacturers’ brands to sell for less than comparable advertised brands. She attributed the price differential to the latter’s superior reputation. For example, she noted that the retail price of an extensively advertised brand of soap flakes was higher than that of two unadvertised brands although “chemically there is absolutely no difference … advertising alone maintains the fiction that this soap-flake is something superfine (Braithwaite, p 30)”.

She conceded that sometimes there were quality differences, but where this is so “advertisement induces consumers to bear a difference in price out of all proportion to the difference in quality.” (p. 30).

Although decrying the growth of “reputation monopolies”, which were not being successfully contained by weaker, unadvertised manufacturers’ brands, Braithwaite observed with approval “a movement in the opposite direction” e.g. the introduction of cheaper store-brand imitations of the advertised brands by certain large-scale retailers. Perceptively, she wrote “they do not however dispense with reputation altogether as a factor in marketing. For the reputation of these large shops themselves is one of the means by which they are able to secure volume and rapidity of turnover.” (p.29). Thus, she demonstrated an insight into why PLs might become more effective competitors to leading national brands (LNBs) than
could manufacturers’ fringe brands. As we will see, Borden’s empirical work established the systematic
nature of the reputation premium, but unlike Braithwaite he did not view it as an unmitigated evil.

In part, the poor quality of the original distributors’ brands (Cherington, 1913, p.223) may have helped to degrade the reputation of the early store brands in the U.S.\(^1\) There seems no doubt that PL quality has continually improved. Today, many large retailers, have a 2-tier store-brand strategy. This includes a low price line at a substantial discount from the NB counterpart to appeal to price-sensitive consumers and a more expensive Premium line touted as of equal or superior quality to the NBs – examples are Safeway’s “Select” label and Wal-Mart’s “Sam’s American Choice” label.

There is a rich marketing literature explaining why consumers may be rational in paying a premium for the advertised brand. In an important article, Bauer (1960), viewed the reputation premium as a payment by risk-averse consumers to reduce the uncertainties in their purchasing decisions. Schmalensee (1978) endorsed the risk-avoidance model as the best explanation for the premium prices long established brands can command over physically identical goods. Moreover, risk avoidance does not just pertain to average quality but extends to within-brand variance in quality. PL market shares are higher and the reputation premium lower where mean PL quality is higher and variance in quality lower. (Hoch and Banerji, 1993). Maintaining box-to-box quality consistency is something that producers of leading advertised package goods brands take very seriously.\(^2\)

In a revealing piece of research, Sethuraman (2000) asked respondents 2 questions to probe why consumers of grocery products were willing to pay more for NBs than PLs. First, respondents were asked to rate the quality of a PL compared to that of its NB counterpart. Second they were asked the price they would pay for the PL relative to the NB’s price. Measurements of objective quality had been obtained and were found to be closely correlated with the quality perceived by the consumers. In the
regression, a 1% increase in perceived quality of the NB increased the premium consumers were willing
to pay for it by 0.36%.

Yet even when respondents perceived no difference in quality, they were on average willing to pay a
28.1% price premium for the national brand. Sethuranam attributes this to “nonquality utility”, which he
ascribes to the superior good will of the NB. He advises manufacturers to focus on “image-based
emotional advertising” He warns warning private label vendors that “just because retailers have closed
the quality gap does not mean that they can close the price gap.”(p.25) - e.g. national brands will still
command a reputation premium regardless of comparative quality.

In the late 1930s Borden’s researchers confirmed the systematic nature of the reputation premium by
price surveys and . by interviews with executives in 61 food, drug, variety and department store chains.3

111. RETAIL GROSS MARGINS. (RGMs)

In the same survey, 57 chains stated that their percentage retail gross margins (RGMs) were higher on
their PL brands, 4 that margins were about the same as on manufacturers’ brands, and none that they
were lower. Again, the conclusion is reinforced by the extensive comparative retail price and RGM data
in numerous individual product categories cited throughout the book. A few earlier economists (Fogg-
Meade, 1901 and Marshall, 1920) who were present when the new phenomenon of manufacturers’
brand advertising swept across England and America, had noted advertising’s strong propensity to drive
down RGMs on advertised brands. Subsequent evidence reported in Steiner (1973,1993, 2000)
establishes that the tendency for leading advertised brands to have lower RGMs than lesser known
manufacturers’ brands and PLs is one of the principle regularities in consumer goods industries.
For Borden, the RGM differential furnished the chief incentive for large retailers to develop a strong private label program. Early in his book Borden describes “The Struggle for Brand Control.” Manufacturers strive to build consumer demand for their brands so that it becomes “desirable, if not essential for wholesalers and retailers to stock and sell his brands, taking them irrespective of the prices he sets.” (Borden, p.35). He records that in densely distributed consumer goods categories, fierce price competition among dealers on demanded brands drove down trade margins. The cause of thin RGMs and retailers’ reaction to this phenomenon has never been put better than by Borden. He observed that it was retailers’ “desire to be free from the direct price comparisons upon merchandise that consumers know to be identical” (p.39) that pushed them to establish PL brands to widen their gross margins and hopefully their profits. In this cite and elsewhere Borden correctly identifies the vigor of what today we call intrabrand competition, rather than the extent of interbrand competition, as the key force responsible for driving down RGMs. Unfortunately, this insight which is widely recognized by manufacturers and retailers, is not as clearly understood by many economists, antitrust attorneys and by the Supreme Court.

Since the private labels offered by different chain stores were not identical, consumers could not make direct price comparisons upon them and were thus able to take the higher markup that characterize competition among differentiated articles. Still, Borden reported that chain executives did not want their PL prices to appear too far out of line with those of their competitors.

A supermarket executive interviewed by Progressive Grocer magazine (1976,p.57) explained the higher margins on PLs this way: “We don’t have to meet competition…as you do with national brand items. We have more flexibility in pricing because the customer has nothing to compare us with.”
These dynamics were nicely illustrated in an interview I had with a drug chain executive in the 1970s. He related that the same manufacturer had been supplying the major chains with their store brand hand lotion. The bottles and labels looked the same except for the retailer’s name. So consumers began to perceive that the rival PL brands were in fact identical, and PL price-cutting raised its ugly head. This caused each chain to demand that the manufacturer redesign its PL hand lotion bottle and label to clearly differentiate it from those of rival chains. Once done, margins escalated back to a satisfactory level.

IV. LONGER TERM INCENTIVES TO CREATE A STRONG PL PROGRAM

A. *Short-term subsidization of private labels can be profitable in the long run.*

While increasing (percentage) RGMs by selling more private labels and fewer leading advertised brands in a category is an essential first step for the retailer, higher RGMs do not automatically equate with higher store profits. For that to happen, the store’s private label sales must increase sufficiently to raise PL’s overall dollar contribution margin after the deduction of non-invoice costs associated with private label sales. The latter costs include interest expenses, which are negatively related to rate of turnover, the opportunity cost of shelf space, the salaries of its private label team and all costs for designing, sourcing, and marketing the private label line.

Chains have often subsidized their private labels by according them more shelf space than warranted by their sales (Progressive Grocer, 1976, p.54) or by pricing them at a seemingly too large discount from the national brand’s price. (Hoch and Lodish, 1998). In part this has doubtless resulted from unsophisticated cost accounting procedures in which profitability was judged solely by the size of a
brands RGM (McKinsey & Co., 1972). But more often it seems to have represented a purposeful short-term subsidization to achieve higher profits in the long run.

Borden found that many retailers saw PLs as a strategic weapon to build good will for their stores thereby wresting control “over the merchandise they sell” from branded manufacturers. Major chains have also recognized that if the effort is successful it creates an “umbrella effect” enabling the retailer to expand his private label offerings to other categories. This expansion is highly desirable. Substantial fixed costs are associated with a retailer’s private label operation, making it profitable to expand its market share into new categories, as well as in categories in which the retailer currently markets store brands.

Moreover, today retailers have still another incentive to broaden their private label offerings. According to a leading industry consultant, they “are most interested in differentiating themselves from other chains …and they view private label as a primary differentiator.” (Cannondale Associates, 2001, p.26).

B. Pushing private labels is more profitable than pushing less popular manufacturers’ brands.

Borden reported that retailers can often obtain lesser known manufacturers’ brands on an exclusive basis that permit as generous a markup as a store brand. But he warned that this course “may involve uncertainty and risk” regarding the tenure of the territorial exclusive. In fact there is an abiding free rider problem. If the retailer’s efforts succeed in creating a following for such a brand, the manufacturer is sorely tempted to end the exclusive and sell it to other dealers who will take market share from the original retailer and expose him to potential price competition. By contrast, if the retailer succeeds in building a following for his PL, consumers must return to his store to purchase it.
For these reasons slower selling manufacturers’ national brands as well as regional brands have been falling by the wayside. Echoing a view that has been voiced by the trade for a number of years, a Wal-Mart executive recently stated, “… in time I believe you will see only two offerings per category on the shelf – the national brand leader and the store brand. There will be no space available for the second or third brand player in the category.” (Berlinski, 1997, p.19).

The Hoch, Montgomery and Park (2002) study cited earlier not only confirmed the steady market share growth of PL in the U.S. since 1987, but also discovered that although store brands took market share from national brands ranked 1st, 2nd, and 3rd, in their category, their share losses were less than predicted by a proportional draw. As a group only brands ranked below 3rd lost more than expected given their starting market share position. Likewise in the UK where, PL market share grew from 16.4% to 30% from 1975-1997, the share of the brand leader fell only from 34.2% to 31.8% and the #2 brand only from 15.3% to 13.7%. But the combined market share of brands ranked below 2nd plunged from 34.1% in 1975 to 24.2% in 1997 (KPMG, 1999).

C. Retailers with strong private label programs have more leverage with manufacturers.

Retailers in this envious position are better able to bargain with manufacturers for a lower price on their private labels and on the leading national brands. For example, A&P had long established a high volume private label operation. In a 1979 Supreme Court case the evidence showed that A&P’s Chicago Division, which carried Borden’s national brand milk, was able to play Borden off against another supplier to obtain an enormous price saving from Borden on A&P’s private label milk that competed with the Borden brand.
In numerous other instances the retailer is able to use the strength of his existing PL to bargain for price concession on national brands, even the most popular ones. (See Narasimhan and Wilcox, 1980). Such pricing concessions may not be granted to competing retailers whose store brands pose a lesser threat to the NB manufacturer, thereby helping to widen the RGM of the retailer that owns a high market share PL in the category. It is reported that even Coca Cola is not immune to such upstream pressure and that in several markets it “lowered the wholesale price of its products in response to the introduction and aggressive shelf placement of a premium store brand by a large supermarket chain.” (Morton and Zettlemeyer, 2000, p.2, note 1). Indeed, the 2000 Private Label Manufacturers Industry Roundtable (p.4) prominently lists as a benefit of having a strong private label program that it provides the retailer with a “leverage position in sourcing national brands” that enables the chain to get better deals from the manufacturer.

V. Arenas of Conflict and Competitive Weapons Used by PLs and NBs.

1-Price

Cutting the PLs price against competing LNBs is the most obvious weapon. But its effectiveness is often overstated. Borden found evidence that cutting a PL’s price below its reputation disadvantage could be injurious since many consumers perceive that too great a difference in the NB/PL price spread suggests that the PL’s quality is inferior.

A finding reported in numerous articles in the marketing literature is that price effects are asymmetric. Manufacturer’s price cuts hurt private labels more than private label price cuts hurt the national brands. (See Blattberg and Wisniewski, 1989: Sethuraman (1990), Cotterill and Putsis, 2000) Moreover, NBs lose fewer sales to PLs when their price is raised than PLs lose to LNBs when their price is increased.
(Sivakumar and Raj, 1997). Still, PL price cuts do take market share from LNBs, and when the national 
brand raises its price it loses share to the private label. Dhar and Hoch (1997) conducted a 
comprehensive study involving 34 edible grocery categories sold in 106 major U.S. grocery retail chains. 
They found that across all categories the mean NB/PL price gap was about 40% and that “…a 10% 
change in the price gap fraction results in a 0.8% change in store brand share.” (p.223).

2- Shelf Space

By shelf space is broadly meant the retailer’s power to decide on the placement of NBs and its own-
label brands on the store shelves, endcaps, and island displays for everyday sale and during promotional 
periods. This prerogative distinguishes competition between national brands and private labels from 
competition among NBs, as Hoch, Montgomery and Park (2002) emphasize. Of course, NBs compete 
among themselves by offering the retailer various incentives to obtain preferred position on his shelves. 
But the retailer has the final say which is the PL’s ace in the hole.

An experiment at Dominick’s supermarkets in Chicago tested the additional sales generated by 
expending the facings, e.g. the horizontal space on the shelves, versus changing the vertical location from 
the bottom shelf to an eye- level shelf. Their strong conclusion was that “a couple of facings at eye level 
did more for the product than five facings on the bottom shelf.” (Dreze, Hoch, Purk, 1994 p.324). This 
finding will not be news to supermarkets seeking to expand their PL sales.

Some years ago I asked my graduate business school students to visit a supermarket and observe the 
store’s positioning of its national brands and private labels. A few reported that they were placed side by 
side with “compare and save” signage. All the rest had found that the PLs were at eye level – except for 
one lone student who related that the NBs were at eye level and the PLs on a high shelf at a Kroger 
store. After a slight pause, he added that it was his wife who had done the research. After another pause
he related that she was in a wheel chair. So unless you are in a wheel chair or a 7 foot center in the NBA, you will find the store brands at eye level.

Cotterill and Putsis (2000) using data from 143 food product categories in 59 geographic markets reported that the effort of PLs to combat NB price promotions by lowering PL prices “is a meager way to capture volume from national brands. Feature and display promotion appear more effective ways of gaining share…” for PLs. (p.36). But they found the results from Point of Sale display to be asymmetric, with a bigger pay off for NBs than for PLs.

Hoch et. al (2002) found that the only statistically significant activity associated with an increase in PL market share in year 2 was promotional display, such as an end cap or island display, during year 1. This effort probably increased share by stimulating a higher rate of trial, resulting in additional steady purchasers. But again, the evidence reflected an asymmetric pattern. National brands increased their market share with each of 3 promotional vehicles – by a print ad feature, by coupons and also by promotional display.

3- Quality and Innovation

Improved quality is credited throughout the marketing literature as a major reason for the growing acceptance of PLs. For instance, Hoch and Banerji,(1993) found that private label market shares were greatest where its quality relative to NBs was high.

At the same time real product innovation is one of the strongest competitive weapons against private labels in the manufacturer’s arsenal. A good product improvement by the manufacturer leaves retailers PLs in that category in the position of imitating yesterday’s favorites.

There are, of course, scattered instances of real innovation by PLs. Wal-Mart is credited with innovations in the fruit and sport drink categories (Berlinski ,19970).In the U.K. CO-OP Superstores
recently scored a coup by beating both P&G and Unilever in the race to launch capsules containing a pre-measured dose of liquid detergent. (Rodmell, 2001, p. 17). However, retailers do not enjoy comparable economies of scale that would permit them to employ a first rate R&D staff, and so typically they must wait for the LNB to innovate and respond by copying any successful, high volume product introduction by the manufacturer.

3- The contest to capture horizontal and vertical market shares, the role advertising

There is horizontal competition among firms in the manufacturing sector and in the retailing sector and vertical competition among firms at the two stages over their respective shares of a brand’s consumer price. (Steiner, 1991, 2000). In vertical competition, the retailer’s share of an item’s final price is its (\(RGM\)) and the manufacturer’s share (\(1-RGM\)). The two forms of competition are related.

If a retail chain builds a larger horizontal market share for itself and/or for its private label line, this can facilitate raising its vertical market share, e.g. its RGM, by increasing its bargaining power with manufacturers. Thereby, the chain can often obtain lower prices from its NB and PL suppliers than can less powerful retailers.

Moreover, if the retailing sector becomes more concentrated, that appears to facilitate the growth of private labels, increasing the chain’s RGMs. Analysts attribute the higher market share of PL in the U.K, to the fact that supermarket retailing there is far more concentrated than in the U.S. But in the U.S during the past 5 years, Wal-Mart began to focus on building its private label volume, which previously it had largely ignored. This task was clearly facilitated by the simultaneous growth in Wal-Mart’s sales volume and its aggressive store-opening program. One reason for this symbiotic relationship between growth of PL sales and increased concentration in retailing is the undoubted scale economies in private labeling.
The per unit cost of obtaining a skilled staff devoted to designing, purchasing and marketing its private labels declines as the chain’s total sales increase.

The manufacturer’s principal weapon enabling it to depress retailers’ gross margins and thereby obtain a larger share of an item’s retail price is to build strong consumer franchises for its brands, usually through advertising. (Steiner, 1993). Not only does this increase its vertical market share, but it simultaneously captures horizontal market share from competing store brands and/or holds their share at a low level.

From the early days of LNB/PL rivalry, it has been clear that PLs have a more difficult time obtaining market share in categories dominated by leading advertised brands. In 1939 Borden (1942, pp 594-5) surveyed 20 corporate food chains and 16 voluntary chains to determine whether they marketed a store brand in each of 21 categories. The principal reason given for not having a store brand was that “the advertised brands were too strongly entrenched to permit the development of satisfactory volume.” Among the categories in which PLs were scarce were baking soda, corn flakes, canned soup, soaps and soap flakes – all heavily advertised. Studies in the 1960s and 1970s revealed the same inverse relationship between advertising intensity and PL market shares (Cook and Schutte, 1967, pp40-49: AC Nielsen, 1976, p.218:Parker and Conner, 1978, p. 18-A), as has more recent research (Hoch and Banerji,1993).

Of course, some store brands have been nationally advertised, especially those of Sears and also J.C. Penney and some other major retailers. But such ad outlays are a small fraction of what manufacturers spend. As with innovation, there is a scale economy issue. Few retailers have sufficient total private label sales to afford a national advertising campaign with enough gross rating points to compete effectively against the LNB’s advertising campaign in a product category.
V1 – NB/PL Competition in Action

This section provides examples of the benefits of NB/PL competition starting with those from the 1930s reported by Borden. Mostly the examples illustrate that it is the growth of PL market share, for whatever cause, that forces reductions in the factory prices of competing national brands.

Borden’s price survey had found that the spread between the retail prices of the advertised cereal brands and the imitative PLs was small. Questioned about this, a leading industry manufacturer related that the spread had been much larger but that “private brand competition …had forced down the price of the manufacturers’ brands.” (p 558). The same had occurred in fruit flavored gelatins (Jell-O being the leading brand.). The leading advertised brands in these categories “have had imitators whose price competition has driven down the prices and gross margins of the originators and thereby has brought a limitation on the competition in non-price forms and on the profits of the originating manufacturers.” (p.603)

Borden’s interviews with other consumer goods makers identified a deterrent effect of PL entry. “…certain manufacturers stated that the potential threat of private brand competition has led them to keep their prices low, with the result that such brands have not entered their fields.” (p.597).

During the great depression of the 1930s, several leading tire manufacturers, hungry for business, began supplying Sears, Western Auto and others with PL tires of like quality to the famous national brands but at considerably lower factory prices to enable the PLs to be sold for less than the LNBs while yielding a higher RGM. Allstate and the other PLs became fierce competitors of the LNBs. Despite high levels of concentration in tire manufacturing, this competition between the brands of firms at successive
stages held down LNB factory prices and produced modest RGMs and consumer price levels. (See Steiner, 1993, p.732 and n.12 p.737 for further information and sources).

In other examples of NB/PL competition, trade sources advised me that the substantial reductions in P&G’s prices for liquid dishwashing detergents in the 1960s and in Reynolds’ price for aluminum foil wrap in 1972 were principally motivated by efforts to recapture market share lost to store brands. For the same reason, in early 1977 makers of the national brands of motor oils and other automotive merchandise sold in discount stores struck back with massive price cuts and promotional allowances, which substantially lowered the retail prices of such famous brands as Shell, Pennzoil and Valvoline and slashed the NB/PL price spread. (Discount Store News, p.62).

This era also provided examples of innovations by branded manufacturers and the competitive response of private labelers. General Mills’ Hamburger Helper, one of 1971’s most successful new product introductions, was greeted with a less expensive PL imitation within 120 days. In 1973, Clairol’s Herbal Essence shampoo, one of the year’s hottest drug store items, was also quickly faced with PL competition. An unhappy chain store executive I interviewed said that just as his efforts to build a decent PL volume in razor blades had finally succeeded, along came Gillette’s new Trac-11 Shaving System, forcing him to go back to the drawing board.

As I have earlier related in substantial detail (Steiner, 1985, pp122-125), the introduction of PL versions of ordinary incandescent light bulbs onto supermarket shelves in the early 1980’s drove down their incredibly high 55% RGM on national brand light bulbs (supermarkets’ store-wide mean RGMs were then around 22%) and reduced the retail prices of a 4-pack of GE or other national brand bulbs from $3.40-3.60 to around $2 in many markets. In the Washington, DC area the supermarket price for
the NB settled at $1.99 and that of the PL version at $1.49. In markets where no PL had been introduced LNB light bulbs continued to retail for around $3.49.

Sometimes a threatened national brand with deep pockets can fight back so aggressively that the PL manufacturer is driven to the wall. With customers like Wal-Mart and Safeway, The Cott Corp. was so successful with its store-brand soft drinks that it grew from a tiny family business in 1990 to a firm with sales in excess of $1 billion circa 1996. Coke and Pepsi retaliated with a ferocious price cutting campaign in the U. S. and Canada, causing Cott and other PL suppliers to cut prices by “even more than Coke and Pepsi to defend their market share.” In the process a 2-liter bottle of Coke or Pepsi “frequently sells for as little as 59 cents in some U.S. markets compared with prices of around $1 before the price war began.” (Wall Street Journal, 1998, p. B-6).

Also in the 1990s, some of the major RTE cereal companies were forced to reduce their prices due to the inroads of cheaper PL versions. And in 1992 - 1993 P&G cut prices three times on the pioneer disposable diapers brand, Pampers, and in April, 1993 cut the price of Luvs by 16%. The price cuts were a response to a rise in PL market share during the period 1988-1992 from 14.1% to 20.4%, as well as a smaller rise in Kimberly Clark’s share from 33.7% to 36.9% (Advertising Age 1993 p.43).

V11 – The “Mixed Regimen” – an Informal “Dual-Stage Model” of effective NB/PL Competition

Below are sketched the competitive interactions and gross margin relationships that characterize three commonly observed industry structures –manufacturers’ brand domination, retailers’ domination and the mixed regimen. The evidence argues strongly that the latter structure, in which powerful national brands
vie against established private labels of high market share chains, generally maximizes welfare in a non-commodity, consumer goods industry.

1- Margins in Manufacturers Brand Domination and in Retailer Domination.

The basic proposition my informal dual-stage model is that “the structure of a consumer goods industry and the relative and absolute margins of manufacturers and retailers are largely determined by the magnitudes of two cross-elasticities that define the willingness of consumers to switch stores within brand and to switch brands within store. When the magnitudes are markedly different, margins at the two stages will be negatively related.” (Steiner, 1993, p.718). In both manufacturers brand domination and retailers domination such is the case, with manufacturers enjoying the high margins and retailers the low ones in the first structure, while in the second one the margin relationships are reversed.

Michael Lynch points out that with a monopolistically competitive retailing sector, the elasticity of demand facing a brand’s manufacturer can change inversely to that experienced by the brand's retailers, as the dual-stage model predicts, although this relationship is contrary to the predictions of the derived demand theorem. (Lynch, 1986).

Briefly, in categories dominated by leading advertised brands, consumer are readily able to make direct price comparisons across stores upon merchandise they know to be identical. Many consumers will switch stores within brand, taking their patronage to Retailer B if Retailer A does not stock famous Brand X or price it competitively. Since each of the LNBs has a strong consumer franchise, consumers are reluctant to switch brands within store. The vigorous intrabrand competition keeps a lid on retailers’ margins while the requirement to stock famous brands reduces their elasticities of substitution in negotiating with manufacturers. This permits the LNBs to raise factory prices above cost without losing
much retail penetration (the combined market share in the category of the retailers who stock the brand) or dealer support.

By contrast, in categories where manufacturers' brands lack a loyal following with consumers, retailers have high elasticities of substitution. For if a manufacturer raises his price above those of his rivals, retailers can easily purchase a similar brand from another maker without losing scarcely any sales in the category. That is because most consumers are content to switch brands within store, making their purchases from among the brands the retailer offers, and few shoppers will march out of Retailer A’s store if he fails to stock little-known Brand Y or to price it competitively. Unlike a famous brand, few consumers will recognize as identical the same manufacturers’ Brand Y on sale at different retail stores. So dealers can apply to Brand Y the higher markup that characterizes competition among differentiated articles. These relationships cause interbrand competition within stores to be vigorous and Intrabrand competition to be lax. Hence, retailers enjoy wide margins and manufacturers thin ones.

Concentration is the other important variable that affects margins, in good part through its effects on consumer brand and store switching behavior and retailers’ elasticities of substitution. Concentration at one stage raises margins there and depresses them at the other stage. (See discussion in Steiner (2000)

2 - The Mixed Regimen.

This structure seems to maximize total surplus in a product category – the sum of consumer, distributor and producer surplus – with its characteristically moderate margins at both stages and its low unit costs associated with the scale economies enjoyed by large manufacturing and distribution firms. Moreover, it produces an environment that stimulates product innovation. Whereas in the other two structures there is a lack of vigorous price competition at one of the stages, in the mixed regimen both stages are reasonably
competitive. For LNBs and PLs “keep each other honest” due to unique competitive interactions that prevail when there is horizontal competition among famous manufacturers’ brands that retailers must carry and the private label brands of powerful retailers who, as the LNB’s largest customers, can bargain down their factory prices and also have the final say as to shelf-positioning and promotions within their stores.

When in the aggregate the PLs of the major chain retailers command a significant market share, LNB margins and factory prices are constrained lest they rise to a level that causes the LNBs to lose market share to the PLs because their retail prices exceed those of the PLs by more than the LNB’s reputation premiums. At the same time vigorous intrabrand competition holds down retail markups on the LNBs. This produces a reasonable level of LNB retail prices below which the PLs must be priced by at least the amount of the reputation premium to obtain a satisfactory share of market. And in Section V we identified some powerful non-price weapons that the two kinds of brands also use to discipline each other’s markups, prices and sales volumes.

It is important to recognize that the mixed regimen represents a welfare-optimal balance-of-power situation. If the LNBs become too successful, we are back to a manufacturer’s brand domination structure with its supracompetitive margins for the LNB makers, often maintained by substantial mobility and entry barriers. On the other hand, if PLs succeed in demolishing the market power of national brands, retail price levels in this private label domination structure will likely escalate to an even higher level than under retailer domination. That is because stores of the same chain do not compete by price on the chain’s own-label brands, thus eliminating intrabrand competition - the chief force that disciplines RGMs. Moreover, rival chains do not stock each other’s private labels. This enfeebles interbrand competition by eliminating it within store where consumer search costs are low and forcing all interbrand
competition to take place among stores where its price depressing effects are dampened by high search costs.

V111 – Two Antitrust Issues

1- Computing HHIs and defining relevant product markets.

Private labels present a special problem here. They are not a single brand but separate brands marketed by different retailers. Still, in computing the HHI in the relevant product market it is probably best to aggregate them, as Nielsen and IRI do. Yet the FTC and The Antitrust Division have found that whatever their national market share, there are often large variances in PL market shares across the relevant geographic markets, which greatly complicates the Agency’s analysis.

The object of delineating the relevant product market is to identify the group of firms that are close competitors. In my view, firms that can take significant market shares from each other are close competitors and are so considered by firm managements. *The focus should therefore be on the ability to gain market share rather than the means by which the gain is attained.*

However, in the Merger Guidelines the relevant product market is determined by whether a monopolist over the category could profitably sustain a roughly 5% price increase. But we have seen that NB/PL competition also has non-price dimensions. Private labels seem more likely to gain market share by improving their quality and obtaining more prominent shelf space than by price cutting. I can envision rather frequent instances in which PLs had consistently been gaining market share, yet by the “5% test” only the NBs would be included in the relevant product market. Testing this hypothesis would be a fruitful research project.

2 - National Brand/Private Label price fixing.
The article’s central thesis has been that NB/PL competition is a unique and welfare-enhancing type of rivalry. But I have recently learned that competition is sometimes being replaced by collusion. In a food category in which I served as a consultant, an industry executive with hands-on responsibilities, reported that a Category Captain from a leading manufacturing firm had visited retailers to urge them to raise the price of their PLs in concert with the forthcoming price increase of his LNB so as to maintain the existing price spread. The Captain argued that this would maximize retailers’ profit on their PLs, rather than trying to capture market share by maintaining the present price of the PL or increasing it only slightly. The Captain supported his case with a specially prepared study from a national market research firm whose cross-price elasticities indicated that his LNB and the PLs were not close competitors.

I was advised of a second such initiative in a non-food industry by the consultant who, at the behest of the Category Captain’s firm, made a very similar pitch to the major retailers. He advised that it was almost universally successful – with the exception of Wal-Mart, who refused to go along with increasing its PL’s price.

Whatever the cross–elasticity results in the commissioned research in these two cases, it seems obvious that such determined efforts to prevent their customers’ private labels from using the price weapon against them demonstrates that these LNB manufacturers considered the PLs to be close competitors, e.g. to be in the same relevant product market. Surely, this is just as much horizontal price fixing as an hypothetical attempt by Colgate toothpaste to persuade Crest toothpaste to raise its price in concert with Colgate’s forthcoming price increase.
NOTES

1 Private labels in the U.K. and elsewhere in Western Europe do not appear to have been similarly tainted, which probably enabled them to be priced closer to their national brand counterparts and to enjoy a higher market share than in the U.S.

2 Consumer Reports (1967, pp 534-536) found no quality differences between Clorox and five other liquid chlorine bleaches and recommended that shoppers buy the least expensive bleach. My questions to the Clorox company elicited the reply that sodium hypochlorite, the principal active ingredient in these products, was extremely unstable and that their tests showed that Clorox reached the consumer “at or above label strength” in a substantially higher percentage of cases than the less expensive bleaches.

3 The Borden book has an interesting genesis. Recognizing the need for a scholarly and impartial study of the economic effects of advertising, the Advertising Research Foundation proposed that the Harvard Business School (HBS) undertake the project. The project was well funded. HBS appointed Neil Borden, Professor of Advertising, to head it and to author the book with the active assistance of an Advisory Committee composed of other noted HBS professors. Borden was also provided with a substantial group of research assistants to help in data gathering (It was before the days of Nielsen and
In addition to utilizing the information contained in the existing, extensive HBS case studies, Borden’s group prepared careful questionnaires used in conducting numerous field interviews with manufacturers, wholesalers, and retailers; surveyed consumer attitudes; and executed surveys of retail prices. Borden’s (1941) book and Marshall’s *Industry and Trade* (1920) remain the two best works on the consumer goods economy to this day.

**References**


Cook, V.J. and T.F. Schutte (1967) *Brand Policy Determination*, Marketing Science Institute,
Boston: Allyn & Bacon.


Discount Store News (1977) March 14, 16.


Lynch, M.P. (1986) *The ‘Steiner Effect’. A prediction from a Monopolistically Competitive Model Inconsistent with any Combination of Pure Monopoly or Competition*. FTC Bureau of


Progressive Grocer (1976). October


