

Output: Market Conduct in the U.S. Ready-to-Eat Cereal Industry, by Jeff Reimer, Food System Research Group. Published in *Journal of Agricultural and Food Industrial Organization* 2(9)2004. Draft available at http://www.aae.wisc.edu/fsrg/working_papers.htm

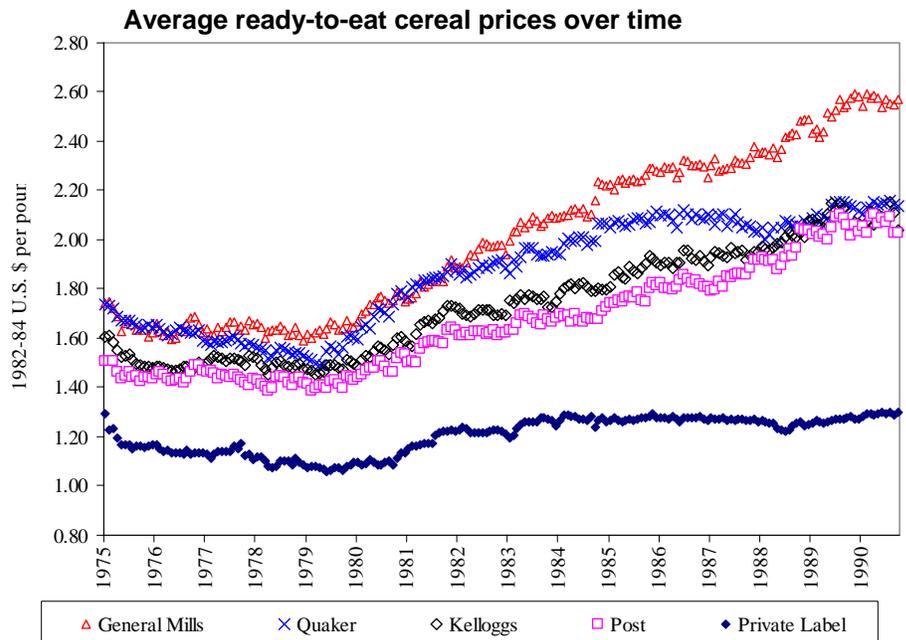
THE HIGH COST OF BREAKFAST

Explaining high markups for breakfast cereals

The US ready-to-eat breakfast cereal industry is remarkable for its high levels of profitability, not only relative to other food manufacturing firms but also compared to most sectors in the economy as a whole. While production costs and retailer share make up about 36% and 20% of the retail price of cereal, the rest (44%) is average manufacturer gross margin. Cereal firms can be lauded for channeling their rivalries in ways such that high markups over costs can be maintained for long periods of time; however, high markups redistribute income from millions of cereal-buying households to a relatively small number of investors, and reflect an inefficient allocation of economic resources relative to a more competitive industry.

The figure (right) plots prices of manufacturer-brand cereals along with prices of store-brand (so-called “private label”) cereals, which have yet to make major inroads into this market.

Previous research suggests that the costs of producing branded cereals are less than the retail prices of private labels. The figure shows that branded cereal prices have little relation to private label prices, nor, by extension, to the basic costs of cereal production (grains, sweetener, packaging, labor, capital).



Unit values from Selling Area Markets, Inc. (SAMI), normalized on the Bureau of Labor Statistics US average Food and Beverage Consumer Price Index (1982-84 base).

APPROXIMATE COLLUSION?

Previous research is consistent in identifying product differentiation and aggressive brand promotion as key aspects of cereal firms' large markups. Yet, there is much less consensus as to whether strategic pricing interactions (oligopoly pricing) also play a role in the high markups. There are a handful of very large firms in this industry and considerable barriers to entry by potential competitors. When determining the prices of their brands, firms take the anticipated response of their rivals into consideration. Over time, the firms may be able to set prices higher than they would in an industry that has sustained price competition.

Existing research is inconclusive as to whether this actually happens. The paper from the FSRG study addresses this debate by determining whether cereal firms strategically interact on price, and, if so, determining whether this boosts markups to the extent achievable under perfect collusion, or "shared monopoly."

The paper's econometric results show that pricing is determined largely by strategic considerations as opposed to changes in underlying costs and demands. This boosts markups by an average 2.5 percentage points higher than what is possible through product differentiation and other strategies by themselves. This effect is about 43% of the maximum contribution that perfect collusion could add to the margins, that is, the level associated with firms getting together and making an illegal agreement to fix prices.

Overall, the evidence is consistent with the general theme of the prosecution's side in the 1970s Federal Trade Commission "shared monopoly" case against the top three cereal companies. Perhaps the most appropriate description of pricing is that it is "approximately cooperative," meaning that through their interactions over time, firms have moderate ability to raise prices above what we would see in a perfectly competitive industry. This does not imply that *illegal* price fixing is occurring; yet, strategic pricing interactions clearly are part of the reason for the high markups in the ready-to-eat cereal industry.

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ISSUES: Does manufacturer price collusion underlie high markups in breakfast cereals? Factual merits of an anti-trust case involving a widely purchased food product. Firms' formation of prices. Imperfect competition.

FINDINGS: Strategic pricing interactions by large cereal firms are part of the reason that breakfast cereal prices are higher than what would be seen in a perfectly competitive industry.

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