

The Internet and the Consumer: Countervailing Power Revisited¹

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ABSTRACT *The Internet is a tool with the potential to enable consumers to effectively participate in collective bargaining in the marketplace. The purpose of this paper is to address the viability of the concept of countervailing power in the Internet era. First, some theoretical perspectives on how on-line consumer networks have the potential to be a new source of countervailing power are introduced. Next, the potential for consumer countervailing power in the Internet era is discussed. A case study that illustrates the viability of the propositions is then presented. Finally, implications and limitations of the paper are briefly discussed: if the potential for countervailing power can be established, then the circumstances under which collective bargaining would occur and the determinants of its outcome would be of vital interest to consumer economists and policy makers.*

Keywords: electronic commerce, Internet, countervailing power, consumer, consumer behaviour.

Introduction

Subject: [nukkad] Empowering the online consumers

Date: Thu, 3 DEC 1998 00:48:37-0500(EST)

Organization: Mumbai Central

Fellow nukkad denizens:

I read an interesting case of using the net to get a better bargain and realized that this is a perfect forum for us to do the same.

This couple decided on a car they liked and bargained with the car dealer to get the car for US \$18000. They then used the net (presumably via a mailing list) to find people in their town who were in the market for the same model of the car. They went back to the car dealer and asked him to reduce the price to US \$15000 since now there were 5 more people who were willing to buy from the

same dealer. The dealer was glad to reduce the price as he made it up in volume (and he did not have to pay sales commissions to his people) and everyone else was happy because they got a much better deal than they would have ever got on their own. A classic win-win scenario.

We have had a few people ask for info on buying PCs on 'nukkad'. I bet we are also buying other appliances around the house and maybe some other high-ticket items. Do you think it is possible to do something similar like the above example? I think the PC market is particularly suitable for such bargaining but I am sure there are other areas where collective bargaining would work. What do you think?

Harshal@mumbai-central.com²

The email message presented above raises interesting questions about the potential of the Internet for consumers to form groups during the purchase process. It is possible that the Internet is a potential tool to enable consumers to effectively participate in collective bargaining in the marketplace. If this can be established, then the circumstances under which collective bargaining would occur and the determinants of its outcome would be of vital interest to consumer economists and policy makers. Hence this paper will address the viability of the concept of countervailing power in the Internet era.

The concept of countervailing power, the concept that a solution to the problem of economic power can be achieved by 'the neutralization of one position of economic power by an other' predates the Internet.³ It was first introduced in the book *American Capitalism: The Concept of Countervailing Power* by J. K. Galbraith.⁴ Although the concept received some criticism from mainstream economists⁵ it was adopted by consumer advocate Ralph Nader⁶ as a theoretical basis for organized consumer activities. This paper aims to revisit the concept and examine the effect of the newest communication medium, the Internet, on the potential for countervailing power during the purchase phase of consumption.

The role and impact of the Internet as a social technology has been a topic of interest in academic circles. The Internet has been characterized as a networking technology that enables people to share ideas and develop opinions and create an interconnected world of organizations and individuals.⁷ The empowering role of the Internet is demonstrated by the fact that Internet technology such as email and the World Wide Web is now being used as 'grassroots weapons of democracy'.⁸ The Internet has bonded people worldwide into virtual communities by generating greater communication between like-minded groups and individuals. Non-governmental organizations, citizens' groups and the like are using the Internet to encourage a consensus of views, to exchange information, to coordinate opposition, to plan protests and to alert their diverse publics to what they are doing.

From a business perspective, the on-line community has potential value as a source of loyalty that stems from membership of on-line communities.⁹ From the perspective of consumer scientists, a related question can be raised with respect to the on-line community: are consumer networks on-line a new source of countervailing power and, in turn, can they empower the consumers? This is the possibility that was raised in the Introduction to this paper by reference to the nukkad email message. The paper will attempt to provide further insight into and support for the viability of countervailing power in the Internet era.

The structure of the paper is as follows: first, some theoretical perspectives on how on-line consumer networks can be a source of countervailing power are introduced. Next, the potential for consumer countervailing power in the Internet era is discussed. A case study that illustrates the viability of the propositions is then presented. Finally, implications of the paper are briefly discussed.

Countervailing Power

The Theory of Countervailing Power: Its Concept and Related Literature

One of the oldest of economic problems, as Galbraith explains, is the regulation of economic power.¹⁰ The discussion of the concept of countervailing power begins with the acknowledgment of the existence of economic power in modern Western society that 'impaired or destroyed competition'. Classical economic theory is based on the notion of many sellers doing business with many buyers. Each is well informed as to the prices at which others are buying and selling, and no buyer or seller is large enough to control or influence the price that is set in the marketplace. In this ideal marketplace, prices and quantity demanded find their most efficient level. From this perspective, economic power that is large enough to control or exercise substantial influence on prices is problematic because prices would no longer reflect 'the ebb and flow of consumer demand'.¹¹

Prior to the theory of countervailing power, two solutions for the problem of economic power were recognized: one is competition and the other is regulation by the state. The theory of countervailing power is based on the idea that there is a third mechanism that can check and regulate economic power. The fundamental tenet of countervailing power is that in market economies the market power of large firms is often curbed not just by competition from other firms at the same horizontal level, but also by the power of customers or suppliers. Galbraith writes:

To begin with a broad and somewhat too dogmatically stated proposition, private economic power is held in check by the countervailing power of those who are subject to it. The first begets the second. The long trend toward concentration of industrial enterprise in the hands of a relatively few firms has brought into existence not only strong sellers, as economists have supposed, but also strong buyers as they have failed to see. The two develop together, not in precise step but in such manner that there can be no doubt that the one is in response to the other.¹²

The concept of countervailing power generated much discussion among economists in the late 1950s.¹³ Although it has been suggested that the theory of countervailing power did not have a big impact on subsequent theoretical work, it was later adopted into studies of labour union behaviour, and the relationship between manufacturers and retailers.¹⁴ Galbraith himself used those two situations as the main illustrative examples of development of countervailing power in his original work.

Of particular interest to this paper is Galbraith's comments on the relationship between producers and retailers (mass buyers), examples of which include chain stores, department-store chains and co-operative buying organizations of independent department and food stores.¹⁵ Although Galbraith did acknowledge the possibility that countervailing power could evolve among consumers, he suggested that the assumption that producers of consumer goods sell their products directly

to consumers is rather simplistic. Instead, he pointed out that in reality, goods pass to consumers by way of retailers and other intermediaries who are required, by their situation, to develop countervailing power on the consumer's behalf, and bargain and extract lower prices from producers.

This argument was used by researchers in industrial organizations in the study of market structure and its impact on the market price.¹⁶ In the 1990s, with the introduction of multi-stage games and new bargaining concepts in the analysis of industrial organization, a few economists revisited the concept of countervailing power and provided a mathematical model to demonstrate its viability using the Nash bargaining solution.¹⁷

The industrial organizational studies were able to provide systematic evidence of countervailing power. From an empirical perspective, Lustgarten found that buyer concentration was positively correlated with seller concentration and negatively correlated with the seller price cost margin.¹⁸ He concluded that high buyer concentration was a factor that offset the ability of concentrated sellers to obtain prices in excess of direct costs. Schmacher found that buyer concentration had a consistently negative impact on seller profitability, which is consistent with the countervailing power hypothesis.¹⁹ From a theoretical perspective, von Ungern-Sternberg's model showed that, in the first stage of bargaining between producer and retailers, the producer's selling price is a decreasing function of the retailer's bargaining power and an increasing function of the number of retailers.²⁰

These results establish evidence that countervailing power provides an active restraint on the exercise of seller power consistent with the theory of countervailing power. At the same time the results also raise an interesting question, which is very relevant to consumer economists: who ultimately benefits from the countervailing power—the strong buyer (i.e. retailers or mass buyer in Galbraithian terminology) or the consuming public?

In the theory of countervailing power, Galbraith assumed that the gains from the countervailing power of mass buyers are passed along to the consumer, but the process is not clearly explained.²¹ Critics have argued that it is the concentration of retailers that creates countervailing power and yet, that concentration of retailers can also create situations where the retailers can enjoy their oligopolistic position, and become the major beneficiaries of their economic power. Schumacher argued that whether consumers are the primary beneficiaries of countervailing power depends on 'whether or not the power on the buyer side is coupled with a lack of market power on the resale side', that is, whether there is competition among retailers.²² The theoretical analysis of Dobson and Waterson showed that consumers can benefit by lower prices only when the increased retailer concentration does not lead to an appreciable increase in retailer selling power.²³

To summarize, these studies concluded that large or concentrated retailers could exercise countervailing power and extract lower price from sellers. However, the benefit of this countervailing power can be transferred to consumers only when the power of retailers can itself be checked and by competition among retailers. But what if consumers could somehow by-pass retailers? While admittedly the industrial organizations' studies have contributed to systematic development of the theory of countervailing power, in our opinion, the conclusions drawn from these studies seem to ignore another possibility, that the countervailing power can exist at the consumer level, too.

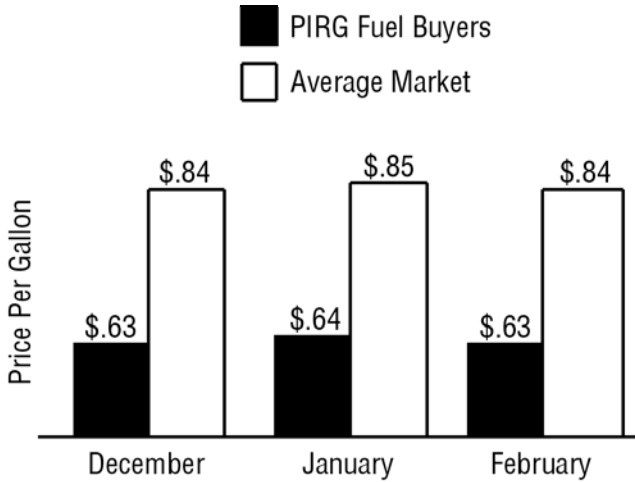


Figure 1. PIRG fuel buyers vs average market price in metropolitan Philadelphia, winter 1998/99.

Source: http://www.pirg.org/fuelbuyers/fuelbuyers_howmuchcanisave.htm

The Concept of Consumer Countervailing Power

Nader, a strong advocate of consumer countervailing power, stated that organized consumers (or 'banded consumers' in his terminology) can demand regulation from government and, more significantly from the perspective of this paper, undertake private action for negotiating the conditions of buying.²⁴ In other words, if consumers with similar needs for certain products or services can somehow get connected, they can exercise countervailing power.

Consumer countervailing power would emerge in group buying and group negotiating processes.²⁵ If a critical mass of consumers can band together as a group, they can negotiate a volume discount from the manufacturer. One example of consumer countervailing power thus exercised is the Nader-inspired PIRG (Public Interest Research Group) Fuel Buyers. It is an organization of fuel consumers in the Philadelphia area that negotiates with local fuel dealers for better deals. The fuel dealers in turn can benefit from a larger volume of sales. On average, the prices that the members of this group pay are 10–20 cents per gallon lower than the average retail price of oil (Figure 1) and a member can save up to \$200 during winter.²⁶

While the concept of consumer countervailing power is very appealing, the phenomenon itself cannot easily be attained in real life. Nader stated that the evolution of a more just and efficient market economy has been hampered by the fact that consumers have not been organized, as opposed to sellers who have been well organized.²⁷ He argued that the lack of organization of consumers is, in major part, due to the fact that 'consumers have no regular, inexpensive communication system accountable to them that can organize their actions and resolve their basic grievances'.²⁸ In a passionate essay, he predicted that the widespread availability and use of home computers would increase consumer networking significantly and thus increase the likelihood of consumer countervailing power.²⁹ This point will be further discussed in the next section.

The Internet: A New Vehicle for Countervailing Power

Before we begin our discussion of the characteristics of the Internet, we would like to revisit the conditions that enable consumers to benefit from countervailing power in the market for consumer goods. First, consumers can exercise countervailing power themselves in the marketplace if they are more concentrated or better organized, regardless of whether the existing economic power in the marketplace comes from retailers or manufacturers. Second, if consumers are in a marketplace where consumers and manufacturers interact directly, a situation which Galbraith considered as seemingly simplistic, countervailing power would be exercised solely by consumers, given that they could achieve concentration, with consumers as the ultimate beneficiary.³⁰ Third, as suggested by the original theory of countervailing power and the industrial organizational studies, if retailers can exercise countervailing power in the first stage of the bargaining process with manufacturers, and if retailing is a 'competitive' industry, then the benefit of retailer's countervailing power would be transferred to consumers in the second stage of bargaining.

The remainder of this section will be devoted to the discussion of the characteristics of the Internet that are potentially related to the above conditions, with discussion of the features of the new communication medium that the old media could not as effectively provide.

An Effective Method of Communication

The first and foremost important characteristic of the Internet is the promotion of the possibilities of social networking. The Internet is 'a descriptive term for a web of thousands of interconnected telephone, satellite, and wireless networks built on communication technology. This infrastructure is a network of networks, reaching out and connecting separate islands of computers into a seamless web'.³¹ Using network interaction media such as email, chat and the Usenet, people can discuss a range of topics and even work on complex collective projects. In this way, the Internet is not only a communication medium but also a group medium, sustaining and supporting many-to-many interactions through its connectivity.³²

The Internet encourages the expansion of community networks. Information can easily be passed along, for example, to friends via email or to third parties through newsgroups and bulletin boards. Unlike traditional communication media such as the telephone, which are predominantly one-to-one communication media, networked communication allows one-to-many (as in the case of email and newsgroup) and many-to-many communications (as in bulletin boards and the like). In the process, contacts between previously disconnected people occur, allowing relationships to develop on the basis of communicated shared interests. The focus on shared interests in forming social network can also be empowering for otherwise disconnected groups such as groups of consumers with diverse social and physical characteristics.³³

Another feature of the Internet that is relevant to its effectiveness as a communication tool is its ability to sort and search information to cater to individual needs. As societies become more complex, individuals' definition of their own interests becomes more fragmented, which may result in increasing problems of information complexity and overload. Whereas conventional media have always involved a process of preselection of information by the information

provider (in most cases media or businesses), the Internet offers consumers direct access to information of various sorts, and the means to quickly search through it to select that which is of direct interest. For example, using search engines like google.com it is easy to find user groups and discussion groups that share a common interest. This feature of the Internet makes the process of actively searching and identifying other consumers with a shared interest much easier than ever before.

As stated in the Introduction, the Internet has the potential to go well beyond merely bringing people together. The Internet is already proving itself to be a medium for the generation of collective action.³⁴ A case of on-line collective action that is often cited is the case of Lotus MarketPlace. Consumers banded together on-line to protest against Lotus MarketPlace being launched because of concerns about privacy issues. It was a case where the power of the Internet medium to share information, to bring an issue into focus, and to develop a community and shared value resulted in the cancellation of a product that seemed undesirable to consumers.³⁵

Eliminating the Friction of Distance

While the impact of technology in redefining spatial and temporal boundaries is not new, it is generally agreed that the pace and extent of the change has accelerated dramatically with the introduction of the Internet.³⁶ The Internet allows the network and economic activities of both consumer and businesses not to be restricted by physical distances, a phenomenon Cairncross named 'the death of distance'. Thus with the Internet, geographical boundaries are of lesser importance in buying and selling of goods and products.³⁷

Muniz and O'Guinn state that the new communication medium has the potential to unite geographically dispersed individuals with commonality of purpose.³⁸ Similarly, Westland and Clark suggest that the networks of people today are more likely to be based on 'shared interest' than on 'physical proximity'.³⁹ The implication of these changes is that on the Internet, it would be easier to unite consumers who share a common need for certain products and services, regardless of their geographical location. Put differently, it implies that it is possible to bring together the critical mass of consumers necessary to exercise countervailing power via the Internet.

Disintermediation

Rapid technological changes have also created opportunities for disintermediation. Disintermediation occurs when access to information or services is given directly to consumers, eliminating the middle man who typically supplied the products or services in the traditional marketplace.⁴⁰ It is suggested that with the introduction of Internet commerce, many companies will re-evaluate the economics of marketing channels. The new medium has 'the potential to lower unit costs and radically alter supply chain relationships with suppliers and consumers. By doing so, the traditional links between company, supplier and consumers are broken down'.⁴¹ Benjamin and Wigand also suggest that as the technology develops, manufacturing companies will reduce their reliance upon intermediaries in the supply channel.⁴²

Disintermediation has the potential to link manufacturers and consumers, which in turn would enable consumers to procure goods and services directly from manufacturers. The implication is that if and when necessary, consumers would be the sole source and beneficiary of countervailing power.

On the other side of the disintermediation debate, Currie has pointed out that Internet commerce is likely to create new intermediaries. These new intermediaries would take the form of IT outsourcing companies and 'infomediaries'.⁴³ New intermediaries would emerge due to the fact that most firms lack the necessary technical and managerial skill to design, maintain and manage an Internet function. Also, due to the enormous amount of information that is provided to consumers and the lack of control over its quality, there is a niche for trust-based intelligence agents that help sort information.

Retailer competition in the frictionless economy

Theoretically, it can be expected that the competition among retailers on the Internet would be greater than in the traditional market. In the electronic environment, firms are no longer necessarily tied to physical locations because all functions, including providing information about products, order processing and post purchase customer relationship management, could be conducted on the network. In addition an Internet retailer can hold far lower inventory levels than a conventional retailer who must have items in stock on site. As technology advances and becomes more affordable, the start-up cost for retail businesses would significantly be lower than in traditional markets.⁴⁴ Thus potential retailers can enter into market more easily, and the level of competition would be higher. Brynjolfsson and Smith state that the unique characteristics of the Internet have created the potential for frictionless commerce where 'retailer location is irrelevant, consumers are fully informed of prices and product offerings and retailers all make zero economic profit'.⁴⁵

Empirical results, however, seem to tell another story, at least if price dispersion is any indicator of market power imbalance. Lee found that prices for used cars sold on-line tend to be higher than prices for used cars sold in traditional markets. Clemons *et al.* found that the price offerings of on-line travel agents for airline tickets vary by as much as 20%. In the case of studies of homogeneous physical goods, results are mixed. Bailey observed that the average prices of books, CDs and software offered on the Internet were higher than in conventional stores. Brynjolfsson and Smith found that while, in general, the average prices of books and CDs offered on the Internet were lower, there were also substantial and systematic price differences across retailers. They concluded that their analysis of the pattern of price dispersion and retailer popularity suggests that retailers with the lowest prices do not receive the most sales.⁴⁶ Thus, it seems that the potential of the Internet to create a frictionless economy is offset by some other factors, such as product and firm uncertainty.⁴⁷

Case Study: Letsbuyit.com

The case study approach has been an important method for researchers seeking to document IT (information technology) implementation, and for the study of electronic commerce. The case study methodology is desirable in exploratory and

explanatory studies of little known phenomenon because it can provide detailed insights about such phenomena.⁴⁸

A single case study can demonstrate the viability of a concept when 'that case represents a critical case to test a well formulated theory, a unique case, or a case which reveals a previously inaccessible phenomenon'.⁴⁹ Three such cases have already been alluded to in this study, namely nukkad, PIRG Fuel Buyers and MarketPlace. A fourth will now be added. It is hoped that this will be sufficient to justify revisiting countervailing power in the Internet era.

Founded in Sweden in January 1999, LetsBuyIt.com first launched its website in August 1999. Currently, LetsBuyIt.com is operating in the UK, Germany, Sweden and France with 1,265,698 members. LetsBuyIt.com is a group buying site (also known as co-buying, aggregate buying and collective buying site). It uses the Internet to gather consumers together and negotiate directly with suppliers on their behalf. It is thus potentially a direct example of consumer countervailing power as described in this paper.

Once consumers decide which product to purchase with LetsBuyIt.com, they join a 'co-buying' group. Details of prices that can be obtained with different numbers of buyers are displayed in a graph form on the website. This is how the group buying or co-buying usually operates: the price at which purchases can be made depends on the number of buyers, with the price level separated into tiers. Each tier corresponds to a certain number of buyers. When that critical mass is reached, the price drops to the next step. Consumers can observe the prices with the current number of buyers, and calculate how many more people are needed to reach the next best price available. Each offer has a specific closing date.

A consumer may choose to purchase at current price or at best price. In the former case, the purchaser is guaranteed the price level that is reached on the closing day. The 'best price' is available only if enough people have joined to achieve the appropriate tier price. On the site, there is a referral option that consumers can use to email to friends the information about products being offered, to facilitate the aggregation process.

LetsBuyIt.com allows consumers to request certain products to be offered by using the request field on the website. Once a suggestion is made, other consumers who are also interested in the specific product can vote for that product. If enough people vote for the product, the company will bargain with suppliers or manufacturers to extract preferential conditions.

There are several other group buying sites operating like CoShopper.com (operating in seven European countries and in Japan) and kr.Groupbuy.Yahoo.com (operating in South Korea). Some of the US group buying sites that had gained much attention like Mercata.com and B2C division of Mobshop.com ceased operations earlier this year. However, experts say that the demise of Mercata is related to the change in the market condition that hit venture capital and that on-line group buying is still a viable concept with potentials.⁵⁰

Concluding Comments

In his discussion of the consumer's strategic position in the information society, Gronmo suggested that the position of consumers would improve as the interests and the collectivity among consumers increase, and consumers would potentially be influential or powerful.⁵¹ In this paper we have argued that the Internet era is indeed enabling consumers to combine into effective bargaining groups, and

furthermore that this is consistent with the concept of countervailing power as put forth by Galbraith. The argument was supported by reference to recent developments in economic theory, study of the electronic marketplace, and actual cases.

If an agreement among consumer scientists can be reached that the necessary evidence has been supplied to establish the viability of the concept of countervailing power in the Internet era, then a big research agenda is created. Assuming the establishment of the viability of this research area, which may require additional research, the circumstances under which countervailing power emerges as an effective market force need to be investigated. Second, factors related to the strength and effectiveness of consumer countervailing power need to be identified. Third, the existence of forces counter to countervailing power would need to be researched, since what the Internet gives the consumer, the Internet could also take away.

There are always two sides to a story. Though our task was merely to demonstrate the viability of countervailing power in the Internet era, we have discussed the notion that retailers or new intermediaries could co-opt some of the market power from consumers, and that the problem of uncertainty still remains in the new era. We do not want to dismiss the possibility that the new technology could even work against the consumer interest. For example, as Mayer suggested in his discussion of potential consumer problems with French Videotex system, the technology might advance far enough so as to identify each individual's preference and need, and consumer products could be customized accordingly.⁵² If and when such delicate target marketing or mass customization becomes possible, it would be hard to gather a critical mass of consumers. These and other issues will arise as the Internet technology matures, and will augment the research agenda described above. The resultant body of knowledge will provide guidance to policymakers in the Internet arena.

Notes and References

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