Chapter 14: Cooperation without Incarceration: Bigger Pies, Fairly Divided

**What are the three parts of the "fairness principle" needed to sustain cooperation?**

Utilizing "fairness" principles to divide the spoils while sustaining cooperation

For cooperation to be sustained, all of the cooperating parties need to be satisfied with the returns they receive from continuing to cooperate. If any player becomes sufficiently dissatisfied, it will inevitably abandon its cooperative behavior. Non-cooperation from a single player may lead to a cascading collapse in cooperation by others.

**Individual Rationality**

The first condition of fairness is that no firm in a cooperative arrangement should receive *less* than it could obtain in a non-cooperative setting. Unless it makes sense for each firm to cooperate, meaning that each firm does at least as well by cooperating as by refusing to cooperate, then cooperation will not be sustainable. In this sense, the original division of the spoils will not be fair. Because of the fairness conditions, it is important to consider the outcome that firms can achieve when they do not cooperate. The "threat" being non-cooperation and a myopic pursuit of one's individual goals. The same outcome is referred to by the acronym **BATNA—the best alternative to a negotiated agreement.** It is the yardstick against which the firm's rewards under a cooperative arrangement are measured. In organizing a fair division of the spoils, the non-cooperative outcomes for all the participants have to be taken into account.

If the component and equipment makers existed in a world without cooperation, new entrants and internal competition would drive their **economic profit to zero**, meaning that they would earn a return on their invested capital *equal* to the cost of acquiring that capital. The threat point or BATNA, for these companies, the point at which they would be better off without cooperating, is at this level of reward, when they earn no more than their cost of capital.

**Firms that operate without competitive advantages should not expect to earn returns above their cost of capital even when they work in a cooperative environment.** The principle of individual rationality implies that the only benefits of cooperation that are subject to divvying up are those gains above the non-cooperation outcomes, that is, gains that are the benefits to cooperation itself. When among all the cooperating companies only one firm enjoys competitive advantages over its actual potential rivals, it will reap all the rewards. In many instances, however, more than one firm benefits from competitive advantages, and has some claim on the cooperative gains. In the personal computer industry supply chain, both Microsoft and Intel enjoy significant competitive advantages.

**Symmetry**

Under the principles of symmetry, if all the legitimate claimants to the benefits of joint cooperation, that is, all those enjoying competitive advantages and therefore not forced to cooperation by competitive pressure, look essentially the same, then they should divide the benefits of cooperation equally. If, among essentially identical cooperating firms, some of them consistently appropriate a disproportionate share of the benefits of cooperation, then the firms that have been shortchanged are going to be dissatisfied, and legitimately so. Forms with authentic grievances will not cooperate indefinitely.

If two firms in an industry both enjoy competitive advantages, cooperation requires that both participate. Then, of the benefits of cooperation can be shared between them, so that each dollar of benefit surrendered by one firm is transferred to the other one, the division of the benefits should be equal. The firms are equal in that each is essential for there to be any benefits of cooperation, and therefore, according to the symmetry condition, they ought to expect to share in them equally. If either makes a determined effort to seize more than an equal share, threat move will ultimately undermine the cooperation between them, hurting them both. As in so many other areas of business strategy, a calculated restraint on aggression is essential to long-term success.

**Linear Invariance**

The need for fairness applies to situations in which several firms, all with competitive advantages, occupy the same segment in the value chain and divide the market horizontally. In this case, the fairness principle dictates that if there are two firms in a segment, and one of them has twice the size or strength of the other, then its portion of the benefits from cooperation should be twice as large.

Nash used the term linear invariance for this version of the fairness requirement. It works by assigning shares of cooperatively exploited horizontal market in proportion to the cooperating firms' relative economic position--to each his own, on other words.

**What are the benefits in analyzing how an industry and its players could cooperate even when there is no chance that the companies in a particular industry can overcome their competitive behavior?**

The cooperative perspective is instructive even where there is no chance that the companies in a particular industry will be able to overcome their antagonisms and work out some kind of cooperative arrangement. It can identify **potential areas of cooperation**, even if they are limited to only one or a few of the areas was listed earlier in the chapter, like specializing research and development to avoid duplicating one another's efforts. Only after it has made these decisions is it time to turn to the question of what rewards it might reasonably expect to earn from these focused activities.

It is also useful in highlighting a firm's genuine strengths by pointing out where it would fare if the industry were organized cooperatively. In this respect, it can help **clarify realistic expectations** and terms for prospective strategic alliances and relationships between suppliers and purchasers.

Finally, if a firm's own prospective position within a cooperative configuration of an industry does not look promising—at the extreme, **the firm has no reasons for existing if there is no cooperation because, for example, it is a high-cost supplier**—this information provides an important strategic insight into a company's future. Its survival will depend on the failure of the other companies in its industry to cooperative effectively with one another. If it wants to continue, it will have to improve its position before the stronger market participants learn to cooperate successfully.

By recognizing the ultimate consequences for itself if others cooperate, the firm's management can get a sense of how long it has to live and how far it has to go to survive. These are essential pieces of information for formulating a useful strategy for such a disadvantaged firm. Such insights add to the overall value of a cooperative viewpoint which is an indispensable supplement to the more standard forms of competitive analysis. In the area of competitive analysis, it is important to keep in mind the fundamental complexity of the problems at issue. Clarity depends on a picture built up carefully from a group of simplifying perspectives. Fully cooperative view of the world, however unrealistic in pro-active, is a perspective that contributes meaningfully to that clarity of vision.

Successful cooperation is neither common nor easy. The rival firms have to find a way to work in harmony to advance their joint interest, and they have to do it legally, to avoid drawing the wrath of the agencies charged with preventing and punishing restraint of trade.

In Chapter 15 we will study several potential outcomes of a potentially cooperative arrangement in the case of Nintendo and Eythl Corporation