NEW MEASURE OF COMPETITION CAN HELP ASSESS THE MARKET POWER OF FIRMS LIKE TESCO AND MICROSOFT

Competition authorities like the UK's Competition Commission are relied on to break up monopolies and protect consumers. But regulators can't always tell if a firm is a monopoly or not. This means that some large firms might be punished unfairly and some monopolies might go unnoticed.

But in research published in the August 2008 issue of the *Economic Journal*, Professor **Jan Boone** proposes a more effective method of assessing the degree of competition within a market. The new method, used together with existing measures, should help regulators and, ultimately, consumers, to get a fair deal on the high street.

The study develops a measure of competition called relative profits differences (RPD). In every market, inefficient firms have lower profits than efficient firms. But in a more competitive market, efficient firms are rewarded more and inefficient firms punished more harshly (in terms of profits) than they are in uncompetitive markets. By estimating how quickly profits fall as a company becomes less efficient, it is possible to measure the competitiveness of a market.

Recent high-profile competition cases include Tesco and Microsoft. Although both firms claim that they are big simply because they are more efficient than their rivals, regulators haven't been swayed. This new method may be of interest to the management of each company if either decides to appeal against regulatory decisions.

At the moment, regulators normally use two indicators to determine whether a firm is a monopoly:

(1) Concentration – the proportion of the market that is served by a certain number of firms. So if the two-firm concentration ratio is 75%, then the two largest firms together serve three-quarters of the market. A high level of concentration is normally taken to mean low competition.

(2) The price-cost margin – the difference between prices and the cost of producing each unit. If prices are much higher than costs, then it might indicate that firms are exploiting monopoly power.

Competition is an important concept in economics. The degree of competition in a market is seen as an indicator of the market's health – and a healthy market will be good for consumers. But competition, like health, is not easily defined. Consequently it is very hard to measure.

Concentration is easy to measure but not very informative about the market's health. Low concentration is generally seen as indicating more competition. But intense competition will drive inefficient firms out of business. With only efficient firms left, concentration might be high even though there are only a few firms left in the market due to intense competition.

This is a recurrent theme in the Microsoft case, where Microsoft interprets its high market share in the PC operating system market as evidence of intense competition ('for the market' as it is called) not that it has monopoly power.

The price-cost margin isn't a perfect measure of competition either. A high price-cost margin might indicate a monopoly exists. But in 'new economy' sectors (like software and pharmaceuticals), the production costs are very low while the initial development costs are huge. So price has to be substantially above costs in these sectors to recover the development costs.

So a high price-cost margin doesn't necessarily mean that a monopoly exists. In fact, a low price can actually indicate a monopoly, if monopolies try to drive competitors out of business (as in predatory pricing cases or Windows Media Player being given away for free with the operating system) thereby stifling competition.

Due to these problems, concentration and price-cost margins – although often used – are not reliable for competition policy decisions. Mergers may be blocked, or a firm might be found guilty of 'market abuse' inaccurately.

The RPD method is better ('more robust') than these existing measures of concentration and price-cost margins.

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Notes for editors: 'A New Way to Measure Competition' by Jan Boone is published in the August 2008 issue of the *Economic Journal*.

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