Chapter 4

Contestable Markets and the Nature of Competition

> The first thing to go is the traditional conception of the modus operandi of competition … in capitalist reality as distinguished from its textbook picture, it is not that type of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization … which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives … It is hardly necessary to point out that competition of the kind we now have in mind acts not only when in being but also when it is merely an ever-present threat. It disciplines before it attacks. The businessman feels himself to be in a competitive situation even if he is alone in his field.
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> Joseph A. Schumpeter (1942), *Capitalism, Socialism, and Democracy*: 84–85.

In the classic board game, Monopoly, the objective is to drive all of your opponents into bankruptcy by owning and developing blocks of colour-coded property until you are the only remaining player. Players collect rent from their opponents and can charge higher prices as they own more properties of each colour. The game is built on the idea that monopolies—one firm controlling a market—generally produce worse outcomes for consumers (higher prices, for example) than markets characterized by many business firms in competition with one another.

Our experiences in daily life tend to reinforce this negative belief about monopolies and markets dominated by one or a few large firms. Generally the prices, quality, and customer service are better when we deal with businesses such as clothing, groceries, or restaurants that are in highly competitive industries than it is when we deal with businesses in markets with less competition such as electric utilities or cable television; or even government-owned bureaucratic monopolies like the post office.

A large part of any modern microeconomics principles class in high school or college is devoted to exploring and comparing the outcomes that occur under different market structures. These usually range from markets with lots of firms competing with similar products (competitive markets) to markets dominated by one (monopoly) or a few (oligopoly) firms. Since the days of Adam Smith, the key concern in thinking about the differences among market types is the level of competition among firms, which is thought to be a force that disciplines the behaviour of businesses. Put simply, when firms are in greater competition with other firms they tend to provide better prices, quality, and customer service, and be more innovative and efficient. As is best summarized by noted economist William Baumol in his presidential address to the American Economic Association,

> standard analysis leaves us with the impression that there is a rough continuum, in terms of desirability of industry performance, ranging from unregulated pure monopoly as the [worst] arrangement to perfect competition as the ideal, with [desirability] increasing ... as the number of firms expands. (Baumol, 1982: 2)

At one extreme on this continuum of competition are markets or industries described as having "perfect competition" (lots of firms competing with identical products), while at the other are markets that are a monopoly (dominated by one firm). Generally, economists also consider two additional markets in the middle of the continuum often called "monopolistic competition" (lots of firms competing but with products or services that are differentiated from one another) and "oligopoly" (a few large rival firms). Each market has specific properties that identify and differentiate it.[6] But, for simplicity's sake, as Baumol states, we can generally conclude simply that markets with more small firms are better (or more efficient) than those with fewer large firms.

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6. This footnote is for readers interested in a quick definition of these markets. In the model of perfect competition, firms are very small relative to the market, produce identical products (like eggs or wheat), and sell their products at a given market-determined price; and it is easy for new firms to enter and old firms to exit. Monopoly markets are dominated by a single

Joseph Schumpeter was one of the first economists to question this standard description and indeed viewed this traditional framework as being somewhat misleading. After discussing the widespread increase in prosperity and economic development that occurred throughout the last few centuries prior to his writing *Capitalism Socialism and Democracy* (CSD), he notes:

> As soon as we go into details and inquire into the individual items in which progress was most conspicuous, the trail leads not to the doors of those firms that work under conditions of comparatively free competition but precisely to the doors of the large concerns ... and a shocking suspicion dawns upon us that big business may have had more to do with creating that standard of life than with keeping it down. (CSD: 82)

Schumpeter's view of actual economic history, which was formative of his views of how the economy actually worked, was more a picture of progress based on innovation that had been produced in reality by industries dominated by larger firms. Perhaps more importantly, Schumpeter examined these industries and observed disruptive innovations over time that continued to remake the industries themselves and the broader economy and, in doing so, produced a regular churning and replacement among these larger firms. In other words, it was not the same large firms that dominated these industries over time.

Schumpeter viewed actual cases of both perfect competition and monopoly as being rare: "If we look more closely at the conditions ... that must be fulfilled in order to produce perfect competition, we realize immediately that outside of agricultural mass production there cannot be many instances of it" (CSD: 78–79); and similarly, "it becomes evident immediately that pure cases of long-run monopoly must be of the rarest occurrence and that even tolerable approximations to the requirements of the concept must be still rarer than are cases of perfect competition" (CSD: 99).

firm selling a product for which there are no good substitutes and generally protected from competition by some type of barrier (such as a license or patent) that prevents new rival firms from entering the market. Under monopolistic competition (sometimes termed "imperfect competition") firms produce products that are somehow differentiated from one another, by factors such as quality, location, and brand name (*e.g.*, restaurants). An oligopoly is a market with only a very small number of large rivalrous firms that can sometimes collude with one another (*e.g.*, a cartel).

In Schumpeter's view, the most important aspect of the true competitive process was not really the count of the number of *existing* firms in the industry (which is the dimension on which the traditional continuum is built in microeconomics). Instead, it was whether it is easy for new firms to enter and compete with (and displace) existing firms. In other words, Schumpeter focused on the degree to which there were barriers in place for new firms to be created or existing firms to enter existing markets. If we return to the opening quotation for this chapter, we see Schumpeter eschewing the standard "traditional" or "textbook" notion of competition in favour of one in which it is the competition from new goods or technologies that matters. In fact, Schumpeter continues with the following passage:

> the competition from the new commodity, the new technology, the new source of supply, the new type of organization ... [t]his kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly; the powerful lever that in the long run expands output and brings down prices is in any case made of other stuff. (CSD: 84–85)

Thus, the ability of new firms, goods, and technologies to enter and compete with existing firms, and to displace them through the process of innovation and creative destruction through time—or at least the threat of it—was a much more important aspect of real-world competition and progress than textbook models of price competition between firms.

How then does Schumpeter rectify his conclusion with the accepted wisdom that competitive markets generally produce better outcomes than industries with fewer larger firms or monopoly? He justifies his position by differentiating between outcomes at a point in time compared to outcomes over a longer time. Schumpeter argues:

> First, since we are dealing with a process whose every element takes considerable time in revealing its true features and ultimate effects, there is no point in appraising the performance of that process [at] a given point of time; we must judge its performance over time, as it unfolds through

> decades or centuries. A system—any system, economic or other—that at every given point of time fully utilizes its possibilities to the best advantage may yet in the long run be inferior to a system that does so at no given point of time, because the latter's failure to do so may be a condition for the level or speed of long-run performance. (CSD: 83)

In a nutshell, Schumpeter's assessment leads him to conclude: "In this respect, perfect competition is not only impossible but inferior, and has no title to being set up as a model of ideal efficiency" (CSD: 106).

Schumpeter's alternative view is that entrepreneurial innovation creates temporary monopoly power, and profits, and the quest for such profits is the driving force behind the process repeating itself through time, producing long-run economic development as large firms replace one another in industries that are not really highly competitive at any point in time. Over the long term, it is these industries dominated by larger firms that create more progress and prosperity than the ones that are normally considered "perfectly competitive".

In his book *Business Cycles: A Theoretical, Historical, and Statistical Analysis of the Capitalist Process, Volume 1* (BC1) he asks readers to

> visualize an entrepreneur who ... carries out an innovation ... that his receipts will exceed his costs. The difference we shall call Entrepreneurs' Profit, or simply Profit. It is the premium put upon successful innovation in capitalist society and is temporary by nature: It will vanish in the subsequent process of competition and adaption. (BC1: 105)

> In some cases, however, it is so successful as to yield profits far above what is necessary in order to induce the corresponding investment. These cases then provide the baits that lure capital on to untried trails. (BC1: 90)

This ongoing process of entrepreneurs, in search of profits, creating new innovations that generate short-term monopoly power by displacing old firms was the real competitive force of progress in the economy over the long term. The real competition each business firm faced was the threat of being run out of business by something new—of being creatively destroyed, so to speak. Importantly, this means that for an existing business the competition to be worried about is the threat of new entrants:

> It is hardly necessary to point out that competition of the kind we now have in mind acts not only when in being but also when it is merely an ever-present threat. It disciplines before it attacks. The businessman feels himself to be in a competitive situation even if he is alone in his field (CSD: 85).

> Not only is practically every enterprise threatened and put on the defensive as soon as it comes into existence, but it also threatens the existing structure of its industry or sector almost as unavoidably. (BC1: 107)

The result of this ever-present threat of competition is that it forces existing firms to act competitively. They must continue to innovate and price competitively as long as the industry is open for rivals to potentially compete: "In many cases, though not in all, this will in the long run enforce behaviour very similar to the perfectly competitive pattern" (CSD: 85).

This idea that it is not the current number of firms in an industry, but rather the openness of the market to the entry of new competitors, that matters when assessing the desirability of market outcomes has been developed in more detail in modern theories of "contestable" markets associated with the work of William Baumol.[7] According to Baumol, "[a] contestable market is one into which entry is absolutely free, and exit is absolutely costless" (1982: 3). The outcomes in these markets are

> freed entirely from their previous dependence on ... incumbents and, instead ... [depend on] the pressures of potential competition; [the outcome in these contestable markets] is, generally, characterized by optimal behaviour and yet applies to the full range of industry structures including even monopoly and oligopoly. (1982: 2)

Given these arguments, it is clear that the problem case is not one simply of an industry dominated by a single firm (*i.e.*, a "monopoly") or several large firms, but rather the case of a firm or industry protected from the dynamic forces of competition. When government policies, for example, prevent new firms from entering and competing with (and/or displacing) existing firms, these

7. See William J. Baumol (1982).

are the markets where outcomes are likely to be inferior. The threat of entry is the key to good outcomes, and government policies that lower or prevent this threat are harmful.

Schumpeter's work also has important implications for government anti-trust policy. Standard anti-trust policy that focuses on the current levels of competition within an industry entirely misses what Schumpeter viewed as the most important margin of competition, the threat of new firms and new goods. Retrospectively, we can see that almost all the major concerns about monopolization throughout the twentieth century eventually saw the supposedly offending companies creatively destroyed by new firms or technologies. Have you ever even heard of AOL's instant messaging monopoly, Myspace's digital monopoly in social media, Nokia's cell phone monopoly, or The Great Atlantic and Pacific Tea Company (A&P)'s monopoly on groceries? Probably not, because while at the time these were viewed as troubling monopolies arousing widespread calls for government intervention (that sometimes happened), they have all been displaced by creative destruction instead.[8]

The innovations of the cycling, dominant (large) firms, from Microsoft to Apple, to the displacement of Blockbuster by Netflix, or Uber taking on Yellow Cab and the taxi industry are examples of what Schumpeter viewed typified true competition. More importantly, this type of competition is responsible for a greater share of economic development through time than is the textbook competition that characterizes markets with many smaller firms producing identical products, such as the competition among wheat farmers (there are 20,000 wheat farmers in the state of Kansas alone!). Thus the "ideal" markets for true competitive innovation, discovery, and generating progress are not necessarily those markets most revered in economic theory as being "competitive". The most important implication for government policy is that it should not prevent or limit this type of competition by protecting firms or industries from new competition.

8. For more examples and details, see Ryan Bourne (2019).