Innovation

Digital platforms force a rethink in competition theory

Economists need to provide regulators with tools to deal with market concentration

Diane Coyle

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Anxiety about the health of competition in the US economy — and elsewhere — is growing. The concern may be well founded but taking forceful action will require economists to provide some practical ways of proving and measuring the harm caused by increasing market power in the digital economy.

The forces driving concentration do not affect the US alone. In all digital markets, the cost structure of high upfront costs and low additional or marginal costs means there are large economies of scale. The broad impact of digital technology has been to increase the scope of the markets many businesses can hope to reach.

In pre-digital days, the question an economist would ask is whether the efficiencies gained by big or merging companies would be passed on to consumers in the form of lower prices. Another key question was whether it would still be possible for new entrants to break into the market.

Digital platforms make these questions harder to answer. The basic economic theory, developed by Jean Tirole and others, establishes that in such markets one “side” will cross-subsidise the other. So the signal prices send about competition is completely different from in a traditional market. Platforms also generally expand into neighbouring markets, so the standard market definition exercises done by competition authorities are doubly uninformative. Big digital companies argue that the consumer benefit they provide through free services is immense. So where is the harm?

They rely heavily too on competition among themselves, and the threat of digital disruption: just as Facebook quickly toppled MySpace, so it could be toppled in turn. They argue that competition for the market is intense, and some competition experts agree.

This might be right, but we do not know. Economists are letting down competition regulators in failing to provide the tools for evaluating in specific cases the claim that — in a world of significant returns to scale and network effects — bigger is better for everyone.

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One much-needed tool is how to assess consumer benefits. Google and Facebook provide services consumers greatly value without taking money directly from them; but advertisers place great value on the services too, and their payments will be passed on ultimately to consumers in the price of whatever is being advertised. How high is that price? The network effects of digital platforms do produce real economic welfare gains, but nobody knows how big these are or who captures them.

A second issue is how to take into account the interactions between markets, given that most platforms and tech companies steadily expand into other activities and markets. There has probably been too little focus in antitrust policy for a long time on the purchasing power of big companies.

A third issue, perhaps the most important, is the effect increasing concentration has on incentives to innovate and invest. The economic welfare gains from innovation will usually dwarf the gains from lower prices. Competition economics has always been poor at trying to quantify these relative gains, but the stakes are high now that innovation is seen as one of the main drivers of competition. How can potential challengers develop new technologies to topple an incumbent if they have to compete with an apparently zero price? For that matter, how will investment in physical networks or content get funded if an incumbent using the network and content captures all the profit downstream?

Reversing the kind of increased concentration seen in the US takes a significant commitment of political capital and bureaucratic energy. These are more likely to be forthcoming if the analysis and evidence is there to back them up. It is up to the economists to provide the ammunition.

The writer is professor of economics at the University of Manchester