Pros and Cons of Excess Competition

By Ryuhei Wakasugi

The issue of excessive competition is under active discussion in Japan, but not for the first time. It came up before, in the 1960s, regarding the coordination of the capital investments of the heavy and chemical industries. The argument made at that time can be summed up as follows.

Excessive competition in the market is creating large numbers of undersized firms. In addition, the overlap of investments is creating excess capacity and is making production inefficient. These developments will result in reducing the international competitiveness of Japanese companies. Too much competition is as bad as not enough: the costs to the national economy exceed the associated gains. Government authorities should therefore seek to prevent excessive competition by intervening in private-sector decisions concerning the size of capital investments to achieve economies of scale.

More recently, the excessive competition of Japanese companies is cited as worsening trade friction and as being the cause of low profit rates and labor's low share of the national income. Furthermore, it is argued that the continuation of excessive competition will result in the waste of resources and the exacerbation of environmental problems. This article will examine why such issues are being raised at this time.

Reasons to avoid excessive competition

Let us imagine the market as existing on a continuum with a pure monopoly of one company on one side and perfect competition on the other wherein infinite numbers of companies exist and the market shares of those companies are so small that the effect of any one of them on the overall market is negligible. Under the traditional theory of industrial organization, when the number of firms is large, the market approximates pure competition, product prices equal marginal costs, and resources are allocated efficiently.

On the other hand, when the number of firms is small, product prices diverge from marginal costs and resource allocation becomes inefficient. The higher an individual company's market share, the greater the divergence between prices and marginal costs. In other words, the more vigorously competition takes place, the greater the economic welfare. In such a world, a condition of excessive competition can never exist. However, in the more recent theory of industrial organization, the addition of the following postulates draws attention to the possibility of excessive competition.

The first postulate assumes the existence of economies of scale. In industries with high fixed costs, an individual firm increasing its market share will reduce its average costs and achieve more efficient production. This agrees with the intuitive understanding that the total surplus of the overall economy will likely be higher in a market consisting of firms of a sufficient size to permit efficient production rather than in a market with large numbers of small-scale firms.

The second postulate assumes the existence of competition governed by strategic behavior. Real markets are often neither a monopoly of one firm nor the locus of pure competition. Rather, they may be oligopolies of a few firms. In such a situation, the conduct of one firm affects the conduct of others, inducing companies to act strategically. Such behavior in an industry of decreasing costs signifies that competition will continue until production reaches a level that precludes the entry of competing firms, or, stated another way, until excess profit is reduced to zero.

The third postulate assumes the importance of time in competition. A given amount of time is needed to master production technology or to acquire experience. Seeking to develop proficiency before others, companies compete in investing in research and development and in plant and equipment, thereby hoping to capture markets ahead of their rivals. Once a company begins to trail behind or loses a particular market, its distance behind other companies will only widen.

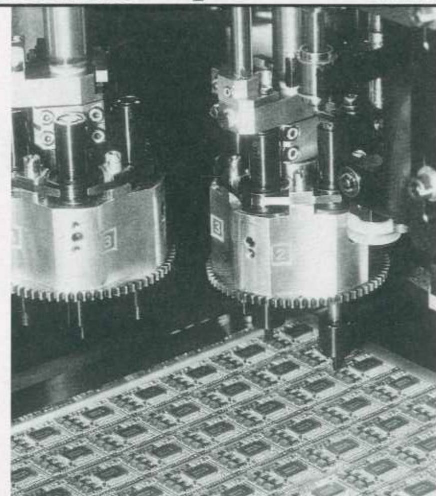
When competition takes place in an oligopolistic market meeting the above criteria, it is theoretically possible that the economic welfare (the total surplus, or the sum of the producer's surplus and the consumer's surplus) will be less than when competition is restricted to some degree. Although a smaller number of firms may decrease somewhat the consumer's surplus, the economies of scale engendered on the production side will help increase the producer's surplus.

Is trade friction caused by excessive competition?

Many people believe that trade friction with U.S. and European firms stems from the excessive competition among Japanese firms and that, unless this situation is righted, trade imbalances and trade friction will remain unresolved. Are there real grounds for holding such a position?

The automobile and semiconductor industries are situated in oligopolistic markets consisting of a few firms. We can therefore assume that companies behave strategically toward each other in these markets. In addition, these industries have high fixed costs and are ruled by the learning curve, which indicates that they are industries with decreasing average costs. Competition in these industries will not be over maximizing short-term profits but over profits derived from production efficiencies that expanding market shares allow. Trade friction has a tendency to intensify in industrial sectors like these, in which economies of scale operate.

That being the case, the question becomes whether Japanese companies are more aggressive than their U.S. or European counterparts in expanding the scale of production or in increasing R&D and capital investments. In this context,



Semiconductor production line. The industry, dominated by a small number of companies, is extremely competitive, with profits derived from production efficiencies that lead to greater market share.

many note that Japanese companies have larger numbers of lifetime employees and maintain a variety of continuous and long-term ties with other companies. It cannot be denied that this causes Japanese firms to place greater emphasis on stable, long-term profits and on the continuation of the firm rather than on quick returns. Furthermore, their activities are directed toward gaining market share in the future and subsequent fiscal terms rather than toward increasing profits in the current term. They consequently strive to outdo their rivals in expanding the scale of production, in capturing market share, and in supplying products at low prices.

It has been statistically demonstrated that Japanese companies have lower profit rates than foreign companies and that their ratio of retained earnings to pretax profits is exceedingly high. This has led some Japanese business leaders to argue that Japanese companies should avoid excessive competition, should increase their profit rates, should reduce the costs of competition over capital investments, and should increase the share of revenues going to their employees.

One can wonder, however, if it is possible to accurately determine the degree of divergence between the current level and the optimum level of competition and to develop suitable policies to restrain excessive competition.

Can excessive competition be restrained?

In order to restrain excessive capital investments in such industries as iron and steel, synthetic fibers, petroleum refining, petrochemicals, and pulp and paper, the Japanese government for all practical purposes allocated the expansion of productive capacity among individual firms during the 1960s. This situation, however, had two significant and unfortunate consequences.

First, it did not accord with the principles of equal opportunity and fairness. The government's attempt to avoid willful intervention at this time is illustrated by the allocation of capacity expansion quotas in turn or as a proportion of existing productive capacity. These efforts still fell short, since they protected the interests of existing companies and severely hampered the entry of new firms. Acting in a manner that discriminates in favor of existing companies is undesirable from the standpoint of economic liberalism, or a society built around free competition.

Second, the government's endeavors to prevent excessive competition had the perverse effect of generating excessive competition. If it is widely understood that the government will be allocating capacity expansion quotas based on existing production capacities, companies are likely to increase their productive facilities to maximize their future expansion quotas. Companies increasing their strategic capital investments in anticipation of future investment opportunities will create new excessive competition, a situation without benefit for the national economy.

Furthermore, the expectation that the government will restrict competition sooner or later by establishing counter-recession cartels will distort the manner in which companies perceive their competitive positions. Joseph A. Schumpeter has remarked that automobiles with brakes can go faster than those without. A situation fully analogous to this developed within Japan's economy. Ironically, government intervention to prevent excessive competition produced it instead and accelerated the rapid growth of Japan's economy.

The voluntary export restraints of recent years can be cited as representing a similar situation. Under this system of regulation, companies that are granted export allocations are able to collect monopolistic rents. In addition, the fact that the export opportunities of the entrants are limited jeopardizes the principle of equal opportunity and fairness in engaging in economic activities. Voluntary export restraints also result in the reduction of market competition.

The lesson we can draw from these examples is that the prevention of excessive competition must not interfere in the competitive activities of individual companies. If excessive competition derives from unrestrained capital investments, instituting policies that increase the relative cost of such investments will effect changes in resource allocation among companies and in the strategies they engage in. Extending the legally prescribed useful life of facilities and equipment or reducing capital-investment tax breaks will diminish the return on capital investments, ease competition over such investments, and prevent excessive competition. This may even result in lifting profit rates and in increasing labor's share of the national income.

What should be emphasized here is that government policies to prevent excessive competition should not be based on individual acts of willful intervention. Rather, they should be high in transparency and should avoid partiality, that is to say, they should maintain market competition, equal opportunity and fairness. Furthermore, since such policies act to limit competition, their ability to fully restore what was forfeited through excessive competition should be empirically demonstrated.

The problems Japan's modern economy is facing will not be solved if the avoidance of excessive competition is used as a pretext to curb market competition and to establish cartels. In fact, it will make solutions more difficult to achieve by restraining free competition and by holding back the creative endeavors of companies.

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