

# Two meanings of dynamic competition

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## **Introduction**

Today, as we celebrate the 75<sup>th</sup> anniversary of the Stafford Little Lecture F. A. Hayek delivered at Princeton University titled 'The meaning of competition', we have gathered an impressive group of talented speakers who have looked at Hayek's lecture from a contemporary perspective. In his lecture Hayek defined competition as 'a process which involves a continuous change in the data and whose significance must therefore be completely missed by any theory which treats these data as constant.'

By defining competition as a process where information is diffuse and thus conducive to an evolutionary discovery process, Hayek debunked the predominant idea of 'perfect competition'. This textbook form of competition, Hayek argued, is neither desirable nor workable. Hayek distinguished static competition, which builds upon the theoretical model of perfect competition, from a dynamic competition that builds upon the practical reality of imperfect competition in disequilibria. Competition, Hayek summed up, 'is by its nature a dynamic process whose essential characteristics are assumed away by the assumptions underlying static analysis.'

What have we learned from Hayek's seminal lecture, which was later published in *Individualism and Economic Order*? Are antitrust enforcers and judges adequately accounting for competition as a dynamic process rather than a static market rivalry?

I will argue that today's prevailing view of competition distorts Hayek's insights in a way that undermines rather than reinforces competition. The

modern approach to competition, illustrated by assertive antitrust enforcement across the Atlantic, does not refer to perfect competition. And yet, the analysis remains predominantly static. The modern approach does not ignore the role of innovation and non-price effects in competitive rivalry. And yet, the analysis fundamentally lacks a robust approach to innovation concerns. The modern approach does address competition as a process – the so-called ‘protection of the competitive process’ – to justify radical antitrust interventions and unbounded regulations. And yet, the analysis diametrically ignores the evolutionary nature of competition as a process.

Hayek distinguished between the two meanings of competition: static competition and the more appropriate dynamic competition. Seventy-five years on, we have before us two meanings of *dynamic* competition. The first and prevalent view of competition as a dynamic process aims at protecting competition as a process where a sufficient number of small competitors characterise an idealised market structure. In that regard, American Neo-Brandeisians and European Ordoliberalists share the view of competition as a dynamic process that can only be preserved if the state intervenes to preserve the market structure and guarantee the freedoms of less competitive rivals to continue operating in the market. The second (and genuine) view of competition as a dynamic process builds upon a Hayekian–Schumpeterian nexus where competition preserves the incentives for market actors to innovate since these incentives are the engine of competition.

I now intend to demonstrate how the approach to dynamic competition as a justification for preserving the market structure distorts rather than protects competition, as mainstream voices claim.

When Hayek delivered his lecture in 1946, he was a professor of economic science at the London School of Economics and had published, in 1944, his seminal book, *The Road to Serfdom*. To celebrate Hayek’s legacy in London about the adequate approach to the process of competition makes lots of sense. To celebrate it at the Institute of Economic Affairs is all the more relevant when we recognise the long-lasting relationship between Hayek and the Institute.

I am proud to have jointly organised the conference as the Schumpeter Project on Competition Policy of the Information Technology and Innovation Foundation. The aim of the conference is to rethink our approach to competition policy from an innovation perspective. I particularly thank

Victoria Hewson for helping to organise this timely conference. And this leads me to a preliminary remark before our inquiry on how today's notion of competition as a dynamic process is a travesty of the principles of dynamic competition.

### **The Hayekian–Schumpeterian nexus**

In his lecture, as in much of his work, Hayek carefully ignores the writings and research of another Austrian economist who pioneered the study of innovation – Joseph Schumpeter. However, in his lecture only, it is striking how Hayek advocates for a dynamic competition by debunking the notion of perfect competition in a remarkably similar way to Schumpeter without ever quoting, referencing or acknowledging the author of *Capitalism, Socialism, and Democracy*, published in 1942.

In his lecture, Hayek cites 'Toward a concept of workable competition' by John Maurice Clark, who magisterially criticised the very premises of the model of perfect competition, too often used by economists back then. Instead, Clark depicted the model of perfect competition as opposed to a workable competition where firms have market power and generate profits, and can therefore compete effectively. Clark (1940) argues that this model of workable competition should be the one relevant to government officials:

[Technical progress] would increase the number of industries which, despite large-scale production, have the characteristics of fairly healthy and workable imperfect competition, rather than those of slight-qualified monopoly. In such cases, one may hope that government need not assume the burden of doing something about every departure from the model of perfect competition.

Clark's insights constitute a formidable source of inspiration for Hayek's case against perfect competition as Hayek argues that:

[W]e should worry much less about whether competition in a given case is perfect and worry much more whether there is competition at all. What our theoretical models of separate industries conceal is that in practice a much bigger gulf divides competition from no competition than perfect from imperfect competition. Yet the current tendency in discussion is to be intolerant about the imperfections and to be silent about the prevention of competition.

Hayek rightly pointed out that the contradictions of the proponents of perfect competition ultimately made an ironic case for monopoly. Indeed, perfect competition suggests that the competing firms act in a monopoly-like manner since there will be no excess of supply. 'Enthusiasm for perfect competition in theory,' Hayek argues, 'and the support of monopoly in practice are indeed surprisingly often found to live together.' This illustrates the radical proposals of treating large firms as public utilities, thereby creating the monopolies these very proposals intend to tackle.

Hayek's case against perfect competition as both unworkable and undesirable markedly echoes the case made a few years earlier by Schumpeter (1942) in *Capitalism, Socialism, and Democracy*. Indeed, compare Hayek's stance that "'perfect" competition means indeed the absence of all competitive activities' with Schumpeter's argument that:

Perfect competition implies free entry into every industry... But perfectly free entry into a *new* field may make it impossible to enter it at all. The introduction of new methods of production and new commodities is hardly conceivable with perfect – and perfectly prompt – competition from the start. And this means that the bulk of what we call economic progress is incompatible with it. As a matter of fact, perfect competition is and always has been temporarily suspended whenever anything new is being introduced – automatically or by measures devised for the purpose – even in otherwise perfectly competitive conditions.

Both Hayek and Schumpeter debunk the case for perfect competition and argue that 'imperfect competition' allows for a dynamic competition which is the essence of the competitive process – namely, competition through innovation.

So, why did Hayek ignore Schumpeter's case for imperfect competition as instrumental to dynamic competition steering innovation? The complex relationship between Hayek and Schumpeter lies in Hayek's focus on dispersed knowledge as an alternative to the 'perfect knowledge' assumption implied in the perfect competition model. In comparison, Schumpeter emphasised the accumulation of knowledge as an essential part of distributional capacities necessary to turn inventions into innovations, thereby effectively enabling dynamic competition.

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Indeed, when Hayek describes the theoretical assumptions upon which perfect competition lies, he lists:

1. A homogenous commodity offered and demanded by a large number of relatively small sellers or buyers, none of whom expects to exercise by his action a perceptible influence on price.
2. Free entry into the market and absence of other restraints on the movement of prices and resources.
3. Complete knowledge of the relevant factors on the part of all participants in the market.

And Hayek considers the assumption of perfect knowledge as 'one of the most important of the points where the starting point of the theory of competitive equilibrium assumes away the main task which only the process of competition can solve.' In other words, while perfect competition assumes perfect knowledge, therefore potentially leading to a situation of perfect competition tolerating monopolistic situations where the monopolist acts as a central planner, imperfect competition (or dynamic competition) presupposes dispersed knowledge through a decentralised market structure.

The Hayekian view of dynamic competition as a discovery process (i.e. an opinion-formation endeavour between firms of roughly equal size) distinguishes this Hayekian view of dynamic competition from the Schumpeterian view of dynamic competition where innovation capabilities build upon the ability to accumulate and process information into efficient facilities. In other words, while Hayek posits that dispersed knowledge is essential to dynamic competition, Schumpeter argues that the appropriability of knowledge makes dynamic competition effective. Although they disagreed on the assumptions of perfect competition and rejected the static analysis of competition, Hayek meticulously rejected Schumpeter's idea of imperfect competition as epitomised by the dynamic competition exerted by large-scale companies capable of producing the so-called 'gales of creative destruction' – namely, of innovating. On the other hand, Schumpeter grasped the efficiency and innovation logic underlying some large business entities:

[P]erfect competition is not only impossible but inferior, and has no title to being set up as a model of ideal efficiency. Hence, it is a mistake to base the theory of government regulation of industry on the principle that big business should be made to work as the

respective industry would work in perfect competition. And socialists should rely for their criticisms on the virtues of a socialist economy rather than those of the competitive model.

Regardless, the Hayekian–Schumpeterian nexus of debunking perfect competition as a theoretical model justifying government interventions whenever market reality departs from this textbook fiction remains powerful and instructional. Hayek focused on dynamic competition as characterising a desirable dispersion of knowledge. In contrast, Schumpeter focused on the need for dynamic competition as essential to the process of innovation which characterises the capitalist society. Unfortunately, Hayek’s focus on dispersed knowledge and suspicion of large-scale companies may lead today’s radical antitrust advocates to inaptly appropriate Hayek’s view as justification for radical government intervention. This was illustrated in 2018 when Lina Khan, the ‘Neo-Brandeisian’ chair of the Federal Trade Commission, inappropriately referred to Hayek to justify the break-up of companies and the aggressive fight against ‘monopolies’.<sup>1</sup>

Despite both advocating for a dynamic view of competition over a static view of competition as dominated by perfect competition models, Hayek and Schumpeter mostly disagreed on major aspects of competition. We can briefly summarise these as follows:

- *Bigness*: Hayek favoured smallness over bigness as he did not perceive the necessity of scale as part of the process of innovation. Schumpeter considered that the figure of the entrepreneur as not only inventor but, most importantly, innovator within large-scale facilities enabling innovation through the exercise of market power.
- *Incentives*: Hayek considered that uncertainty was the main driver of innovation and characterised competition as a discovery procedure. Schumpeter considered that certainty – the ability to extract rents and the thirst to enjoy temporarily monopolistic positions – was the main driver for entrepreneurs to innovate.
- *Structure*: Hayek considered that competition cannot exist unless enough firms are present in the market. Schumpeter considered that market structure is irrelevant since a single firm can still compete and innovate as long as the threat of entry through potential competition remains a credible threat.

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1 See <https://www.c-span.org/video/?445473-9/yelp-conference-antitrust-law-technology-panel-2> at 28 min.

- *Law:* Hayek considered that antitrust laws could and should ensure that the process of competition remains vivid. Schumpeter considered that antitrust laws are most likely to punish innovation efforts mischaracterised as ‘monopolistic practices’.

While Hayek retained a view of the markets idealised as an information-sharing/spreading mechanism, Schumpeter entered into the black box of the firm to understand and account for the incentives of the entrepreneur depicted as the hero of innovation, the disruptive force of capitalism that drives economic growth through market power (at the microeconomic level) and generates the economic disequilibria that are needed (at the macroeconomic level).

In short, Hayek perceived dynamic competition as a discovery process. Schumpeter perceived dynamic competition as a disruptive process. Both emphasised the evolutionary nature of competition, with Schumpeter making innovation an essential component of this evolution and Hayek making knowledge an essential component of this evolution. Both agreed on the time-dimension of assessing competition dynamically. None accepted the assumptions and relevance of static, price-exclusive competition.

Indeed, the Hayekian–Schumpeterian nexus emphasises that competition is a dynamic process where an evolutionary rivalry enables market forces to generate transitory equilibria, fostering innovation and dispersion of knowledge in society. Nevertheless, this nexus is currently contested by radical reformers of antitrust policy – the American Neo-Brandeisians and the European Ordoliberalists. They embrace the rhetoric of dynamic competition to advance a return to static analysis. Unfortunately, however, we live in an age of creative destruction as prophesied by Schumpeter and in an age of impossible central planning given informational constraints as prophesied by Hayek. Never has the Hayekian–Schumpeterian nexus been as relevant as today, and yet never have antitrust radicals and government officials been as keen to resort to the concept of dynamic competition in a way that betrays the notion of competition as an evolutionary process made possible by the entrepreneurial spirit.

### ***Competition as a dynamic process under perfect competition***

Perfect competition is back – surreptitiously for now, but back in mainstream economics and government enforcement. Indeed, under cover of the language of perfect competition, the return to old antitrust enforcement

– be it through a so-called Neo-Brandeisian or an Ordoliberal label – claims that markets are imperfectly working because of the presence of large business entities which monopolise markets.

The plan is to break up large companies, prohibit mergers, regulate large business entities like public utilities and reinstate government-run monopolies whenever possible. Free market ideas are not jettisoned. They are blatantly ignored. Rather, bills and proposed regulations aim to tame free markets and disrupt innovations whenever powerful incumbents can effectively capture the regulator with the help of populist anger over success.

Basing the current powerful assault on free markets and business success on claimed free-market principles is duplicitous! Because we believe in free markets, the proponents unashamedly argue, we need regulations, and we need to break up companies into pieces (or prevent them from merging) so that markets can become free again.

Free markets, for them, mean free competition, which itself means free entry and free exit – in other words, the opposite of any contractual arrangements since such arrangements inherently restrain trade and competition. Free competition is the cousin of perfect competition where market exchanges mystically take place without contractual restraints. It is a market without contracts, exchanges without well-defined property rights, since contracts are unacceptable restraints of trade and property rights are monopolistic claims and barriers to innovation.

The proponents of ‘reinvigorating’ antitrust laws essentially argue not only that large companies prevent smaller companies from competing but also that these large companies may inevitably become larger given the network effects inherent in the digital economy and that are overly prevalent in today’s economies. To protect the competitive process, firms of roughly equivalent size should compete against one another; otherwise, the market would ‘tip’ towards one or a few companies. These market-tipping allegations – meaning nothing but a looser notion of no-fault monopoly or even the mere fear of future monopolisation – justify preventative measures aimed at downsizing the large and artificially protecting the small.

Rather than seeing competition as a discovery process, let alone as a disruptive process, the radical proponents of this kind of dynamic competition advocate preserving the market structure where monopolies are avoided in the first place. Still, even oligopolistic markets should not emerge under



any circumstances. Irrespective of the competitive rivalry present in monopolistic or oligopolistic markets, they intend to reach this idealised market structure of perfect competition without the name. They intend to promote an atomised market structure in which no firm can effectively outcompete its competitors (i.e. effective prevention of oligopolistic or monopolistic structure of the market) under the misleading moniker of dynamic competition.

This return to a structuralist yet flawed vision of competition (and correspondingly of aggressive antitrust interventions) is based on a misguided view of dynamic competition. Since perfect competition has no legitimacy in rational economic decision-making, they tend to defend dynamic competition under an equally flawed market structure that prevents market tipping and its 'gatekeepers' from ever coming to the fore.

To advocate for a return to the outdated view of a structuralist approach to competition according to which competition only exists if small and atomised firms populate the market, these radical advocates needed to provide a pretense of science for their view of dynamic competition – or, at least, an objective standard of antitrust analysis. This was only possible after chastising the consumer welfare standard as providing support for an economically static analysis of antitrust laws. In other words, these advocates argued – convincingly to some – that because the consumer welfare standard may allow too many behaviours to go unpunished, it must be that the consumer welfare standard insufficiently accounts for dynamic competition. Harms to dynamic competition – or 'harm to innovation' – remain under the radar of antitrust authorities who operate under the consumer welfare standard, the argument goes. Consequently, disparaging the consumer welfare standard as an ill-suited antitrust enforcement tool and advocating for the protection of any firm's ability to compete and innovate on the market, these radical advocates end up defending speculative counterfactuals as part of their defence of 'the competitive process'.

How can it not harm innovation when a large firm can innovate at a greater pace than smaller firms, thereby preventing the latter from enjoying the expected benefits of their innovation efforts? How can it not violate the competitive process when large firms with massive research capabilities disrupt competitors and kick them out of the market, thereby preventing less efficient rivals from innovating and competing due to cut-throat competition? The excess of innovation and competition capabilities of some superstar firms prevent sluggish rivals from innovating. These are

the unconvincing harms to competition the new prophets of dynamic competition aim at protecting us from. The welfare of the consumers, let alone the competitiveness of the overall economy driven by superstar firms and by gales of creative destruction, is utterly ignored for the sake of protecting the dynamic process of competition understood as an Ordoliberal version of every firm's ability to operate in the market as part of an absolute freedom (i.e. a legal entitlement) to twist the evolutionary process of competition to their advantage.

Antitrust radicals do not want more competition: they aspire to less competition. Contrary to their promise to 'reinvigorate' antitrust and boost competition, they lament the excess of competition whenever such excess takes the form of disruptive innovation.

According to the antitrust radicals, the evolutionary process of competition is better guaranteed whenever the government intervenes to ensure that every firm has an equal right and ability to compete and innovate in the market. In other words, disruptive innovation by one or a few players may considerably distort the market structure so that the competitive process becomes irremediably distorted unless the government intervenes.

This leads us to the third and fundamental aspect of the misguided construction of dynamic competition by antitrust radicals under the guise of protecting the competitive process. This aspect relates to the need for early and timely government intervention in the market. Otherwise, irreparable harms would irremediably unfold. To dynamically protect competition, antitrust radicals suggest that incipient doctrines and other preventative measures are necessary to avoid the very emergence of anticompetitive conduct in the first place. This philosophical underpinning of government interventions as early as possible to prevent harm to competition from arising subsequently directly applies essential elements of the precautionary principle.

In what I describe as 'precautionary antitrust', antitrust advocates recommend antitrust authorities intervene before monopolies or any anti-competitive conduct arise only for the hypothetical harm to the market structure understood as reduced consumer choices and reduced abilities for sluggish firms to innovate. To protect dynamic competition, antitrust radicals are ready to declare the end of antitrust with regulation. Antitrust radicals advocate moving away from antitrust's long judicially enforced rules by taking antitrust away from the courts.

In an unashamed weakening of the rule of law and a disregard of the virtues of the judicial process as an essential part of the Common law, they support a revolutionary shift from ex post antitrust enforcement to ex ante regulatory intervention. This shift surreptitiously embeds the precautionary principle in antitrust matters as it is positively biased in favour of precaution and the preservation of the status quo of the market structure and negatively biased against disruption and radical changes of the market structure. Moreover, because alleged harms to the consumer are too time-consuming and require a too high evidentiary threshold to investigate, precautionary antitrust recommends government intervention without evidence of any harm but merely a hypothetical risk of damage.

Consequently, de facto prohibition of mergers, regulation by size, the break-up of companies, interim measures and other regulatory obligations are imposed despite the innocuous nature of the practices subject to these stringent prohibitions. The precautionary logic enters the regulation of competition by arguing dynamic concerns.

With precautionary antitrust, officials err on the side of false positives rather than false negatives: they prefer caution, notwithstanding its costs to innovation, over disruption. In a society driven by rent-seeking activities through judicial and legislative processes, complainants about disruptors are the most vocal. They can effectively capture the regulator who internalises the political, judicial and economic costs of civilian conflicts among market actors.

Precautionary antitrust acquires its coercive power by stealth under the moniker of dynamic competition, although its existence and consequences are antinomic to the dynamic process of competition as protective of incentives to innovate. This is the true meaning of dynamic competition we now turn to as it has been distorted by influential actors after having been historically ignored.

### ***Competition as a dynamic process under evolutionary competition***

The fervour of protection of the dynamic competition process under assumptions of perfect competition remains a travesty of the very essence of competition as both a discovery process and a disruptive process under the Hayekian–Schumpeterian nexus. To alter the working of market forces to advantage smaller, less efficient firms because they would supposedly be entitled to survive in the marketplace irrespective of changing

circumstances represents a weakening of competition rather than a reinvigoration. The incentives to innovate as a way of outcompeting rivals indeed inevitably diminish since rent-seeking activities from influential rivals weaponising antitrust and competition rules will deplete the entrepreneurial rents expected from innovation and competition.

Due to regulatory capture of government officials acting to 'preserve' the competitive process while undermining this very process, the current meaning of dynamic competition employed by antitrust radicals provides no adequate account of dynamic competition as an inherently evolutionary process that is antithetical to the assumptions of perfect competition. Indeed, dynamic competition, as opposed to static competition, suggests that entrepreneurs build up dynamic capabilities enabling them to generate, use and leverage market power so that the entrepreneurial rents hoped for can be appropriated in a process conducive to both innovative outcomes and competitive rivalry. And yet, antitrust radicals refer to dynamic competition while replicating the undesirable and unrealistic assumptions underlying perfect competition.

Genuine dynamic competition understands that perfect competition is the enemy of good competition: it represents the absence of competition where value appropriation through contracting and integration is impossible. However, value appropriation (or asset appropriability) is essential to innovation. This innovation process represents itself the main route for robust competition where rivals compete through particular knowledge. Moreover, such knowledge becomes used in a disruptive manner so that competition takes place not merely as an imitation game or a marginalist tit-for-tat game with rivals but rather as a radically disruptive (i.e. unexpectedly novel) way of competing.

Within this framework of dynamic competition through innovation, innovation is not only a positive side-effect of the competitive process – a claim that antitrust radicals would readily agree with – but most importantly, innovation represents the source of competition – a claim that antitrust radicals are keen to overlook.

Moreover, dynamic competition serves consumers. In that regard, dynamic competition fits within the consumer welfare standard. However, rather than being the endpoint, the consumer welfare standard constitutes the starting point of the antitrust analysis: in other words, a practice that does not hurt but benefits consumers cannot be in opposition to the dynamics

of competition. However, a practice that does not immediately benefit consumers may contribute to dynamic competition, as it may be instrumental in building up the necessary dynamic capabilities for further competition. For instance, if a firm wants to increase its price to subsidise research and development expenditures to advance breakthrough research or enter new markets dominated by capital-intensive technologies, consumers may not immediately benefit from these price increases. Nevertheless, the company's likelihood of generating innovation and to subsequently exert further competitive constraints on incumbents in other markets will inevitably lead to consumer benefits.

Contractual restraints such as protecting intellectual property rights and securing vertical integration for minimising uncertainty costs may generate considerable competitive benefits rather than being anti-competitive. Whenever we err in equating any contractual restraint as anti-competitive conduct, we may generate unintended consequences where the most aggressive rivals are punished for disrupting the status quo. In contrast, restful rivals are rewarded with the status quo.

Against that background, the principles of dynamic competition would underlie that dynamic efficiency as the ability of the market to go from one equilibrium to another should constitute a fundamental objective of antitrust authorities.

### ***Toward dynamic antitrust: meaningful competition***

I started this discussion by inquiring what we have learned from Hayek's lecture on the meaning of competition specifically and what we have learned from Hayek in general. The answer is that, together with Schumpeter, we learned from Hayek that perfect competition represented by static antitrust analysis does not constitute a valid and legitimate account of the process of competition.

But we have learned it too well: opponents of the true dynamic process of competition have dumped any reference to perfect competition and embraced the notion of dynamic competition in a twisted way to advance their radical agenda of preserving the structure of the market in an effort to achieve an idealised vision of perfect competition in disguise. As perfect competition is meaningless, since it represents the absence of competition and is both impracticable and undesirable, the notion of dynamic competition as an instrument to secure a given market structure is equally meaningless. Dynamic competition takes place irrespective of market structure and

irrespective of the size of companies. The only relevant metric remains the ability of firms to disrupt the status quo to compete through innovation for the benefit of both consumers and the overall productivity of the economy.

Rather than a meaningless and erroneous vision of dynamic competition as a Trojan horse to a structuralist return to outdated visions of competition, we have outlined the need to support meaningful competition, i.e. competition on merit, where the merits are innovation and disruptive competition. These are the principles of what we call 'dynamic antitrust' that government officials and intellectuals need to not only grasp but implement and advocate. Otherwise, a precautionary, risk-averse vision of dynamic competition would inevitably lead to preserving market structure at the expense of the dynamism of the market economy, however increasingly characterised by rapidly changing business environments.

Radical advocates such as the American Neo-Brandeisians and the European Ordoliberalists, together with their distorted account of dynamic competition, need to face robust resistance; otherwise, instead of promoting true competition, the structuralist idea of protecting competitors will gain, covertly yet rampantly, ascendancy and remain dominant for a long time, generating in its wake a host of long-lasting unintended consequences. We need principles of dynamic antitrust based on the rule of law where legal certainty matters as a driver to innovation for entrepreneurs. Also, a generalised rule of reason better accounts for ex post antitrust enforcement than the blanket prohibitions of precautionary antitrust. Finally, we need principles of dynamic antitrust which fully recognise the entrepreneurial spirit of competing through innovation. Otherwise, radical reforms will substitute the entrepreneurial spirit of competition through innovation with the bureaucrat's spirit of competition through regulation.

Hayek helped us debunk perfect competition. We now need to debunk the misguided view of dynamic competition and travel the road of dynamic antitrust with governance principles conducive to economic growth, shared prosperity and disruptive innovation for the benefit of consumers and collective competitiveness.

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