



Are Tesco acting competitively?

A submission to the Competition Commission's investigation into the groceries market

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Executive Summary

Now that Tesco's market share of the UK grocery industry has risen above 25%, it has become a target on two fronts. Firstly, regulatory bodies such as the Competition Commission can define it as a monopoly, providing an economic justification for blocking future acquisitions and intervening in current operations. Secondly, the general public have begun to send mixed messages by remaining as customers whilst sympathising with fears about the company's growth and ubiquity.

Both lines of attack stem from the same root cause: a theoretical misunderstanding over economic terms such as "monopoly" and "competition". This report outlines the historical context of economic thinking, and demonstrates why Tesco's current problems are the consequence of a faulty mindset. With a proper definition of competitive behaviour, the activities of Tesco are clearly benefiting consumers.

The current regulatory predicament is a consequence of textbook economics

"The question of undue monopoly power in the supply chain is undoubtedly a real issue, which competition authorities could address, along with other policy instruments"

Peter Mandelson, 27th February 2006

When any single firm accounts for more than 25% of a given market, the Office of Fair Trading (OFT) is able to define it as "a monopoly" and intervene into the decisions and actions of the firm's management. The theoretical explanation for why this is deemed necessary -- and also the public support to provide its legitimacy -- comes straight from the textbook economics that outlined the societal welfare costs of a monopoly.

Under highly stylised conditions (of perfect information, infinite buyers and sellers, product homogenisation, and costless entry and exit) the *price* of a good reflects the cost of producing *one extra unit* - or what economists call "marginal cost pricing".

If the firm sold anymore then the cost of making the extra goods would exceed the price they receive, and therefore they'd start to lose money.

As the diagram below shows, optimum output is where marginal revenue (the price per item) equals the marginal cost. This is deemed efficient in two respects - allocative efficiency (since price is equal to marginal cost and hence available to the consumer at the lowest possible price) and productively efficient (the firm is producing on the lowest possible average cost curve (AC)).

This is contrasted with a monopoly whose position of market power makes them a price-setter (as opposed to a price-taker), and the demand curve they face is downward sloping, rather than horizontal. Consequently they produce at a price higher than under perfect competition (at P_m rather than P_c), sell a lower quantity (Q_m rather than Q_c), and create dead weight loss - potentially gainful trades that

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just aren't realised. The shaded region shows the "monopoly" profits, and under these conditions social welfare is lower than under perfect competition, and so - as the story goes - there's a role for government intervention to "correct" the market failure.

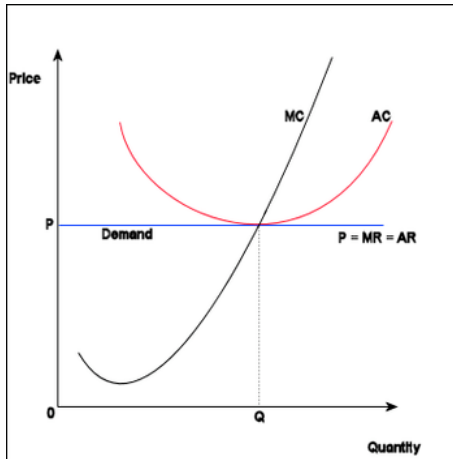


Figure 1: Neoclassical Perfect Competition
Source: Wikipedia

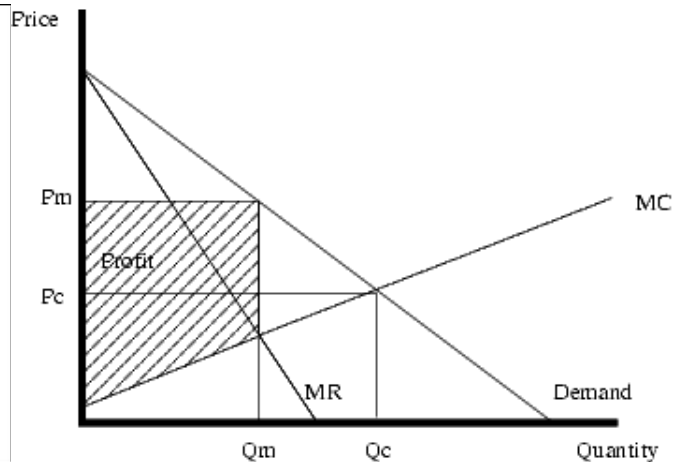


Figure 2: Neoclassical Monopoly
Source: Wikipedia

Are Chairman Mao jackets "perfect"?

Several immediate points should raise suspicion, chiefly an application to real life. Under the above classifications the "perfect" market for jackets is one in which everyone is faced with the exact same product - same colour, same size, same fabric. Moreover, the consumer would be declared worse off should they start to have a choice between other colours, sizes and fabrics. A short walk around Communist China in many ways fits the conditions of perfect competition, whereas a snapshot of the hustle and bustle of Hong Kong would be labelled monopolistic. Does this make sense?

If the supermarket industry were perfectly competitive, consumers would have no preference between Tesco, Sainsbury's, Asda, Somerfield, or Waitrose - each store would be identical in terms of product range and ambience. The single mother who needs a trolley full of affordable staple goods, and the childless young couple who want ethnic cuisine, would no longer find stores that cater to their

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specific demands. Instead, homogenous buildings would make customer loyalty irrelevant.

In such a state - the one which the OFT label "perfect" - there would be no competition as we know it. No innovation, no choice, and no incentive for firms to make profits.

Do "monopolies" do what we fear they'll do?

The argument against monopolies boils down to power, and customer's fears that such power will be exploited to raise prices and reduce the availability of products - it is these two factors that drive the conclusion that monopolies reduce social welfare. But the political fears that Tesco's thirst for *low* prices harms their suppliers, and also that they are selling too *much*, highlights a glaring inconsistency in orthodox reasoning. On the one hand Tesco are punished for selling not enough products at too high a price (since they're "a monopoly"), and on the other they're accused of not producing *enough* add on value (to pass through to their suppliers) and are building *too many* new stores.

Even within the neoclassical framework, however, theoretical faults emerge with the perfect competition model. The condition that *there are many buyers and sellers* is challenged with the case of Bertrand Competition - a set of conditions that shows how just *two* non-collusive firms can produce the results consistent with marginal cost pricing.

A consistent approach would be to realise that competition is a discovery process and not a static description of current market conditions. In other words, it should be a definition applied to a type of activity (and how that activity operates over time), rather than a set of objectively defined characteristics.

Competition as a social process: why the customer is sovereign - even with Tesco

The preferences of Tesco management - the size of store they'd prefer to manage, the type of work force they employ, the suppliers they utilise, the promotions they create - are irrelevant in a market economy. Every individual customer is the true decision maker, since it

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is his or her preferences and actions that dictate how Tesco will respond. The infinite wants of each customer are represented by their most pressing needs, and all Tesco can do is create a production structure that serves them as effectively as possible.

On monopoly

The economic problem is scarcity, and since it will always exist there will always be consumers with unmet needs - constant pressure for new ways of producing and delivering products. No system, let alone an individual firm, could possibly satiate the demands of consumers.

As Ludwig von Mises pointed out in *Human Action*, there are two types of monopoly, and neoclassical thinking confuses the two. The first is *exclusive control of the vital conditions of human survival*, and refers to a monopolist who can inflict harm upon those who do not follow their orders. Such a monopolist is wholly irreconcilable with a market economy since it eradicates the option for someone to abstain from participation. If this type of monopolist exists, traditional legal channels exist to punish them.

The second type is *exclusive control of the supply of a definite commodity* and is indeed consistent with a market economy. But this only leads to how we define the commodity - surely every firm has exclusive control of their own products?

Which product?

Not only is it hard to define the *market* within which a firm operates, but it's not at all clear how to objectively define the *product*. If monopoly means "single-seller", then it's the aim (and accomplishment) of every firm to achieve this state. The whole *point* of a market economy is to provide consumer choice, and therefore a unique product. Poets hold a monopoly over their poems, but this doesn't give them an advantage over the market as whole.

For every given market, every firm within it is a monopolist with regard to their own product.

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Leaving aside the financial services, petrol stations and other non-grocery products that Tesco provide, even within the grocery sector their range of different types of store makes it hard to define what specific product they provide. A city-centre or rural Tesco Express provides a different service than a Tesco Extra - the former is a convenience store with essential products, the latter are out-of-town hypermarkets combining a wider stock of foodstuffs together with clothing, home ware and larger electrical appliances. Modern firms are complex organisations that differ along many margins, margins that make each one their own monopoly, and make larger ones a *variety* of products so intricate it becomes impossible to lump them all within one category.

Which market?

The OFT definition of monopoly - 25% of market share - is entirely arbitrary. Not only is there no economic justification for that specific figure, but also there is no objective definition of what constitutes "the market". If we define Tesco as a grocery company, then their competitors include other supermarkets, corner shops, farm shops, petrol stations, and even home allotments. The range of products sold by Tesco extends their competitors to other florists (both at home and abroad), newsagents, department stores and garden centres. The rise of internet shopping makes the market in which Tesco operate a global one - white goods must compete with all other firms that will ship to the UK, and their financial services compete internationally. The "exponential" growth of Tesco is also exponentially growing the markets in which they operate. Ultimately, since resources are scarce, every commodity competes with all other commodities.

"Some sixty years ago people used to declare: You cannot compete with the railroad companies; it is impossible to challenge their position by starting competing lines; in the field of land transportation there is no longer competition... [But] The bigness and the economic "power" of the railroad companies did not impede the emergence of the motor car and the plane"

Mises (1949(1963)) p.275

The steel needed by Tesco to build new stores is also needed by Ford to make new cars. The electricity with which to power those store must be bought for a price that reflects the demands of all other industries, and all households. Therefore, every new store being built not only suggests that consumers value a new Tesco's more than a new Sainsbury's, but that consumers value a new Tesco's over *all other possible uses* of the materials and labour required to build it.

Growth is a sign of efficiency, not of inefficiency

"To assign everybody his proper place in society is the task of the consumers. Their buying and abstention from buying is instrumental in determining each individual's social position. Their supremacy is not impaired by any privileges granted to the individuals qua producers. Entrance into a definite branch of industry is virtually free to newcomers only as far as the newcomers succeed in supplanting those already occupied in it by filling better or more cheaply the demands of the consumers. If the existing plants are sufficient, it would be wasteful to invest more capital in the same industry. The structure of market prices pushes the new investors into other branches."

Mises (1949(1963)) p.275

If a firm acquires enough capital to fund an expansion of their activities there are two factors at work. The availability of funds for reinvestment signals that the firm is operating efficiently, and producing economic gains - if they're selling things for more than they're paying for it then value is being added to the economy and everyone wins. Also, if they can make more profit from expansion than from investing the capital into an infinite number of alternative uses, it suggests that the present size of the operation is too small - as it grows, it becomes increasingly efficient. As long as suppliers are free to stop supplying, and buyers are free to stop buying, there is no objective size at which the firm becomes inefficient. On the contrary, the more profitable it is, the more efficient it's becoming.

It is imperative to understand the relationship between consumers and firm, and that the former control the latter. A firm can only ever respond to the demands of their customers, and can never create that demand. They may well devise a brand new product but this is merely an anticipation of hitherto unknown desires. A firm can pre-empt demand, but the results will *always* remain subjected to the preferences of their consumers.

Of the two types of monopoly that people refer to, therefore, one does not exist and the other is ubiquitous. Neither, therefore, constitutes grounds for state intervention.

Defining competition: from *concentration* to *contestability*

Despite its importance the term "competition" had been used by economists for well over a century with barely a thought - it meant exactly the same as it did in common discourse. It was shared by both the classical economists and businessmen, and meant *the process of outdoing ones rivals*. The term simply meant the way in which we see sports, but rephrased within economic language: the acquisition of scarce resources, trade or methods that creates contest between those with similar desires.

"There was no difference in this respect between economic competition and athletic competition. In both cases, competition was treated as a process by which competitors sought to gain an advantage over their competitors. Competition was a continuing, ceaseless activity and not some static state of affairs."

Wagner (2001)

In the march toward increasing formalisation John Stuart Mill's comment that *"only through the principle of competition has political economy any pretension to the character of a science"* took increasing significance. Competition became the strict theoretical assumption of a horizontal demand curve, and a distinction emerged between: *"Competition as a market structure and competition as a behavioural activity"* (McNulty 1968)

This disjoint was highlighted by Wagner in explanation for why da Empoli's 1931 book *Theory of Economic Equilibrium* received radically different reviews:

"The authors described in the Years of High Theory were pursuing a program dedicated to a static, structural treatment of competition as an adjective. In contrast, da Empoli's book ... represented an effort to treat competition as a rivalrous process, as a verb and not an adjective."

Wagner (2001)

A "competitive market structure", is a different theoretical term than a "competitive market". The OFT try to promote the former, whereas the public - surely - really want the latter.

Some economists define a competitive market not as containing perfect competition characteristics, but one that is *contestable*. Providing new entrants are able to challenge for the profits being generated by incumbents, the market is competitive. Since the barriers to entry and exit are the solve province of government regulations, their only responsibility in providing a "competitive market" is refraining from restrictions on businesses. In fact regulations can be counter productive since they raise the cost of doing business, offering an advantage to existing firms, or larger ones who can afford legal advice and regulatory expertise.

The definition of competition as contestability can even be extended to a situation where just one firm exists. Providing a rival could *potentially* enter the market (which they'd only do if they were confident of making a profit), the market is contestable. Where they to stay out then the message is clear - consumers are getting the best deal possible.

Allaying consumer fears of a monopoly: exposing vested interests and confronting economic ignorance

The attack on Tesco comes from two distinct (yet related) sources: the vested interests of rival producers - who exploit economic theory, and apprehensive consumers - who don't understand it.

Much of our fear over monopoly strength stems from Marx's critique of capitalism, and his assertion that modern capitalism creates a natural tendency toward increasing concentrations of capital. This claim has been proven wrong, however, because natural proclivities for firms to grow (such as economies of scale) are offset by other forces that limit growth (such as managerial capabilities).

There's enough theoretical evidence - summarised in the sections above, and presented in the references below - to show that criticisms of Tesco are not based on logic. Bad economics is being used as a crutch with which to object to the growth rate and profitability of Tesco, and it should be kicked away. The complaints are really a discussion of individual taste, and the desire for some groups to use the state as a vehicle with which to subject others to their own desires. This is paid for by competing businesses that'd rather spend their resources on lobbying government, than providing a better product. Their strategy is to convince us that *Tesco* are bad, rather than that *they* are good - and this is the truly anti-competitive situation.

Competition is the striving to outdo ones rivals by providing a better option, not using the law to hobble them. Football coaches should try to improve their teams, rather than undermine their opponents, and it's the same situation here. Consequently the anti-Tesco argument has nothing to do with Tesco per se - it is merely the tallest Poppy and a convenient focal point for the broader issue of modernity and consumerism. In other words, the campaigners don't have a problem with Tesco, they have a problem with Tesco's customers.

The campaign against Tesco is really a complaint against Tesco's customers

"The market is a democratic institution aggregating the decisions of whomever participate in it. When all is said and done, complaints about the market are nothing but complaints about the people themselves..."

Paul Piccone

It's important for consumers to realise that the OFT is not merely being lobbied by concerned consumers, but by also by Tesco's competitors. There are two roots to making profits: Providing a lower price or higher quality than your competitors; or lobbying government to give you a subsidy or to tax your competitors. The truly anti-competitive situation is when the arena switches from superstore shelves to political debating rooms.

The reward of profits then shifts away from those firms that can satisfy the pressing needs of voluntary consumers, to those best able to argue their case in Westminster. Firms must spend less on supplying a popular product, and more on hiring lawyers. Customer satisfaction no longer decides the company's fate - it's in the hands of argument, rhetoric and technical arguments.

What a newcomer who wants to defy the vested interests of the old established firms needs most is brains and ideas. If his project is fit to fill the most urgent of the unsatisfied needs of the consumers or to purvey them at a cheaper price than their old purveyors, he will succeed in spite of the much talked about bigness and power of the old firms.

Mises (1949(1963)) p.276

In the USA regulations now clearly target Wal-Mart and are mistakenly discussed and voted on as if they're the proposals of consumer groups. The funding inevitably comes from rival retailers and exposure of this damages the credibility of these campaigners.

Sir Terry Leahy's claim that UK customers currently have choice (since 90% have at least three alternative supermarkets nearby) won't convince someone who'd reply "Yes, but Tesco are one of those three

choices for every consumer, so at a national level they're a monopoly". But it would be convincing to someone who understands that each individual store must compete with at least 2 others, and must compete or die.

It is important not to slip into the OFT's classification of Tesco as a monolithic entity. The changes in supply chain (in response to the pressing needs of customers expressed through their purchasing habits) are the decisions of individuals - intrapreneurial managers who anticipate and respond to consumer demand. The legal entity of "Tesco" obscures the real decision making process within the firm, since we're talking about individual staff.

Confusing end states with procedures

The entire confusion about monopoly comes down to the history of economic thought. Neoclassical economics follows the river of Leon Walras, where a fictional auctioneer reconciles plans prior to trades taking place. This enables blackboard analysis to construct a supply and demand diagram, produce a shift in one of the curves, and then conclude that equilibrium A becomes equilibrium B. It is a useful teaching device, but unrealistic.

By contrast, Carl Menger - and his fellow Austrians - produced an alternative river that looks at processes, asking, "How does A become B?" Rather than an assumption that all preferences are known, and there's no false trading, Austrians assume that the preferences are unknown, and entrepreneurs exist to arbitrage. The market is therefore a learning device, and accumulates information (via the price system).

In fact, all economists agree that it is the search for profits that creates an efficient market, and therein lies the contradiction behind the traditional model of a monopoly. They try to graft the concept of "a competitive market" onto an observed market state, without realising that a competitive market can *only* arise as a spontaneous order. Each consumer has their own preferences, and firms must predict, pre-empt and respond to them as they can. Successful firms will prosper, and unsuccessful ones realise their talents lie elsewhere -

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all the while resources and customers move from inefficient providers to the efficient ones.

"I wish now to consider competition systematically as a procedure for discovering facts which, if the procedure did not exist, would remain unknown or at least would not be used."

Hayek (2002) p.9

This discovery process will be the outcome of competition - and a firm with a high market concentration may well emerge. If it does, then it is the efficient size for that industry and providing consumers with their best possible list of alternatives. Any government intervention done under the crutch of "competition" (a term the OFT do not define) is therefore the antithesis of what they're claiming - it takes the market away from its competitive outcome.

Tesco's market power

This whole debate is focused on the extent of market power Tesco possesses. It is an important (albeit subtle) point to realise, however, that Tesco *have never forced another firm to close down*. Instead, Tesco customers have chosen to frequent Tesco's rather than the alternatives, and since the alternatives have been unable to offer a better service their resources and capital are of greater use elsewhere.

Tesco have never sucked trade out of town centres - their customer's have voluntarily left in search of a better deal. No matter how unpalatable the results of supermarket competition appear, it is imperative to realise who the decision makers - and therefore the causes of these effects - really are. Consequently the OFT report is not an attack on Tesco, but on the preferences and rights of the 17 million customers who choose to pass through their doors.

Concluding remarks

The OFT uses the term "competition" as an adjective that labels the conditions of various market states. This is consistent with textbook

economics, but is a faulty (and retreating) type of economic reasoning. Increasingly the discipline is returning to the pre-c20th attention to processes, evolution and spontaneous order that used "competition" in the way the general public does.

Their theory is not only outdated but logically flawed, and this can be demonstrated with statistical measures that refute their predictions - (real) prices are falling and volume is increasing. The Austrian theory provides ammunition with which to confront the OFT and to provide academic confirmation.

It is also a means to reassure loyal customers that making a choice for the best retailer is not anti-competitive, but part of a competitive system! The rate of growth of a company is entirely constrained by their ability to keep customers coming through the door, and it is those very customers who will decide the future growth - and activities - of Tesco.

It's time to convince OFT that their theory is invalid (internally inconsistent) and unsound (wrong-headed), and to persuade consumers that their fears are misplaced. As long as they buy in accordance with their tastes, contestability will always ensure that they remain king.

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