A Theory of Yardstick Competition

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An Overview provided by Matt Shreeve and Emily Lai

Theory and Practice…

- Context
- Theory
- Practice
  - Benefits
  - Complications

How could a policy-maker deal with monopoly?
What’s wrong with monopolies?

- Price Maker $\Rightarrow$ Higher Price
- Lower output $\Rightarrow$ Allocative Inefficiency
- Example – Water distribution network
- Very large scale $\Rightarrow$ Economies of Scale
- Higher productive efficiency $\Rightarrow$ Consumers may benefit

Regulation is often used because monopoly power can be abused

Our distribution network…

- What can the regulator do?
- Cost-of-service regulation
- Lagged price adjustment
- Or…
Yardstick Competition

- **Why?** To provide an incentive to firms to reduce costs
- **How?** By creating an element of competition between these monopolies
- **Is this good?** In equilibrium each firm chooses a socially efficient level of cost reduction

Yardstick competition in practice

Assume identical firms – i.e. identical costs
C cuts costs by 50%, e.g. technological innovation

Price/Cost

Regulator sets price P1
Regulator re-calculates price

Average decreases to P2, and A, B & D make losses
Incentive for them to cut costs ⇒ consumer benefits

Yardstick Competition Among Identical Firms

- Take Cost levels of identical firms…
- To Set the Price Rule
  - Inefficient cost choice ⇒ ?
  - Bankruptcy
Yardstick Competition In Alternative Environments

- Average Cost Pricing
- “Reduced-form” Regulation

Average Cost Pricing

- Price = AVG (Other Benchmarked Firms)
- Price is independent of individual cost
- Costs set by the other firms can be achieved
“Reduced-form” Regulation

- Yardstick Competition requires identical groups
- No identical twins?
- Can Correct for the heterogeneity. How?
  - Regression of costs

Potential Limitation

- Participating firm’s Collusive manipulation.
- Role of the regulator
  - Cost Intervention
Yardstick Competition is ....

An adaptive regulatory tool to reduce costs for franchised monopolies by inducing comparative competition.

- Thank You! -