

# Relaxing Competition through Product Innovation

Jan Boone, Erik Brouwer, Lapo Filistrucchi and Henry van der Wiel

We study the relation between competition and innovation. Using firm level data for the period 1993-2006 from Statistics Netherlands, we first estimate the elasticity of each firm's profits with respect to its costs to measure the degree of competition each firm faces, as proposed by Boone(2008). We then use the estimated profit elasticity to explain firms innovation activity. Our results provide empirical evidence for the claim that more competition leads to more innovation but that firms innovate to release competitive pressure. We find instead no evidence of an inverse U-shaped relationship between competition and innovation.

Keywords: competition, innovation, product differentiation

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