Concentration ratios and the herfindahl-hirshman index (hhi)

[Finance]

Market concentration can be defined as the accumulated market shares of companies that will display the scope of how much of the supply of the product is held by the largest business entities. In this regard, there are two significant types of concentration ratios that are utilized at present: concentration ratios and the Herfindahl-Hirschmann Index. Concentration ratios gauge the scope of the market that a particular number of companies possess, specifically the top two four or eight companies.

In essence, these are economic instruments that are used to measure the amount of competition in a particular industry (Jonathan Jacobson, American Bar Association, 2007). The most commonly used concentration ratio is the four firm concentration ratio. This concentration ratio as the portion of the output of one industry that is sold by the four largest companies in that sector. If the industry analysis displays a ratio of 40 percent, then the industry is considered to be competitive. In this view, the degree of competition can be construed in the level of the ratio.

If the ratio is low, then the industry is competitive; if the ratio is high, then the sector is described either to be oligopolistic or monopolistic. The Herfindahl-Hirschmann Index (HHI) calculates the concentration ratios by squaring the market portion of the fifty largest companies in the sector, with the formula as follows: HHI = s12 + s22 + s32 + ... + sn2 where the sn value to be established as the market share of the last firm (Investopedia, 2010).

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