Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.1 Competition and Market Power

4.1.2 Barriers to entry

Notes

Contestability, ease of entry and barriers to entry:

Characteristics of contestable markets:

- Contestable markets face actual and potential competition.
- Entrants to contestable markets have free access to production techniques and technology.
- There are no significant entry or exit barriers to the industry. For example, there will be no sunk costs in a contestable market.
- There is low consumer loyalty.
- The number of firms in the market varies.

Implications of contestable markets for the behaviour of firms:

- If markets are contestable, firms are more likely to be allocatively efficient. In the long run, firms operate at the bottom of the average cost curve. This makes them productively efficient.
- The threat of new entrants affects firms just as much as existing competitors. Due to the low barriers to entry which provide easy access to the market, firms are wary of new entrants entering the market, taking supernormal profits, and then leaving. This is also called hit-and-run competition.
- Markets which are highly contestable are akin to a perfectly competitive market. This is because existing firms act as though there is a lot of competition.
- There could be supernormal profits in the short run and only normal profits in the long run. In the short run, new firms can enter and take advantage of the supernormal profits. However, in practice, firms can only earn normal profits in the short run. This is because it is the only way to prevent potential competition. Without supernormal profits, there is no incentive for new firms to enter, even if barriers to entry and exit are low.

Types of barrier to entry and exit:

- Barriers to entry aim to block new entrants to the market. it increases producer surplus and reduces contestability.

- The greater the **economies of scale** that a firm exploits, the less likely it is that a new firm will enter the market. This is because they would produce comparatively expensively, so they cannot compete.

- **Legal barriers** can act as a barrier to entry. For example, patents and exclusive rights to production (such as with television) mean other firms cannot enter the market. Some industries, such as the taxi industry, gain market licences to operate. Since new firms have to gain a licence, there is a barrier to entry.

- Consumer loyalty and **branding** can make a market less contestable. This is since demand becomes more price inelastic, and consumers are less likely to try other brands. Sometimes a brand can become associated with a product, such as 'Hoover' with vacuum cleaners.

- **Predatory pricing** involves firms setting low prices to drive out firms already in the industry. In the short run, it leads to them making losses. As firms leave, the remaining firms raise their prices slowly to regain their revenue. They price their goods and services below their average costs. This reduces contestability.

- **Limit pricing** discourages the entry of other firms. It ensures the price of a good is below that which a new firm entering the market would be able to sustain. Potential firms are therefore unable to compete with existing firms.

- Some firms might employ **anti-competitive practices,** such as refusing to supply retailers which stock competitors.

- **Vertical integration** means one firm gains control of more of the market, which creates a barrier to entry. It could result in one firm gaining **control of important technologies**, and they might prevent other firms gaining access to them.

- Firms might saturate the market with their goods using **brand proliferation.** This disguises consumers from the actual market concentration. For example, the many brands of the laundry soap market are provided by only a few large conglomerates.

- Barriers to exit prevent firms from leaving a market quickly and cheaply.

- They include the cost to **write off assets and pay leases.** Firms have to continue paying leases and contracts, even after closure. It could make it cheaper to stay in the industry than to leave. This makes the market less contestable.

- **Losing a brand** and consumer loyalty is hard to put a monetary value on, but is still considered a cost of leaving the market.

- **The cost of making workers redundant** might discourage firms from leaving an industry.

- For example, Amazon created barriers to entry by exploiting their workers and having exclusivity with the Kindle. They gained a large market share and a strong buying power. By lowering the price of the Kindle when it was launched, they made a loss in the short run, to increase their long run revenue.

- **Sunk costs and the degree of contestability:**

- There are different degrees of contestability across markets. All markets have the potential to be contestable, but it depends on what kind of costs firms face, and how loyal consumers are. No markets are perfectly contestable, markets generally have some degree of contestability.
- It is hard to judge the degree of contestability, since in reality there will be some costs to entry and exit.
- An application point of contestability could be the bus industry, which the government helps to make more contestable. Also, the budget airline industry could be seen as having some degree of contestability, if firms rent planes for a few years and then sell them. Ryanair entered the market cheaply by choosing less popular landing slots. In recessions, however, the market is less profitable.

- Sunk costs are a barrier to contestability.
- They are costs which cannot be recovered one they have been spent. For example, advertising incurs a sunk cost. A market with high sunk costs is less favourable to enter, because the risks associated with entering the market are high.
- High sunk costs are likely to push a market towards a price and output that is similar to a monopoly.

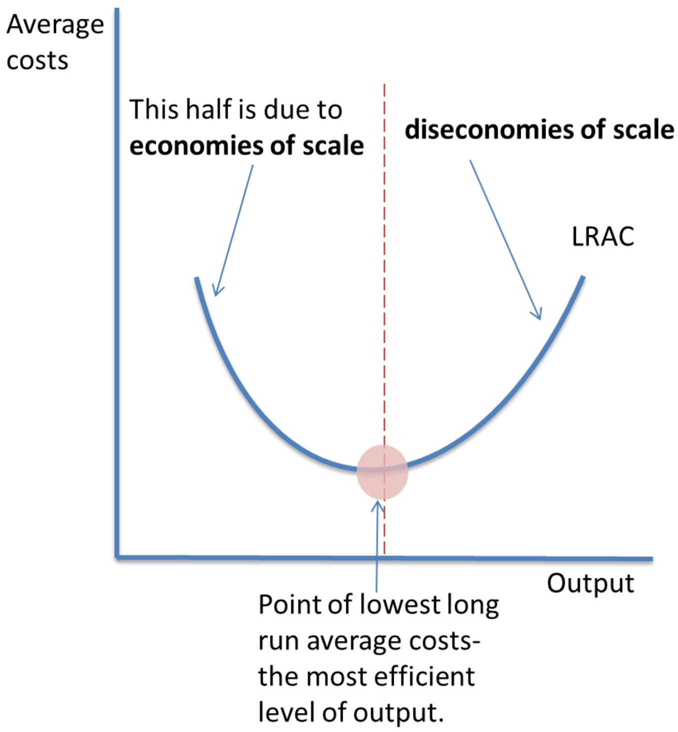
Economies of scale and their impact on cost and price

- **Internal economies of scale:**
- These occur when a firm becomes larger. Average costs of production fall as output increases. They can create a barrier to entry to the market.

- Examples of internal economies of scale can be remembered with the mnemonic **Really Fun Mums Try Making Pies**

- **Risk-bearing:** When a firm becomes larger, they can expand their production range. Therefore, they can spread the cost of uncertainty. If one part is not successful, they have other parts to fall back on.
- **Financial:** Banks are willing to lend loans more cheaply to larger firms, because they are deemed less risky. Therefore, larger firms can take advantage of cheaper credit.
- **Managerial:** Larger firms are more able to specialise and divide their labour. They can employ specialist managers and supervisors, which lowers average costs.
- **Technological:** Larger firms can afford to invest in more advanced and productive machinery and capital, which will lower their average costs.
- **Marketing:** Larger firms can divide their marketing budgets across larger outputs, so the average cost of advertising per unit is less than that of a smaller firm.
- **Purchasing:** Larger firms can bulk-buy, which means each unit will cost them less. For example, supermarkets have more buying power from farmers than corner shops, so they can negotiate better deals.

- **Long run average cost curve:**



- Initially, average costs fall, since firms can take advantage of **economies of scale.** This means average costs are falling as output increases.
- After the **optimum level of output,** where average costs are at their lowest, average costs rise due to **diseconomies of scale.**

- The point of lowest LRAC is the **minimum efficient scale.** This is where the optimum level of output is since costs are lowest, and the economies of scale of production have been fully utilised.