

Edexcel Economics A-level
Unit 3: Business Behaviour

Topic 3: Market Structures and
Contestability

3.6 Contestability

Notes



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.
-  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.

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 once 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.

