

Characteristics of contestable markets

Contestability measures the extent of barriers to entry and exit in a market. The easier it is for firms to enter and leave, the more contestable the market is.

Competition refers to the degree of rivalry between firms already operating in a market. A market can have low contestability but intense competition. For example, in an oligopoly.

Conditions for a contestable market

- **Low barriers to entry and exit:** Firms can enter easily and leave without significant costs.
- **Low sunk costs:** Firms can recover most costs when leaving, allowing “hit-and-run” competition.

Implications for firm behaviour

Contestability can change how existing firms behave, even when no new firm actually enters the market.

Limit pricing

Limit pricing occurs when an incumbent firm sets its price low enough to discourage potential competitors from entering the market.

Incumbent firm sets $\text{Price} = \text{AC}$ → firm earns normal profit → no supernormal profit available to attract new entrants → entry is discouraged

For example Royal Mail kept second class stamp prices capped to prevent private courier networks like DPD from entering the domestic letter market.

Normal profit in the long run

New entrants increase competition and undercut existing firms. This is likely to remove supernormal profit in the long run.

Lower prices and greater consumer surplus

The threat of entry discourages firms from charging excessively high prices. Lower prices make products more affordable and increase consumer surplus.

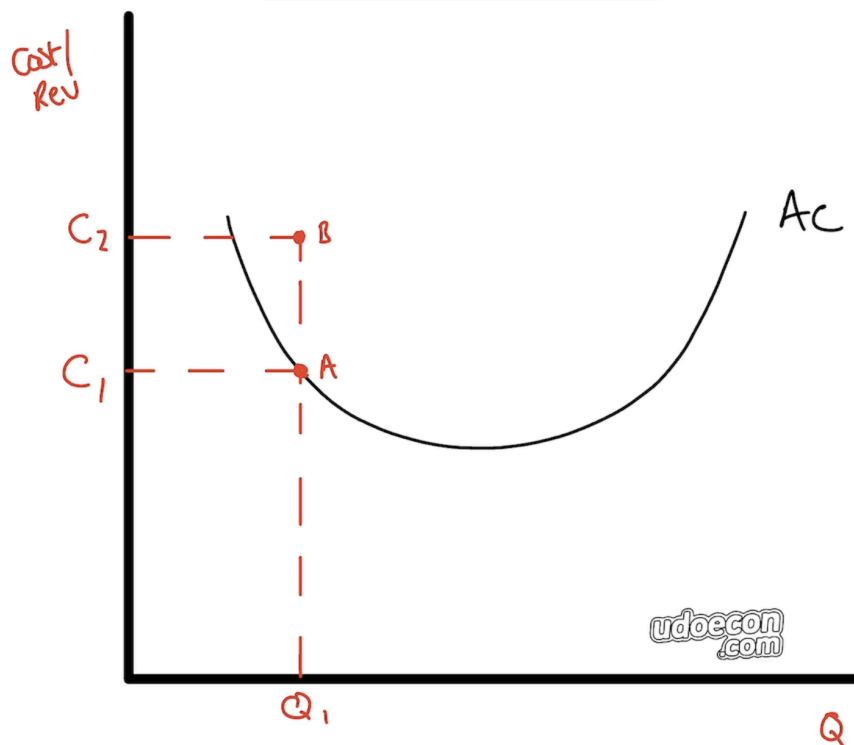
Greater cost efficiency

Firms have an incentive to control their costs because inefficient firms can be undercut. This may reduce organisational slack and encourage firms to operate on their lowest possible average total cost curve. For example, the *arrival of digital banks like Monzo forced giants*

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like Barclays to close thousands of physical branches to eliminate operational waste and cut average costs.

Firms are therefore more likely to achieve X-efficiency.



Possible dynamic efficiency

The threat of entry may still encourage firms to innovate so that they can maintain a competitive advantage.

Less stability for firms and workers

Hit-and-run entry can cause frequent changes in the firms operating in a market. Existing firms may lose market share or be forced to leave. For example Ryanair opens and closes European routes in under 48 hours based on demand, entering when profits spike and exiting instantly with zero sunk asset loss.

Barriers to entry and exit

Legal barriers: Patents, licences and regulations can restrict new competitors. For example UK patents grant pharmaceutical firms a 20-year legal monopoly.

Sunk costs: Unrecoverable costs make entering risky and leaving expensive. For example, developing a new drug takes roughly £2bn in upfront R&D and clinical trials, which cannot be recovered if the drug fails regulatory approval.

Economies of scale: Large firms have lower average costs, making it difficult for smaller entrants to compete. For example Tesco leverages its 28% UK grocery market share to secure massive purchasing economies of scale .

Brand loyalty: Strong brand loyalty creates inelastic demand for incumbent firms because consumers habitually buy from them regardless of minor price differences. For example esco's Clubcard loyalty scheme reaches over 22 million UK members .