Barriers to Entry and Exit in Markets

Barriers to entry are designed to **block potential entrants** from entering a market profitably. They seek to **protect the power of existing firms** and maintain **supernormal profits** and increase producer surplus. These barriers have the effect of **making a market less contestable** - they are also important because they determine the extent to which well-established firms can price above marginal and average cost in the long run.

The 1982 Nobel Prize winning economist **George Stigler** defined an entry barrier as “A cost of producing which must be borne by a firm which seeks to enter an industry but is not borne by businesses already in the industry”.

Another Economist, George Bain defined entry barriers as “The extent to which established firms can elevate their selling prices above minimum average cost without inducing potential entrants to enter an industry”.

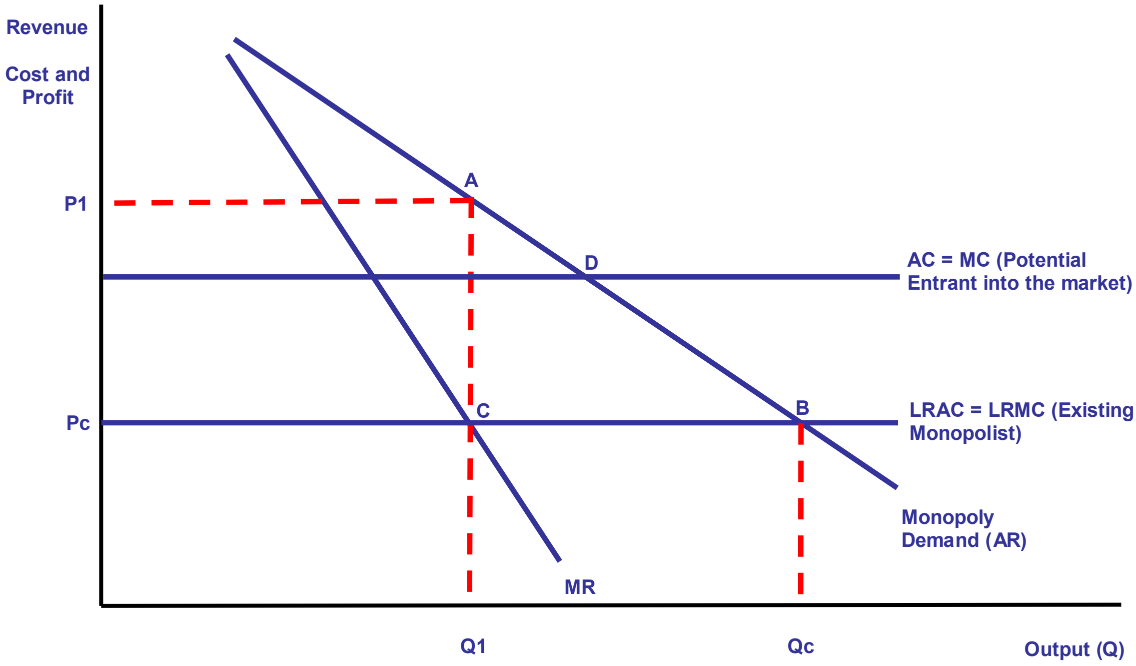
The Bain interpretation of entry barriers emphasises the **asymmetry in costs** that often exists between the incumbent firm and the potential entrant. If the existing businesses have managed to exploit **economies of scale** and developed a **cost advantage** over potential entrants, this might be used to cut prices if and when new suppliers enter the market. This is a move away from short-run profit maximisation objectives – but it is designed to inflict losses on new firms and protect a dominant market position in the long-run. The monopolist might then revert back to profit maximization once a new entrant has been sent packing!

Another way of categorising entry barriers is summarised below

- **Structural barriers** (also known as ‘innocent’ entry barriers) – arising from differences in production costs.
- **Strategic barriers** (see the notes below on strategic entry deterrence).
- **Statutory barriers** – these are entry barriers given force of law (e.g. patent protection of franchises such as the National Lottery or television and radio broadcasting licences).

Entry barriers exist when costs are higher for an entrant than for the incumbent firms. This is shown in the next diagram.

The incumbent monopolist has achieved economies of scale so that that its own LRAC and LRMC are lower than that of a potential entrant. If the monopolist maintains a profit maximising price of P1, a market entrant could achieve above normal profits since its costs are lower than the prevailing price. At any price below Pe the potential entrant will make a loss – and entry can be blockaded.



Theory of Early Mover or First Mover Advantage

Sometimes there are sizeable advantages to being first into a market – first-movers can establish themselves, build a customer base and make life difficult for new firms on the scene. The first-mover idea is summarised thus:

Grow first & become larger ⇨Achieve economies of scale ⇨ Bigger business ⇨ generates the resources to do more innovation ⇨ More innovation leads to better products and lower costs ⇨ Catalyst to grow bigger ⇨ Eventually no entrant can compete ⇨Later entrants may be forced to exit the market

Barriers to Exit – (Sunk Costs)

Whilst textbooks tend to concentrate on the costs of entering a market, often it is the financial implications of leaving an industry that act as one of the most important barriers – hence we need to consider exit costs. A good example of these is the presence of sunk costs.

Sunk costs cannot be recovered if a business decides to leave an industry. Examples include:

- Capital inputs that are **specific to an industry** and which have **little or no resale value.**
- Money spent on **advertising, marketing and research and development projects** which cannot be carried forward into another market or industry.

When sunk costs are high, **a market becomes less contestable**. High sunk costs act as a **barrier to entry of new firms** because they risk making huge losses if they decide to leave a market. In contrast, markets such as fast-food restaurants, sandwich bars, hairdressing salons and local antiques markets have low sunk costs so the barriers to exit are low.

- **Asset-write-offs** – e.g. the expense associated with writing-off items of plant and machinery, stocks and the goodwill of a brand

- **Closure costs** including redundancy costs, contract contingencies with suppliers and the penalty costs from ending leasing arrangements for property
- **The loss of business reputation and goodwill** - a decision to leave a market can seriously affect goodwill among previous customers, not least those who have bought a product which is then withdrawn and for which replacement parts become difficult or impossible to obtain.
- **A market downturn may be perceived as temporary** and could be overcome when the economic or business cycle turns and conditions become more favourable

Strategic Entry Deterrence

Strategic entry deterrence involves any move by existing firms to reinforce their position against other firms of potential rivals. There are plenty of examples of this – including the following:

- **Hostile takeovers** and acquisitions – taking a stake in a rival firm or buying it up!
- **Product differentiation** through **brand proliferation** (i.e. investment in developing new products and spending on marketing and advertising to reinforce consumer / brand loyalty).
- **Capacity expansion** to achieve lower unit costs from exploiting internal economies of scale.
- **Predatory pricing**: Predatory behaviour is defined as a **dominant company** sustaining losses in the short run with the knowledge it will be able to recoup them once the competition is forced to exit, and is in breach of the Competition Act 1998. We return to this in the chapter on oligopoly and cartels.

Strategic barriers may be deemed **anti-competitive** by the **British and EU competition authorities** - The EU Competition Commission has been active in recent years in building cases against European businesses that have engaged in anti-competitive practices including **price fixing cartels**.

Allegations of predatory pricing in the Cardiff bus market

Cardiff's main bus company has been accused of "predatory behaviour" in an investigation by the Office of Fair Trading (OFT). The OFT found that the Cardiff Bus Company, which carries an estimated 80,000 people each weekday in Cardiff, used its dominant position to run its no frills services with revenues so far below costs that it was impossible for its competitor (2Travel plc) to remain in the market. Cardiff Bus denied it had infringed competition law.

Sources: News reports and the Office of Fair Trading

Borders v Amazon

Borders bookstore has broken away from Amazon after seven years to launch its own standalone website. Borders.com will have a total of 2 million books and DVDs in its inventory. In addition, in an agreement with Alibris, Borders will now offer about 60 million used books for sale. The site also features a link to its cobranded e-bookstore with Sony and has the ability to download digital audio either in DRM or DRM-free formats. The success or failure of the attempt by Borders to break the stranglehold of Amazon in the battle for market share in the UK will be an interesting test case of the scale of barriers to entry and the power of first mover advantage.

Source: Tutor2u blog, June 2008

Despite the inevitability of entry and exit barriers markets are constantly evolving and we often do witness the entry of new suppliers even when one or more firms have a clear position of market power. Entry can occur in a variety of ways:

1. **A takeover from outside the industry** (sometimes known as the “Trojan-horse route” to by-pass any structural entry barriers that might exist within an industry.)
2. **A transfer of brand names from one sector of the economy to another** (for example the diversification practiced by both EasyGroup, Virgin and Stagecoach in recent years.)
3. **Increasing competition from overseas** – i.e. the liberalisation of markets around the world

Case Study: Water – A Case for Competition?

Since 1989 the number of water authorities in the UK has fallen from 39 to 27 as a result of **horizontal integration**. In addition to the concern of many the ownership of UK water companies has increasingly fallen into **foreign ownership**. Most customers have no choice about who supplies them with water and they are generally supplied with their nearest water company.

The **Water Services Regulation Authority** (Ofwat) monitors standards of service (such as leakage repair and how quickly complaints are dealt with) and also the prices charged to customers. Due to the huge amount of investment required to improve the UK’s water infrastructure and to meet European Union water quality standards prices to customers have risen above the rate of inflation (thus rising in real terms).

Over the years the government has attempted to open up the water industry to competition enabling customers to choose their supplier. In 2003, legislation was introduced seeking to open up the market by allowing customers using more than 50 million litres of water a year to choose to switch suppliers and this threshold may be reduced in the years ahead. But for millions of individual households, there is little chance of **effective competition**.

A **national grid for water** is some way off not least because of the expenditure involved in creating one, but the water industry could copy the principle of **‘common carriage’** which enables competition to occur in the energy sector. This would mean that a new entrant to the water supply market would be allowed access to the supply network by the existing monopoly firm. With the help of the regulator entry barriers to the water industry could be lowered and competition introduced. This would make the market more **contestable** but the existing firms would more than likely have huge economies of scale advantages over any new entrant.

With climate change affecting water supply, the continued problem of leaking pipes and debate over the introduction of household water metering the future of the water industry will remain high on the political agenda.

Source: Robert Nutter, EconoMax, May 2008

Suggestions for further reading:

Water companies are not being encouraged to be innovative and efficient (Telegraph, July 2008)