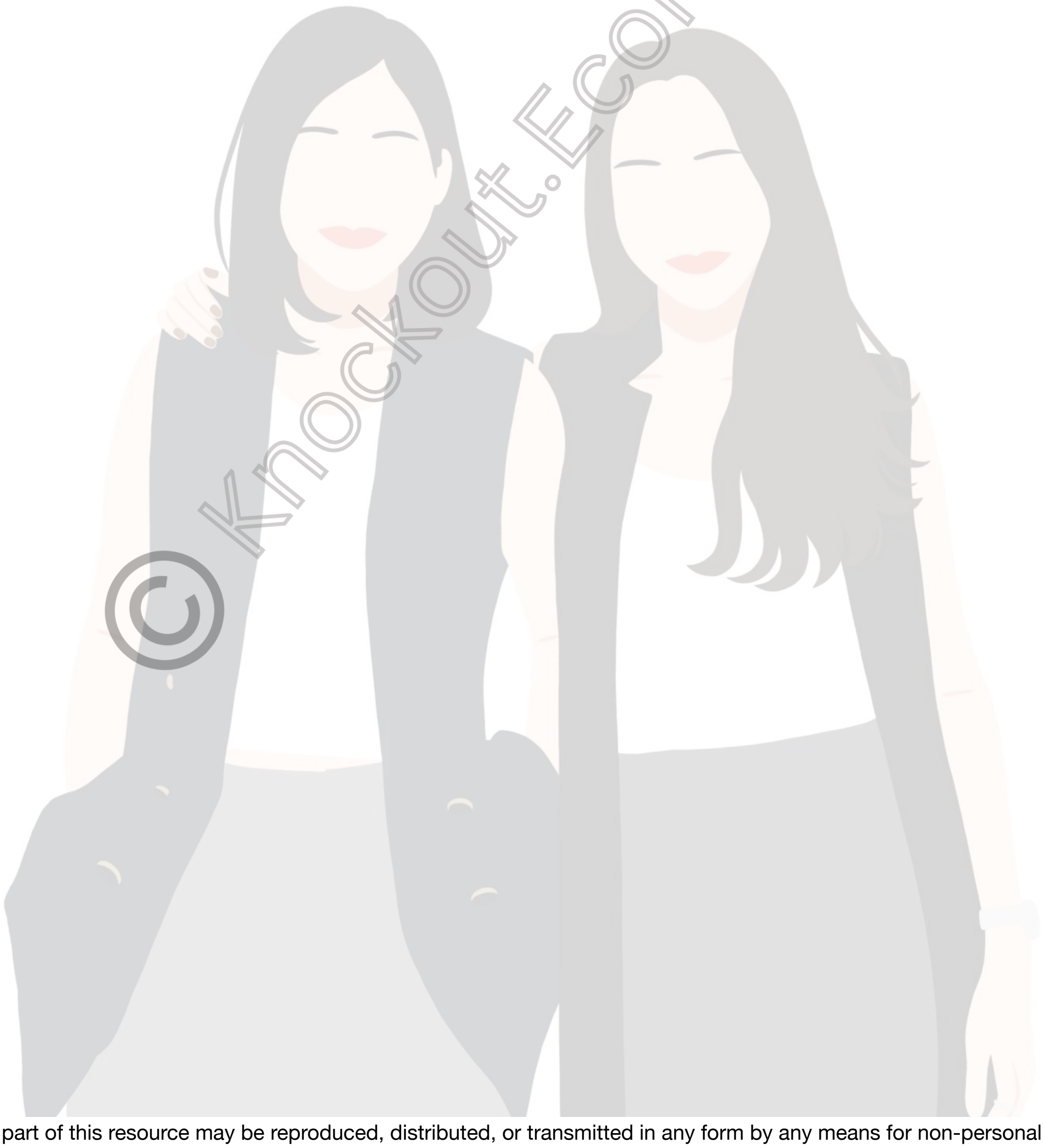
CHAPTER 14 : Contestability

Key terms

1. Contestable market : a market where there is freedom of entry to the industry and where costs of exit are low
2. Hit-and-run competition : when firms can enter a market at low cost attracted by high profit and then leave the market at low cost when profit fall
3. Sunk cost : costs which cannot be recovered when a firm leaves an industry



1. Characteristics of contestability

- High actual/ potential competition
- No level of supernormal profit
- No barrier to entry/exit
- No sunk cost in the market
- Low level of collusion
- Low concentration ratio

2. Implication for behaviour firm

- If the market is contestable, firms are more likely to be allocative efficient. In the long run, firm operate at the bottom of the average cost curve, it can achieve productive Efficiency
- The threat of new entrants affect firm just a many existing competition. Due to the low barriers to entry which provide easy access to the market. Firms are aware of new entrants entering in the market, taking supernormal profit and the leave market (Hit and run competition)
- Supernormal profit can be earned in the short run and only normal profit can be earned in the long run

3. Advantages and disadvantages of contestability

Advantages	Disadvantages
Firms - It is easy for new firms to enter the market and start competing with existing firms in the market - Firms will have to keep costs down in order to remain competitive and therefore reduce X-inefficiency - Firms in strongly contestable market with low barriers ton entry and exit are also likely to be productively and allocatively efficient	**Firms** - Firms will only earn normal profit in the long run and possibly in the short run as well. This will reduce the amount of retained profit available for research and development, but losses may be less likely as there may be more stability in the market - Firms may use limit pricing to deter new entrants and therefore only earn normal profit
Consumers - Prices will tend to be lower and nearer to the prices in a competitive market - There are increased incentives for firms to respond to consumer preferences	**Consumers** - There may be less innovation as the possible benefits for firms may be reduced, deterring these firms from entering into the market and leading to fewer new products being developed