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Barriers to Entry

Task

Investigate how the following barriers to entry may affect competition. Give examples of where these barriers to entry may occur.
Barriers to entry

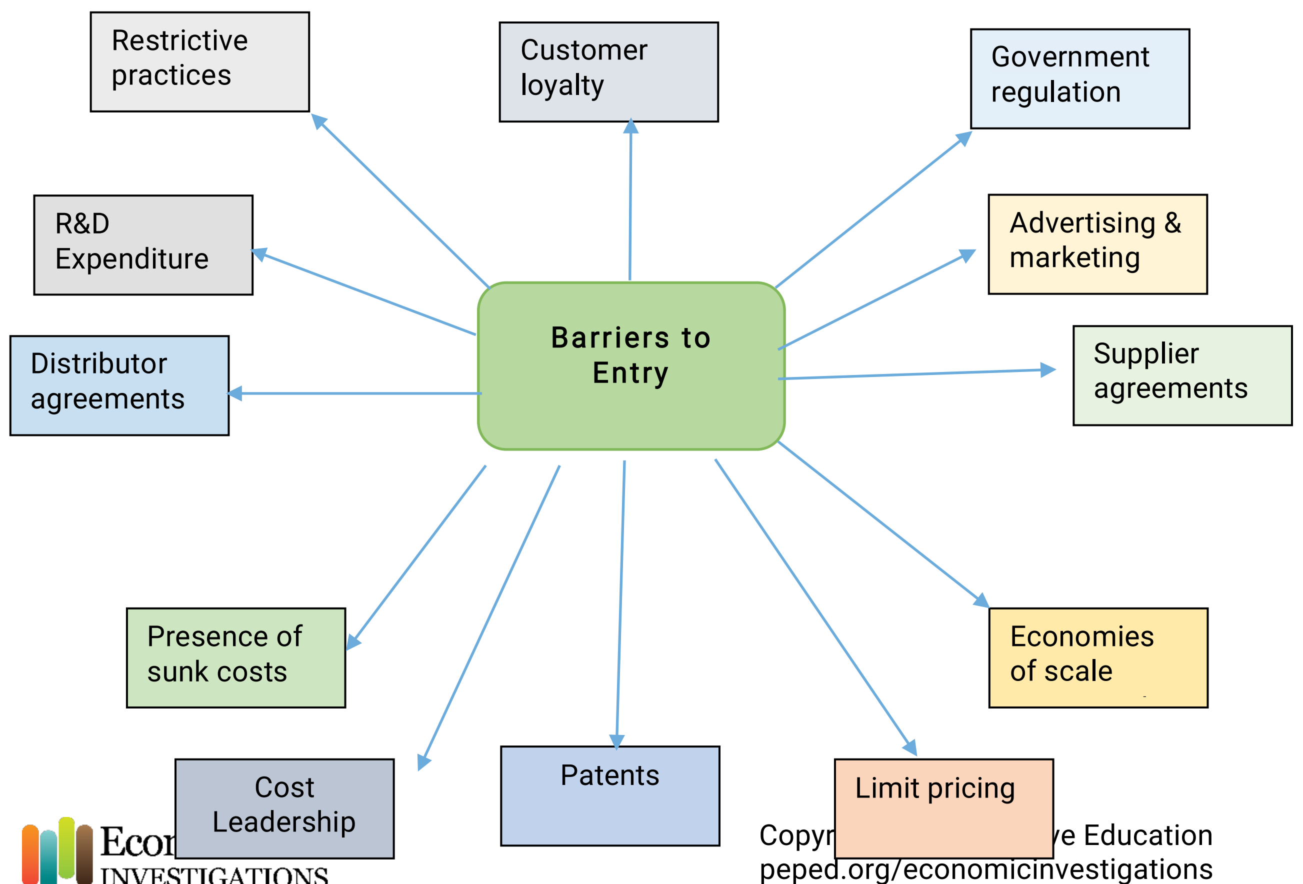
Definition Circumstances particular to a given industry that create disadvantages for new competitors attempting to enter the market. These may include government regulations, economic factors, and marketing conditions.

Introduction

Barriers to entry are factors that will prevent or make it difficult for new firms to enter a market. Barriers to entry make markets less contestable and reduce competition. The more significant barriers to entry are, the less competitive the market is likely to be. Barriers to entry are an aspect of monopoly markets.

Barriers to entry are designed to block potential entrants from entering a market profitably. They seek to protect the monopoly power of existing (incumbent) firms in an industry and therefore maintain supernormal (monopoly) profits in the long run. Barriers to entry have the effect of making a market less contestable.

Examples of Barriers to Entry



The economist Joseph Stigler defined an entry barrier as "A cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry."

This statement by Stigler emphasises the asymmetry in costs between the incumbent firm (already inside the market) and the potential entrant. If the existing businesses have managed to exploit some of the economies of scale that are available to firms in a particular industry, they have developed a cost advantage over potential entrants. They might use this advantage to cut prices if and when new suppliers enter the market, moving away from short run profit maximisation objectives - but designed to inflict losses on new firms and protect their market position in the long run.

Strategic barriers may be deemed anti-competitive by the British and European Union competition authorities and action is taken against European businesses that have engaged in anti-competitive practices, including price fixing cartels. Despite the existence of barriers to entry, we often do witness the entry of new suppliers into markets and industries where one or more firms have a clear position of market power.

Supplier agreements, exclusive agreements with key links in the supply chain can make it difficult for other manufacturers to enter the markets.

- **Patents**

  Giving the firm the legal protection to produce a patented product for a number of years

- **Limit Pricing**

  Firms may adopt predatory pricing policies by lowering prices to a level that would force any new entrants to operate at a loss

- **Cost advantages**

  Lower costs, perhaps through experience of being in the market for some time, allows the existing monopolist to cut prices and win price wars.

- **Economy of scale**

  Large, experienced firms can generally produce goods at lower costs than small, inexperienced firms. Cost advantages can sometimes be quickly reversed by advances in technology. For example, the development of personal computers have allowed small companies to make use of database and communications technology which was once extremely expensive and only available to large corporations.

- **Advertising and marketing**

  Developing consumer loyalty by establishing branded products can make successful entry into the market by new firms much more expensive. This is particularly important in markets such as cosmetics, confectionery and the motor car industry.

- **Research and Development expenditure**

  Heavy spending on research and development can act as a strong deterrent to potential entrants to an industry. Clearly much R&D spending goes on developing new products (see patents above) but there are also important spill-over effects which allow firms to improve their production processes and reduce unit costs. This makes the existing firms more competitive in the market and gives them a structural advantage over potential rival firms.

  Some products, such as microprocessors, require a massive upfront investment in technology which will deter potential entrants.

- **Presence of sunk costs**

  Some industries have very high start-up costs or a high ratio of fixed to variable costs. Some of these costs might be unrecoverable if an entrant opts to leave the market. This acts as a disincentive to enter the industry.

- **International trade restrictions**

  Trade restrictions such as tariffs and quotas should also be considered as a barrier to the entry of international competition in protected domestic markets.

- **Sunk Costs**

  Sunk Costs are costs that cannot be recovered if a business decides to leave an industry Examples include: " Capital inputs that are specific to a particular industry and which have little or no resale value " Money spent on advertising / marketing / research which cannot be carried forward into another market or industry When sunk costs are high, a market becomes less contestable. High sunk costs (including exit costs) act as a barrier to entry of new firms (they risk making huge losses if they decide to leave a market).

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Overcoming Barriers to Entry

- A takeover from outside the industry (sometimes known as the “trojan horse route” enables a new entrant to by-pass any structural entry barriers that might exist within an industry)
- The widening of a product range from a firm outside a specific market but with a state of technology sufficient to challenge existing firms
- A transfer of brand names from one sector of the economy to another (for example the diversification practiced by both EasyGroup and Virgin in recent years)
- Increasing competition from overseas - perhaps stimulated by fluctuations in the exchange rate of the development of a competitive advantage by foreign businesses
- Growing markets – if demand is increasing, market prices might be expected to rise and through the working of the price mechanism, higher prices offer increased potential profits for new entrants even if their initial production costs are higher than the incumbent firms
- Existing firms may be content to control the flow of new firms coming into a market rather than engaging in strategies designed to block the entry of any new firm outright

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