Contestable Market Theory Between Static and Dynamic Competition

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Contestable Markets and the Conditions of Competitive Entry

The contestable market hypothesis was introduced in 1982 by the American economist William Baumol. Contestable markets are those markets that are served by a small number of firms, but these firms face the threat of new market entrants. The concept of contestable markets is relevant to both oligopoly and monopoly industries because, despite having few market players, these firms still operate in competitive conditions. This is because the firms already in the market are constantly threatened by potential competitors who can enter the market and exit quickly (Baumol et al., 1982; Baumol, 1982).

A contestable market is defined by several conditions. First, there must be low barriers to entry and exit. New firms should be able to enter the industry without facing major legal, financial, or technological obstacles. Second, there should be little or no sunk cost. Sunk costs are expenses that cannot be recovered when a firm leaves the market. If these costs are high, firms may hesitate to enter because failure would result in substantial losses. Third, new entrants should have access to the same technology, information, and resources as existing firms. Finally, firms must be able to enter and exit before established companies respond aggressively.

The theory suggests that actual competition is not always necessary to control prices and profits. The possibility of competition may be enough. If an existing monopoly charges excessively high prices or earns abnormal profits, new firms may enter, offer lower prices, attract customers, and then leave if the incumbent responds. This process is known as hit-and-run entry. The threat of such entry encourages established firms to keep prices closer to costs and operate efficiently.

Static Competition and the Traditional Market Structure Approach

Static competition focuses on the structure of a market at a particular point in time. Traditional economic analysis often examines the number of firms, market share, concentration, pricing, and output. Under this approach, a monopoly is assumed to have significant market power because it is the only seller, while perfect competition is assumed to produce efficient outcomes because many firms compete.

The structure-conduct-performance model reflects this static approach. It argues that market structure influences firm conduct, which then determines economic performance. A highly concentrated market may allow firms to raise prices, restrict output, and earn abnormal profits. Competition policy based on this model often seeks to reduce concentration, prevent mergers, or regulate monopolies.

Contestable market theory challenges the idea that the number of firms alone determines competition. A market with one or two firms may still behave competitively if entry is easy. Conversely, a market with many firms may not be truly competitive if legal restrictions, brand loyalty, control of distribution, or high sunk costs prevent new entry. Therefore, static concentration ratios may provide an incomplete picture of market power.

Dynamic Competition, Innovation, and Entrepreneurial Rivalry

Dynamic competition focuses on change over time. It emphasizes innovation, investment, entrepreneurship, technological development, product improvement, and the creation of new markets. Firms do not compete only through price; they also compete by developing better products, reducing production costs, introducing new business models, and responding to changing consumer preferences.

From a dynamic perspective, temporary monopoly profits may encourage innovation. A company that develops a new technology may earn high returns before competitors imitate or improve the product. These returns reward risk-taking and investment. If competition policy focuses only on current prices and market shares, it may discourage innovation by preventing firms from recovering research and development costs.

Contestability has a dynamic element because potential entrants can challenge existing firms. However, the original theory often assumes that new firms have access to the same technology as incumbents. In reality, dynamic competition may involve different technologies, capabilities, and strategies. New entrants may disrupt an industry not by copying existing firms but by creating a new way of serving customers (Sidak & Teece, 2009).

Digital platforms provide an example. A traditional taxi market may have high barriers due to licenses and vehicle ownership, but a technology company can enter by creating a platform that connects drivers and passengers. The entrant changes the structure of the market rather than simply joining it under existing conditions. Dynamic competition therefore involves innovation that can alter entry barriers themselves.

Sunk Costs, Strategic Behaviour, and the Limits of Contestability

Perfect contestability is rare because most industries contain sunk costs. Advertising, research, training, specialized equipment, regulatory approval, and network development may not be recoverable when a firm exits. These costs protect established firms because entrants face risks that incumbents have already absorbed.

Existing firms may also use strategic behavior to discourage entry. They can reduce prices temporarily, increase advertising, sign exclusive contracts, control essential facilities, or create excess capacity. An entrant considering the market may expect retaliation and decide not to enter. This weakens the hit-and-run assumption because the incumbent may respond before the entrant recovers its investment.

Brand loyalty is another barrier. Consumers may prefer established companies even when new firms offer lower prices. Building trust takes time and advertising, which creates sunk costs. Network effects can also reduce contestability. A service becomes more valuable when many people use it, giving large platforms an advantage that new entrants cannot easily match.

Government regulation may either reduce or increase contestability. Licensing, safety standards, tariffs, and professional qualifications can create barriers. Some regulations protect consumers and public welfare, while others may protect existing firms from competition. Deregulation can make markets more contestable, but removing rules without considering safety or quality can also create harm.

Airlines, Utilities, and Applications of Contestable Market Theory

The airline industry has often been used to illustrate contestability. Aircraft can be leased or moved between routes, allowing airlines to enter profitable markets. If an incumbent charges high prices on a route, another airline may begin service. The threat of entry can discipline prices even when only one carrier currently operates.

However, airports have limited slots, gates, and takeoff rights. Established airlines may control these resources, creating barriers. Customer loyalty programs and network connections also strengthen incumbent power. Therefore, airline markets may be partially contestable but not perfectly contestable.

Natural monopoly industries such as electricity, water, and railways have high fixed and sunk costs. Building duplicate networks is expensive and inefficient. These industries are less contestable and often require regulation. Governments may separate competitive services from monopoly infrastructure. For example, different firms may compete to supply electricity while using a regulated transmission network.

Telecommunications markets show how technology can change contestability. Traditional fixed-line networks required expensive infrastructure, but mobile and internet technologies created new forms of competition. Still, spectrum licenses, towers, and network effects remain important barriers. Contestability therefore changes over time with technology and regulation.

Competition Policy and the Balance Between Structure and Entry

Contestable market theory has influenced competition policy by shifting attention from the number of firms to the conditions of entry. Regulators should ask whether new firms can enter, whether customers can switch, and whether incumbents control essential resources. A concentrated market may not require intervention if entry is genuinely easy and rapid (Motta, 2004).

However, potential competition should not be assumed without evidence. Regulators must examine sunk costs, access to finance, intellectual property, data, distribution channels, and strategic barriers. A firm may claim that entry is possible while maintaining practices that make it unrealistic.

Static and dynamic analysis should be combined. Static analysis identifies current concentration, pricing, and market power. Dynamic analysis considers innovation, future entry, and technological change. Policies should prevent abuse while preserving incentives for investment and development.

In conclusion, contestable market theory provides an important alternative to traditional competition analysis. It shows that the threat of entry can discipline firms even in concentrated markets. However, perfect contestability depends on strict assumptions that rarely exist fully. Sunk costs, strategic behavior, brand loyalty, network effects, and regulation can limit entry. The most effective analysis combines static market structure with dynamic competition and innovation. Competition policy should therefore focus not only on how many firms exist but also on whether meaningful entry and rivalry are possible.

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