

## Contestable markets

EE 382

## Theory of contestable market

- Developed in the late 1970s and early 1980s by William Baumol
- What Baumol argued was that it was unnecessary for the market to be in perfect competition in order to produce economically efficient market behavior, **what really mattered was whether the market was contestable or not**
- Example
  - American domestic airlines
  - Low cost airlines

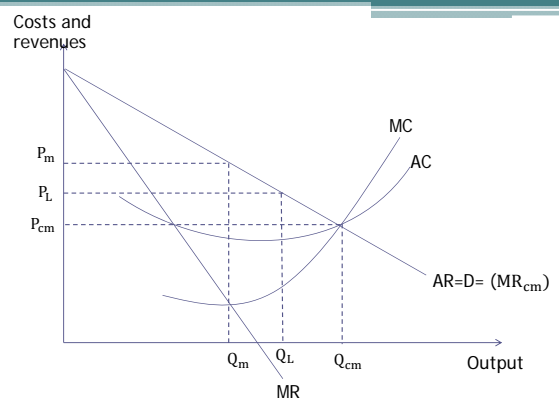
The **most important feature** of a contestable market

- No barriers to entry and especially no sunk costs
  - Always a real threat that new producers will enter the industry to capture any abnormal profit that is being earned by charging lower price
  - The threat of hit-and-run competition - producers enter the market, set their price lower than the existing producers, capture the available abnormal profit, and then exit the industry

- They will have to be productively efficient so that they can compete with any potential entrants
- They will charge competitive prices and restrict earnings to normal profit in order to avoid attracting hit-and-run competition
- The **difference** between a contestable market and a perfectly competitive market is that it does not matter how many producers are actually there in a contestable market
  - The threat of entry by new producers that disciplines them all to behave in a competitive manner rather than the existence of actual competitors within the market

## Three other factors that are necessary for a market to be contestable

- Any entrants must have access to the same technology as existing producers
- Existing producers do not have large reserves to finance that they can use to reduce their prices instantly to a level below that charged by entrants in a price war
- There is a low degree of brand loyalty and so consumers respond instantly to any price difference by moving their purchases to the producer with the lowest price



If all of the assumptions of the contestable market fully apply to the monopolist then the firm will not pursue a strategy that profit maximizes at output level  $Q_m$  with the associated market price of  $P_m$

Rather it will act like the perfectly competitive firm and set the output level at  $Q_{cm}$  with the associated price of  $P_{cm}$

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If entry and exit barriers are relatively high, then the contestability of the market is severely compromised and the firm's output level will tend towards the monopolist position of  $Q_M$

## Contestability and the airline sector

- Control over landing slots is becoming less of an issue for a number of reasons
  - Landing slots have become available with the demise of certain airlines
  - A growth in the use of less congested regional airports which represents competition to the major hub airports such as Heathrow
- The internet has provided an important source of detail to potential passengers in terms of flights, prices, etc which was previously only in the domain of travel agents

- The frequent flyer initiative, which was a mechanism used by airlines to tie passengers into using their services, is now less of a benefit to passengers than it has been in the past because the savings to be made on the low cost fares in many cases more than offsets the free air miles
- The growth in low cost carriers

## Reference

- Mallard G., and Glaister S. (2008). Transport Economics: Theory, Application and Policy. Palgrave Macmillan.
- Cowie J. (2010). The Economics of Transport. Routledge.