LECTURE 3.2

BARRIERS TO ENTRY

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Barriers to entry are a precursor to market power.

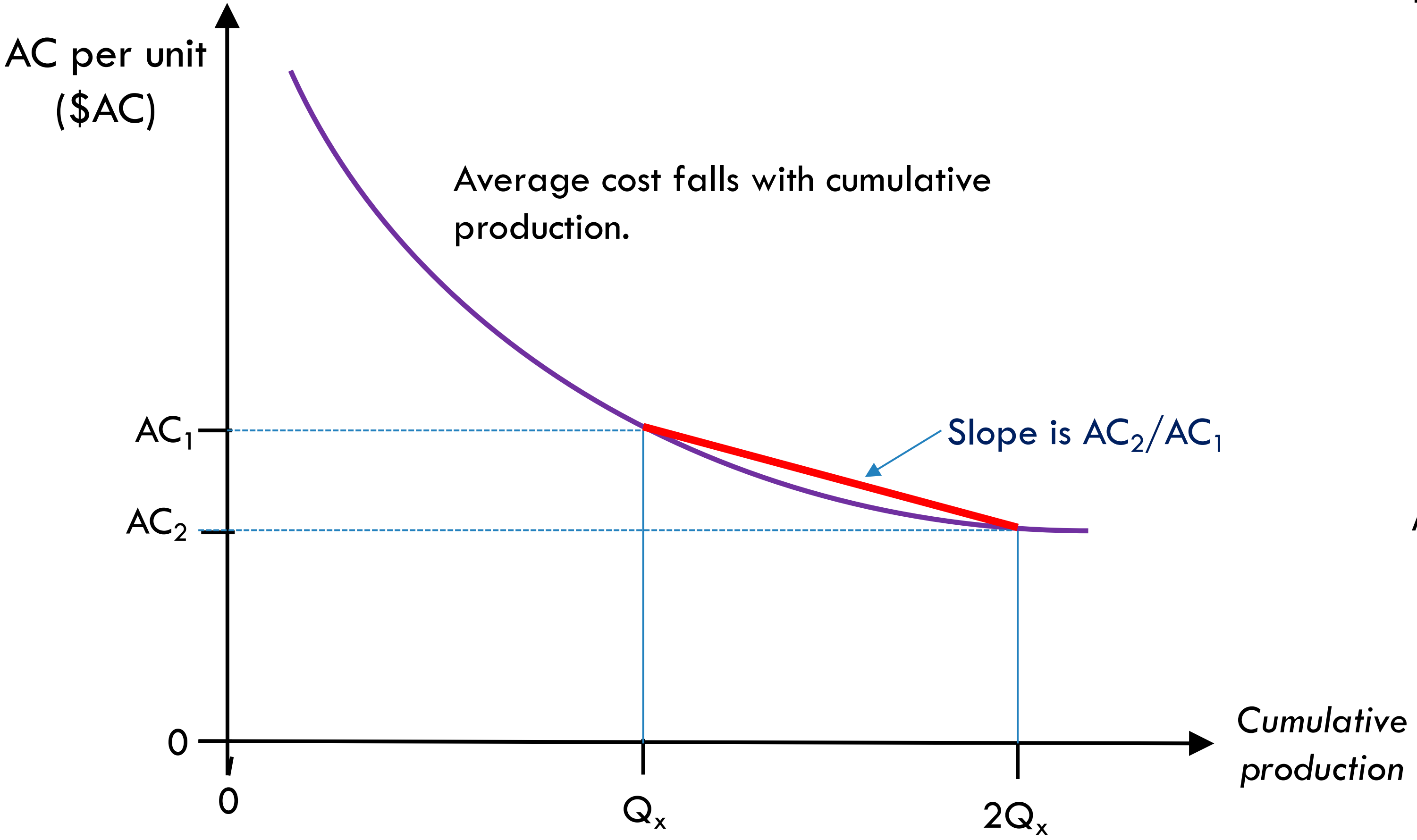
What types of things do represent barriers to entry? First, what might be important for shaping an entry decision?

- Effect of entry on prices – what affects this? Hint: What will incumbent firms do (prices, output) if I enter?
- Incumbent advantages – what might they be or include?
- What if I fail and leave the industry? Are there sunk costs of entry?

INCUMBENT ADVANTAGES

- Precommitment contracts - distribution, raw materials etc. Limit opportunities for new entrants in terms of suppliers and customers
- Licenses and patents – legal barriers to entry
- Pioneering brand advantages or switching costs. These are potentially important in case of experience goods that require use to understand quality. Where this can be assessed prior to purchase the advantages of incumbents is lower.
- Learning curve effects (see next 2 slides)

THE PRODUCTION LEARNING CURVE



Think about the magnitude of learning benefits in terms of 'slope', i.e. how much average costs decline as cumulative output doubles.

When cumulative output equals Q_x, average cost of production is AC_1. When cumulative output doubles AC decreases to AC_2, so ratio of ACs is AC_2/AC_1. If AC_1=80 and AC_1=72, slope is -0.90 so doubling output reduces costs by 10 percent

THE PRODUCTION LEARNING CURVE

- Distinct from economies of scale, where average cost falls with **current** output
- Derived from notion of a product life cycle. Products go through a process of introduction, growth, maturity and decline.
- Evidence: ‘median slope of the learning curve is about -0.8’, so a doubling of cumulative output tends to reduce costs by around 20%. That is, AC_2 is around 80 percent of AC_1.
- Potentially has important effects on marginal cost and this should be factored in when considering whether to take on a contract.

BARRIERS TO ENTRY

McAfee lists the following (amongst others) as representing or reinforcing entry barriers:

- Large minimum efficient scale relative to industry size
- Variety of differentiated products in the market meaning that the product space is already filled
- Consumer switching costs and networks
- Brands and reputation
- Limited access to distribution channels
- Limited access to raw materials
- Government regulation