

## June 2003 Past Paper

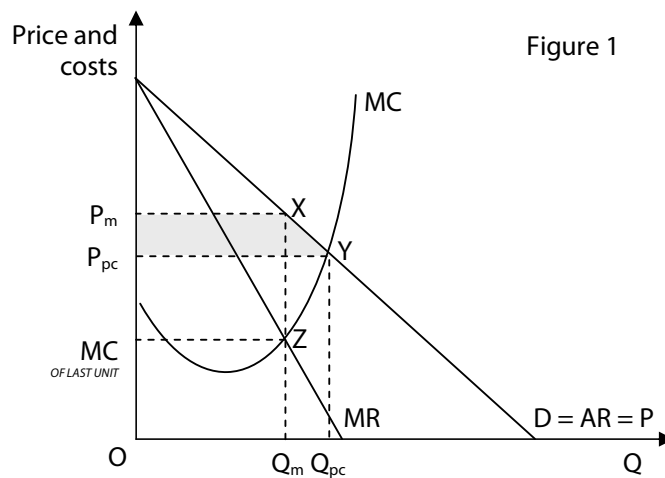
### Question 3

**(a) Identify the characteristics of a contestable market, and explain how contestability can lead to benefits for consumers. [10]**

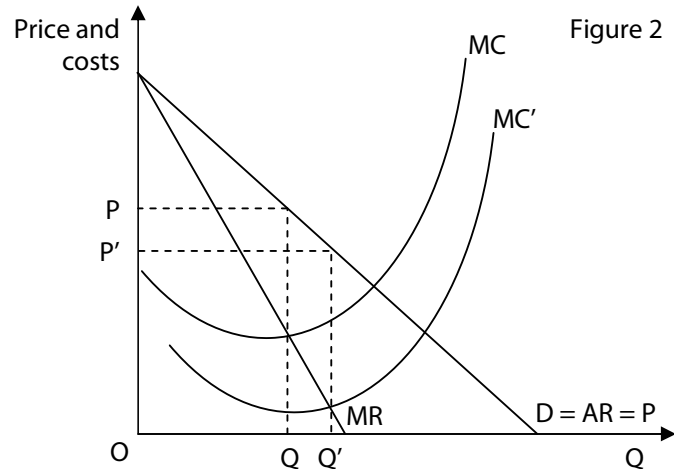
*Focus on either perfect competition or monopolistic competition or contestable markets as discussed in class.*

- Characteristics of a perfectly contestable market
  - i. Large number of firms.
  - ii. Similar or homogeneous products.
  - iii. No barriers to entry in the long run, no sunk costs. Causes the threat of hit and run entry.
  - iv. Perfect knowledge.
- Benefits for consumers.
  - i. Low prices.
  - ii. Increase in consumer surplus.
  - iii. Greater choice for the consumer.
  - iv. Greater output.

This can be shown diagrammatically as shown below. The MC curve is the market supply curve under perfect competition and D the demand curve under perfect competition. The shaded area,  $P_m X Y P_{pc}$ , represents the increase in consumer surplus gained from changing market structure from a monopoly to perfect competition. This leads to greater efficiency and improved product quality, so consumers benefit from increased contestability.



If there is less contestability in the market consumers can also benefit, as a shift in the market structure toward a less contestable market structure such as monopoly will cause the MC curve to lower from MC to MC' as firms are able to take advantage of economies of scale. This gives the consumer a lower price, P', and a greater output, Q' is produced.



**(b) Discuss the extent to which markets for spectator sports are economically contestable in terms of their characteristics and their consequences. [15]**

- In the main leagues there are a fixed number of firms. The market is dominated by a number of large firms, but there are many small firms operating in many different sports.
- Consumers see the products offered by different spectator sport firms as being unique. Generally fans are very loyal to one club in a given sport giving each firm the position of a monopoly over its fan sub-market.
- Barriers to entry are very low to enter at the lower end of the market however to effectively compete with large clubs the barriers to entry are immense. The fixed number of places in the main leagues mean any new firm would find it hard to enter the market and consumers are very loyal to their existing firm and highly unlikely to switch clubs for lower ticket prices.
- Consumers and producers have reasonable knowledge of the industry but very strong brand loyalty prevents consumers from utilising their knowledge.
- The very high barriers to entry mean the market does not have many characteristics of a contestable market, so consumers cannot benefit from an increased consumer surplus, efficiency, lower prices and greater output as shown in figure 1 and explained in part a.
- However, the firms do often choose to pass on lower costs gained by economies of scale at least in part to their fans as shown in figure 2 and explained in part a, though many large clubs do make large supernormal profits.