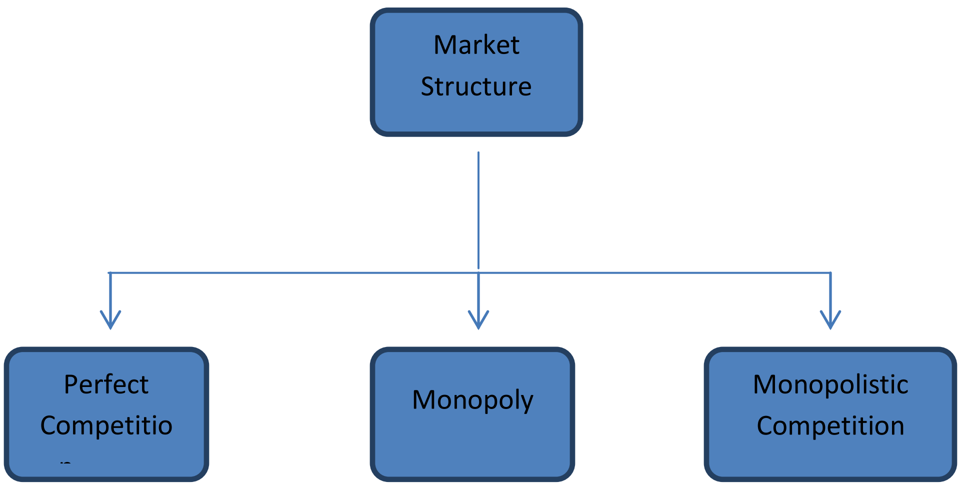
# Concepts to Barriers to Entry by Bains, Stigler: Sources to barriers to entry

## Introduction:

To understand the concept of barriers to entry we first need to understand the concept of market power and different market structure. They differ from each other in terms of their characteristics. There are mainly three market structures:




1. **Perfect competition:**

   The main assumptions of perfect competition are:

   i. Large number of buyers and large number of sellers
   ii. Homogeneous product
   iii. Free entry and free exit
   iv. Perfect information about market

Here, barriers to entry are not possible. Similarly, barriers to exit are also not possible. In this structure neither buyers nor sellers have the market power. It means that they cannot influence the market price.

2. **Monopoly:**

   Monopoly refers to a market situation where there is only single seller of a commodity and there are no close substitutes of that commodity. In such a situation, monopolist or the single seller of the commodity has some kind of power or control over the supply of a commodity and hence he is in a position to influence the price. The main assumptions of monopoly are:

   i. One seller who decides the price
   ii. No close substitutes
   iii. No entry for new firms.

The monopoly firm faces no threat of entry from potential rivals. When you have a market that has only one firm producing, but the firm is producing at a lower price than you would expect it to exact in the market, this could suggest that it is fearful of rivals entering and so is trying to deter entry by keeping the price down. Sometimes we will have a situation where there appears to be only one firm in the market, but it is not really a monopoly – the threat of entry will erode its market power. It means that barriers to entry are concerned with the market power.

**3. Monopolistic competition:**

Under monopolistic competition there is freedom of entry and exit. Thus under monopolistic competition it is found that both the features of competition and monopoly are present. The assumptions of monopolistic competition are:

i. Large number of sellers
ii. Product differentiation
iii. Selling cost
iv. Free entry and free exit

In this market structure there are no barriers to entry. It means that 'barriers to entry' is the characteristic of monopoly.

**Definition:**

**Barriers to entry are the obstacles that make it extremely difficult for small or startup enterprises to get a foothold or thrive in a market or industry.** The existing competitors are extremely big, dominant or established, making it virtually impossible for anybody new to come onto the scene and gain market share. In other words we can say that the existence of high startup costs or other obstacles that prevent new competitors from easily entering an industry or area of business. Barriers to entry benefit existing firms already operating in an industry because they protect an established company's revenues and profits from being whittled away by new competitors. Common barriers to entry include special tax benefits to existing firms, patents, strong brand identity or customer loyalty, and high customer switching costs. Economic, procedural, regulatory, or technological factors that obstruct or restrict entry of new firms into an industry or market. Oligopolies and monopolies may maintain their position of dominance in a market because it is too costly or difficult for potential rivals to enter the market. Obstacles to entry are called barriers to entry. They can be erected deliberately by the incumbent(s) - called **strategic or artificial barriers, which** can be created by firms themselves - or they can exploit barriers that naturally exist in the market, also called **structural barriers.** Structural barriers are given by a firm's inherent situation. If we summarize the definition, we can say that a barrier to entry means:

A. **Restrict potential entrants from making profit in the market**
B. **Protect and maintain monopoly power of existing firm**
C. **Generate and maintain supernormal profit in the long run**
D. **Barriers to entry make a market less competitive**

Here we need to understand that barriers to entry either create monopoly or maintain monopoly of the existing firms. The economic theory clearly says that monopoly outcome is not efficient in the market. We can say that if there exists any kind of artificial barriers to entry created by the either market or government leads to inefficient outcome and higher prices in the market and hence consumer welfare will decline in the market due to higher prices. Therefore, Barriers to entry seek to protect the power of existing firms and maintain supernormal profits and increase producer surplus.

The definitions of barriers to entry by different economists are as follows:

(1) **J.S.Bain: "**A barrier to entry is an advantage of established sellers in an industry over potential entrant sellers, which is reflected in the extent to which established sellers can

persistently raise their prices above competitive levels without attracting new firms to enter the industry."

(2) **Joseph Stigler:** "A barrier to entry is a cost of producing (at some or every rate of output) that must be borne by firms seeking to enter an industry but is not borne by firms already in the industry."

(3) **J.M. Ferguson:** "A barrier to entry is a factor that makes entry unprofitable while permitting established firms to set prices above marginal cost, and to persistently earn monopoly return."

Another classification of barriers is:

(1) **Economic Barriers:** An economic barrier to entry is a cost that must be incurred by a new entrant and that incumbents do not or have not had to incur.

(2) **An Antitrust Barrier:** An antitrust barrier to entry is a cost that delays entry and thereby reduces social welfare relative to immediate but equally costly entry.

All economic entry barriers are antitrust barriers. However, many antitrust barriers are not economic barriers. Antitrust is a larger category than economic. When free entry leads to the efficient number of firms, if a market has no antitrust entry barriers, then it is efficient. If it has no economic entry barriers, then it is eventually efficient. An antitrust entry barrier in a market that is otherwise efficient reduces welfare relative to what it would have been in the absence of that barrier.

Barriers to entry are factors that prevent a startup from entering a particular market. As a whole, they comprise one of the five forces that determine the **intensity of competition** in an industry The others are **industry rivalry, the bargaining power of buyers, the bargaining power**

**of suppliers and the threat of substitutes.** The intensity of competition in a certain field determines the attractiveness of a market that is; low intensity means that the market is attractive.

Factors involved as **barriers to entry may be either innocent** (for example, the dominating company's absolute cost advantage) or **deliberate** (for example, high spending on advertising by incumbents makes it very expensive for new firms to enter the market).

## Forms of barriers:

The various forms of barriers are:

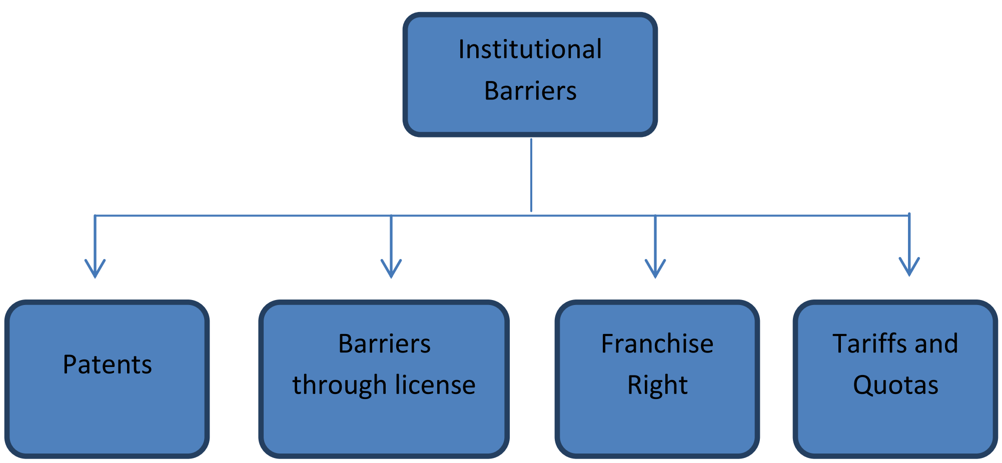
### Clear Product Differentiation:

Product differentiation is the main characteristics of a monopolistic competition. In monopolistic competition commodities are close substitutes. Due to product differentiation new firms have to incur high advertisement cost to promote their own commodity. The higher advertisement cost will lead to higher financial burden on the owner of the new firm. The owner of the small businesses cannot afford the huge amount of advertisement cost. Another effect of the higher advertisement cost is the higher price. If new firms set prices at high level the well-established firms will decrease the price to attract the consumers. In this case, the buyer has come to identify the brand name of the firm with the product. In markets where significant product differentiation exists, it is very difficult for new firms to enter. Potential entrants somehow have to overcome the consumers' natural inclination to identify a seller's brand name with the product, and that will not be very easy. Another problem is that the preferences of the consumers cannot be shifted immediately.

Products which are different to others stand out and are the natural choice for those customers who seek what these products offer. With such differentiation and sufficient demand, companies have the choice of charging higher prices or increasing sales through lower prices. Lower prices, which is also a part of how a brand is differentiated, acts as a significant barrier. **If you cannot make a product that is any better than one which is currently sold for the price that it is sold at, then entering this market will be very difficult.** Overcoming product differentiation barriers often needs strong innovation to create products that leapfrog existing competitor offerings in terms of both functionality and cost. The latter may be achieved through approaches such as parts reduction and assembly simplification.

### Institutional barriers:

Another type of barriers to entry consists of institutional barriers, which are erected by government. The types of institutional barriers can be explained with the help of following chart:




These barriers take on many forms.

The first type of institutional barriers is **a patent.** Firms and individuals are issued patents by government for new products and inventions. During this time the owner of the patent has the sole right to produce and sell that product. This definitely confers a monopoly on the holder of the patent. By rewarding inventors with a limited monopoly, there will be an incentive for research and development, which is, of course, the goal of patents. In this case, the institutional framework creates the barriers and this institutional framework has been created by the government. A legal patent can provide a pure monopoly because other firms can't use its patent

E.g. a pharmaceutical company can get a drug patent for 7 years, meaning no one else can sell that particular drug.

**A.** A second type of institutional barrier includes **licensing restrictions by government.** Many different occupations (beauticians, barbers, lawyers, doctors, school teachers, nurses, taxicab drivers, etc.) require some type of government license or certificate. Without the license, a person is not allowed to practice a given occupation. What is the purpose of such a requirement? Ostensibly, it is to protect the consumer and guarantee quality. After all, no one wants to go to a physician who has not been to medical school or to be represented by a lawyer with no legal training. For these individuals and others in the health professions, the licensing restrictions seem appropriate. The license doesn't guarantee good quality. If the license doesn't really guarantee quality for the buyer, there is little reason for it except to restrict the supply. **In another words we can say that the government may act as a barriers to entry into a certain market through restrictive licensing requirements.**

B. A third type of institutional barrier exists when the government gives **exclusive franchise rights** to a firm to sell a product. An obvious example of this would be the U.S. Postal Service, which has the sole right to deliver first-class mail. Another example is the torrent power that provides electricity in Gujarat. Other examples would include cable TV companies and utility companies as local phone service, electricity, etc.

C. Another type of institutional barrier erected by government is the use of **tariffs and quotas.** Tariffs are taxes on imported goods while quotas consist of a maximum amount of a good that can be imported into a country. Government imposes tariffs and quota to protect the domestic industries. An import tariff will increase the price of the foreign product and hence the demand would decline. In this case, foreign player cannot enter in the domestic market. Similarly, government can also decide the quota of imports. Above the decided quota imports are not possible.

### Ownership or Control of a Key Scarce Resource:

Many firms have an ownership or control over the resources that are used in the production of final commodity. There is a scarcity of these resources in the market. Owning scarce resources, which other firms could use, creates a considerable barrier to entry, such as an airline controlling access to an airport.

### Network effects:

Network effect also has an impact on barriers to entry. **Network effect is the effect that one user of a good or service has on the value of that product to other people**. In other words we can say that the effect that multiple users have on the value of a good or service to other users.

The higher the number of people using the specific good or service the greater the individuals benefit. If a strong network already exists it may limit new entrants. New entrants are not able to get consumers in the short run and hence they fail to gain sufficient numbers of users to create a positive network effect. The spread of popularity of the telephone in the 20th Century, and more recently the increased popularity of social media, are example of strong network effects. In many industries, the success of the business requires a firm to have a critical mass of users. This is particularly the case with social media. People don't choose necessarily the best technical social media – but the ones their friends use. It can be difficult for a new firm to enter because people are reluctant to use a service that not many other do use.

### High set-up Costs:

This is the type of natural barrier. New firms need to incur some costs to set up the factory in the market. High set-up costs deter initial market entry. These costs cannot be recovered and hence these are known as sunk costs. Firms are not able to recover the sunk costs when the leave the market. Sunk costs include marketing and advertising costs and other fixed costs. Due to high set up costs firm are not ready to enter the market which in turn creates the monopoly.

### High R&D Costs:

If new firms want to enter in the market they need to provide either same quality of goods or higher quality of goods which may require research and development. To produce these kinds of goods firms have to spend enough money on R & D. at the initial stage this is difficult for small firms. When firms spend money on research and development (R & D), it is often a signal to potential entrants that they have large financial reserves. In order to compete, new entrants will have to match, or exceed, this level of spending in order to compete in the future. This deters entry and is widely found in oligopolistic markets such as pharmaceuticals and the chemical industry.

### Capital requirements:

Some industries require significant investment in setting up and operating. Manufacturing, for example, can require large factories and specialist machines. Service also can be costly to set up, for example where a large number of service personnel needs to be recruited, trained and equipped. High capital costs are typical when setting up for the first time. There may also be ongoing capital investments required, for example to cope with rapid changes in technology. Other capital costs include parts inventories, customer credit, and various other start-up losses.

Big and cash-rich companies are able to make a large capital investment required, or may be able to raise the funds elsewhere. Even so, this may require careful analysis that could result in a non-entry decision.  For smaller companies, capital requirements can be a significant barrier.

Overcoming capital requirements may be achieved by starting small and growing organically, from profit, rather than seeking large loans. When rapid growth is essential, this is a less valid approach and collaborative options such as partnering or licensing may be preferable. When there is rapid change in the industry, with such as the need to replace out of date machinery, and incumbents are slow to made needed investments, then this can play to the advantage of new entrants.

### Economies of Scale:

Economies of scale occur when the unit cost of a product declines as production volume increases. When existing competitors in an industry have achieved economies of scale, it acts as a barrier by forcing new entrants to either compete on a large scale or accept a cost disadvantage in order to compete on a small scale. There are also a number of other cost advantages held by existing competitors that act as barriers to market entry when they cannot be duplicated by new entrants—such as proprietary technology, favorable locations, government subsidies, good access to raw materials, and experience and learning curves.It is a barrier to entry for other companies because once a company which is already in the business attain a production volume which leads to decrease in the unit cost of a product it is difficult for other companies to achieve that sort of unit cost of a product and therefore companies do not make an effort to compete against such companies which achieved economics of scale.

### Artificial Barriers:

The barriers that we have discussed so far are natural in nature. But there are some artificial barriers to entry in the market. The artificial barriers are:

### Predatory Pricing:

**Predatory pricing is the act of setting prices low in an attempt to eliminate the competition.** In other words, **Predatory pricing is a deliberate strategy of driving competitors out of the market by setting very low prices or selling below Average Variable Cost (AVC).”**Predatory pricing is illegal under anti-trust laws, as it makes markets more vulnerable to a monopoly. Companies may engage in a variety of activities that intend to drive out competitors, such as create barriers to entry for new competitors or unethical production methods to minimize costs.A sign of predatory pricing can occur when the price of a product gradually becomes lower, which can happen during a price war. This is difficult to prove because it can be seen as a price competition and not a deliberate act. However, in response to a new firm entering the market, the incumbent monopoly could cut price and make a temporary loss. The incumbent monopoly may have significant savings to finance a price war. However, faced with a low price, the new firm may be unable to make profit and so be forced to leave the market.

### Limit Pricing:

A limit price (or limit pricing) is a price, or pricing strategy, where products are sold by a supplier at a price lower than the average cost of production or at a price low enough to make it unprofitable for other players to enter the market. Limit pricing is pricing by the incumbent firm(s) to deter entry or the expansion of fringe firms. The limit price is below the short run profit maximizing price but above the competitive level. Therefore, the monopolist may decide to set a price below this profit maximizing level, but still enable it to make higher profits than in a competitive market. For limit pricing to be effective, the monopolist needs to increase output up to the level where a new firm will not be able to make any profit on entering the market. Limit pricing means a short run departure from profit maximization. If successful, businesses can maintain their market power and make higher profits in the long term.

### Advertising:

Advertising is another sunk cost - the more that is spent by incumbent firms the greater the deterrent to new entrants. New firms cannot afford higher advertisement cost. If new firms enter the market, the well-established firm incurs very high advertisement cost to attract the consumers. Therefore, new firm won't be able to catch the enough consumers to run the business in the short run.

### Distribution Channel:

Distribution plays an important role in production channel. Access to distribution channels is another major barrier to entry as those companies which are established in a line of business usually have control over channels of distribution through their relationship with distributors and therefore new entrants to an industry will find it really difficult to market their products or services which proves to be a significant barrier to entry. It is also known as vertical integration. Vertical integration occurs when a firm has control over the supply and distribution of the good. For example, oil companies can keep the price of petrol very high to discourage new petrol retailers. If a new firm wants to enter the petrol retail market, it will have to buy petrol from one of the big oil companies, who can set a high price, thereby discouraging entry into the petrol market.

### Conclusion:

We have studied the concept of barriers to entry and sources of barriers to entry. Barriers to entry are the obstacles that make it extremely difficult for small or startup enterprises to get a foothold or thrive in a market or industry. There are different types of sources like institutional barriers, economic barriers, artificial barriers etc. Here the main point that we should keep in mind is that barriers create monopoly in the market either by institutional way or by artificial way. It means that barriers would decrease the welfare of the consumers and increase the welfare of the producers in the market in the form of increase in price due to some market power. Some barriers are illegal in nations.