Rose-Hulman Institute of Technology
Department of Humanities & Social Sciences / K. Christ
SV353, Industrial Organization

1.4: Competition and Contestable Markets

The taxonomy of markets describes idealized forms of market structure based on three criteria.

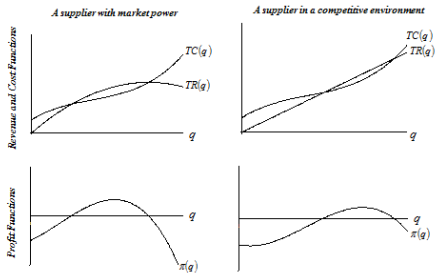
Taxonomy of market structures

	Monopoly (Joint Profit Max.)	Oligopoly	Monopolistic Competition	Perfect Competition
	Imperfect Competition			
Number of Firms	One	Few	Many	Many
Type of Product	Unique (no substitutes)	Unique or Differentiated	Differentiated	Homogenous (undifferentiated)
Conditions of Entry	Significant barriers to entry	Significant barriers to entry	Insignificant barriers to entry	Free entry (and exit)
	Price Makers			*Price Takers*

Review of basic theory of the firm.

Key concepts:
- Production function
- Revenue, cost, and profit functions
- Price-taking behavior
- Marginal cost pricing

Standard Theory of the Firm and Perfect Competition



From theory to stylized facts to an alternative model: Cabral's model of competitive selection.

Perfect Competition

Perfect Competition (Textbook Definition)
Atomicity (Price taking behavior)
Product Homogeneity
Perfect Information (about prices)
Equal Access (to technology)
Free Entry / Exit (Costless)

Theoretical Predictions	Stylized Facts
Entry or Exit	Simultaneous Entry and Exit
Normal economic profit	Distribution of positive/negative profits Persistent positive profits
Unique firm "size" (determined by cost functions)	Entrants and Exiters are smaller on average Size distribution of firms

An alternative model: Contestable markets

Key concepts:
- Sunk costs
- Hit and run competition
- Market discipline

Contestable Markets

- A market served by only one firm, but with "competitive" pricing.
- Its fundamental feature is low barriers to entry and exit; a perfectly contestable market would have no barriers to entry or exit.
- Contestable markets are characterized by 'hit and run' entry. Even a single-firm market can show highly competitive behavior – the monopolist is "disciplined" by the threat of potential competition.
- Has been used to argue for weaker application of antitrust laws.

Relevant exercises: Problem Set 1: exercises 4 and 5.