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Can reduced entry barriers worsen market performance? A model of employee entry

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Abstract

The fundamental contribution of the paper is to contest the view that reducing barriers to entry cannot retard market performance when firm rivalry is productive. In a model of employee entry, we demonstrate that a reduction in barriers to entry causes no fall in industry price when incumbents are able to buy-off potential entry through higher wages. Over the longer term, the analysis illustrates that reductions in barriers to entry can cause industry price to be *greater* than if entry barriers had persisted at their initial level. Correspondingly, the model indicates that investment in endogenous barriers to entry and wage ceilings on executive salaries may *enhance* market performance. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

An increase in firm rivalry need not always result in greater economic welfare (see for example, Salop (1979) and Dasgupta and Stiglitz (1980)). However, the more familiar, and from a competition policy perspective, influential depictions of less than perfectly competitive markets demonstrate that an increase in firm rivalry

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can enhance both competitiveness and economic welfare. In these markets, it is held that reductions in barriers to entry and exit to an industry cannot retard market performance. In other words, a reduction in barriers to entry is either expected to cause a fall in market price or at the very least have no effect. This perspective has led to a competition policy 'rule of thumb' where a reduction in barriers to entry is currently perceived as one of the main objectives (rather than as a means) of competition policy.

In this paper we demonstrate that consideration of the dynamic entry process as endogenous raises doubts about this conclusion. We argue that reductions in barriers to entry may retard market performance in markets where increased firm rivalry enhances market performance. We, therefore, advise against a 'rule of thumb' approach to the regulation of barriers to entry. In a model where an incumbent's employees pose the only threat of entry, reductions in barriers to entry may result in increased salaries rather than an increase in actual entry. We show that, in the short run, reductions in barriers to entry may result in higher salaries and no entry. Over a longer time period reductions in barriers to entry may cause firms to limit the number of their employees in the knowledge that the subsequent threat of entry will translate into increased salaries. In this case reductions in barriers to entry cause higher prices and lower output. In other words, they retard market performance.

The basic intuition behind our result rests on the concept that production technology and entrepreneurial ideas are knowledge which may be disseminated through employment.[1] Specifically, an incumbent's employees often constitute the most credible potential entrants, having a detailed knowledge of the production technology, and both output and factor markets. This may be particularly true of employees (most likely senior executives) who have sufficient entrepreneurial ability and capital to be credible entrants and competitors to an incumbent. The analysis is likely to be relevant to client-oriented and technology-led industries where certain employees acquire specific human capital[2] through employment, where this human capital is necessary for market entry and is transferable to other firms. For example, in the technology-led sector, the launch of Real Networks Inc., which competes with the Microsoft Media Player, was instigated by Rob Glaser, a former executive of Microsoft. Recently, Microsoft has suffered further losses in senior management and in response have increased executives' benefits (Buckman, 2000). Similarly, in the mobile phone industry former employees of Nokia, Ericsson and Motorola set up the British company Sendo, in competition with their

[1] To our knowledge, we are the first to consider a model where employees represent a significant threat to entry.

[2] We use the term human capital in a broad sense to encompass not only production know-how but also those inputs necessary for completing sales such as business contacts, client lists and accumulated goodwill.

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