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Potential Competition in the Presence of Sunk Entry Costs: An Experiment*

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Abstract

I study the effect of sunk entry-costs on potential competition in a multi-market framework, where potential entrants have different home market profits. Although sunk-entry-costs are supposed to increase entry barriers, my experimental results suggest that firms view entry costs differently depending on their home market profits. I find that subjects are reluctant to enter, and compete in another market if they are already earning monopoly rents. Subjects instead, collude tacitly and earn monopoly rents in home markets, thereby weakening the effect of potential competition. In contrast, subjects who earn small secure returns in their home markets aggressively enter the contestable market whenever there are scopes for earning net profits. The threat of entry and the effects of potential competition are strong in the latter situation, forcing the monopoly incumbents to lower prices to limit-pricing levels.

Keywords: potential competition, contestable markets, sunk cost, limit-pricing, hit-and-run entry, collusion, experiment

JEL Classification Codes: C91,C92, D4, L1

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