TPJC JC2 Preliminary Examination 2017
EQ3 – Question and Answers

<u>Question</u>

Globalisation has brought about both opportunities and challenges. Some firms have capitalised on this phenomenon to expand overseas. Netflix, an over-the-top (OTT) video streaming service from America which provides on-demand video content over the Internet, has begun its foray into international markets since 2011.

Source: The Business Times, January 21, 2017

(a) Explain possible factors affecting Netflix's decision to enter Singapore's OTT market. [10]
(b) In the light of globalisation, discuss whether it is beneficial when firms increase in size. [15]

<u>Suggested Answers</u>

(a) Explain possible factors affecting Netflix's decision to enter Singapore's OTT market. [10]

<u>Introduction</u>

The objective of all firms, at least in the long run, is to maximise profits, by maximising total revenue and minimising total costs. In deciding on its strategies, a firm like Netflix needs to consider the impact of its behaviour and decisions on its revenue and costs. It will also need to consider the impact of external circumstances. In the first part of the essay, we will explain possible factors that affect Netflix's decision to enter Singapore's OTT market.

<u>Body</u> (any 3 well-explained factors)

Factor 1: Barriers to entry
One of the factors that Netflix needs to consider in its decision to enter Singapore's OTT market is that of barriers to entry (BTE). BTEs are obstacles, either natural or artificially imposed, to prevent potential entrants from entering the industry, thereby restricting competition. One natural BTE that Netflix needs to consider is that of start-up costs. If the start-up costs are high, perhaps due to huge infrastructure outlays and technological investment, then Netflix might not want to enter the industry as it would incur substantial costs. If the costs turn out to be too high, they would earn subnormal profits. However, in this context, Netflix is a well-established brand with most of its services already developed and distributed online. As such, start-up costs in terms of infrastructural development are likely to be low, signalling that BTE are low and it is beneficial for Netflix to enter Singapore's OTT market, since it does not incur significant entry costs.

Factor 2: Impact on revenue
Another possible factor that influences Netflix's decision to enter Singapore's OTT market is the impact of Netflix's entry on their revenue.

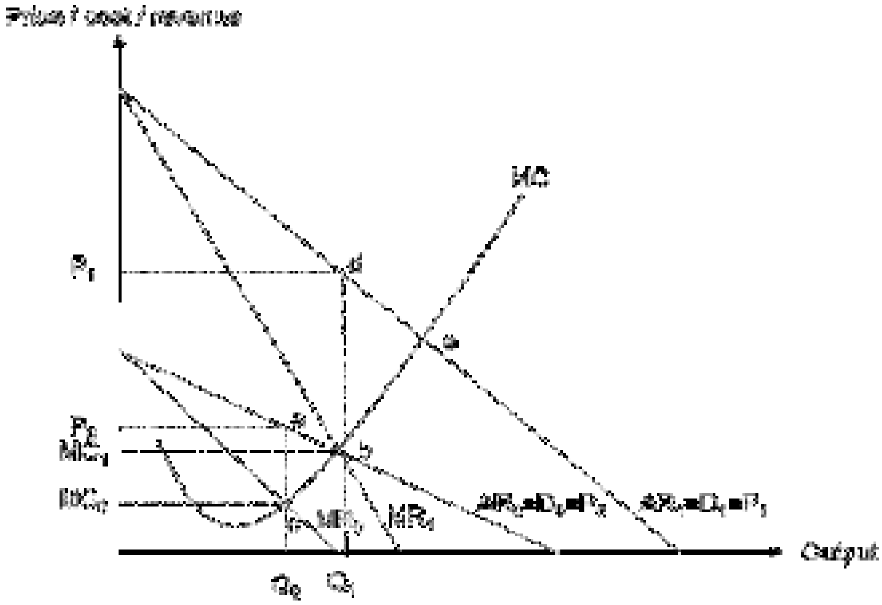
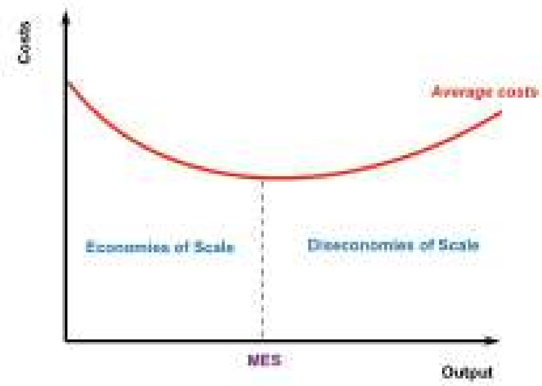


Figure 1: Increase in TR from Netflix's international foray

Netflix is a firm originating from the USA. By tapping into international markets such as Singapore, Netflix's market share will increase, thereby increasing its total revenue. With a greater customer base, the higher market share means an increase in demand for Netflix's services. Originally, Netflix produced at the profit maximising output level Q_0, where the marginal cost (MC) curve intersects the marginal revenue (MR) curve MR_0, and corresponding price P_0. With its international foray, Netflix's demand/average revenue (AR) curve shifts rightwards from AR_0 to AR_1, with their MR curve following suit. This increases both the profit maximising output and price to Q_1 and P_1 respectively, thus leading to an increase in total revenue from P_0Q_0 to P_1Q_1. In such a situation, Netflix is likely to enter the OTT market.

It is not definite that entering Singapore's OTT market means an increase in Netflix's revenue. Netflix's revenue might not increase significantly if there is a lack of demand for Netflix's services, for instance, if consumers still prefer to watch live-air TV. However, this is probably not the case in Singapore, as consumer tastes and preferences have changed towards a preference for on-demand content due to busier lifestyles and perhaps an inclination towards instant gratification. Hence, it is likely that Netflix's revenue will increase.

Factor 3: Impact on costs of production



Another factor that affects Netflix's decision to enter the OTT market is the impact of its entry on its costs of production. By entering into international markets, Netflix expands its scale of production beyond the USA. As long as Netflix is still operating below the minimum efficient scale, it will be able to reap greater internal economies of scale (iEOS), which is defined as the decrease in average cost of production from a greater scale of production. One example of the iEOS it can reap is that of marketing EOS, where Netflix is now able to spread its advertising costs over a large range of output. As advertising costs are fixed costs of production, the larger scale of production beyond USA means that the per unit advertising cost is lower. With lower costs of production, Netflix's profits would increase, ceteris paribus, and Netflix should enter the OTT market in Singapore.

However, keeping the factor of costs in mind, Netflix also needs to consider if its entry into Singapore's OTT market would result in the firm operating beyond the MES and suffering internal diseconomies of scale (iDOS) instead, where an increase in the scale of production would unfortunately lead to higher average costs instead. For instance, costs of production might increase due to a lack of co-ordination between Netflix employees from the different countries, leading to a fall in productivity of workers.

Furthermore, entry into Singapore's OTT market would also directly increase Netflix's costs as it would have to incur start-up expenses to penetrate the market, such as the cost of setting up its office. Ultimately, though, Netflix's decision on whether to enter the market depends on whether the increase in revenue (as explained in the first point) exceeds the increase in cost of production, i.e. if they foresee an increase in profits. If the costs incurred are likely to exceed the increase in revenue, they might decide to stay away instead to avoid a loss in profits.

Factor 4: Economic outlook

A third factor that affects Netflix's decision on whether to enter Singapore's OTT market is the current economic outlook in Singapore. If the economic outlook is positive, it will be more likely that Singaporeans will take to Netflix, since it can be considered a normal good, where higher incomes would lead to higher demand for the normal good. As such, demand for Netflix and hence revenue will be more likely to increase. On the other hand, if the economic outlook in Singapore is negative and economic growth is worsening, then incomes will be falling, and consumers will not be likely to take to Netflix. In such a scenario, Netflix might want to consider delaying its foray into the Singapore OTT market by waiting for a more positive economic outlook, so as to increase the likelihood that its revenue will increase significantly.

Factor 5: Consumers' tastes and preferences

Lastly, another factor that Netflix can consider is consumers' tastes and preferences. In deciding whether to enter a new market, Netflix needs to take into account the characteristics of the consumers it is targeting, as they may be different from that of consumers in the USA. For instance, Netflix needs to consider whether and to what extent consumers in Singapore will demand for the specifics of the services offered by Netflix, including the price plans and the genre of TV shows that are desired by Singaporean consumers. If, say, the majority of Singaporean consumers prefer Asian TV shows as compared to American TV shows, then Netflix might want to decide not to enter Singapore's OTT market, or if it decides to enter the market nevertheless it would need to differentiate its services to ensure that it can cater to the tastes and preferences of Singapore's consumers.

<u>Conclusion</u>

All in all, Netflix will need to consider a variety of factors, including the impact of its entry on costs and revenue, as well as any information it might have about the market in question. Ultimately, Netflix will need to conduct a cost-benefit analysis in order to decide whether to enter the market or not. If their total revenue exceeds total cost, then Netflix would be earning supernormal profits and thus should enter Singapore's OTT market, and vice versa.

Other possible factors:

- Market contestability (link to revenue)
- Barriers to entry (link to revenue)
- Existence of supernormal profits to be earned
- Ability to withstand competition with existing firms
- Existing supernormal profits (link to ability to engage in strategies to establish position in SG market)

Level	**Descriptor**	**Marks**
L3	For a developed and well-explained answer that explains the various factors affecting Netflix's decision, with application to the context laid out in the preamble.	8 – 10
L2	For an underdeveloped explanation of the various factors affecting Netflix's decision.	5 – 7
L1	For a descriptive explanation of the factors affecting Netflix's decision, or for an answer that scratches the surface on the factors but does not directly answer the question requirements.	1 – 4

(b) In the light of globalisation, discuss whether it is beneficial when firms increase in size. [15]

Introduction

As explained in part (a), if Netflix decides to enter Singapore's OTT market, it may be able to benefit from its larger size and market share. Apart from the considerations explained earlier, Netflix also needs to take into account external factors that might affect the impact of its decision – the impacts of globalisation, for instance. Globalisation is the process by which countries become more interconnected through a freer flow of goods and services, labour, capital and ideas/technology. Globalisation has brought about both positive and negative impacts. Thus the next part of the essay aims to discuss whether, in light of globalisation and its impacts, it is beneficial for firms to increase in size, in terms of benefits and costs on consumers, producers and society, as well as the economy.

Thesis: Beneficial when firms increase in size

T1: Benefits from freer flow of goods and services

One of the drivers of globalisation is the freer flow of goods and services. With globalisation, there is greater access to world markets, and firms are able to move beyond their domestic customer base, expanding their market demand beyond the domestic boundaries. It is thus beneficial for firms to increase in size by harnessing the freer flow of goods and services to expand overseas (like Netflix did), as this would give the firm greater ability to reap internal EOS, which involves the lowering of average costs of production as firms increase their scale of production. Furthermore, being able to sell their goods and services in overseas markets would also directly increase total revenue. With higher total revenue and lower costs of production, firms' profits would increase, thus benefitting the firm itself.

From a consumer point of view, the ability to consume goods and services from overseas would mean greater variety, thus improving consumer welfare.

Additionally, these higher supernormal profits earned would increase the ability of the firm to engage in research and development (R&D). This could be via product or process innovation, either to improve on the quality of their products or to lower the cost of production via more efficient production processes respectively. In so doing, the firm could further ensure higher revenue and lower costs, and hence higher profits, in the long run.

From a society point of view, this would also lead to greater dynamic efficiency.

The freer flow of goods and services would undoubtedly have its downsides too – the ability of firms to expand into overseas markets would mean that domestic firms would in general face greater competition and greater threat of competition. In the light of this, it would be beneficial for firms to increase in size as the higher market share and hence supernormal profits earned would give the firm greater ability to compete with overseas firms via various price and non-price strategies. Thus increasing its size enhances the survivability of the firm.

T2: Benefits from freer flow of capital

With globalisation bringing about freer flow of capital, it may be beneficial for firms to increase in size because now they will be able to harness the capital or technology transfer to improve their productivity or efficiency of their production processes. As a result, increasing in size would help them to expand their scale of production and reap iEOS – specifically technical EOS that allows them to spread the costs of their expensive and/or specialist capital machinery over a larger range of output. This lower cost of production will thus increase firms' profits, ceteris paribus.

Also, the freer flow of capital means that firms may be able to enjoy lower costs of production if they can move their capital/machinery and hence production processes where the cost of labour is cheaper. For instance, by increasing in size and expanding its production to low-cost labour countries like Vietnam, firms selling manufactured goods (e.g. apparel firms) would be able to capitalise on the cheaper labour from overseas, as compared to if they did not increase in size and restricted production to within domestic boundaries. With a lower cost of production and yet higher output, this would increase the firm's profits.

T3: Benefits from freer flow of labour
Thirdly, the freer flow of labour brought about by globalisation would mean that labour can flow more efficiently towards where it is needed the most. Thus as firms increase in size, they can employ additional workers more easily now. In other words, workers are free to move to other countries with better job opportunities. This improves workers' material and non-material standard of living, as employment brings with it income, and hence a greater ability to consume goods and services. They can use the higher income to improve their non-material standard of living as well, for instance, via spending on healthcare or education.

From an economy point of view, the freer movement of labour would mean that if firms increase in size and bring in workers from other countries, the home country would enjoy an increase in the quantity (and sometimes quality) of resources, thus increasing the economy's productive capacity, achieving potential growth.

<u>Anti-Thesis: Not beneficial when firms increase in size</u>

AT1: Costs from freer flow of goods and services
However, there are also costs when firms increase in size. As explained earlier, the freer flow of goods and services makes it possible for firms to expand into overseas markets, thus increasing their profits through higher revenue and lower costs of production. However, as firms grow bigger, their greater market share will enable the firm to set higher prices and restrict output. Graphically, the increase in market share corresponds to an increase in demand for the firm's goods and services, resulting in a rightward shift in the MR and AR curves as in Figure 1 back in part (a). With higher market share, the gap between price and marginal cost has increased (P_0-MC_0 < P_1-MC_1) and the deadweight loss has increased significantly from area abc to area deb in Figure 1. This means that allocative inefficiency is worsened, harming society's welfare.

Furthermore, consumers would suffer from the higher prices charged ($P_1 > P_0$), thus eroding consumer surplus and welfare.

AT2: Costs from freer flow of capital
Although the freer flow of capital benefits firms by lowering their cost of production and increasing profits, it also brings about costs to households and the economy. With freer flow of capital and the transfer of technology from other countries, there is the possibility of capital-labour substitution, where technology and capital takes over the work of labourers. As the structure of the economy has changed towards a more capital-intensive one, workers find themselves displaced and lacking the skills for jobs in new industries. As such, they become structurally unemployed.

As workers become unemployed, the loss of income would directly worsen material standard of living, and the erosion of skills and inability to find work would also lead to worsened non-material standard of living because of demoralisation and social problems.

AT3: Costs from freer flow of labour
When firms increase in size to capitalise on the freer flow of labour, it could lead to workers migrating from one country to another. Although this benefits firms in terms of being able to utilise lower cost methods of production, the economy would lose out. If high-skilled workers migrate out of the country in search of better job opportunities overseas, this would lead to brain drain, where the average quality of workers in the country now decreases, thus reducing the country's productive capacity. As a result, this limits the country's potential for sustained economic growth.

AT4: Merits of firms remaining small in size
In the first place, it could be beneficial for certain firms to remain small in size. Some firms operate in industries where the minimum efficient scale is attained at a rather low level of output. As such, even if the firm tries to harness the benefits of globalisation by growing in size, it could be harmful for the firm in terms of raising costs by more than proportionately, as the firm starts to experience iDOS at a rather low level of output. This applies to small businesses such as corner shops and specialty restaurants. If they increase in size, they would start to earn subnormal profits instead. Hence, there is merit to remaining small.

Furthermore, there are some firms that would benefit from remaining small in size because of the personalised services they offer, and the customer loyalty they enjoy. For example, hairdressers and beauty parlours enjoy the advantage of geographical niche and customer loyalty, because of where they are located and the special services they can offer to their customers. As such, demand for these firms' services are already price inelastic, providing some degree of monopoly power. If these firms become too large, they may not be able to continue to provide such personalised services to consumers, resulting in lower revenue and hence profits.

Note: Accept other relevant points on both sides.

<u>Evaluative Conclusion</u>

Ultimately, whether it is beneficial for firms to increase in size in the light of globalisation depends largely on the nature of the firm, and whether the benefits of doing so outweighs the costs. Firms operating in a monopolistically competitive (mpc) industry may find themselves better off remaining small, as they get to enjoy their certain degree of monopoly power from geographical location and customer loyalty, whereas larger firms from oligopolistic and monopolistic industries may find themselves enjoying iEOS and hence higher profits when they increase in size. Firms will thus need to conduct cost-benefit analyses with the data they can gather in order to predict whether they will gain from becoming larger.

However, firms do not take into account the impacts of their becoming large on other stakeholders, i.e. consumers, society and the macroeconomy. As a result, government intervention may be necessary to keep a check on how far firms increase in size to harness the benefits of being large – for instance, competition watchdogs are tasked to consistently check if consumers and societies indeed benefit, or if firms becoming large would lead to exploitation of consumers and worsening of consumer welfare.

Specifically for consumers and society, whether it is beneficial when firms increase in size would also depend on firms' decisions – for instance, whether they decide to pass on cost savings from higher iEOS in the form of lower prices, or if they choose to retain their profits. Also, whether they choose to use their supernormal profits to engage in R&D to improve dynamic efficiency, or if they just retain their profits.

Lastly, whether it is beneficial for firms to increase in size would also depend on the nature of the economy. In the case of a small and open economy like Singapore, with a rather small domestic consumer base, the additional revenue gained from opening up to overseas markets is very likely to outweigh the increase in costs from having to enter these foreign markets, at least in the long run. On the other hand, for large economies that have a sizeable domestic sector, it may not necessarily be beneficial for firms to increase in size, depending on whether the benefits outweigh the costs, or vice versa.

Level	**Descriptor**	**Marks**
L3	For a well-developed and rigorous discussion on the benefits and costs of firms increasing in size, in the light of globalisation and its impacts.	8 – 10
L2	For an underdeveloped, two-sided answer that discusses the benefits and costs of firms increasing in size, in the light of globalisation.	5 – 7
L1	For a one-sided answer that only explains why it is beneficial <u>**or**</u> harmful for firms to increase in size. OR For an undeveloped/descriptive two-sided answer that lists out why firms should and should not increase in size. OR For an undeveloped answer that does not address the question requirement of considering globalisation and its impacts on firms' decision whether to increase in size.	1 – 4
E3	For a well-explained judgement that is supported with economic reasoning.	4 – 5
E2	For an underdeveloped justification of stand made, one that is lacking in economic rigour.	2 – 3
E1	For an unjustified stand/unexplained judgement made.	1