<u>**ACJC Preliminary Examination 2017 Paper 2 Question 3**</u>

**In 2001, local banks in Singapore merged to form sizeable banks, in line with the Government's policy of encouraging local banks to merge and consolidate their operations in order to compete internationally. But in 2015, Competition Commission of Singapore (CCS) blocked a healthcare merger in a bid to maintain healthy competition.**

***Source: The Straits Times, 2014 and 2015***

**(a) Explain the factors that are likely to influence firms' decision to merge. [10]**

**(b) Assess the economic justifications for the Competition Commission of Singapore (CCS) to block mergers. [15]**

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**Question (a)**

<u>Introduction</u>

- Explain what is merger
- Explain briefly the objective/rationale for merger
- Explain briefly the factors that would influence firms' decision to merge: (1) Benefit – increase TR, (2) Benefit and cost – may increase / decrease average cost of production (due to internal economies of scale & diseconomies of scale), (3) threat of competition and (4) Constraints – receptivity of stakeholders.

<u>Body Paragraph 1 – *Total Revenue (Benefit)*</u>

In deciding whether to merge, firms would consider the **benefits** of merger. The merger could have an **impact on the total revenue** of the firm. If merger increases firms' total revenue, the firms may consider merging.

- Merger allows the firms to acquire existing brand loyalty immediately. Brand loyalty usually takes time to build up and is not immediately available when a firm grows internally.
- Example: merger between POSB and DBS Banks in Singapore (horizontal merger).
- Such merger will <u>*increase the market share and market power*</u> of the merged bank and the new bank will acquire larger consumer base → increase the DD for banking services → increase the TR of the bank → could increase in profit of the bank.
- Merger could allow the bank to increase TR and hence profit immediately. This could allow the bank to better compete against other international firms.

Therefore the benefits of merger could influence firms' decision to merge. The larger the increase in TR, the more likely for firms to merge.

<u>Transition Paragraph</u>

While merger could increase TR and thus profit of firms, firms would also have to take into consideration the impact of merger on their cost. Firms hope that merger could benefit them by increasing their TR and reducing their cost in order to have the highest profit possible. While merger could benefit the firm by reducing the average cost of firms, there is a possibility that such merger may cost the firm by raising their average cost of production too. Thus firms have to weigh the possible benefits and cost of merger in their decision making process.

Body Paragraph 2 – *LRAC (Benefit & Cost)*

Besides the benefit of higher total revenue, firms would also be considering other **benefits** of merger as well as possible **cost of merger**. When firms merge and expand production, they could benefit from **lower average cost of production**. However, if the merged firm expands beyond the minimum efficient scale (MES), the merged firm would see a **rise in their average cost of production,** a ***cost*** firms would have to bear if they choose to merge**.**

- When firms merge, they could benefit from lower average production cost by better enjoying internal economies of scale.
- Internal Economies of Scale (EOS) refers to cost savings arising from the benefits of increasing the output by expanding the firm's scale of production (size of firm). Internal EOS enables the firm to spread its cost over a larger output, hence lowering its Long Run Average Cost.
- When banks such as DBS and POSB merged → larger consumer base → larger output → the bank could better enjoy **technical EOS**. The merged bank is able to spread the high cost of the latest technology and sophisticated banking systems over large output → reduce the LRAC.
- When firms in the healthcare industry merge → larger consumer base → larger output → the firms can have specialization and division of labour → Workers can do more simple and repetitive jobs in large-scale firms, rather than many different small jobs. There is les time lost in workers switching from one operation to another, if they had to do many different jobs. The increased productivity thus allows the firm to enjoy lower average cost of production.
- While firms could benefit from merger, there is a possibility that merger could lead to higher average cost. When firms merge, they could grow too big beyond the MES → *internal diseconomies of scale.*
- Merger → the task of coordinating work shared out among several large departments and managing a large staff performing a variety of functions becomes increasingly difficult as the firm expands. As layers of supervision increase, the cost of information and communication grow more than proportionately, hence per average cost of each output starts to increase.

Thus when firms merge, they would have to consider the impact on their average cost. If the merged firm is producing below the MES, the firm would benefit from a lower LRAC. However, if the merged firm expends beyond the MES, the firm would see a higher LRAC, a possible cost the firm may incur.

Body Paragraph 3 – Weighing current Benefits & Costs

In deciding whether firms should merge, they have to consider the benefits and cost of merger. Firms would consider the relative change in cost and revenue. If the **increase** in TR is more than the **increase** in total cost → it is still profitable to merge and firms are more likely to merge. Otherwise, if the increase in TR is less than the increase in total cost, firms are not likely to merge. Firms would consider the cost and benefit of merger and when there is net benefit to merger, firms would be more likely to merge. At the same time, firms may also need to take into consideration the *time period.* While it may not be profitable to merge in the short term, the merger could be profitable in the long term. Therefore, in their decision making, firms may want to also take into consideration, the time period, in addition to the cost and benefit of merger.

Body Paragraph 4 – Weighing Future Benefits & Costs

Besides cost and benefit, firms would also consider the *threat of competition* they might face, especially with increase globalization.

- Growing competition from international banks that are larger and more cost efficient than domestic banks (e.g. DBS and OCBC).
- Example of international banks: Deutsche Bank, Citigroup and HSBC
- Citigroup has an estimated 100 million customers while HSBC has 20 million customers, indicating the substantial revenue these banks are earning.
- Their size enables them to invest billions of dollars in the latest technology and sophisticated systems. As these banks can spread these costs over millions of customers world-wide, they can efficiently deliver a wide-range of customised products at low unit costs, enjoying internal economies of scale.
- Singapore banks on the other hand are smaller and thus may not be able to compete against these global banks.
- Thus mergers between DBS and POSB → larger banks → increase TR and decrease average cost of production → larger profit → carry out innovation to provide better financial services → enable domestic banks to better compete using non-price competition against those large international firms.
- Merger of banks → lower average cost → able to pass on cost saving to consumers → enable domestic banks to better compete using price competition against those large international firms.

Thus when considering merger, firms would also consider the possible threat of competition that might face.

<u>Body Paragraph 5 – Possible Constraints</u>

Beside the cost and benefit of merger, firms would also consider the <u>*constraints*</u> they are facing. Success of the merger may be constrained by the <u>*lack of receptivity*</u> of the various stakeholders in the company.

- Firms would also consider the receptivity of the various stakeholders in the company. Stakeholders may not be receptive towards merger because some stakeholders fear that a merger would reduce the future value of the firms.
- Example: Merger between Tesco (a supermarket group) and Booker Group (wholesaler) was blocked in the initial stage of discussion because the news of merger was met with strong disapproval from the stakeholders.
- Tesco and Booker Group failed to merge given the lack of receptivity.

Thus firms' decision to merge can be influenced by the constraints they are facing.

<u>Body Paragraph 6 – Possible Constraints</u>

There are also other constraints that firms may need to take into account when considering whether to merge. <u>*Government regulations*</u> could restrict or prevent the firms from merging.

- When two large firms plan to merge, they may be subjected to CCS anti-trust law.
- This is the case where CCS blocked the healthcare merger between Parkway Holdings Ltd and Fortis Healthcare Singapore Pte. Limited. These two firms were under the scrutiny of CCS because the firms are large firms with possibility to become monopoly after merger.

Thus government regulations could be one of the factors that firms might consider when deciding to merge.

<u>Conclusion</u>

Firms would have to weigh the possible cost and benefit before making a decision whether to merge. If benefits outweigh the cost, firms will most likely merge to form larger firm. However, while firms may want to merge, they might be restricted by government policy which prohibits some firms from merging.

| Knowledge, Understanding, Application & Analysis | | |
|---|---|---|
| *Level* | *Descriptors* | *Marks* |
| L3 | • Develop analysis of the factors that will influence firms' decision to merge.<br>• Answer that address both the benefit and cost of merger.<br>• Answers are well-organized and coherent, with good use of examples. | 8 – 10 |
| L2 | • Undeveloped explanation of the factors that will influence firms' decision to merge.<br>• Answers are largely supported by economic analysis<br>• Theoretical answer not supported by examples | 5 – 7 |
| L1 | • Points are largely irrelevant<br>• Descriptive answer lacking economic analysis or contains many conceptual inaccuracies. | 1 – 4 |

<u>**Question 3(b)**</u>

**Assess the economic justifications for the Competition Commission of Singapore (CCS) to block mergers.**
**[15]**

<u>Introduction</u>

- Competition Commission of Singapore (CCS) is Singapore's competition authority. It is a statutory board under the Ministry of Trade and Industry and is tasked to administer and enforce the Competition Act
- CCS blocked the healthcare merger in a bid to maintain healthy competition in the industry so that firms would be dynamic efficient and less allocative inefficient.
- However, such healthcare merger could also bring about lower price and higher output.

<u>Body Paragraph 1</u>

There may be economic justification for CCS to block the merger to increase competition and encourage dynamic efficiency.

- When CCS blocked the merger → more competitive & less likely to be complacent → firms will be incentivised to engage in R&D to find better healthcare services and better treatment procedures for patients. Thus competition could lead to dynamic efficiency.

Thus when CCS block the healthcare merger, firms in the healthcare industry may be dynamic efficient.

<u>Transition Paragraph</u>

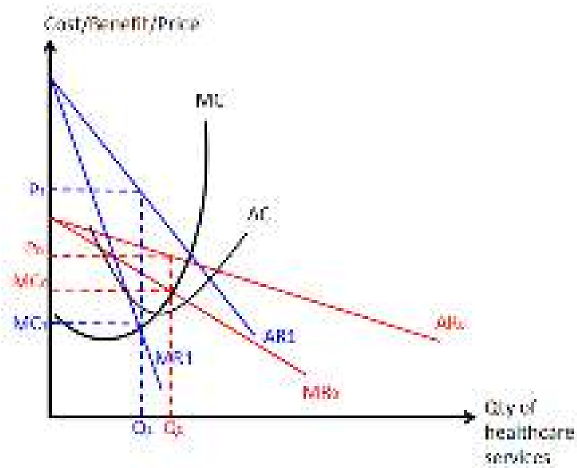
Producing good quality healthcare services is important for Singapore to remain as one of the top player in the medical tourism. Quality healthcare is one of the key reasons why foreigner consumers are attracted to Singapore for medical treatment. Singapore was ranked the most attractive among seven Asian countries in terms of "patient experience". However, Singapore was also one of the least attractive where costs were concerned. Lower costs and the growing availability of quality care in neighbouring countries such as Malaysia and Indonesia will not only lure medical tourists away from Singapore, but could also encourage patients to stay home for treatment. And unlike Singapore, the attractiveness of the patient experience in these countries grew, while healthcare costs in these places remained relatively low. Thus there is an urgent need for Singapore to keep the healthcare cost low and that is why CCS blocked the healthcare merger.

Body Paragraph 2

Competition Commission of Singapore blocked the healthcare merger to ensure higher consumer welfare and to prevent the formation of larger firm that are more allocative inefficient.

- When CCS blocked the merger → at profit maximization MC=MR, firms would produce at $Q_0$ and charge a price $P_0$.
- However, merger of two healthcare firms → increase market share and reduce the number of competitors in the healthcare industry → as there are fewer competitors who can provide similar healthcare services, the demand for healthcare services become more price inelastic (from $AR_0$ to $AR_1$) → at profit maximization MR=MC, the newly merged firm will be able restrict output to $Q_1$ to charge a higher price, $P_1$, for the healthcare services.
- Larger merged firms will produce at a lower output and charge a higher price and → reduce the consumer surplus and hence welfare.
- Thus CCS block the healthcare merger to ensure low price so that healthcare remains affordable for the consumers → more equitable distribution of healthcare services
- At the same time, merged firm would be more allocative inefficient.
- Before merger: $P_0$ > $MC_0$ and is allocative inefficient. However, the gap between price and marginal cost is relatively small.
- However, after merger: $P_1$ > $MC_1$. However, the gap between the new price ($P_1$) and new marginal cost ($MC_1$) is even larger → more allocative inefficient.

Thus government blocked the merger to so as to ensure that prices are low, output is higher and firms are less allocative inefficiency.




Transition Paragraph

Merged firms in the healthcare industry may charge higher price and lower output assuming there is no cost saving. However, there is a possibility that the merged firms may experience substantial EOS and pass on the cost saving to the consumers in the form of lower price and higher output. Thus there may not be any economic justification to block the merger.

Body Paragraph 3

Merged firms may be able to enjoy EOS and benefit consumers by charging a lower price and producing at a higher output.

- When firms merged → larger consumer base → larger healthcare or banking services → the firm could better enjoy technical EOS. The merged bank is able to spread the high cost of latest technology and sophisticated systems over large output → reduce the AC.
- Hence firms may pass the cost saving to the consumers in the form of lower price.
- Lower price → higher consumer surplus.
- However, should CCS block the merger → smaller output → enjoy a smaller extent of iEOS → higher AC → higher price.

Thus there are benefits to merger and thus there may not be justification for government to block the merger.

Transition

Merger can be beneficial to the consumers if the merged firm passed on the cost saving to the consumers. And whether the firm would pass on the cost saving to the consumers would depend on the contestability of the healthcare industry. Globalisation has made the market more contestable and if the healthcare merger passed through, the merged firm may pass on the cost saving to the consumers.

Conclusion

- CCS blocked the healthcare merger in a bid to maintain healthy competition in the industry so that firms would be dynamic efficient and less allocative inefficient.
- However, such healthcare merger could also bring about lower price and higher output for the consumers.
- Whether there is any economic justification for CCS to block the merger, it also depends on the market share of the merged firm. If the market share is large enough so much so that it can be considered a monopoly, then there may be a case for CCS to block the merger.
- While it is argued that globalization could increase the contestability and encourage the merged firms to pass on the cost saving to the consumers, it may take two to three year for a new entrant to be able to enter and compete against the larger merged firms. And during that period, the merged firms may not pass on the cost saving to the consumers.

| **Knowledge, Understanding, Application and Analysis** | | |
|---|---|---|
| *Level* | *Descriptors* | *Marks* |
| L3 | • Developed and balanced explanation on whether there is economic justification for CCS to block the healthcare merger. The economic justification is based on allocative efficiency, price and dynamic efficiency.<br>• Answer is well supported by economic analysis.<br>• Answers are well-organized and coherent, with good use of examples (banking and healthcare).<br>• Good use of diagrams to illustrate the answer. | 8 – 10 |
| L2 | • Developed but one-sided answer: there is economic justification for CCS to block the merger OR there is no economic justification for CCS to block the merger. Answer is well supported by economic analysis<br>• Undeveloped but balanced answer. Answers are supported by | 5 – 7 |

| | | |
|---|---|---|
| | some economic analysis.<br>• Limited use of examples. | |
| Low L1 | • Points are largely irrelevant<br>• Descriptive answer lacking economic analysis or contains many conceptual inaccuracies. | 1 – 4 |

| **Evaluation** | | |
|---|---|---|
| *Level* | *Descriptors* | *Marks* |
| E3 | For an answer that arrives at an analytically well- reasoned arguments as to whether CCS should block the merger. | 4 – 5 |
| E2 | An evaluative assessment based on some analysis.<br>But lacks synthesis to wrap up the arguments. | 2 – 3 |
| E1 | Arguments evaluated but is superficial & not based on sound evidence and principles | 1 |