

The operator of the upcoming Thomson-East Coast Line (TEL) will be the first to run a rail service under a contract similar to the model recently introduced for buses. The successful bidder will operate the new line for a fixed sum over a fixed period, while the Government collects fare revenue, the Land Transport Authority (LTA) said yesterday. This move aims to increase the contestability of the public transport market.

Adapted from The Straits Times, 2016

Discuss whether making markets more contestable is the best approach to reduce the adverse effects of market dominance in the provision of bus and rail services in Singapore.

[25]

Question Interpretation

Consider and explain alternative views – thesis and anti-thesis

c

Content – contestable market;
adverse effects of market dominance

Discuss whether making markets more contestable is the best approach to reduce the adverse effects of market dominance in the provision of bus and rail services in Singapore.

[15]

Weigh benefits and limitations
before judging

Context – justify with respect to the industry
and the country specified

Introduction

- Define market dominance.
- Define contestability.



The adverse effects of market dominance in the provision of bus and rail services in Singapore

- Limit output and increase price. But P is regulated by Public Transport Council (PTC).
- Still incumbent big firms e.g. SMRT and SBS can limit output to save on costs.
- X-inefficient due to complacency. Redundant factors of production (e.g. capital / labour being employed) → contributes to productive inefficiency.
- Service standards could be poor due to complacency.



Government making markets more contestable is the best approach to reduce the adverse effects of market dominance



It could help

- Contracting model: lowers barriers to entry as it takes away the high set up cost of running bus and rail services (give some examples). New firm(s) could enter the market at the next bid.
- Incumbent operator could lose rights to operate services after "fixed period" → loss of profits.
- Need to increase standards in order to win the next bid.
- Need to keep costs low in order to be the lowest bid. → forced to be productively efficient (define).

Possible limitations of the contestable market approach

- "Hit and run" strategy by firm that won the contract: firm can exit at lower costs → not compelled to stay in the market and up the service standards.
- Firm reducing costs to win the bid by price advantage could sacrifice service standards (e.g. fewer trains / poorer services).



There may be alternative approaches

- More effective regulation / stronger penalties.
Evaluation: this has shown that it is not working very well. Despite fines issued to operators in-lieu of breakdowns, problems continue.
- More operators, thereby increasing competition directly.
Evaluation: natural monopoly argument. Firms could shut down or require govt support (i.e. impact on budget).
- Encouraging other modes of public transport

- Cycling (bike share / infrastructure)
- Taxis (esp. Uber / grab)

Forces the incumbent firms to up their game and improve service standards. Falling dd / more price elastic also forces train and bus operators to reduce costs → promotes productive efficiency.

Evaluation: cycling unlikely to be close substitutes. Govt may have reservations about having too many taxis as it may contribute to congestion and affects the prices / wages of drivers.

[Other possible alternative methods include nationalising of the industry, subsidising certain groups of commuters]

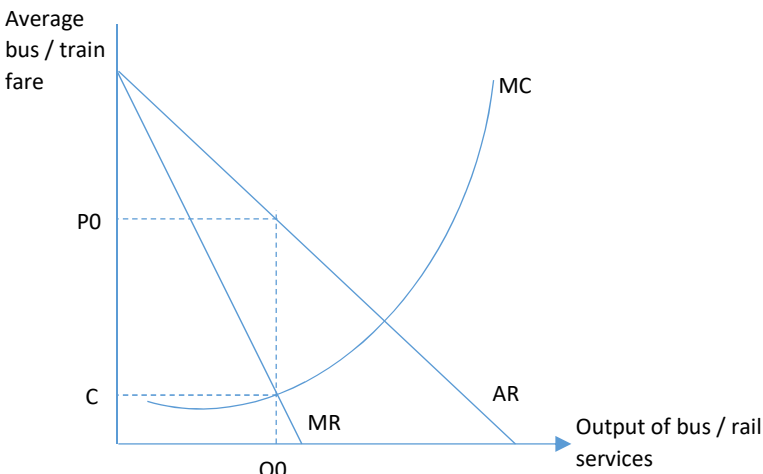
Synthesis / Conclusion / Evaluation (supported weighing to answer question)

Recognise that there are theoretical benefits and limitations to contestability.

Alternative policies incur trade-offs (encouraging other modes of public transports), has shown they are ineffective (stricter regulation), or might be non-viable due to small size of market (natural monopoly).

Furthermore, firms as profit maximisers over time, are likely to want to stay in the market. Hence, less likelihood of hit and runs. It might be a risk, albeit a small one that govt has to take when awarding contract. Limiting the period of the contract may be a solution.

Suggested Answer	Comments
<p><u>Introduction</u></p> <p>Market dominance typically often occurs when there are high entry barriers resulting in one or a few firms dominating the industry/market with large market share such as their strong market power enable them to create artificial scarcity to jack up prices for higher profits. A market is said to be contestable when incumbent firms face relatively high risk of potential rivals in the market as a result of lack of high entry barriers or where the existence of legal barriers are not within the firms' control. To pre-empt the ills of market dominance, the government could make markets more contestable. This essay aims to discuss if such is the best approach to reduce the adverse effects of market dominance.</p>	<p><i>Set the context in relation to the question</i></p>
<p><u>Adverse effects of market dominance in context of question.</u></p> <p>Typical adverse effects of market dominance includes the observation where the firm could limit output and increase price. As shown in Fig. 1, a firm that dominates the market faces a relatively price inelastic demand curve as there are few or no substitute to its goods or services. As a profit maximiser, it produces at output Q_0, where the marginal cost (MC) is equal to the marginal revenue (MR). This is because at output levels lower than Q_0, the firm can gain more revenue than costs, whereas at output levels higher than Q_1, the firm incurs more costs than revenue. At the Q_0, the firm can charge price P_0, which is higher than the MC. This means that at the marginal level of output, the society values the good more than the cost of producing it. Society's welfare is hence not maximised.</p> <p>However in Singapore, bus and train fares, are regulated by the Public Transport Council. Hence, the dominant firms – SMRT and SBS – are unlikely to adversely affect commuters by increasing prices. That said, they could choose to compromise on the service output by increasing the interval between each bus or rail. This could be done to reduce the operating cost to maintain their profits.</p>	<p><i>Explain the <u>adverse effects of market dominance in the provision of bus and rail services in Singapore</u></i></p> <p><i>Theoretical adverse effects</i></p> <p><i>Recognise the role of PTC in the contest of question</i></p>

 <p style="text-align: center;">Fig. 1</p> <p>As dominant firms that are protected by high barriers to entry (e.g. government licensing and high set up costs), SMRT and SBS could maintain high levels of supernormal profits over the long run, without fear of these being eroded by new entrants. The firms could hence become complacent and employ more factors of production (e.g. machinery, labour) than they really need. This creates the problem of x-inefficiency, which leads on to productive inefficiency. The issue of complacency, together with the possibility of reducing output, could lead to falling service standards.</p>	<p><i>Highlight issues with service standards</i></p> <p><i>X – inefficiency.</i></p>
<p><u>Evaluating “contestability”</u></p> <p>The contracting model lowers the barriers to entry and exit in the bus and rail services as set up costs are absorbed by the government. Infrastructural development and vehicles are owned by the government. The operators are only responsible for running the bus and rail services. Therefore, more firms would find it viable to enter the market. The market is also made more contestable as the incumbent firms are not assured of the long term supernormal profits. At the end of each contract term, the government would open up bidding for the next contract. Should the incumbent firm be found unsuitable due to high prices or poor service standards, the firm might not be awarded the next contract. Hence, there is a high threat to its future market share and hence profits while the firm is still dominating the market.</p> <p>In this way, the firm is “kept on its toes” while it is dominating the market. It will have to increase or uphold service standards in order to win the next bid. As the firm’s revenue is now a flat fee awarded by the government, it is incentivised to keep its operating costs low in order to maintain its profits. This could potentially bring about productive efficiency, overcoming the x-inefficiencies associated with market dominance.</p>	<p><i>Explain how government making markets more contestable could reduce the adverse effects of market dominance</i></p>

<p>However, it is also possible that making markets more contestable may not overcome the adverse effects of market dominance. A firm that has won the contract may decide not to continue bidding for the next contract. This could be due to the firm finding it not profitable to be operating bus or rail services in Singapore in the future. As such, during the term of that contract, the firm might deliver a poor service standard. Furthermore, in its effort to protect its profit margin, a firm may cut back on services and the employment of other factors of production in order to cut costs. Again, this may be to the detriment of service standards.</p>	<p><i>Possible limitations of making markets more contestable.</i></p>
<p><u>Evaluating alternative approaches</u></p> <p>Making markets more contestable is not the only way to reduce adverse effects of market dominance. One direct way is to have more effective regulation and stronger penalties for incumbent dominant firms. For the buses and rail services in Singapore, the government has typically resorted to issuing fines to the firms if they do not meet service standards. Unfortunately, the regulation and penalties do not seem to be effective as service disruption of MRT services continue.</p> <p>Another option may be to directly increase competition directly by having more operators operating on more bus and rail lines. This allows commuters to have more choice over the route of travel and with which company would they want to travel with. The introduction of competition could see a fall in the demand, and an increase in the price elasticity of demand for each firm's service. Unfortunately, Singapore has a small market and the scope for building multiple transport lines is limited. If the market is shared out across more firms, demand may fall so low for each firm that none of the firms is able to earn at least normal profit at any level of output.</p> <p>Furthermore, the bus and rail industry is likely to have substantial internal economies of scale. With high set up costs and relatively low additional cost of providing services to an additional commuter, resources might be better utilised with big firms that cater to sizeable segments of the markets. At higher levels of output, average cost of each firm dominating the market is therefore lower.</p> <p>Thirdly, the rise of bike sharing and private hire vehicles (e.g. Uber and Grab) has brought about higher competition for public transport such as busses and rails. Competition within the bike sharing and taxi industry could cause the price of these alternative modes of transports to be lowered. These factors could cause a fall in the revenue of these public transport. In response, the bus and rail firms might be considering ways to improve their service standards, thereby overcoming the adverse effects of market dominance.</p> <p>However, cycling are unlikely to be close substitutes for busses and rails. Government may also have reservations about having too many private hire cars in the industry as it is currently seen as a "poor use of human capital" and also erodes the revenue of taxi driver. Having too many private hire cars and taxis in the streets may also</p>	<p><i>Explain other or alternative approaches that may be better or complementary</i></p>

tread on another pain point in the government's microeconomic policy making – reducing traffic congestion.	
<p><u>Synthesis / Conclusion / Evaluation</u></p> <p>Making markets more contestable is not the only solution to reduce the adverse effects of market dominance. As argued in the essay, making the bus and rail industry more contestable also does not guarantee that service standards would improve. However, we could see that alternative policies incur significant policy trade-offs (as in the encouragement of cycling and private hire industry), have been proven ineffective (as in the current mode of penalising poor service), and are non-viable due to the small size of Singapore's market (as seen in the option of increasing competition).</p> <p>Furthermore, firms do not just aim to maximise profit over one time period. It is not illogical to assume that most operators would want to bid to extend their contracts to reap another block of revenue. Hence there is a lower likelihood of "hit-and-run" companies offering poor services after winning a bid. To better keep operators on their toes, limiting the length of the contract could be a solution, but this has to be balanced against the costs of disruptions due to frequent changes, or from the paperwork for the bidding that could come with it.</p> <p>Overall, for now, making the market more contestable seems to be the best option unexplored when it comes to reducing the effects of market dominance in the rail and bus industry of Singapore.</p>	<p><i>Weighing pros and cons.</i></p> <p><i>Lending more weight to preferred option.</i></p> <p><i>Proposing refinement to further strengthen chosen option.</i></p> <p><i>Judgement.</i></p>

Level	Knowledge, Comprehension, Analysis and Application	Marks
L3	<p>For answers that exhibit balanced and rigorous analysis of the adverse effects of market dominance and how making the market contestable helps to reduce it plus 2 other possible alternative approaches with their limitations, using economic framework and with reference to the preamble.</p> <p>Answers that only include limitations of just one approach are capped at a maximum of 17m</p> <p>Answers that do not include limitations at all are capped at a maximum of 15m</p>	<p>15 – 20</p> <p>(18)</p>
L2	<p>Answers that have incomplete or descriptive explanation of how making the market contestable helps to reduce the adverse effects of market dominance such as failing to consider its limitations OR possible alternative approaches (Lop sided answers)</p> <p>OR Answers that do not demonstrate use of an economic framework to organise and structure the essay.</p>	<p>9 – 14</p> <p>(12)</p>

	OR Answers that have insufficient depth and/or rigour in the explanation of economic concepts, relationships and theory.	
L1	Descriptive and superficial answers.	1 – 8 (6)
Level	Evaluation, Synthesis	Marks
E3	Conclusion / judgement on whether making the market contestable in helping to reduce the adverse effects is the best approach derived through a clear synthesising process and framework using real world knowledge.	4 - 5
E2	Attempted synthesis on whether making the market contestable in helping to reduce the adverse effects is the best approach. There are however some logical flaws and inaccuracies in the synthesising process.	2 - 3
E1	For an answer that gives an unsupported statement on whether making the market contestable in helping to reduce the adverse effects is the best approach.	1