

Demergers

Notes for Edexcel Economics A, unit 3.1.3 on demergers

Written by Tom Furber, tfurber.com/edexcel-economics

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Examples of demergers

A demerger is when one firm splits up into two or more smaller firms.

Examples of demergers include:

- **Tata Motors** demerged into two separate firms, one for commercial vehicles and another for passenger vehicles.
 - See the press release here for further information:
<https://www.tatamotors.com/press-releases/tata-motors-to-demerge-its-businesses-into-two-separate-listed-companies/>
- GSK plc:
 - In July 2022, GSK plc separated its consumer healthcare business from the GSK Group.
 - GSK Group planned to focus on biopharmaceuticals including vaccines, while the consumer healthcare business, named Haleon, covers brands for consumer healthcare products including toothpastes, supplements and pain relief.
- Other examples include: Hewlett-Packard and Carphone Warehouse.

There has also been talk of imposing demergers on big technology companies as a competition intervention. The CMA has ordered Meta (Facebook) to sell Giphy. Another example is that US regulators have considered forcing Google to sell its Google Chrome internet browser.

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Reasons for demergers

- **Prevent diseconomies of scale**
 - [Diseconomies of scale](#) mean that as firm output increases, long-run average cost (LRAC) also increases.
 - For example, in a larger firm, coordination difficulties may be more likely, as multiple teams may need to work together and agree on decisions. This could slow down decision making, increasing the costs to the firm of coming to decisions in terms of time and paperwork.
 - By splitting one firm into two smaller firms, diseconomies of scale can be avoided. A lower level of output could reduce LRAC.
- **Increased focus of managers and other workers**
 - A demerger could allow each firm to focus on different products.
 - Separate managers can be hired at each firm to focus on the products that each firm sells, rather than having one set of managers focussing on a wider range of products.
 - This could include spinning off an underperforming part of the company in the hope that the spin-off is more likely to survive under focussed management.
- **Competition regulation**
 - Competition regulators could take action by forcing firms to break up.
 - Firms could even engage in a demerger if they foresee competition authorities enforcing a break-up in the future.
- **Raise funds**
 - Firms can raise revenue through the sale of part of the company.
 - Also by spinning off a loss-making part of the company, overall profits may increase for the remaining company.
 - Funds could be useful to increase investment back into the business or to pay dividends to shareholders.

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What are the effects of demergers on businesses, workers and consumers?

Businesses:

- Reduce LRAC by reducing the extent of diseconomies of scale.
 - However firms may not be able to benefit from economies of scale.
- Increased competition reduces the price-making power of firms. Firms reduce prices, move towards the allocatively efficient outcome.
- Price competition encourages firms to reduce costs in order to lower their prices, which may lead to X-efficiency.
- Less profit as firms no longer have supernormal profit. This could lead to dynamic inefficiency.
- If a smaller firm spins off from a parent company, the smaller spin off may struggle without the backing of the parent company. For instance, the spin off company may have previously been dependent on infrastructure and management from the parent and may have increased costs from funding its own. This reduces profits.

Consumers:

- Possibility of lower prices due to the removal of diseconomies of scale and the removal of a monopoly power. This could increase consumer surplus.
- However where there are economies of scale, a demerger could increase long-run average costs. This could increase consumer prices and reduce consumer surplus.
- More competition could increase variety for consumers.
- Quality may increase, as the increase in competition makes it easier for consumers to switch to a substitute good if its quality is higher.
 - However if, after the demerger, firms have less profit to reinvest in product development, quality could fall over time.

Workers:

- Where one of the separated firms is a loss-making entity, there may be a need to reduce costs to prevent firm shut down.
 - Cost-cutting could involve laying off workers.
 - This could reduce labour demand and increase unemployment.
- If the separated firms can grow more quickly due to greater focus, this could increase the derived demand for labour.
 - This could boost wages and employment.
- Monopsonies could also demerge.

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- This could reduce the monopsony power that each firm has, increasing the number of firms willing to hire workers.
- The increase in competition over workers could increase wages and employment.

The type of demerger also matters. For instance, consider a separation of two vertically integrated firms (a supplier and a buyer). The supplier can begin to sell products to other buyers. This could lower barriers to entry in the market and therefore increase contestability.

Other evaluation points for demergers

The effects of a demerger depend on:

- **The size of the firm relative to its minimum efficient scale.**
 - If the firm's level of output is below its minimum efficient scale, then the firm is likely experiencing economies of scale.
 - However a demerger, reducing output per firm, prevents firms from exploiting economies of scale to the same degree. So long-run average costs could increase following a demerger.
- **The extent of synergy** between the two parts of the firm.
 - Where there are existing synergies within a firm, a demerger could prove more damaging. This could include synergies from vertical integration (saving on costs from buying inputs), horizontal integration (economies of scale from producing more) or from similar company cultures.
 - However within some firms there may be a lack of synergy. This could occur because of culture clashes between teams that produce different products for example. In such cases, a demerger could allow the newly formed firms to pursue their own objectives and have their own company cultures, making the demerger more likely to be successful.
- **The extent to which competition authorities can intervene to break up firms.**
 - In practice, there are limitations on competition authorities' abilities to intervene. This means that firms may not need to be as worried about being forced to break up.
 - **Regulatory capture:** Regulatory capture is when regulators are lobbied by firms in order to water down regulation. For instance, a regulator may be promised a highly paid job in the private sector in the future, in exchange for not breaking up a firm. This could make it less likely that competition regulators break up a firm.
 - **A small regulator of a global firm:** The UK's Competition and Markets Authority (CMA) intervened initially to block a merger between Microsoft and Activision

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Blizzard. However, upon receiving concessions from Microsoft, the CMA allowed the merger to proceed.

- While the CMA's actions allowed them to win concessions from Microsoft for consumers, others criticised the CMA's change of mind. Such interventions could lead to a situation where the CMA has disapproved a merger, while EU and US competition regulators have approved a merger.
- This could threaten investment in the UK by large companies.

Practice question on demergers (written in the style of Edexcel Economics A)

This section features a practice question with a short extract, written in the style of Edexcel Economics A.

Short extract: In July 2022, GSK plc separated its consumer healthcare business from the GSK Group. GSK Group planned to focus on biopharmaceuticals including vaccines, while the consumer healthcare business, named Haleon, covers brands for consumer healthcare products including toothpastes, supplements and pain relief.

Question: Discuss the possible benefits of the demerger of GSK plc. (12 marks)

Related Resources for Edexcel Economics A

Edexcel Economics A notes, model answers and practice questions:

<https://tfurber.com/edexcel-economics>

Edexcel Economics A Theme 3 notes, model answers and practice questions:

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Related topics:

- [Business growth.](#)
- [Costs.](#)
- [Revenues.](#)
- [Business objectives.](#)

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