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THE NATURE AND SIGNIFICANCE OF CONGLOMERATE FIRMS

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In order to gain an understanding of the significance of trends in conglomerate mergers, the nature and theory of conglomerates need to be clarified. The Federal Trade Commission has classified three types of conglomerate mergers. Product extension mergers involve firms which have some degree of functional relationship in either production or distribution. Market extension mergers involve firms which are in the same general product line, but sell in different geographic markets. The other category of conglomerates consists of essentially unrelated combinations.

THE NATURE OF CONGLOMERATE FIRMS

The full significance of conglomerate mergers may be more completely conveyed by considering a broader spectrum of individual firm approaches to the market. Figure I illustrates such a spectrum in eight categories. Category 1 represents the prototype of the pure firm in economic theory. It consists of one product and one plant. Category 2 represents geographical diversification into multi-regional, national or international markets. The second type of diversification is suggested by Category 3, which represents the multi-plant firm. The nature of the geographic diversification is, of course, influenced by the value versus transportation cost characteristics of the product. Different types of management control problems are likely to be posed if manufacturing operations are located in points geographically separated.

Still another type of diversification is indicated by Category 4. This is the multi-product firm in which there is some relationship between research, manufacturing or marketing functions for two or more products.

While definitions are inherently arbitrary, misunderstanding might be reduced by adopting a more discriminating classification scheme in identifying conglomerates. The categories of the multi-regional marketing firm or the multi-plant manufacturing firm are not conglomerate, whether their geographic or market extension growth was achieved internally or by mergers. For Category 4, the multi-product firm, the more appropriate term is "concentric" rather than conglomerate. A common thread of carryover in research, design, manufacturing or marketing activities is significant from

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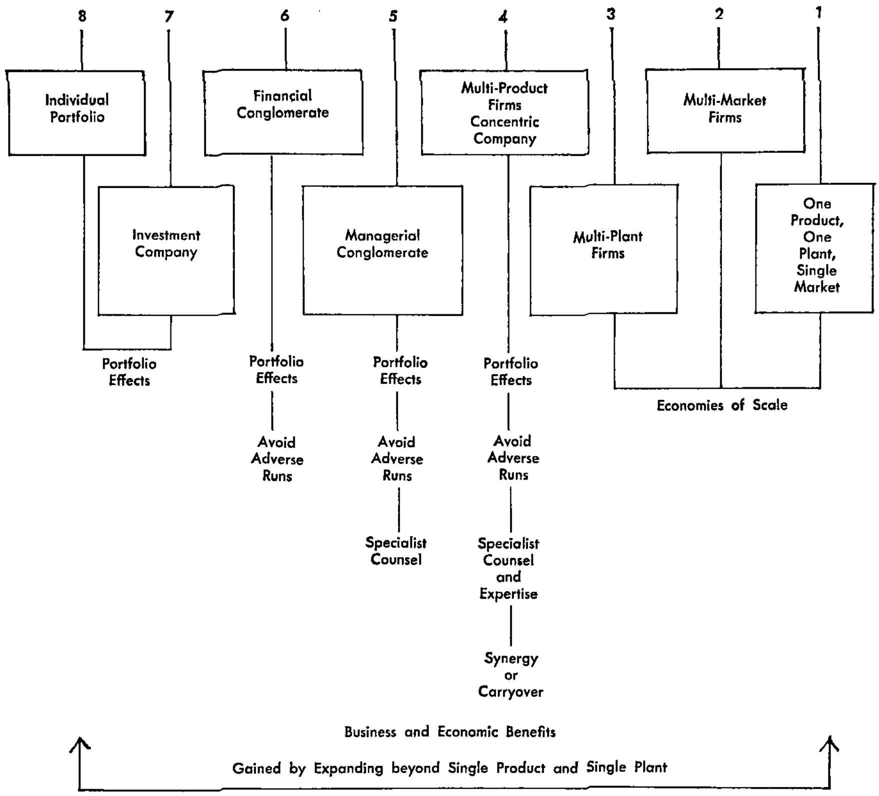

FIGURE I
EIGHT CATEGORIES OF BUSINESS FIRMS

a managerial standpoint. New management control problems are presented because of the different manufacturing costs, marketing effort and expense standards involved for planning and control of these different product activities. Nevertheless, a considerable potential carryover of specific management functional capabilities is offered. In fact, these carryovers must be exploited if the potentials of this kind of diversification, whether internal or external, are to be achieved.

Conglomerate corporations are represented by Categories 5 and 6. These are companies whose diversification, either internal or external, involves products whose engineering, design, production and marketing functional capabilities requirements overlap to a very small degree. It is recognized that throughout this discussion we are dealing with a continuing spectrum. While Category 4 represents a considerable amount of overlap of managerial capabilities, Categories 5 and 6 represent a relatively small potential carryover.

A number of different approaches could be taken to Categories 5 and 6, the non-concentrically diversified companies — the conglomerates. One approach would be to provide a group of management specialists whose services would be available to all of the operating entities. This is suggested by Category 5, managerial conglomerates. Category 6, financial conglomerates, represents a situation in which the parent supplies primarily financial resources. In turn, it applies a system of financial controls and reporting, but does not attempt to interact with the management decisions of the operating entity. A typical policy is that if performance does not satisfy the standard set for the operating company, the parent control group replaces executives with others whose experience and record indicate that they can perform the required managerial task.

Financial conglomerates are basically different from investment companies, which are represented in Category 7. Although such companies may seek the same type of financial reporting from entities in which they place their investments or funds, they merely sell that investment if performance does not meet standards. Further technical distinctions result from the legal requirements that registered investment companies may not place more than 5 percent of their funds in any one company nor hold more than 10 percent of the voting shares of a company in which it makes its investment. Thus, the investment company does not exercise control in the sense of owning over 50 percent of the shares of a company. On the other hand, considerable influence can be and is exercised when the holdings are as little as 10 percent of the company's shares. But the predominant policy of investment companies, in the spirit of the Investment Company Act of 1940,[1] has been to avoid exercising influence over managements, using instead their buying and selling activities as a control on management performance.

The final category in the spectrum is the individual portfolio. Although the individual technically does not operate under the same constraints as investment companies, there is no fundamental difference in the position of the individual as compared with the investment company. On the other hand, the investment company's activities represent three differences. First, the investment company is generally able to assemble larger aggregates of funds than is the individual. Second, by combining funds from a large number of different individuals, diversification is made possible for the individuals. Indeed, an individual might obtain a diversified portfolio by investing in a number of investment companies. Finally, the investment company provides professional management selection of securities and is compensated for expertise and specialization.

The foregoing taxonomy of eight categories of types of firms has three purposes. First, it illuminates the essential nature of the firm in economic theory. This is the characteristic of ultimate financial responsibility for the operations of the entity. A second purpose is to clarify the distinct dif-

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[1] Act of Aug. 22, 1940, ch. 686, §§ 1-53, 54 Stat. 789 (codified in scattered sections of 11, 15 U.S.C.).

ferences between the categories in terms of financial responsibility and extension of managerial competence. For example, it is inaccurate and misleading to state, as has occurred in a number of discussions of "conglomerates," that a multi-product firm is essentially no different from an investment company. Both of the preceding two purposes are related to the third: the framework provided by the foregoing category characterizations of types of approaches to business activity provides a basis for understanding their nature in a theoretical framework. This aspect shall now be pursued.

The Theory of Conglomerates

We shall now reverse the sequence in which the categories were discussed and start with the last two, 8 and 7. Category 8, the individual portfolio, achieves diversification consistent with the theory developed by Tobin, Markowitz, Sharpe and others.[2] If the investments combined in the portfolio are not all related by a perfect positive correlation, the portfolio will improve the return-risk trade-off. For a given return, risk will be reduced, or for a given risk, return can be increased.

Beneficial portfolio effects can be increased in either of two ways. One is to combine securities for which the correlation of returns is perfect but negative. Thus, if only two securities were in a portfolio, and if the correlation between their returns were negative 1, a portfolio of equal amounts of the two would eliminate any variation in their combined return.

Alternatively, even if the correlation between the two returns of the securities is not perfectly negative, variance can be reduced toward zero. Thus, if the correlation between the securities is not perfectly positive, some number of securities exist for some given pattern of correlations between $+1$ and -1 so that, in combination, risk is reduced essentially to zero. This provides a basis for a distinction between an investment company and the individual portfolio. Since investment companies can combine resources from an unlimited number of individuals, the power of investment companies to reduce variance is greater than that possessed by individual portfolios.

When we move to Category 6, the non-concentric conglomerate exercising financial responsibility and controls, two additional elements are introduced. The risk reduction advantages of the portfolio can be retained. Utilizing the enhanced ability to raise funds which is conferred by its corporate form, the conglomerate firm can achieve both the diversification accomplishments of the investment company, *i.e.*, the pure portfolio effect, and the augmented size of portfolio effect. By definition, Category 6 assumes financial responsibility for the individual operating entities. Thus, the

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[2] Markowitz, *Portfolio Selection*, 7 J. Finance 77 (1952); Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk*, 19 J. Finance 425 (1964); Tobin, *Liquidity Preference as Behavior Toward Risk*, 25 Rev. of Econ. Studies 65 (1958).

failure of an individual operating entity, because of gambler's ruin,[3] as its income or cash flow varies, can be avoided.

The second potential benefit from the pure financial conglomerate is that management's skill in formulating effective financial plans and controls, and the interactive effect of the implementation of financial planning and control principles can improve the operations of the entity. Basically, what is involved here is a specialization and expertise in financial planning and control. Thus, inequality in competence on this one segment of management functions provides a theoretical basis for a rationale for financial conglomerates.

The managerial conglomerate, Category 5, carries both of the attributes of the financial conglomerate further. By providing managerial counsel and interacting on managerial decisions, there is potential improvement of managerial performance. This is another pervasive element in a general theory of mergers. The existence of two firms with unequal management quality provides a sound economic basis for a merger. If, by combining the two firms, the superior management is spread over the two firms, true social gains have been achieved. Also, a business basis for a deal exists. If *A* is the firm with superior management and *B* is the firm with inferior management, the assets of firm *B* are worth more to firm *A* than they are to either the management or the present owners of firm *B*.

Another type of general theory for diversification, internal and external, is synergy. This aspect embraces a very wide range of elements which ultimately result in a $2 + 2 =$ more than 4 effect. Synergy results from complementary activities or from the carry-over of managerial capabilities. A few examples may be given to illustrate the point. One firm may have a strong research organization, while the other may excel in production and marketing; joining the two renders both firms more effective. Similarly, one firm may possess good product lines but lack the requisite marketing organization; the former's combination with the firm having the strong marketing organization of the type required benefits both firms. In the development of a product family, a firm may develop products that have consumer demand but require a variety of marketing channels. Again, appropriate merger combinations will achieve the requisite balance throughout the operation.

In the concentric firm, Category 4, a high degree of carryover of functional management capabilities is achieved. Indeed, a fundamental characteristic of the concentric firm is that the nature of the interrelated activities is such that the cost of operations or quality of the product of a segment of the concentric firm, as a part of the concentric firm, is superior to what could

[3] Gambler's ruin refers to the possibility that while the average return of the entity may be satisfactory, fluctuations in the average return may give rise to a series of losses or negative cash flows, causing bankruptcy for the operating entity.

possibly be achieved if that segment were operating independently, assuming equal quality of management under both situations.

For all three of the categories, the concentric firm, the managerial conglomerate, and the financial conglomerate, synergy of various forms and degrees may exist. While the greatest degree and types are likely to be found in the concentric firm, synergy is not necessarily absent in the other two categories.

While these principles of conglomerate mergers have both generality and plausibility, another basic question must be both posed and answered. Why did the wave of conglomerate mergers not occur decades earlier or later?

THE TIMING OF THE INCREASE IN CONGLOMERATE MERGERS

A number of factors may be suggested as an explanation for the heightened activity in conglomerate mergers in recent years. The first involves the increased pace of technological change in our economy, and the maturation of several individual industries. For example, as a result of the impact of the automobile and airplane on the railroads, firms in the railway equipment industry were compelled to enter other industries in order to maintain growth. A similar set of forces operated on the textile industry with the development of synthetic fibers. The substitution of oil for coal had a similar impact on the coal industry.

Although its impact is admittedly less sweeping, a related factor which must be considered is the shortening of product life-cycles caused by the increased pace of technological change. This would be particularly true in the chemical industry, but it is also equally valid for individual product lines in a wide variety of industries.

A second pervasive factor is the general development of management technology. Improvements in generic management functions as well as the development of theory and decision models in the specific management function areas have had considerable impact. Where improvements have been achieved, the differences in quality of management have been sharpened. Another influence is that the ability to apply generic management capabilities and specific techniques such as financial planning, management, and control over a wide variety of industries has increased.

A number of changes which have encouraged conglomerate mergers have occurred in the equity markets. One aspect has been the generally rising equity prices since the mid-1950's. Another influence was the recognition of growth in earnings per share as an improvement factor in the valuation of securities. As a result of purely financial agreements in mergers and practices permitted by present accounting rules, earnings per share can be increased in a number of ways. If two companies with unequal price-earnings ratios merge on the basis of current market prices, the earnings-per-share of the higher price-earnings ratio company will increase. Similarly, a company which acquires for cash other companies having profitability will increase its earnings-per-share.[4] And finally, the acquisition of companies through debt instruments, both straight and convertible, and various other forms of senior securities such as preferred stock, also provides a basis for increasing earnings-per-share. Thus, the development and use of a variety of financial techniques have encouraged conglomerate mergers.

Another institutional influence in recent years has been the virtual prohibition of those horizontal and vertical mergers which involve firms of any substantial size. Thus, conglomerate mergers have increased because they have been less vulnerable to prohibition by regulatory agencies.

Any one of these explanations alone would be insufficient to explain the increased activity in conglomerate mergers; however, taken in combination, they provide a plausible framework for explaining the recent emergence of this phenomenon in the American economy. Additionally, it should be noted that these explanations suggest that the forces involved are not temporary. Consequently, since we may look to continued activity in the years to come, it becomes important to analyze the economic consequences of conglomerate mergers.

Analysis of Antitrust Aspects of Conglomerate Mergers

A number of other objections to conglomerate mergers have been raised. These may be summarized into seven categories: conglomerate mergers (1) extend monopoly power, (2) encourage cross subsidization, (3) increase "deep pocket" advantages, (4) increase entry barriers, (5) result in increased, noneconomic reciprocity arrangements, (6) increase macroconcentration, and (7) increase the size of power groups. Since little empirical analysis has been made of the above arguments, a conclusive evaluation will not be possible. Instead, each point will be analyzed on the basis of its consistency with general economic concepts and prevailing principles and practices of business management.

Extended Market Power

The argument has been made that the objection is not to conglomerate diversification as such, but rather to conglomerate diversification achieved by the merger route.[5] It is asserted that, unlike external expansion, diversification which is achieved internally must meet both business and market tests.[6] This view is beguilingly attractive, but it ignores the sig-

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4 For an explanation of the mechanics of these effects, see J. Weston & E. Brigham, Managerial Finance ch. 27 (2d ed. 1966).

5 Heflebower, *Corporate Mergers: Policy and Economic Analysis*, 77 Q.J. Econ. 537 (1963).

6 *Cf. Hearings pursuant to S. Res. 40 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess., pt. 2 (1965).

nificant potential economic benefits that are achieved through the forms of inter-firm combinations described in this paper. Furthermore, it misses the central, indeed critical, issue of market control. If the merger results in market control, then clearly public policy should raise barriers; but in the absence of market control, the resulting concentric or conglomerate firm is continuously confronted with the discipline of the marketplace.

Another related objection is that conglomerate mergers permit the extension of market power in one industry into other industries.[7] This argument, upon analysis, generally turns out to depend upon one or more of the other specific objections. While the specification of what constitutes market power has not been formulated rigorously, the usual basis suggested is the combination of (1) a high (more than 10 percent) share of the total market sales and (2) higher than average profits.[8] A full evaluation of this definition would require a separate paper. Suffice it to observe that high concentration may also be associated with the technological and managerial requirements or opportunities of the industry. In addition, high profits may reflect successful performance as well as market power in some sense. But the basic question is whether a strong and successful firm enjoys unfair advantages in unrelated industries.[9] The opposite conclusion seems more plausible, for conglomerate diversification by the acquisition of firms in other industries actually increases the vigor of potential competition. The threat of potential entry becomes pervasive because the range of potential entrants is increased. But the specifics of the market power argument usually constitute one or more of the following objections.

Cross-Subsidization

The cross-subsidization criticism argues that in the large conglomerate, various types of predatory behavior can occur because activities that are less profitable can be subsidized by the profitable segments of activity. The effects are aggravated if the profitable segments exercise some elements of monopoly control over their markets.[10] However, this argument lacks plausibility on grounds of general economic theory. If some activities are unprofitable, it is better to dispose of them rather than to subsidize them. Overall performance of the conglomerate would be improved by discarding

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7 *Cf.* Foremost Dairies, Inc., 60 F.T.C. 944, 1084 (1962); J. NARVER, CONGLOMERATE MERGERS AND MARKET COMPETITION ch. VI (1967).

8 *Cf.* Shepherd, *On Appraising Evidence about Market Power,* 12 ANTITRUST BULL. 65 (1967).

9 *Cf.* Rill, *Conglomerate Mergers: The Problem of "Superconcentration,"* 14 U.C.L.A. L. REV. 1028, 1055 (1967).

10 Blair, *The Conglomerate Merger in Economics and Law,* 46 GEO. L.J. 672, 673-74 (1958); Edwards, *Conglomerate Bigness as a Source of Market Power,* in BUSINESS CONCENTRATION AND PRICE POLICY 331-59 (Nat'l Bureau Econ. Research ed. 1955); *Hearings pursuant to S. Res. 191 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary,* 89th Cong., 2nd Sess., pt. 5 (1966).

unprofitable segments of activity.[11] The argument that, as a form of predatory behavior, losses could be recouped after competition had been eliminated similarly fails to carry logic. Unless entry barriers are high, the attempt to raise prices and increase profits to recoup loses caused by earlier predatory pricing behavior will attract new competition.[12] And since conglomerate mergers reduce entry barriers, the increased crossing of industry boundaries by large firms seeking additional profit opportunities diminishes the feasibility of predatory pricing behavior.[13]

A related argument is that the entrance of large firms into a wide variety of industries, particularly those that have traditionally been the province of small firms, further restricts the potential area of operations for small firms. It is contended that this will lead to an undesirable restructuring of the American economy, in which only large diversified conglomerate firms could survive. This is a form of the "deep pocket" theory next considered.

The "Deep Pocket" Theory

If the "deep pocket" theory refers to helping operating units avoid gambler's ruin, it cannot be objected to on efficiency grounds, for it would be a social waste to permit bankruptcy and shifts of economic resources away from operations possessing long-run favorable productivity.[14] However, the "deep pocket" objection has also been defined as the ability of large firms to engage in heavy advertising and "unnecessary model and style changes." These are practices which smaller firms "could not afford" or represent activities for which risks are so great that large aggregates of economic resources are required to "play the game."[15] However, this argument can also be extended to other, clearly socially desirable forms of competition, such as quality improvements and research and development expenditures. Product differentiation takes many forms, but all such efforts are profitable only if effective. If elasticities of demand response are not sufficiently high in relation to elasticities of cost outlays, the activity is unprofitable and, rationally, will not be pursued. To object to effective non-price competition is to deny consumer rationality or to object to the

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[11] The "classic case" of predatory price discrimination turns out, on closer examination, not to be based on factual evidence. McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J. LAW & ECON. 137 (1958).

[12] "I am still waiting for the first verifiable example [of predatory pricing by a large firm]." Adelman, *Market Issues: An Economist's View*, in THE IMPACT OF ANTITRUST ON ECONOMIC GROWTH 25 (Nat'l Industrial Conference Bd. ed. 1964).

[13] "To sum up, predatory pricing seems so improbable a consequence of conglomerate acquisitions that it deserves little weight in formulating antimerger rules based on prospective effects." Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1346 (1965).

[14] *Cf. Hearings pursuant to S. Res. 40 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess., pt. 4 (1965).

[15] Reynolds Metals Co. v. FTC, 309 F.2d 223 (D.C. Cir. 1962).

principle of competition generally. The objection, therefore, does not have a valid basis.[16]

Effect on Entry Barriers

A variant of the foregoing is the objection that the preceding forms of activity increase entry barriers. Other things being equal, lower entry barriers are to be preferred to high entry barriers. Probably the most energizing of economic forces is entry or potential entry into a product market area.

Commentators generally have recognized five major forms of entry barriers: (1) control of scarce raw materials or control through patents; (2) economies of scale; (3) absolute cost advantages; (4) product differentiation advantages; and (5) large capital requirements.[17] Analytically, these five barriers to entry should be regrouped into three. Large capital requirements represent a form of scale advantage. Product differentiation advantages represent either scale advantages or absolute cost advantages. Control over scarce materials represents truly a form of monopoly control. The same is true of patent protection; both are clearly within the province of public policy. But the trend toward conglomerate mergers is not likely to be significantly influenced by or to contribute greatly to entry barriers relating to control over scarce materials or patents. It is in the realm of increasing cost of entry requirements and product differentiation barriers to entry that conglomerate mergers are likely to have the greatest impact. However, these are, in fact, forms of cost advantages or scale economies, reflecting efficiency and providing economic justification for conglomerate mergers.

Reciprocity

A fifth concern with conglomerate mergers is the possibility of increased reciprocity,[18] *i.e.*, the practice of basing purchases upon the recognition of sales to the other party, rather than on the basis of prices and product quality. It is contended that the reciprocity would be "spon

16 *Cf.* P. ANDREWS, ON COMPETITION IN ECONOMIC THEORY 123-27 (1964).

17 J. BAIN, BARRIERS TO NEW COMPETITION (1956); Mann, *Seller Concentration, Barriers to Entry, and Rates of Return in Thirty Industries, 1950-1960*, 48 REV. OF ECON. & STAT. 296 (1966).

18 *Back Scratching Deals Raise Antitrust Ire*, BUS. WEEK, Feb. 9, 1963, at 45; Donnem, *The Conglomerate Merger and Recriprocity*, 8 ANTITRUST BULL. 283-91 (1963); Edwards, *The Large Conglomerate Firm: A Critical Appraisal*, in MONOPOLY POWER AND ECONOMIC PERFORMANCE 117-21 (Edwin Mansfield ed. 1968); Hale & Hale, *Reciprocity Under the Antitrust Laws: A Comment*, 113 U. PA. L. REV. 69 (1964); Handler, *Emerging Antitrust Issues: Reciprocity, Diversification and Joint Ventures*, 49 VA. L. REV. 832 (1964); Phillip, *Reciprocity Under the Antitrust Laws, Observations on the Hales' Comment*, 113 U. PA. L. REV. 77 (1964); Note, *Reciprocity — A Violation by Natural Reaction*, 32 GEO. WASH. L. REV. 832 (1964); Note, *The Future of Recriprocity: A Study in Antitrust Decisional Techniques*, 2 VAL. U.L. REV. 114, 116-38 (1966).

taneous"; that a large conglomerate buys in large volume from many firms, and sellers will spontaneously recognize that the buyer may shift his purchases if reciprocal transactions are not made. Yet the evidence in the leading cases on reciprocity, an illegal practice, suggests that overt action is necessary if reciprocal transactions are to be achieved.[19] Indeed, in *United States v. General Dynamics Corp.*[20] (hereinafter the *Liquid Carbonic* case), the efforts were not only overt, but strenuous; and even when vigorously pursued, the efforts to use reciprocity to increase sales yielded only small results. Reciprocity practices are increasingly viewed as a nuisance by business firms. With the broadened application in recent years of decentralized management responsibility and accountability, reciprocity increasingly conflicts with established management policies. Managers must be free to follow the most economic and efficient policies if they are to be fairly evaluated. If some managers were required to engage in transactions because it would help some other segment of the firm which was unable to meet market competition, the comparative performances by divisions and their managers would be distorted. Reciprocity is therefore unsound both from the standpoints of the firm and the economy.

But it may be argued that when all other factors are equal, "spontaneous reciprocity" may influence buying decisions. If price, quality, service, financing, the relations with salesmen, dependability in delivery, etc., are all equivalent, recognition of sales to one firm rather than another may lead to purchases from the firm's customers. To have a basis for obtaining such business, the other firms would have to offer some superiority in price, quality or the other variables. If they failed to obtain the sales after offering a superior value, a basis for a charge of overt reciprocity behavior would have been established. In this connection, an excerpt contained in the court's decision in the *Liquid Carbonic* case is to the point. According to a Liquid Carbonic executive: "All that is needed to place this program in dire jeopardy and bring strong corporate pressure for its demise is to have one irate letter written to federal authorities by a company resenting what was felt to be undue pressure."[21] Additionally, in view of the great suspicion of reciprocity potentials created by conglomerate firms, they are subject to pressure to avoid even the appearance of illegality. The corporate office of the conglomerate firm must promulgate clear criteria based upon competitive business and economic practices to guide its sales and purchasing departments. Thus, if reciprocity has been a practice in American industry, the widespread conglomerate development is likely to hasten its diminution rather than to increase it.

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19 *See, e.g.*, FTC v. Consolidated Foods Corp., 380 U.S. 592 (1965); United States v. Ingersoll-Rand Co., 320 F.2d 509 (3d Cir. 1963); United States v. General Dynamics Corp., 258 F. Supp. 36 (S.D.N.Y. 1966).

20 258 F. Supp. 36 (S.D.N.Y. 1966).

21 *Id.* at 45.

Macro-concentration Measures

Great concern has been expressed over the Federal Trade Commission calculations which show that for the period 1948-1957, the 200 largest manufacturing companies in the United States increased their share of total manufacturing assets from 48 percent to 58.7 percent. During the same period, the 100 largest firms increased their relative position from 40 percent to 48 percent.

Conglomerate mergers contributed to this increase in the market share of the largest firms. Table I shows the position of 60 conglomerates in

TABLE I

60 CONGLOMERATES' APPEARANCE IN THE FORTUNE 100 AND 200 LISTS FOR 1961 AND 1968

In Top 100 — 1961	12
In Top 100 — 1968	18
In Top 100 — 1961 but not 1968	5
In Top 100 — 1968 but not 1961	11
In Top 100 — 1961 and 1968	7
In Top 101-200 — 1961	15
In Top 101-200 — 1968	16
In Top 101-200 — 1961 but not 1968	10
In Top 101-200 — 1968 but not 1961	11
In Top 101-200 — 1961 and 1968	5
In Top 200 — 1961	27
In Top 200 — 1968	34
In Top 200 — 1961 but not 1968	6
In Top 200 — 1968 but not 1961	13
In Top 200 — 1961 and 1968	21

SOURCE: FORTUNE DIRECTORY OF THE 500 LARGEST U.S. INDUSTRIAL CORPORATIONS (1969).

the largest 100 and 200 manufacturing companies between 1961 and 1968. A net increase of six conglomerates in the list of the top 100 occurred between 1961 and 1968; however, five that were in the top 100 in 1961 were no longer in that group in 1968. The number of conglomerates in the top 200 increased by a net 7 during the interval, reflecting a gross increase of 13, offset by 6 eliminations. But the share of the top 100 and 200 firms, as measured, reflects some exaggerations. The identities of the largest firms do not remain constant over the time interval for which the statistics are calculated. Rather, the percentages are for whatever 200 or 100 firms happen to be the largest in a particular year. Thus, the statistics only measure the fact that the most successful companies are relatively more successful than the average for all manufacturing companies.

There may be another important exaggeration in these percentages. While the base is all assets in manufacturing, individual corporations are classified by their predominant activities. If its predominant activity is manufacturing, a firm is categorized as a manufacturing company, even though it may diversify into other industrial classifications. Similarly, if a corporation has diversified into foreign operations, its assets applicable to foreign sales should not be allocated to the domestic manufacturing operations. If nonmanufacturing assets and assets related to foreign operations are included in both the numerator and denominator of the share of the top 100 or 200 firms, an upward bias remains. Large firms may be expected to be more diversified than smaller firms, particularly in foreign operations.

Assume that the assets of large firms, as measured, are 50 percent of total manufacturing assets, and that foreign operations account for 40 percent of the firms' assets. Then 40 percent of the 50 percent is 20; the 50 percent of the large firms less the 20 percent devoted to foreign operations would be 30 percent. The 100 percent for the universe less the 20 percent represented by foreign operations leaves 80 percent. Thus, if foreign operations were eliminated, the concentration ratio would decrease from 50 percent to 37½ percent, a decline of 25 percent in the share of the largest firms.

The share of the largest firms is high because some industries are large in comparison with other manufacturing industries. Table II sets forth the facts. Of 155 3-digit industries, 5 representing 3.2 percent account for 38 percent of total manufacturing assets. Furthermore, 42 of the largest 100 firms are in these 5 industries.

The basic force producing the large market share of total manufacturing assets represented by the largest firms results from the concentration of total manufacturing assets in a few industries. Merger activity does not

TABLE II

RELATIVE IMPORTANCE OF FIVE THREE-DIGIT INDUSTRIES AND MANUFACTURING CONCENTRATION, 1968

SIC	($Billions) Total Assets, end of 1968	Number of Firms in Largest 100
291 Petroleum Refining	75.3	18
331 Primary Iron and Steel	26.8	6
371 Motor Vehicles and Equipment	35.9	3
372 Aircraft and Parts	19.3	8
281 Basic Chemicals	26.7	7
Subtotal	184.0	42
Total All Manufacturing	485.9	
Percent 5 Industries to Total-Value	37.9%	
(5/155) Number	3.2%	

SOURCES: Columns 1 and 2:
U.S. BUREAU OF THE BUDGET, STANDARD INDUSTRIAL CLASSIFICATION MANUAL (1967).
Column 3:
FTC-SEC, QUARTERLY FINANCIAL REPORT FOR MANUFACTURING COMPANIES (1968).
Column 4:
NEWS FRONT, June-July 1969, at 56-72.

determine the relative share of individual industries in total manufacturing assets. The relation is established by basic economic characteristics of the industries. These are heavy industries which require large fixed investments. Economies of scale may also explain the preponderance of large firms. These 42 firms account for 29.3 percent of total manufacturing assets. Thus, the main determinant of the high level of macro-economic concentration is the relative size of industries.

Trend to Larger Centers of Power

A seventh concern in connection with conglomerate mergers is that the size of the firms involved is very large.[22] Large economic aggregates with potentially vast social and political power may result. Indeed, this has already occurred and we appear to be only at the beginning of the age of conglomerate mergers. Furthermore, if conglomerate mergers result in increased size of firms, the inhibitions against mergers by firms already large, but specializing in relatively narrow areas of activity, such as General Motors, General Electric Company, etc., will be diminished. If such firms engage in conglomerate mergers — and they may be so impelled to compete effectively for resources in the financial markets — the increased concentration of economic power may indeed have implications of very great concern for the aggregation of social and political power.[23]

CONCLUSIONS

A number of general principles in regard to diversification and mergers have been described. They may be summarized as follows:

1. Portfolio effects — reduction of risk.
2. Financial responsibility — avoidance of gambler's ruin.
3. Scale economies with utilization of generic management functions.
4. Cost advantages in effective utilization of specific management expertise.
5. Combining general management organizations of unequal quality.
6. A wide range of complementarities or synergies representing the achievement of a wide variety of "carryover" economies.

Concern has been expressed about the trend toward conglomerate mergers. Perhaps the various criticisms are inapplicable to some degree to concentric mergers, but have been directed without distinction against firms

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[22] *Cf.* Papers by W. Mueller and J. Blair, in PUBLIC POLICY TOWARD MERGERS (J. Weston & S. Peltzman eds., 1969). *See also Hearings pursuant to S. Res. 262 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 88th Cong., 2d Sess., pt. 1 (1964).

[23] The nature of this power, how it is exercised, and in what spheres, has not been set forth. Careful, documented studies of presumed market power provide evidence of the strength of competitive forces. *Cf.* M. ADELMAN, A & P: A STUDY IN PRICE-COST BEHAVIOR AND PUBLIC POLICY (1959).

which fall within the Federal Trade Commission's classification of conglomerates. This paper briefly examines seven criticisms: (1) extension of market power; (2) cross-subsidization; (3) deep pocket advantages; (4) increased entry barriers; (5) reciprocity arrangements; (6) increased macroconcentration; and (7) augmented power groups. Each raises a broad set of issues not fully explored in this summary treatment. Each of the seven areas of concern needs much more careful study and analysis before a solid basis for public policy can be established. In sum, much more fundamental empirical research is required. This analysis seeks to provide a framework identifying some of the relevant hypotheses which, in turn, suggest the types of empirical tests required to evaluate alternative points of view.

The analysis does establish that there are substantial potential economic benefits from what has loosely been described as the recent conglomerate merger movement. However, it is clear that undesirable effects may also result. Thus, once again, more study and analysis is required before a firm basis for public policy can be established.

Finally, the foregoing analysis establishes that prohibitory policies by the antitrust authorities do not represent "no loss" actions. One risks the loss of substantial economic benefits if sweeping prohibitions against "conglomerate mergers" are put into effect. This risk is increased by the failure to recognize that the term "conglomerate" has been inappropriately applied to a broad class of mergers that, more meaningfully, should be viewed as concentric. The importance of the distinction is that the probability of economic benefits from concentric mergers is very high and the applicability of the criticisms of conglomerate mergers is relatively low. Thus, net public benefits are likely to be achieved by concentric mergers. With regard to mergers which may appropriately be termed financial or managerial conglomerates, the conclusion is less certain, but no basis is provided for prematurely raising barriers against these types of mergers. The potential economic benefits are substantial. Undesirable consequences have not been demonstrated.