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# SOME ECONOMIC ASPECTS OF CONGLOMERATE GROWTH

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## INTRODUCTION

Although conglomerate growth is no longer a new issue in economics and public policy, our understanding of the phenomenon and its implications is far from complete. The conglomerate firm, whose activities extend over various markets, occupies no comfortable place in orthodox economic theory; and empirical evidence on the behavior of such firms is sketchy.

At a more mundane level, even the definition of "conglomerateness" presents difficulties. Conglomerate growth usually is defined as growth that is neither horizontal nor vertical; a conglomerate merger, *e.g.*, is one in which the acquiring and acquired firms are neither competitors nor in a customer-supplier relationship. Unfortunately this distinction is sometimes less meaningful than it appears.<sup>1</sup> Even in obvious cases, where we are certain that growth is neither horizontal nor vertical, the "degree" of conglomerateness may appear to vary. The Federal Trade Commission, for example, termed Procter & Gamble's acquisition of Clorox a "product extension" merger rather than a conglomerate, reasoning that *some* relationship existed between the companies' activities, albeit non-horizontal and non-vertical.

The fundamental economic issue is whether distinctions such as the above are material. That is, does growth of firms carry different implications for performance and competition if it is conglomerate rather than horizontal or vertical; and does the degree of conglomerateness similarly affect our expectations? It is these questions to which this paper is most broadly addressed.

## THE GROWTH OF FIRMS

The importance of understanding the processes and determinants of firms' growth in studies of market power and the evolution of monopolies is generally recognized. Indeed, any discussion of changes in industry concentration is implicitly a discussion of growth patterns. Rising concentration means that large firms are growing relatively fast; declining concentration means that small firms are growing relatively fast.

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<sup>1</sup> For example, is a merger between firms producing the same product in different geographic areas, horizontal or conglomerate? A case in point is *United States v. El Paso Natural Gas Co.*, 376 U.S. 651 (1964).

Conglomerate expansion, whether it is accomplished internally or externally (by merger), is simply one form of the general phenomenon of firm growth, and it will be therefore useful to note briefly the major factors behind the growth of firms.<sup>2</sup>

The most often-cited factor behind the growth of firms is the desire of under-sized firms to reach an optimal scale of operation. At the larger size, the firm hopes to realize various economies in one or more of its activities (production, marketing, finance or management), and thereby realize higher profits. Whether economies of scale are in fact continuously available to growing firms—as managements often believe—is doubtful; studies of optimal size have shown that, typically, economies of scale are realized at sizes far below that of the largest existing firms.

A second factor of considerable importance is the desire of firms to maintain their market share. Since the markets for most products increase as population and per-capita income grow, the firm that wishes to retain its market share will have to grow in absolute size.

Some economists also believe that the government's taxation policy, favoring capital gains over ordinary income, is encouraging corporations to utilize their retained earnings for expansion, rather than paying dividends. This factor has been particularly emphasized in discussions of conglomerate growth since, as we point out below, the presumption of growth for production efficiency is absent in firms with unrelated products.

#### CONGLOMERATES: SOME EXISTING VIEWS

Consider a given group of firms and a specified pattern of expansion (*e.g.*, all firms grow at the same rate, or some grow faster than others). The pertinent question is whether the initial degree of conglomerateness and the proportion of expansion that is conglomerate, are likely to influence market behavior. There are several possible answers to this question, some of which have been widely discussed in the literature.

*A.* In one view, horizontal and perhaps vertical growth carry implications that are absent in the conglomerate case. Specifically, there may be advantages that accrue to horizontally and vertically expanding firms. If the conglomerate lacks these advantages, there may be a sense in which it is less important for public competition policy than the older avenues of growth.

This position is tied closely to the notion that firm behavior is a function of its power within the market. Market or monopoly power refers to the ability of firms to influence the terms at which they supply commodities. Traditionally, it has been inferred or measured by examination of the firm's size within the market (*i.e.*, its market share), the closeness of substitute commodities, and the likelihood of new entry. At one extreme, firms are so

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<sup>2</sup> The reader who wishes to pursue this aspect more fully might consult the works of W. BAUMOL, *BUSINESS BEHAVIOR, VALUE AND GROWTH* (1967); E. PENROSE, *THE THEORIES OF THE GROWTH OF THE FIRM* (1966).

numerous and small relative to the market that they exert no control; such a market is purely competitive. At the other, there is only one firm confronted by no close substitutes or potential competitors; this is pure monopoly. In between lie a numberless group of possibilities representing different states of competition.

In this view, horizontal growth clearly implies some alteration in competitive conditions if it alters the relative size (and perhaps the number) of firms in the market. Conglomerate growth, however, can carry no such implication. It simply does not affect those conditions which determine a firm's power within any defined market. The status of vertical growth is a bit less clear. Vertical expansion initially does not alter numbers, market shares, substitutes, or the potential for entry. Yet it may imply some market foreclosure (of suppliers from customers or vice versa) and increased efficiency. Either of these results suggests that the firm which expands vertically may increase its specific market power in the future.

Professors Jesse W. Markham<sup>3</sup> and George J. Stigler<sup>4</sup> have both expounded a part of the general argument that conglomerate growth may not occupy the same status as growth in other directions. Stigler suggests that the power of a conglomerate firm is simply the sum of its power in specific markets; and that to calculate it otherwise is to argue that the whole exceeds the sum of the parts. Markham, noting that a conglomerate firm which is powerless in each of its markets cannot somehow be powerful overall, concludes that "conglomerateness and nothing more raises no public policy issue. . . ."<sup>5</sup>

B. A second view argues that although the conglomerate firm may lack the advantages accruing to vertical or horizontal integration, it possesses a different set of advantages. The most complete and familiar exposition of this argument is to be found in a 1955 paper by Corwin D. Edwards.<sup>6</sup> The advantages include: easy access to capital, the ability to employ superior factors of production and to obtain factors at favorable terms, the services of a full-time legal staff, mutual back-scratching with other firms, and the capacity to "outbid, outspend or outlose" other firms at any time it chooses. Recent discussions of conglomerates have focused upon factors suggested by the last two advantages: reciprocal buying and so-called conglomerate power — the ability to subsidize some activities from others.

The argument with respect to reciprocity is quite simple. Reciprocal purchasing occurs whenever firms confront each other as both buyer and seller, each stating in effect, "I will buy from you if you also buy from me."

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<sup>3</sup> *Hearings Pursuant to S. Res. 70 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess., pt. 3, at 1269-80 (1965) [hereinafter cited as 1965 *Hearings*].

<sup>4</sup> Stigler, *Mergers and Preventive Antitrust Policy*, 104 U. PA. L. REV. 178-84 (1955).

<sup>5</sup> 1965 *Hearings* at 1271.

<sup>6</sup> Edwards, *Conglomerate Bigness as a Source of Power*, in *BUSINESS CONCENTRATION & PRICE POLICY* 331 (G. Stigler ed. 1955).

Conglomerate firms by their very nature are likely to encounter more such situations than their less diversified counterparts. Thus it is the conglomerate which is most prone to "lock up" sources of supply and demand, in a fashion that bears some similarity both to vertical foreclosure and to tying and exclusive dealing arrangements.

The argument with respect to conglomerate power is that diversified firms can accept low profits in a particular area, in effect subsidizing it out of returns from its more profitable operations. This ability to behave sub-optimally in some market(s) is an important competitive advantage, for if a conglomerate firm cuts prices in one of its markets to a level that implies less than maximum profits, its competitors may be compelled either to follow the price cuts or, if they continue to charge higher prices, to give up market shares. In either case competitors are disadvantaged unless they too can subsidize the unprofitable market from other areas. Subsidization implies greater "staying power" in such competitive struggles, and may also effectively insulate the conglomerate from predatory (or even active) price competition by its rivals.

C. A third position on the role of conglomerates, based upon objections to certain points in the first two, argues, in effect, that neither market power, narrowly defined, nor conglomerateness, provides a full explanation of the behavior of firms.<sup>7</sup> The argument that a firm's behavior can be attributed solely to its market power in the traditional sense, may be inadequate in two distinct but related ways. The first difficulty is simply that the usual measures of market power may be deficient. Market shares are perhaps the primary index of such power, yet they ignore other factors. Should we be prepared to say, for example, that two firms with equal market shares really possess the same market power if one is backed by vast resources elsewhere and the other is not? The second objection to the market power argument is that it is tied closely to the profit-maximizing model of the single-product firm; as such, it may be inadequate to describe the behavior of multi-product firms which, quite "rationally," may choose to act "sub-optimally" in some markets at some times.

If market power alone cannot completely describe the position and behavior of firms, so too may conglomerateness alone fail to do so. The commonly mentioned advantages of conglomerate firms may in fact have little to do with the conglomeration. For example, the full-time legal office which many large conglomerates enjoy is really a function of their absolute size; large horizontal and vertical companies also have their own internal "law firms," and there is no reason to suspect that the number of markets in which the company operates will significantly affect its ability to establish or utilize such an arrangement. Similarly, a firm's ability to purchase factors of production at favorable terms would seem to be much more a function of either absolute size or specific market power, than it is of conglomerateness.

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<sup>7</sup> For the elements of this argument, see 1965 *Hearings passim*.

In all likelihood, such ability relates to the fact that the firm is an important customer of its factor suppliers. Once again, this need not have anything to do with the number of markets in which the firm operates; it depends rather upon the amounts that the firm is prepared to purchase.

In the case of reciprocity and market power, the argument is less clear, and will be considered in greater detail below. What *is* clear even here, however, is that the ability of the conglomerate to act in certain ways is intimately entwined with its absolute size, and perhaps with its relative size (market share) as well. It is no accident that the power of conglomerate firms is always discussed in terms of the *large* conglomerate. No one has suggested, for example, that a small but diversified firm is likely to engage in extensive reciprocal dealing; or that such a firm can, by virtue of subsidization, drive larger rivals from the market.

The third position on conglomerate growth has thus far been defined only in negative terms: it is *not* either of the first two positions. The position is indeed a rather vague one, but it does imply the following positive statements: both market power and conglomerateness may make a difference to the behavior of firms; and it also may be that absolute size of firm is significant. To the extent that absolute size matters, it is the *fact* of firm growth rather than its *direction* in which we ought to be most interested.

#### THE SIGNIFICANCE OF CONGLOMERATENESS: SOME OBSERVATIONS

The arguments discussed above indicate that there is no such thing as a unified theory of the conglomerate firm. Questions about the behavior of conglomerates are most unlikely to be settled deductively. It is possible, however, to define further some of the pertinent questions, and to suggest what some possible answers may ultimately turn out to be.

##### A. Efficiency

Consider three firms of equal absolute size, one purely horizontal, one vertically integrated, and one conglomerate. In the case of the horizontal firm, there is always a presumption that it *may* have attained its size because of economies of scale. If goods can be produced more efficiently at large scale, firms will tend to grow to attain this scale.<sup>8</sup> Similarly, the vertically integrated firm *may* have reached its present size for reasons of efficiency; perhaps integrated operations allow production to occur at lower unit resource costs than separated operations.<sup>9</sup> Can efficiencies justify the size of the conglomerate firm? Neither the economies of scale nor the economies of integration arguments apply here. Of course the conglomerate may enjoy managerial economies, but this is equally true of the horizontal and vertical firms.

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<sup>8</sup> This is not to imply that horizontal firms of any given size are necessarily efficient; size may be attained for other, less desirable, reasons.

<sup>9</sup> The same caveat applies to vertically integrated firms of any given size.

It would thus appear that: (a) there are efficiency arguments that may justify horizontal and vertical firms of some given size which cannot justify conglomerate firms of the same size; and (b) there are no efficiency justifications for the conglomerate firm which do not also apply to the horizontal and vertical firms of the same size. Indeed, the managerial efficiency argument may be stronger for horizontal and vertical firms since management is more specialized for the narrower range of activities undertaken by such firms.

Efficiency is clearly a social *desideratum*; it is better to produce more goods with given resources or to use up fewer resources in producing a given quantity of goods. On this count conglomerates may be socially less useful than vertical and horizontal firms, abstracting from size. Whether this is an important consideration, however, is essentially an empirical question. One way to test this proposition is to establish the relatedness of lines acquired by the conglomerate.<sup>10</sup> For instance, if an apparel firm acquires a toy-making firm with the objective of utilizing its plant and labor force more fully during the entire year, the move cannot be presumed socially undesirable.

### B. Restrictive Behavior

Is the conglomerate firm more likely to engage in restrictive, or outright anti-competitive acts, than its horizontal and vertical counterparts? Once again it is necessary to abstract from absolute and relative size, and to speak in terms of companies that are equivalent in these respects.

1. *Reciprocity.* The argument that conglomerate firms are prone to reciprocal dealing is simply an argument of opportunities. Since these firms buy and sell in many markets, they are more likely to find other firms who are both customers and suppliers. If this were the end of the matter, the merits of the argument would be clear. Consider again, however, firms of equal absolute size, in this case one conglomerate and one horizontal. It is true that the conglomerate is more likely to encounter situations in which reciprocity is possible. But the more diversified it is at a given size, the smaller it is in each of its (buying and selling) functions. The horizontal firm of the same size may deal in fewer areas, but it is a quantitatively larger entity, in each of these. Reciprocal dealing is of course a matter of opportunity, but opportunity, while a necessary condition, may not be sufficient; the more "important" firms are to each other, the more likely they are to reciprocate. And it is possible that the conglomerate which is "spread thin" over many activities will not be a sufficiently important buyer or seller in each, to induce reciprocal agreements.

The issue is thus one of weighing two conflicting tendencies: the conglomerate of a given size has more potential reciprocity situations; the

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<sup>10</sup> For a pertinent discussion of relatedness, see J. NARVER, *CONGLOMERATE MERGERS AND MARKET COMPETITION* (1967).

horizontal firm of the same size has fewer opportunities, but may be a more desirable reciprocity partner in those fewer instances. It is not relevant to argue that the large conglomerate is more likely to engage in reciprocity than the small horizontal firm; while this may be quite true, the significant difference is firm size. For specified sizes, it is not clear that conglomeration will result in more reciprocal dealing. The question once again can be settled only by an appeal to empirical evidence.

2. *Predatory behavior.* The conglomerate power argument states that subsidization can be used to place rivals at a disadvantage in specific markets. We consider here the specific example of predatory price policies. If two firms in the same market are of different size, the issue is a simple one. The larger firm by virtue of its resources is more likely to pursue predatory policies successfully than the smaller firm, regardless of the degree of conglomerateness in each. Even if we think in terms of subsidization, the large horizontal firm is not precluded from a predatory course. Such companies may cut prices in certain geographic areas, sustaining them by profits in other areas. Indeed, large horizontal firms typically produce a "variety" of products. The products tend to be substitutes for each other, such as a Buick and a Pontiac, but this need not prevent the company from taking low profits in one line in order to discomfit competitors.

The fact that large firms can cut price more easily than small firms tells us nothing about the effect of conglomerateness, however. Assume two firms, *A* and *B*, of equal absolute size. Firm *A* sells exclusively in the widget industry, while *B* has 10 percent of its sales in widgets and 90 percent elsewhere. From the standpoint of "staying power" the firms are equally matched; they have the same resources with which to sustain subnormal widget profits if necessary. The fact that *A* is horizontal and *B* is diversified may, however, imply an important difference. This difference lies in the familiar proposition that *diversification reduces risk*. Although *A* and *B* are in one respect equal, *B*, the conglomerate firm, stands to *lose less* if it pursues predatory pricing and fails, than does *A*. Firm *A* has all its eggs in one basket; a losing price competition would finish it. Firm *B*, however, has 90 percent of its "eggs" in other "baskets." If it loses a competition with *A*, its negative payoff is limited.

There is, of course, another side to the reduction of risk. Whereas diversification restricts *B*'s maximum loss (and non-diversification enlarges *A*'s maximum loss), it also restricts *B*'s maximum *gain* from competing and winning (as non-diversification enlarges *A*'s maximum gain). On pure profit-maximizing grounds, then, it is not clear that *B*'s conglomerateness gives him an advantage vis-à-vis *A*. If he cuts price and loses, his loss will be relatively small, but so will his gains if he cuts price and wins.

Suppose, however, that large firms act partially as risk averters. This is a plausible supposition supported by much casual evidence. In this case, conglomerate *B* is much more likely than specialist *A* to begin price cutting.



Extending the example, we may say that conglomerate *B* is more likely to pursue *any predatory practice* than is specialist *A*, given some specified probabilities of success and failure. There is, then, an important sense in which conglomerateness itself may influence a firm's behavior.

3. *Entry.* The risk aversion argument also suggests that conglomerates are more likely to enter some markets in which there is an abnormal risk of failure. Entry may demand a certain amount of capital and thus preclude small firms from coming into some markets. But if risk is a factor, a conglomerate firm may be more willing to enter than a specialized firm of the same size because the conglomerate is already protected (to some degree) against risk. If it enters the new market and fails, it is still likely to receive profits from its other independent activities. The specialist may have other resources if it enters and fails; but because these resources are themselves specialized, it can enter the new market only at some peril. If it fails in the new market, and its other specialized activities also happen to "turn sour," it faces grave difficulty. The general proposition implicit here is clear: the more diversified a firm is, the more likely it is to undertake risky activities, including entry into risky markets. This element, working as it does to reduce the concentration of market power in the hands of older firms, can indeed be regarded as a positive aspect of conglomerate growth.

4. *Technology.* While the importance of technological innovation on firms' growth and profitability has long been acknowledged, its likely impact upon the *pattern* of growth (conglomerate or otherwise) appears to have been neglected. These results are essentially due to the inherent uncertainties of investment in research and development. First, many research projects fail to produce a product or process which can be used commercially.<sup>11</sup> The second uncertainty in research and development activities is that their yield might not fall within the product range of the firm, and hence might be unusable. (The research lab which, while attempting to come up with a better insecticide, discovers a new drug, is not infrequent.) Indeed, the more basic is the research done, the higher is the likely payoff in the event of success, but less predictable is the direction of results. The conglomerate firm with diverse products and production processes is thus better equipped to exploit the products of a broad-based research and development department. One way to test the validity of this hypothesis is to see whether the conglomerate group displays a higher proportion of technologically oriented firms with large and active research labs.

#### CONCLUSIONS: SOME POLICY OBSERVATIONS

A judgment about the social desirability of conglomerate growth is, at present, purely speculative and uncertain. While there is no presumption

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<sup>11</sup> Richard R. Nelson, citing a management study notes, that 60 percent was the median failure rate and 50 percent was the minimum failure rate among research and development projects. Nelson, *The Economics of Invention: A Survey of the Literature*, 32 J. Bus. 114 (1959).

that large conglomerate firms realize socially desirable economies of scale, we have seen that conglomerate firms are more likely to enter risky industries and participate more heavily in basic scientific research. Their price behavior is much less certain: while competitive (and predatory) price cutting is less onerous for a diversified firm, the incentives to engage in such price wars are considerably diminished.

A speculative balance sheet of the likely consequences of conglomerates is of little use in itself at the present time. If we are to expand our knowledge significantly we must undertake to test empirically many of the possibilities, implicit and explicit, in the above, as well as in other discussions. Indeed, some of the hypotheses formulated above (on entry, price-behavior, research orientation) can perhaps be tested with available data and should have high priority in any future research.

Important as empirical analysis is for long run policy formulation, we clearly recognize that public officials cannot in the meantime avoid dealing with immediate issues. In this regard it is our feeling that, based on highly imperfect knowledge, conglomerate mergers ought to be treated with caution. The admonition of Richard B. Heflebower<sup>12</sup> several years ago is pertinent: a stringent anti-merger policy in general is reversible; a weak policy, given our traditional reluctance to break up established concerns, is not. Until conglomerate behavior is examined empirically the economy might well benefit from a risk-aversion policy of its own, in which conglomerate growth is considered no more (or less) benign than horizontal or vertical growth.

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<sup>12</sup> Heflebower, *Corporate Mergers: Policy and Economic Analysis*, 77 Q. J. ECON. 537-58 (1963).