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# ECONOMIC POLICY AND THE CONGLOMERATE MERGER

CHARLES H. BERRY\*

The 1968 *White House Task Force Report on Antitrust Policy (Neal Task Force Report)* released earlier this year by the Department of Justice contains a proposed Merger Act.<sup>1</sup> This act would declare presumptively unlawful any conglomerate merger—in fact all mergers—in which a large firm acquires, directly or indirectly, control of the assets of a leading firm in any market in which the total sales of all firms amount to \$100 million or more annually. A large firm is defined by the *Neal Task Force Report* as one with annual sales of at least \$500 million or assets of \$250 million; a leading firm is one with a market share of 10 percent or more, provided that firm is also among the four largest in the industry in question, and that the combined market share of those four firms is at least 50 percent.<sup>2</sup>

On the surface, this recommendation of the Task Force is strikingly similar to one put forward a year earlier by James S. Campbell and William G. Shepherd.<sup>3</sup> The Campbell-Shepherd proposal would bar any merger between leading firms, not just the acquisition of a leading-firm by a large firm. According to Campbell and Shepherd, a leading firm merger is one linking two firms each of which is large within a concentrated industry. By large, they mean a firm with a market share of at least 10 per cent which is among “the three to six largest firms in an industry . . .” and by a concentrated industry “one in which the 4-firm concentration ratio is above 40 percent . . .”<sup>4</sup> Both the Campbell-Shepherd proposal and the *Neal Task Force Report* would exempt industries with sales of less than \$100 million.

In each case, the argument for the proposal relies on the need to “channel” or “direct” the interindustry activity of large corporations in a competitive direction. In the words of the Task Force: “Our proposal . . . is intended to channel the potential competition of large firms along lines that are conducive to reducing levels of concentration in the American economy.”<sup>5</sup> According to Campbell and Shepherd: “Our rule . . . does

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<sup>1</sup> 1968 WHITE HOUSE TASK FORCE REPORT ON ANTITRUST POLICY [hereinafter cited as NEAL TASK FORCE REPORT], 115 CONG. REC. 5651 (daily ed. May 27, 1969).

<sup>2</sup> *Id.*

<sup>3</sup> Campbell & Shepherd, *Leading Firm Conglomerate Mergers*, 13 ANTITRUST BULL. 1361 (1968). Neither author was a member of the Task Force which reported on July 5, 1968, and hence the Task Force did not have access to the published article at that time.

<sup>4</sup> *Id.* at 1363-64.

<sup>5</sup> NEAL TASK FORCE REPORT at 5646.

not bar mergers between firms in certain industries but merely redirects merger activity toward lesser firms and away from leading firms."<sup>6</sup>

Be that as it may, neither proposal is without its critics, and, indeed, Robert Bork, a Task Force member, dissents from the majority report as follows:

This statute may easily be shown to be a prescription for decreasing the consumer benefits that conglomerate acquisitions are capable of creating. *A conglomerate acquisition is not a way of creating monopoly power.* It adds nothing to the market share of the acquired firm and any monopoly position that firm may already have will be paid for in the purchase price. The investment will provide only a competitive return unless the acquiring firm can bring efficiencies to the acquired firm. If this is so, the acquiring firm's choice of one firm in the industry rather than another as a merger partner must be dictated by considerations of efficiency potential. Thus the statute will either shift the acquisition to a less preferred firm, causing a decrease in the efficiencies realized, or cause the abandonment of any plan to acquire a unit in that industry, causing a complete loss of expected efficiencies.<sup>7</sup>

This paper will argue that as conglomerate mergers are presently defined, Bork is wrong. Such mergers can be a way, if not of creating market power, certainly of augmenting such power, and that to define conglomerate mergers in such a way as to make Bork correct is to assume away precisely the merger problem to which the attention of both the Task Force and Campbell-Shepherd was directed.<sup>8</sup>

The argument presented here tends in general, though not without qualification, to support the recommendation of the *Neal Task Force Report*, although the underlying analysis is spelled out somewhat differently. The focus of that analysis is exclusively upon the effect of conglomerate and other mergers with respect to market power.<sup>9</sup> This is only one aspect of the conglomerate merger movement. Such mergers may be motivated by a wide range of other considerations — tax advantages, opportunities for leverage in securities markets, the desire of corporate managers for leverage in securities markets, the desire of corporate managers for growth for its

<sup>6</sup> Campbell & Shepherd, *supra* note 3, at 1379.

<sup>7</sup> NEAL TASK FORCE REPORT at 5658 (emphasis added).

<sup>8</sup> Conglomerate mergers, as defined by the Federal Trade Commission, include far more than the merger of unrelated firms. A "product extension merger," for example, which is a conglomerate merger according to the FTC, is a merger in which "the acquiring and acquired companies are functionally related in production and/or distribution but sell products which do not compete directly with one another . . ." See BUREAU OF ECONOMICS, FTC, *LARGE MERGERS IN MANUFACTURING AND MINING* 6-7 (1969).

<sup>9</sup> The term market power is used throughout this paper as defined by Kaysen and Turner:

Where firms can persistently behave over substantial periods of time in a manner which differs from the behavior that the competitive market would impose on competitive firms facing similar cost and demand conditions, they can be identified as possessing market power.

C. KAYSEN & D. TURNER, *ANTITRUST POLICY* 8 (1959).

own sake, and so forth. The focus of this paper is therefore narrow, but nevertheless relevant to any overall assessment of the economic effects of mergers of this sort.

#### PUBLIC POLICY AND THE CONGLOMERATES

From the standpoint of economics, most public policy toward the non-regulated corporate sector of the United States has, of course, been primarily concerned with the maintenance or promotion of an acceptable degree of competition. Competition is a market oriented concept. The failure, both of economics and of existing legal institutions, to deal definitively with either the conglomerate corporation or the conglomerate merger can be largely attributed to the fact that the conglomerate firm, by definition, does not operate in a single market. The acquisition by a manufacturing corporation of facilities in markets apparently unrelated to those of its present manufacturing activity is not a pattern of behavior either projected by traditional economic theory or readily prevented under the provisions of existing antitrust law.<sup>10</sup> The conglomerate merger, like the question of corporate size per se, is a development to which much public attention has been directed, but about which economics has had little to say.<sup>11</sup> At this level, Bork is correct. If markets *are* unrelated, the conglomerate merger is not a device for the creation of market power, just as the market power of a corporation is not to be read directly from the absolute size of that corporation without reference to its market position.

The obvious point, of course, is that markets as defined both in economics and in law are not independent.<sup>12</sup> Products of different "markets" can be competitive, and such markets cannot be viewed as isolated islands within which the competitive climate is to be judged exclusively by local geography. Even more important in the present context, however, no market will be effectively monopolized without the presence of some barrier preventing or inhibiting the entry of competing firms.<sup>13</sup> Similarly, the effectiveness of tacit or other agreements in restraint of trade among firms within an industry is equally dependent on the exclusion, by some device, of (potentially) uncooperative competitors from outside.<sup>14</sup> Predatory practices

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<sup>10</sup> It is of course true that a number of writers have noted the incentives to corporate managers of rapid corporate growth, including growth by merger, and to this extent the development is consistent both with the projection of that theory and the constraints of antimerger law. See, e.g., W. BAUMOL, *BUSINESS BEHAVIOR, VALUE AND GROWTH* (1959). See also O. WILLIAMSON, *THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM* 10-27 (1964).

<sup>11</sup> See, for example, this rather cryptic comment by George J. Stigler: "If there are conglomerate firms, I suspect that their chief sins are associated with their massing of wealth. But the antitrust laws are not the weapons with which to deal with non-monopolistic concentrations of wealth." G. STIGLER, *THE ORGANIZATION OF INDUSTRY* 304 (1968).

<sup>12</sup> For an illustrative discussion of this point within the antitrust context, see Stocking & Mueller, *The Cellophane Case and the New Competition*, 45 *AM. ECON. REV.* 29 (1955).

<sup>13</sup> This point is discussed at length in J. BAIN, *BARRIERS TO NEW COMPETITION* 1-41 (1956).

<sup>14</sup> See Stigler, *A Theory of Oligopoly*, 72 *J. POL. ECON.* 44 (1964).

to discipline or remove competitors within an industry can also be shown to be increasingly rational the greater the time lag, or the difficulty, associated with the entry of new firms to the industry in question.<sup>15</sup> Competitive structure is not solely, as Bork would have us believe, a matter of market concentration. This would be true even if appropriate market definition on the product side were not a problem. The conditions under which entry will occur, or be anticipated, are equally relevant.<sup>16</sup>

It is nevertheless true that high concentration and the presence of significant barriers to entry tend to go hand in hand. Each, in large part, stems from the same source. Most entry barriers, apart from tariffs and others that are directly legislated, are a consequence of scale, and many instances of high concentration in national markets may also be attributed to scale.<sup>17</sup>

But the concept of scale in this regard is not the usual one. Most of the serious work in economics attempting to define minimum efficient scale has been directed to the manufacturing establishment — to the plant — not the corporation. That work in general, and with some exceptions, suggests that economies of *plant* operation are insufficient to explain, or to justify, much in the way of high concentration in American industry.<sup>18</sup> There is also the implication that major entry barriers are not generally a consequence of plant size.<sup>19</sup> But the relevant scale measure within the overall context of entry is of the corporation, not the plant, and minimum efficient corporate size is not necessarily the same thing as minimum efficient plant size. Indeed, this paper will argue that in many cases significant entry barriers may be attributed to the difference between the two — and to the organization and functioning of American capital markets.

#### THE ADVANTAGE OF CORPORATE SIZE

This argument is most easily made at the consumer goods level. In terms of major manufactured products, it is increasingly the exception

<sup>15</sup> McGee touches on this point, but in the process raises rather interesting questions about much of the literature of predatory practice. See McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J. LAW & ECON. 137-43 (1958).

<sup>16</sup> It should be obvious that the threat of entry is as, or more, important a regulatory force as entry itself. As Bain puts it, "variations in the condition of entry may be expected to have substantial effects on the behavior of established sellers, even though over long intervals actual entry seldom or never takes place." J. BAIN, *supra* note 13, at 4.

<sup>17</sup> Scale here refers to size. For example, economies of scale are present if unit costs always decline with higher levels of output.

<sup>18</sup> Bain, for example, concludes an analysis of plant economies of scale in 20 concentrated industries with "generally, plant concentration plays a minor role, and multiplant developments of firms a major role, in the over-all picture of concentration by firms." J. BAIN, *supra* note 13, at 111. Note also that the 500 largest industrial corporations in 1965, as defined by *Fortune*, reported as a group well over 10,000 separate manufacturing plants in that year. See FORTUNE PLANT AND PRODUCT DIRECTORY (1966).

<sup>19</sup> In this context, Bain writes "The general finding . . . is that very important economies of [plant] scale are found in a rather small proportion of the industries. Economies of scale were found clearly sufficient to impede entry substantially . . . in only 3 or [sic] 20 [concentrated] industries." J. BAIN, *supra* note 13, at 211. See also Saving, *Estimates of Optimum Plant Size by the Survivor Technique*, 75 Q. J. ECON. 569 (1961).

rather than the rule that the consumer is able by inspection to satisfactorily evaluate competing products. Frequently with such products the cost of error in selection is, or is considered, high or significant relative to the price of the product itself. This point is trite in the case of ethical drugs which are obviously beyond the competence of the consumer (or for that matter the prescribing physician) to evaluate. But in other areas as well—most appliances for example—inspection provides little indication of future performance and reliability to the average buyer. The availability of repair services and parts may be a component of that reliability. In this setting, product familiarity or corporate reputation is apt to be an important element in consumer choice. That familiarity or reputation is fostered by national advertising, and advertising in this context becomes a barrier to entry.<sup>20</sup>

Exposure to a corporate brand or name and the concomitant degree of familiarity which attends that name is independent, or largely so, of the volume of products bearing that name. National advertising in the volume required to maintain such familiarity is not likely to generate an expenditure easily lost in the accounts of a small manufacturer. In those markets where consumer choice must be made in the presence of uncertainty with respect to product performance or quality, and where that performance matters, the competitive advantage, other things being equal, will fall to the large firm, and competition will be among the few. And that will be true quite irrespective of the level of minimum efficient (plant) size in the manufacturing process itself.

For producer goods, the picture is less clear. Product evaluation by the technical or commercial buyer may be more expert.<sup>21</sup> On the other hand, the ability to respond accurately and quickly to particular specifications is presumably more important—as is technologically related service. The sale of electronic data processing systems, for example, is apt to be as dependent upon the availability of appropriate programming systems and languages (software) as on the technical capacity and speed of the equipment (hardware) itself. Where such goods are “sold,” the product being tailored to the buyer’s specification, rather than simply bought, sales facilities including the provision for technical service becomes the counterpart to national advertising in the consumer goods industry.<sup>22</sup> In each case, the required

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<sup>20</sup> For empirical evidence of the significance of this barrier, see Comanor & Wilson, *Advertising, Market Structure and Performance*, 49 REV. ECON. & STAT. 423 (1967). For additional discussion of some of the economic effects of advertising, see Telsler, *Advertising and Competition*, 72 J. POL. ECON. 537 (1964).

<sup>21</sup> This point is readily overstated. The complexity of some producer goods may be more than sufficient to offset any expertise on the part of commercial buyers. Corporations selling to other corporations not only advertise but also invest heavily in direct sales efforts of other sorts. It is not clear that those efforts should totally be considered “service.”

<sup>22</sup> This is not to assert that those services are without value, but only that, as in the case of advertising, much of the investment in these services may be fixed, *i.e.*, need not vary, or will vary less than proportionately, with the volume of products handled.

facility can be used more intensively, and therefore more efficiently, with increased sales up to some point. That point appears frequently to be beyond that required for efficiency in the production process alone, and creates in turn a barrier to entry by the small manufacturer.

This same argument can be made at both levels where product innovation and development are important to the industry in question. The commercial success of invention appears to be closely tied to innovation — the actual introduction of the technology in question.<sup>23</sup> With increased emphasis on industrial research and development, the large firm, prepared to adapt internally the product of that research, may be expected, for a variety of reasons, to support more successfully the research facility. Those reasons range from questions of scale in the research function itself (the so-called critical mass) to an increased likelihood that profitable applications of research output will be recognized and implemented. Here as well, the case for corporate rather than plant economies is present.

The extent of these corporate scale advantages is by no means well documented. In many instances, the nature of the advantage itself can be questioned.<sup>24</sup> Nevertheless, the following conclusions can be drawn. First, in those markets for consumer goods where the product is durable, or where failure of the product would impose a cost on the consumer significant in terms of the product's price, and (in both cases) where the construction, performance or content of the product cannot be judged accurately by the consumer, there will be barriers to entry. Under these circumstances, it is simply unrealistic to expect that firms unable to exploit efficiently techniques of national advertising will populate such markets. Those markets may also be highly concentrated.

Second, advantages for the large firm — economies related to corporate size — can also occur in producer goods markets as a consequence of the more intensive use of sales and service networks and of economies in research and development.<sup>25</sup> Where such economies exist, industries will tend to be the province of large corporations, and the scale of the investment commitment required for successful entry will constitute a barrier to entry.<sup>26</sup>

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<sup>23</sup> See Nelson, *The Simple Economics of Basic Scientific Research*, 67 J. POL. ECON. 297 (1959).

<sup>24</sup> Shepherd makes this point when discussing alternative explanations for differential rates of corporate growth. The setting is a general critique of the application of the survivor technique in the estimation of corporate scale economies. See Shepherd, *What Does the Survivor Technique Show About Economies of Scale*, 34 S. ECON. J. 113 (1967).

<sup>25</sup> It is not the intention of the foregoing to argue that the largest corporation will have the greatest such advantage. Indeed, much of the evidence suggests that this is not the case. See, e.g., Mansfield, *Size of Market Structure and Innovation*, 71 J. POL. ECON. 556 (1963). The point is only that the threshold for successful firms in terms of size will lie sufficiently above that implied by what is known about efficiency in the production or manufacturing process alone. This point is made by Mansfield, whose work concentrates on the larger firms in the industries he considers.

<sup>26</sup> The usual argument in this regard is that the cost of capital varies indirectly with the amount borrowed, and that in this context the large corporation has an inherent

Attitudes towards these barriers vary. Advertising, for example, can be regarded as an "artificial" barrier that creates only the impression of reliability or desirability. Products are differentiated for the purpose of differentiation, not in response to the actual preferences of consumers, but the other way around. Preferences are attracted or created by the advertising effort itself. In this context, advertising is seen as a triple waste: first, in the resources it consumes directly; second, in the distortion of product design or content it encourages; and finally, in the creation of an entry barrier tending to preclude full exploitation of productive potential within an industry so protected. The implication is that advertising should be discouraged, the most frequent proposal being the disallowance of advertising expenditure as a deductible item in the reporting of corporate tax liability, or even in the progressive taxation of advertising expenditures.<sup>27</sup>

This question, however, is quite apart from the central theme of this paper. Here the point is only that in those markets where advertising has been effective, the large established firm will enjoy the innate advantage of familiarity. In the absence of, or with a reduction in, advertising to promote that familiarity, it is reasonable to suppose that alternative techniques, though perhaps less efficient ones, would develop to exploit the uncertainty under which choice is made in such markets. The success of advertising is not unrelated to the kind of products which are advertised. It is not clear just how significant any reduction in the relative advantage of the large entrenched firm would be following a marked reduction in advertising intensity. Furthermore, at the present time, national advertising is a fact of economic life, and it would be hazardous, if not foolhardy, to predicate public policy on its forthcoming disappearance, whatever view is taken of its economic contribution.

Where entry barriers are linked to established distribution networks, to vertically integrated manufacturing facilities, or to technically based service facilities, the problem is further clouded by the possibility that the resultant corporate scale economies are "real" as opposed to the "artificiality" of value added in advertising. In some instances, the existence of integrated service and distribution facilities may be the exact counterpart to national advertising — investment in promotional activity to differentiate the product in question with the intention to exclude. Much recorded expenditure on research and development is undoubtedly motivated by the desire to effectively differentiate and not necessarily to improve. Yet there is the possibility that this form of organization is in fact cost saving. In any event, however, an entry barrier will be present, and the nature of that barrier will be such as to impose higher, perhaps prohibitive, costs on the small firm attempting to enter.

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advantage, not only of collateral but also of retained earnings. See Archer & Faerber, *Size of Firm and Cost of Externally Acquired Capital*, 21 J. FINANCE 69 (1966).

<sup>27</sup> See, e.g., L. WEISS, *ECONOMICS AND AMERICAN INDUSTRY* 509-11, 528 (1961).



This being the case — and no argument is made here that this situation is characteristic of *all* U. S. industry, though it is characteristic of much of that industry where high concentration is a public policy concern — the threat of entry by small or even medium-sized corporations is not apt to be an effective regulatory force. It is much more likely that the most effective potential competition will be derived from the threat of entry by the large industrial corporation prepared to diversify. It is to that corporation that those entry barriers which exist within the industrial sector are apt to be least important.

#### THE CONGLOMERATE FIRM AND BARRIERS TO ENTRY

Two views of the conglomerate firm, or of the firm which is becoming a conglomerate, can therefore be contrasted. On the one hand, the development of the conglomerate can be, and has been, characterized as part of a trend toward increased corporate concentration in industry, with increased market power, increased exploitation of the distortive potential of mass media, and, as an inevitable result, a further increase in the significance of oligopoly structure. The fact that this corporate growth is conglomerate is attributed, not to (socially) efficient patterns of investment activity, but to limitations imposed by antitrust constraints on vertical and horizontal acquisitions.<sup>28</sup>

In contrast, an alternative interpretation would regard a trend toward increasing diversification by large industrial corporations as one possibly diminishing the significance of precisely those entry barriers which have been most conducive to the preservation of market power in national markets. If those barriers are typically the result, directly or indirectly, of the size of the investment required for successful entry, if private (and public) capital markets are organized in such a fashion that the requisite financing is not readily available, if the bulk of private industrial investment originates in the retained earnings of industrial corporations, and if those corporations do *not* diversify, such entry barriers will effectively protect large firms in concentrated industries from the competition of small scale entrants.

If, however, large industrials seek investment opportunities independently of their present or past areas of manufacture, the protective content of entry barriers of this sort will be lessened. In this view, the large conglomerate is regarded as a development offsetting in part the failure of equity or capital markets to provide an acceptable or competitive source of new investment funds in parcels of the necessary size.<sup>29</sup>

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<sup>28</sup> See, e.g., Edwards, *Conglomerate Bigness as a Source of Power*, in *BUSINESS CONCENTRATION AND PRICE POLICY* 331 (Nat'l Bur. Econ. Research ed. 1955). The role of current antimerger law is noted by the Cabinet Committee on Price Stability. See *STAFF OF COMM. ON PRICE STABILITY, CABINET, STUDIES 85-86* (1969).

<sup>29</sup> A proposal consistent with this interpretation would be to require either that the bulk of corporate earnings be paid out in dividends and not retained, or that retained

These two views are of course extreme. The choice is not between corporations rigidly and unalterably bound to existing markets on the one hand, and, on the other, "conglomerates" continuously evaluating new alternative investments without regard to established market position. Neither is realistic. But it is equally unrealistic to suppose that all expansion across industry lines by large corporations adds to the competitive imperfection of the industrial sector.

To put the matter bluntly — and here the argument looks like Bork's — the most pervasive barriers to entry in manufacturing and mining are traceable to scale. When entry to industries protected by such barriers occurs (or is threatened), it will most often be by large industrial concerns. If such entry is proscribed, either by statute or by corporate policy, the regulatory impact of the threat of entry to those markets will be lost. Insofar as markets with entry barriers of this sort are also apt to be concentrated, the regulatory force of potential (and actual) competition would thereby be lessened in precisely those areas where its salutary effect ought most to be sought.

#### DIVERSIFICATION BY MERGER

There are, however, objections to this view. A primary one is that such entry is frequently, or even generally, not *de novo* with the creation of new and independent facilities within the entered industry. The conventional route for the large corporation is via merger. Entry by merger results in, at most, a *different* competitor within the entered market, not a new competitor. The impact of that entry therefore depends on the behavioral significance of the change in ownership of the acquired firm. There is very little empirical evidence in this regard, and yet this is clearly an issue central to the evaluation of not only conglomerate mergers, but of all mergers. Nevertheless, some insight can be gained by considering the problem in this context.

For example, the merger of two corporations, each large and each dominant within its industry, and each showing no sign of present or impending financial distress, would appear, without further qualification, to accomplish little in terms of structural change that could be considered *a priori* desirable. If the two (or more) industries involved are *totally* independent, any resulting economy would have to be attributed to the superior managerial competence of the acquiring corporation. This is possible, but difficult to determine, and a slender basis on which to build a case for the merger of two large organizations where other adverse consequences may be present.<sup>30</sup>

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earnings of corporations be reported by stockholders as current taxable income. While it is absolutely clear that current tax may provide an incentive for the retention of earnings, it seems doubtful that such a step would in fact markedly reduce the advantage of the large corporation in obtaining investment funds in large volume. The problem is one of collateral as well as the source of investment funds.

<sup>30</sup> The social loss possible in reducing the threat of corporate take-over is considered further in the conclusion to this paper.

Where the two markets or industries are not independent, but linked either vertically or horizontally, or where there is a technological overlap in the production process, or where common marketing facilities might be employed, there is of course the possibility that the combination may generate increased efficiency. But there is also the possibility that such a merger would carry with it the possibility that real or potential competition between the merging firms would be eliminated. If each firm is large, and if an economy of joint operation is present, each, in the absence of merger, is a prime candidate for entry to the market of the other. It is precisely the possibility of increased efficiency from joint operation that creates the possibility that competition will be lessened by such merger. Indeed, to carry the argument to its extreme, the desire of two such *large* firms to merge might well serve as an indication that an economy of joint operation is present, and that one result of such a merger would be the elimination of entry that might otherwise have occurred.<sup>31</sup> Hence in both cases — either where markets are unrelated or where some interrelation is present — the merger of large dominant firms has little to recommend it. The exception occurs when one party to the merger is failing. In such a case, however, the failing corporation is unlikely to be dominant, and in addition, the combination can be regarded as much a liquidation as a merger.

On the other hand, where one of the merging firms is small, there are additional factors to be taken into account. For the smaller firm, access to the retained earnings of the larger merging partner may provide the counterpart in investment funds which, through the merger, are made available at rates favorable to those obtainable elsewhere. In addition, or alternatively, the merger may establish for the product(s) of the smaller firm access to national markets and merchandising — the acquisition of a known corporate name — at costs less than those which would be incurred by a replication of the facilities of the large firm even were that feasible. A similar possibility exists if further development in the industry of the smaller firm would require a technological base which is readily incorporated into the current operations of the larger merger partner.<sup>32</sup>

Correspondingly, from the larger firm's point of view, the acquisition of a small corporation, already active in an industry where economies from joint operation are possible, can be a relatively inexpensive means of obtain-

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<sup>31</sup> Note that this framework is consistent with the desire to "channel" merger activity expressed both by the *Neal Task Force Report* and by the Campbell-Shepherd proposal. There is one difference, however. The foregoing relies heavily on the possibility that mergers between *large* corporations may frequently be motivated by economies of joint operation, and hence that potential competition between the two is likely to be an important consideration. Both the Task Force and Campbell-Shepherd proposals, on the other hand, seek more to push the investment activity of large corporations toward smaller firms with the object of lessening industrial concentration.

<sup>32</sup> These advantages are, of course, exactly those advantages that might be realized in the case of a merger between two large corporations. The point, however, is that a large corporation is apt already to have the capacity to create the joint facility internally — or by the acquisition of a small corporation — which is an option which the small corporation may not have or has to a small degree.

ing the institutional knowledge and some of the managerial skills and personnel which would be required even for entry *de novo*. The merger may thus be a means of minimizing the acquisition costs of facilities that would be required in any event. No new firm is added to the industry, but if, as is suggested above, there are economies created by the merger, the small firm whose ownership has changed should be in an improved competitive position within its market.

Where that firm is small within that market, it is difficult to argue that the result is a lessening of competition. The converse is more likely. At the very least, the change in this regard is negligible. Both (or all) markets involved behave much as they would have otherwise. Expected economies from joint operation do not materialize. The industries are independent in the sense outlined earlier. Some corporate growth by merger has occurred. Entry by the larger corporation to the market(s) of the smaller has been facilitated to the extent that the merger was less costly than equivalent entry *de novo*.

What this says is that the acquisition of minor market position by merger in a new industry by even a large firm active in a related industry can be considered entry. Any anticompetitive effects are negligible. Entry, or the threat of entry, may be facilitated by such mergers. The regulatory power of the potential competition of large corporations may be increased by such merger activity.<sup>33</sup>

#### COSTS AND BENEFITS OF MERGER POLICY

Curiously enough, this suggests that the contemporary interpretation of antimerger law is not out of place in dealing with conglomerate mergers. Where two corporations with products actively competing in the same (horizontal) market merge, the effect is clearly the removal of a competitor from the market. If neither is failing — as would be likely in the presence of scale economies — lessening of competition can reasonably be inferred. The potential damage from the prohibition of such a merger is chiefly that the possible development of a larger, more efficient firm is delayed, and restricted to the outcome of internal growth (and decline) by the corporations involved. The danger of permitting such a merger is the development, unjustified by economic considerations, of a market structure conducive to patterns of oligopoly behavior within the industry. That danger is clearly greater the more concentrated the market to begin with, and the larger the size within that market of the firms proposing to merge. Within that framework, a judgment regarding the possibility or probability of a substantial lessening of competition can be made. It has been made restrictively in recent years.<sup>34</sup>

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<sup>33</sup> Throughout this discussion, equity considerations relating to the owners of closely held corporations have been and are ignored. This point is considered by Turner. *See* Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313 (1965).

<sup>34</sup> *See, e.g.,* *United States v. Von's Grocery Co.*, 384 U.S. 270 (1966); *United States v. Aluminum Co. of America (Rome Cable)*, 377 U.S. 271 (1964).

With vertical mergers, the situation is not vastly different. Where neither market is highly concentrated, and where the merging firms are each small within their respective markets, the probability of a substantial lessening of competition as a result of the merger is low. Where, however, the merging firms are large — and the concept of size is obviously a subjective one — the courts have regarded the merger as likely to foreclose, or as capable of foreclosing, a substantial portion of the market for the intermediate good in question.<sup>35</sup> The cost to such a policy is that production and distribution economies which may be implicit in the denied vertical integration are thereby lost or delayed. Any realization of such economies may not be achieved by merger where market shares are substantial, but only by internal growth or by the acquisition of market share which does not pose the possibility of substantial foreclosure.

The danger from freely permitting such mergers — and this is not the law, but economic reasoning — is that the potential competition between the parties to the merger is eliminated in the event of their merger, *and that where those firms are large there is a reasonable likelihood that entry would occur*. For example, if economies of joint (vertical) operation are present, it is likely that each of the two firms, if merger were denied, would integrate backwards and forwards respectively to gain the benefit of such economies. Each firm is presumably a more likely entrant to the market of the other than a firm of equivalent size active in neither market. Alternatively, if structure at either stage of the vertical process permits noncompetitive behavior at that stage, that too would create an incentive for entry by corporations active at the other stage where the costs of that noncompetitive behavior are borne directly. Merger, under these circumstances, would permit an accommodation between potentially competitive corporations which would preserve the opportunity for that noncompetitive behavior. If such mergers are proscribed, such accommodation is denied.

In this sense, the public policy of vertical mergers has been closely analogous to that of horizontal mergers. The distinction lies only in actual and potential competition between the merging corporations; but the competition is horizontal in either case.<sup>36</sup>

The case of the conglomerate merger is one step removed, but the analytic framework can be identical. With conglomerate mergers, the link between the markets of the firms proposing merger is less clear than when

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<sup>35</sup> See, e.g., *United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. 586 (1957).

<sup>36</sup> Adelman makes this point indirectly within the context of *United States v. New York Great A & P Tea Co.*, 67 F. Supp. 626 (E.D. Ill. 1946). See Adelman, *The A & P Case: A Study in Applied Economic Theory*, 63 Q. J. ECON. 238 (1949).

This explanation is probably also applicable to a good many instances of price discrimination along functional lines — differential pricing of tires to retail outlets as opposed to automobile manufacturers, for example — as well as to some illustrations of “countervailing power” as expounded along different lines by Galbraith. See J. GALBRAITH, *AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER* (1952). Price concessions yielded by large sellers to large buyers are fully consistent with the ability of the large buyer to integrate backwards. Call it countervailing power if you wish.

the merger is vertical.<sup>37</sup> The potential expansion of one corporation to the market of the other is correspondingly less certain, and the cost in terms of lost potential competition associated with such mergers is therefore less obvious. But it can be present, and indeed will be present increasingly to the extent that there are economic advantages to combining productive activity in different markets within the framework of a single corporation.

The public policy of conglomerate mergers ought therefore to be directly related to the public policy of vertical mergers. In both cases, the merger is between corporations which are not active but potential competitors. In both cases, the merger will foreclose entry which might have brought the merging firms into direct intramarket (horizontal) competition. In both cases, where the merging corporations are large and there are potential gains from joint operation in the two markets involved, there is reason to believe that in the absence of merger, actual entry is reasonably probable. This is perhaps less so in the case of the conglomerate merger where the interrelationship among markets is less clear, but nevertheless such interrelation can be present. It follows, therefore, that the public policy of conglomerate mergers should be very similar to that of vertical mergers, but that the definition of substantial market shares should be somewhat less stringent.

The notion, therefore, ought to be, that no firm capable of independent entry — a large firm — should acquire by merger a significant portion of any market in which it is a potential competitor. Were it to do so, there is a possibility that the merger would foreclose significant horizontal competition in the market of the acquired firm which might otherwise have developed. The *Neal Task Force Report* views its merger rule as contributing to future lessening of market concentration. This paper places greater emphasis on retaining the threat of entry, and on the impact which that threat, or its fulfillment, may have on the performance of concentrated markets.<sup>38</sup> Both suggest a rule of quantitative substantiality with respect to

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<sup>37</sup> This is not, of course, in any way to deny the more familiar argument that the by-product of vertical merger among large firms may tend to increase barriers to entry to both industries by limiting intermediate markets and tending to require entry in the form of a fully integrated operation. Here, too, the focus is on potential competition, though in this case the approach is after, rather than before, the fact. Note that the argument that vertical integration requires vertical entry assumes that vertically integrated firms deal only internally with respect to intermediate products, which is not entirely the case.

<sup>38</sup> Some limited, but highly suggestive evidence on this point is provided by Raymar, who found widespread evidence of simultaneous activity within the same narrowly defined industries prior to merger on the part of merging corporations in 58 electrical machinery mergers classified as conglomerate by the Federal Trade Commission. See Raymar, *Conglomerate Mergers in the Electrical Machinery Industry, 1969* (unpublished manuscript in Princeton University Library). If Raymar's findings were duplicated with a wider sample of conglomerate mergers, they would support not only the argument presented here, but also the possibility that the present section 7 might have wider applicability in the case of "conglomerate" mergers than has been generally assumed. His is an important contribution.

market shares acquired by large corporations without regard to the market position of the acquiring corporation. The policy problem is one of selecting such a rule without destroying the beneficial effects of the conglomerate merger generally.

#### CONCLUSION

This paper considers initially the recommendations of both the *Neal Task Force Report* and of James Campbell and William Shepherd that merger law be amended or augmented to proscribe mergers between firms large in their respective industries. This recommendation is contrasted with that of Robert Bork who concludes that the conglomerate merger is incapable of creating market power, and that the implementation of such a rule would impose needless social cost in preventing efficiency generating consolidations.

This paper is critical of Bork's position on two levels. First, if conglomerate mergers are to be impotent in the creation of market power, industries must be defined as totally independent, both in production and in consumption.<sup>39</sup> As conglomerate mergers are currently defined, this is simply not the case, and the present state of economic science is simply not up to the application of such a definition in any case. A conglomerate merger between two firms producing substitute products — each with market power in its own industry — would presumably increase the degree of market power in both markets. Such a merger would be considered horizontal if the products were close substitutes. A conglomerate merger involving more distant substitutes would have the same qualitative implications for the affected industries. This point, however, is partly one of terminology.

More important is the role that such mergers play in the dynamics of industry structure. It is the thesis of this paper that market power will not be preserved in the absence of effective barriers to entry, and that most such barriers are in one way or other a consequence of corporate scale requirements for successful operation in the industries protected by such barriers. There is the further assertion that the large industrial corporation is an institution uniquely suited to surmount such barriers. If this is so, the conglomerate merger *can* create market power through the elimination by agreement of entry threats as they arise. The threatened firm and the threatening firm agree to merge. Established market position is protected. No new competitor is added to the industry.

The appropriate action would, therefore, appear to be to seek to retain the benefits of the large firm as a potential (or actual) entrant, while avoiding those attributes of the conglomerate merger which may augment or perpetuate existing market power. Both the Task Force and Campbell-Shepherd proposals have sought to accomplish this. Of the two proposals, that of

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<sup>39</sup> In technical terms, the cross-price elasticity both of supply and of demand must be zero.

Campbell-Shepherd is by far the more restrictive. In their formulation the merger of two firms, each in a different industry and each with sales of little more than \$10 million, might not be permissible. A firm with sales of \$20 million is not large. Furthermore, the threat of entry, on which so much of the argument of this paper is based, of a firm with sales of \$10 million is not apt to be devastating.

Within the framework of this paper, the emphasis of the Task Force is more appropriate. The limitation is on the acquisition by a large firm — one with assets of \$250 million or sales of \$500 million — of significant market position in a concentrated industry. To permit such a firm to acquire by merger a leading position in such an industry would be to remove the likelihood, however large that may be, that the firm would threaten the position of market leaders in industries where market power may be present. On this basis, the proposal of the *Neal Task Force Report* has considerable merit.

There are, however, two caveats which must be added. First, the Task Force rule would — and this presumably is the basis of Bork's dissent — remove the threat of corporate take-over from firms with substantial market shares. It is those firms — firms with protected market position — which are least apt to be subject to the pressure of close competition within their industries. Any check on the performance of such firms must come, under the Task Force rule, from smaller firms within those industries. The proposed rule would permit those smaller firms to be strengthened by acquisition. That, however, is a substantially weaker threat to the mismanaged or lazy firm than the take-over. This is the real cost of the merger rule suggested. For this reason, any delineation of that market share which defines a leading firm must be done with appreciable care. Ten percent may be too small, particularly in a concentrated industry. That would be especially true if markets are narrowly defined, as they frequently have been in antitrust interpretation, and, as is fully possible given the leeway in the Task Force's definition of a market.<sup>40</sup> Although this rule is appealing analytically, it has very substantial dangers practically, and a case can be made that with greater emphasis on the potentially competitive interaction among firms, many mergers which this rule would seek to (and should) block might also be found to violate section 7 of the Clayton Act.<sup>41</sup> That, of course, remains to be seen.<sup>42</sup>

Finally, much of the argument of this paper relies on the importance of entry barriers attributable to corporate scale. The large corporation is singled out as immune to those barriers. The *Neal Task Force Report*

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<sup>40</sup> That definition is "a relevant economic market, appropriately defined with reference to geographical area (which may be the United States or another geographic area) and product or service. . . ." NEAL TASK FORCE REPORT at 5651.

<sup>41</sup> 42 U.S.C. § 18 (1964), formerly ch. 323, § 7, 38 Stat. 731, as amended, ch. 1184, 64 Stat. 1125.

<sup>42</sup> See, e.g., Barmash, *Court Opens Way to ITT Deal That Would Set Merger Record*, N.Y. Times, Oct. 22, 1969, at 1, col. 1.



defines a large firm as one with sales of \$500 million. Unless the intent is to gradually reduce the relative size of the large corporations to which the rule is applicable, that definition is clearly inappropriate in any long-run context.<sup>43</sup> If the reasoning of this paper is correct, a large firm ought to be one large enough to enter and succeed in those concentrated industries where independent entry is sought. Any definition of a large firm of size less than that will serve no useful purpose and will only isolate additional firms from takeover where takeover can serve a useful function.

It is for this reason that the proposal of the *Neal Task Force Report* is much to be preferred to the Campbell-Shepherd proposal, but even the Neal Task Force proposal itself would benefit enormously from a careful attempt to examine empirically just what class of mergers would be prevented, just what corporations would be isolated from take-over, and just what scale of entry would be meaningful in those concentrated industries to which the Task Force would wish to channel the interindustry activity of "large" corporations. The *Neal Task Force Report* with respect to conglomerate mergers is an excellent one. The proposed merger law is a reasoned one. However, it deserves and requires careful analysis, for it might be a very bad law.

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<sup>43</sup> The absolute number of corporations covered would increase, with such a rule, rather rapidly. According to *The Fortune Directory of the 500 Largest Industrial Corporations* the number of industrials with sales of at least \$500 million rose from 53 in 1954 to 93 in 1960 to 195 in 1968. See FORTUNE, May 15, 1969, at 166.