U.S. Merger Policy and the 1992 Merger Guidelines

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Abstract. This article reviews the empirical evidence regarding the effects of mergers on corporate efficiency. In light of this evidence it then evaluates the effectiveness of U.S. merger policy as articulated in the 1992 Guidelines of the Department of Justice. It argues that the 1992 Guidelines and the U.S. Government's policies toward business more generally over the past 12 years have been characterized by a bias for bigness. It concludes that this bias will only be eliminated when government authorities in charge of merger policy recognize that many mergers lower economic efficiency and design and enforce their policies accordingly.

Key words. Antitrust policy.

I. The Facts

Mergers are rare and often major events in the life of most firms. For one of the participants they are a cataclysmic event. Top managers are replaced or displaced, organizational forms are restructured, R and D, production and marketing operations are integrated and consolidated. Intuitively one expects that the outcomes of such radical restructuring, like the outcomes from major surgery, will be surrounded by considerable uncertainty. Success will be difficult to predict, and generalizations about the effects of mergers will need to be made on the basis of large scale, ex post evaluations. Fortunately, history has provided us with a large set of observations. There have been literally hundreds of thousands of mergers in the United States in the last century, and hundreds of empirical investigations of their effects. Considerable evidence is also available from abroad. What does this evidence show?

First of all it shows that the profits of merging companies generally decline after the mergers. Remarkably, this finding was made for mergers during the first and second merger waves in the United States in the 1890s and 1920s, when the dominant form of merger was horizontal (Hogarty, 1970). George Stigler (1950) described the first as the wave 'to create monopolies', and the second the wave 'to create oligopolies'. It is obvious that a horizontal merger can increase market power and thereby profits. It is not obvious how it could increase market power and reduce profits. Horizontal mergers might increase or reduce efficiency and thereby increase or reduce profitability. Presumably some mergers did increase market power (e.g., those that created Standard Oil of New Jersey and American
Tobacco). If the net impact of all mergers was to reduce profitability, then the declines in profits from reduced efficiency following the mergers of the first two waves must have outweighed the increases that occurred from both market power and any enhanced efficiency. Since consumers lose when either market power increases or efficiency declines, losses to consumers from the first two merger waves must have been significant.¹

The inefficiencies that mergers can produce arise from the communication, coordination, and other ‘transaction costs’ that are generated when heretofore separate organizations are combined. These costs exist with all forms of mergers. The closing of the loophole in Section 7 in 1950, increased the proportion of vertical and conglomerate mergers occurring in the United States. They too have generally been found to reduce the profitability of the merging companies.²

Profits might increase following a merger, either because market power has increased or because efficiency has increased. No similar ambiguity exists with respect to the effects of a merger on sales or market share. An increase in market power is exercised by increasing price (reducing output) and results in a decline in market share. Efficiency increases manifest themselves as cost reductions and lead to price reductions and market share increases. The largest investigation of the effects of mergers on market shares found that they result in significant declines (Mueller, 1987). A second study found no significant change (Goldberg, 1973). Mergers have generally been found to lead to no changes in the growth of sales of the combining companies or to significant declines.³ At best these results imply that whatever efficiency increases there are from mergers are balanced in their effects on growth or market share by efficiency declines. At their worst they imply either efficiency declines as a result of mergers, or market power increases, or both.

The most positive impression of the effects of mergers one obtains from the existing empirical literature is obtained when one assesses the ‘effects’ of the mergers on the basis of the changes in market values of the merging firms at the time that the mergers are announced.⁴ Acquired firm shareholders enjoy statistically significant increases in wealth, acquiring firm shareholders modest gains or losses.⁵ When one follows the shares of the acquiring firms for several months or years after the mergers, however, one observes continual and significant declines, declines sufficiently large to offset all or more than all of the wealth gains to the acquired firms.⁶ Thus, the event study literature, once the market is given time to adjust fully to ‘the event’, paints the same picture as the profitability and market share studies. Mergers have at best a neutral effect on shareholder wealth, at worst reduce it.

Even when the more sanguine interpretation of the profitability and event studies is accepted, i.e., that mergers have no net private effects, their social effects are likely to be negative. This conclusion is apparent in the recent, detailed analysis of 62 hostile takeovers by Bhagat, Shleifer, and Vishny (1990). The most popular explanation for hostile takeovers is that they occur to remove the