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Corporate Raiders and Junk-Car Dealers: Economics and Politics of the Merger Controversy

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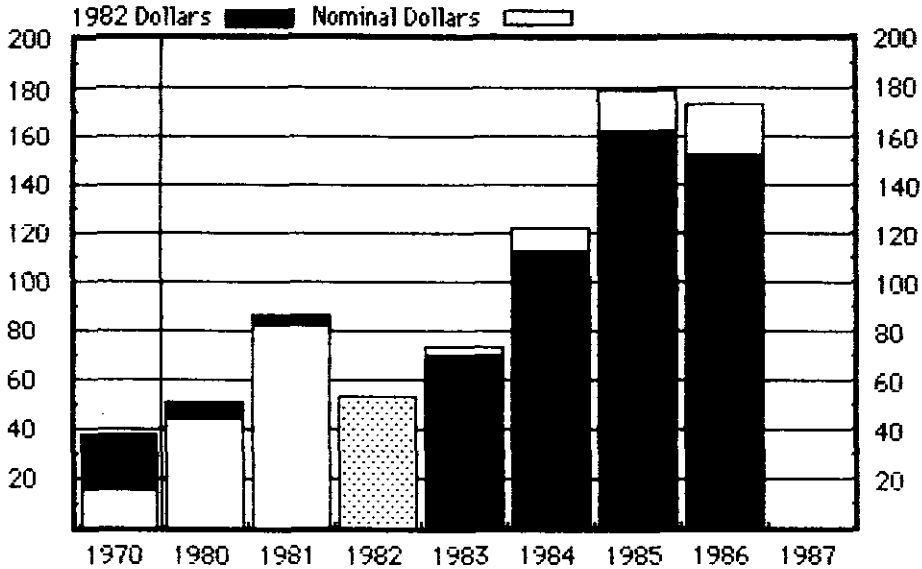
Fueled by almost frantic efforts to adjust and adapt in the face of intense international competition, American industry undertook an immense corporate restructuring in the 1980s, partly in the form of corporate mergers and takeovers. The magnitude of these corporate acquisitions, both collectively and in individual cases, has been large. The Standard Oil takeover of Gulf in 1984, for example, cost $13.2 billion. That was dwarfed, however, by the $24 billion acquisition of RJR Nabisco by Kohlberg Kravis Roberts & Co. in 1988.

Graph 1 below shows the annual value of mergers from 1980 through 1986, expressed both in nominal dollar magnitudes and constant 1982 dollars, with the 1970 magnitudes shown for comparison. The sharp increase in merger activity after 1982 is clear. Table 1 shows both the numbers and values of mergers for ten major industries, classified by acquired firms. As shown, more mergers occurred in the banking and financial industry than in any other, but the mergers with the highest dollar values occurred in the oil and gas industry.

Spoken and written opposition to such mergers has been so strong that it has dominated the public debate about takeovers. Some of this opposition stems from intellectual and political groups who are hostile to market processes, and who see corporate takeovers as a particularly odious and sterile example of these processes. Much of it also, naturally, stems from corporate managements who have found themselves (for reasons explained below) to be actual or potential targets for displacement through "hostile" takeover. Another source of opposition is organized labor, which has suffered membership losses because of foreign competition and corporate restructuring. A final, prevalent source of opposition is economic ignorance.

Graph 1: Annual Value Mergers, 1970 and 1980-1986, in Billions of Real (1982) and Nominal Dollars



Source: *Statistical Abstract of the United States, 1988,* and *The Economic Report of the President, 1989.*

The intent of this essay is to alleviate some of that ignorance. First, the basic economics and empirics of corporate mergers will be discussed. Then, important arguments of takeover opponents, both recent and vintage, will be critically evaluated. A final section deals with some major forces determining legislative and regulatory policy toward mergers over time.

The Role of Greed

The ratio of emotional accusation to dispassionate analysis has been very large in the takeover debate. The charge most frequently and loudly made against corporate takeovers is that they are motivated by greed. At first glance, this seems intuitively obvious. The acquiring firms, corporate raiders, lawyers, and investment bankers involved often clear tens or even hundreds of millions of dollars from a successful acquisition. Such sums stagger the imagination, and the superficial observer naturally concludes that the whole process is simply an ostentatious display of avarice.

Scholarly inquiry necessarily proceeds beyond superficial appearances and characterizations, however. While pointing fingers and shouting "greed" may be emotionally satisfying, and even useful for making converts, the concept is

Table 1. Merger and Acquisition Transactions: Number and Value by Industry, 1982–1986

industry classification of seller	number of mergers					nominal value (mill. dol.)				
	1982	1983	1984	1985	1986	1982	1983	1984	1985	1986
total	2,346	2,533	2,543	3,001	3,336	53,755	73,081	122,224	179,768	173,137
Oil and gas	80	111	102	86	58	9,166	12,076	42,982	23,160	3,247
Banking and finance	426	311	251	381	415	5,605	13,628	5,846	14,037	19,422
Insurance	81	67	66	67	94	5,718	2,966	3,006	2,694	5,413
Mining and minerals	31	18	12	16	14	355	2,946	347	356	148
Food processing	52	74	58	82	101	3,075	1,164	7,095	11,838	4,707
Conglomerate	14	13	18	14	20	3,974	2,745	6,983	16,302	15,307
Transportation	40	36	36	48	58	1,074	5,255	1,252	2,877	6,829
Broadcasting	47	60	83	93	123	787	3,747	1,918	15,013	8,107
Retail	86	90	130	136	147	1,948	1,489	6,673	10,030	13,683
Brokerage & investment	56	63	86	49	47	861	1,455	1,460	579	1,710
Other	1,433	1,670	1,701	2,029	2,529	21,191	25,609	44,662	82,882	94,544

Source: *Statistical Abstract of the U.S., 1988: 504, table no. 843* inadequate as a tool for social analysis. In the first place, the term cannot be given any objective, quantitive definition. What level of desired income constitutes greed? Obviously *any breaking point chosen would be completely arbitrary and scientifically meaningless.*

Besides, people who desire large pecuniary incomes are in an essential sense no different than anyone else. Perhaps the most fundamental of all principles of modern economics is that *everyone is a maximizer.* That is, we would all like to attain, acquire, and accomplish more things than we are able to with our available resources. Consequently, we all rank our ends in order of importance and allocate our scarce means to the attainment of those highest on the list, forgoing the others (i.e., we economize our resource). *Since ultimate income is simply the flow of satisfaction experienced as means are successfully applied to the attainment of ends, and we all want to be as happy as possible, we are all equally "greedy" in that sense.*

Of course there is a difference between Mother Teresa and Carl Ichan; that is, even in this framework it can be useful to differentiate among the *contents* of different individual's value systems, and define a person as "greedy" if he or she ranks the attainment of pecuniary income or worldly goods first, subordinating all other goals. The scientific problem here is that we cannot observe such value systems directly. All such judgments must be *inferred* from observations of people's actions, and it is easy to make mistakes.

Consider John D. Rockefeller, who earned a huge personal fortune in a day when a dollar had about thirteen times its current purchasing power. Was earning such income the only or highest end in Rockefeller's value system? Perhaps, but also perhaps not. As a matter of historical fact, Rockefeller was a loving husband and father who was good to his employees, endowed colleges, charities, and foundations, went to church every Sunday, and paid tithing on every dime he ever earned (Folsom 1987, chapter 5). Earning income may simply have been a means to the attainment of other (perhaps less materialistic) ends with Rockefeller, and this may well be true of some others who seek great wealth.

None of this is to deny that mergers are undertaken to obtain monetary profits, whatever the ultimate uses intended for such profits. Even so, this tells us nothing about the social value of the merger process or of individual acquisitions. Economists since Turgot and Smith have understood that in a competitive market system it is precisely the desire to obtain profits and avoid losses that causes entrepreneurs to shift resources from locations and employments in which the public values them less to those in which the public values them more, and to use them efficiently. *The remaining question is simply whether or not merger activity is an example of such efficiency and value-enhancing processes.* For this reason if not other, the charge of "greed" is ultimately meaningless.

Conglomerate Mergers

While the emotive charge that corporate acquistions are motivated by greed and avarice may have no validity as a criticism of such acquisitions, recognition of the universal maximizing character of man and the profit motive does raise a central issue: Why *do* mergers occur? In particular, why is there a profit to be made by acquiring some firms and not others?

There is not just one answer to this question, but several. First, a simple point that most observers seem to have missed is that many firms merge to reduce risk. Economists define corporate risk in terms of the variability of the rate of return earned by stockholders of the firm. Such variability stems from variability of demand and supply conditions, which cause prices and sales to fluctuate. Since conditions differ from industry to industry, so does the degree of risk.

It is well recognized in the economic literature that bearing risk means bearing a (nonpecuniary) cost of doing business. If a firm is to stay in business, the unit price of its product must be high enough to cover *all* unit costs. It follows that, other things being equal, both the product price and pecuniary rate of return will vary positively with the degree of risk faced by firms in an industry.

Now investors in paper assets have always known that they could reduce their personal risk by diversifying their investments across stocks and/or bonds in unrelated lines of business, so that the price (and hence rate of return) fluctuations of those different assets in the portfolio would (in the absence of general market movements) be uncorrelated. Managements of firms realized that they could do something similar. They could use surplus (retained) earnings or borrowed funds to purchase other *firms* in unrelated lines of business. This form of merger is termed a "conglomerate merger."

Since risk is a real (though unobservable) cost that product price must cover in equilibrium, successful risk reduction through conglomerate merger means genuine cost reduction. Any net reduction in real unit costs of supply results first in higher profits for the firm. What is more, for the profit maximizing firm, any marginal cost pricing rule, or even a fixed markup pricing rule, implies that at least part of any such cost reduction will be passed on to the public in the form of lower product price and higher output. Both investors and consumers gain, and such a risk reduction is clearly socially beneficial.

Not all conglomerate mergers (or mergers of any type) are successful. Mergers are entrepreneurial acts based on anticipated future conditions, and entrepreneurs often make errors in judgment. In particular, the top managers of an acquiring firm may not be able to operate an acquired business with which they are basically unfamiliar as efficiently as they had anticipated. The (stock market) value of the firm may therefore *fall* after the merger. The large merger wave of the 1960s was primarily a conglomerate merger wave, and a significant portion of those acquisitions were unsuccessful.[1]

Some analysts have concluded that the bulk of mergers are unsuccessful, and that the process is therefore harmful on net. David Ravenscraft and F. M. Scherer (1987, 193–210), for example, condemned the merger wave in the 1960s and 1970s after finding that firms in their large sample had lower rates of return over several years after merger. But since a large majority of those mergers were conglomerate mergers, undertaken to reduce risk, falling post-merger *pecuniary* rates of return is precisely what should be expected if most such mergers were successful. As long as nominal rates of return fell less than risk, real rates of return adjusted for risk would then be higher.

It is important to stress that, if a conglomerate merger is to be a success, the decision as to what firm to acquire cannot be made randomly. The firm to be acquired must not only be in a largely unrelated line of business, but it would also be best to find a firm that could be purchased at a bargain price. This observation brings us to the next point.

The Market for Corporate Control

The corporate form of business organization is one of the great inventions of human history, allowing, as it does, the pooling of private resources on a scale previously undreamed. A basic problem, however, is that managers, as hired agents of the owners (stockholders) with fixed salaries, have less than perfect incentives to use corporate resources in ways that maximize stockholder returns. This agency problem is minimized if top executives own enough of the firm's stock that a significant portion of their compensation depends on firm performance, and this arrangement is in fact typical of well-managed firms. Not accidentally, it is typical of poorly managed corporations that the top executives own very little stock in their firms.

Stockholders do have other methods of pressuring their agents. Boards of directors can hire and fire managers, and proxy fights for control of boards do occur. Managers have the edge in these struggles, however. For one, they can use corporate resources to lobby for their position, while rebel stockholders must use their own resources. Also, external benefits generated by individual stockholder efforts of this type reduce overall stockholder efforts.

The opportunity to buy or sell shares freely provides another control mechanism, however. Economists believe the stock market to be highly efficient at setting the share price of a firm's stock accurately at the present value of all of the firm's exepcted future net earnings per share from production and sales. Large numbers of people evaluate the stock of a publicly traded corporation, and, although individuals may make mistakes, their errors are likely to cancel in the aggregate. Also, new information on future firm performance spreads rapidly and is quickly captitalized into present share values.

Other things being equal, the magnitude of a firm's future production, sales and earnings depends, of course, on the efficiency and skill of its management. If the present and expected future earnings are below their potential magnitude because of comparatively inefficient or lackadaisical management, the market will price the firm's stock accurately at a value below the value the firm's asset would have under a more efficient management. In this sense the firm's stock will be "undervalued."

An opportunity then exists for some other firm or entrepreneur (often termed a corporate raider) to purchase the firm at a price below its potential value and make a profit by displacing the previous management and operating the firm efficiently (or by selling parts of the firm to others who can use them efficiently, and hence value them highly). If stock of the firm to be acquired is depressed enough, such a profit opportunity exists even if the buyer has to pay a substantial premium over the pre-merger share price. Indeed, such premiums average over 30 percent.

Such takeover attempts (termed hostile when opposed by the managements of the target firms, and friendly when not opposed) constitute what Manne (1965) termed the "market for corporate control." If this market operates in the fashion claimed, it is socially beneficial because it tends to shift control of corporate assets from less to more efficient managements. In addition, the very *threat* of displacement through takeover arguably pressures existing managements to act in the interest of the firm's owners (stockholders), using corporate assets in such a way as to maximize the present value of the firm.

A closely related argument developed by Donald Dewey (1961) is that mergers are a civilized alternative to bankruptcy by which the assets of failing firms are transferred to successful firms. The major difference in the two concepts is that Dewey's relates best to friendly takeovers, or horizontal mergers within an industry, while the notion of the market for corporate control is more inclusive in scope. Both perspectives imply, however, that acquired and acquiring firms should usually be distinguishable by their pre-merger performance.

Economists Victor and Carol Tremblay (1988) found this to be the case when they recently examined the mergers that occurred in the U.S. brewing industry between 1950 and 1984. They discovered that the average two-year growth rate in market share for the acquiring firms before merger was 17.6 percent. That is, acquiring firms had increased their market share by that much on average in the two years before a takeover. For acquired brewing firms, in contrast, the average two year growth rate in market share prior to acquisition was −11.1 percent. Clearly the acquired firms were less efficiently operated, declining firms.

Similar evidence has been discovered in many other studies of mergers. When the Federal Trade Commission studied the merger wave of the 1960s, for example, it found that the firms acquired by the nine largest conglomerates had, before their acquisition, been operating only about 75 percent as efficiently as the average of the firms in their industries (Brozen, 1982, 336).

Many empirical tests also focus on the *post*-merger performance of the firms. If the market for corporate control operates as advertised, the post-merger value of the most acquired firms should be higher than their pre-merger value. Statistical tests on adequate samples always find this to be the case. But such studies sometimes find that the values of acquiring firms are reduced, such that the post-merger values of the merged firms do not exceed the pre-merger values of the separate firms. On this basis some economists argue that mergers are not value-enhancing and socially beneficial.

Other economists are unconvinced, however. K. Paul Asquith (1980), who studied all post-war mergers involving New York Stock Exchange listed firms, found that the bulk of acquired firms were in fact poorly managed firms, the stockholders of which had lost money for several years prior to acquisition, and that the combined firms had higher value than they had separately. Similarly, Eckbo (1988), studying Canadian mergers, recently found that both target and bidder firms earned large gains from takeovers.

Even more striking are the results of a recent massive study by Lichtenberg and Siegel (1987), who examined 20,000 plants accounting for two-thirds of U.S. manufacturing shipments. They found that those plants in this sample which changed owners had previously been less productive, on average, than others in their industries, and had experienced declining productivity before the ownership changes. They also found that, on average, productivity in these plants began rising about a year following the ownership changes, until they nearly equaled that of plants which did not change owners.

Synergies and Scale Economies

Another factor or set of factors known as synergies motivate many mergers. A synergy exists if characteristics of the separate firms are such that, after merger, the combined firm is able to operate better or more efficiently than before, even if the separate firms were efficiently managed. The classic form of synergy stems from the different but complementary characteristics of the separate firms.

Yale Brozen (1985, 8–9) cites the example of Shell Oil's purchase of Belridge Oil in 1979, a merger that allowed Shell to apply its superior oil-recovery technology to Belridge's large oil reserves, *doubling* Belridge's rate of production. Even though Shell bid much more than the initial value of Belridge stock, the earnings of Belridge more than doubled. The transfer of ownership and management to Shell benefited Belridge stockholders (and, it should be added, the consuming public).

Another form of synergy may be important in some cases. Some production technologies are subject to increasing returns to scale, such that raising the scale of the firm results in proportionately greater increases in output. Other things equal, this reduces unit costs of production. A change to such a technology in an industry provides motivation for firms to build additional capacity, making higher outputs, greater profits, and lower prices economically feasible.

It may be, however, that market demand in the industry may not be large enough to support a large number of the higher scale firms, even at lower unit output prices. In that case, the advantages of scale can still be achieved through mergers by existing firms. This seems to have been the case with much of the merger activity in the brewing industry mentioned above, as firms that were growing and achieving scale economies absorbed others. According to C. F. Keithahn (1978), the minimum efficient firm size for a brewer increased from 4 million barrels in 1960 to 18 million barrels by 1978. Here again, the public benefited from the mergers in terms of higher output and lower real costs of production.

Junk Bonds and Junk Car Dealers

The competitive market system is dynamic and innovative by nature. While most innovations in product, production process, form of business organization, etc., are socially beneficial, they often distress those with vested human or physical capital of older types, or entrenched positions of authority. One of the innovations of the 1980s merger wave that has had this effect is the use of "junk bonds" by the firm of Drexel Burnham Lambert and others to finance many corporate acquisitions.

Junk bonds are simply high-yield bonds that have a default rate marginally greater than that of high-grade bonds. The two features are correlative, and simply illustrate forcefully the principle that the market compensates people with higher returns for bearing greater risk. The term "junk bonds" is therefore unfortunately and unfairly denigrating. Its universal adoption indicates the extent to which the opponents of mergers have been able to dominate the public debate.

The appearance of junk bonds sent a shock through the ranks of managers of large but poorly performing firms because this form of finance provided additional funds allowing corporate raiders to conduct hostile takeovers on a scale that could seldom be undertaken through conventional financing alone. This was true even though "leveraged" or debt-financed buyouts have never exceeded 22.7 percent of the value of all completed mergers in a single year (Shorter 1989, table2). In essence, junk bond investors have been willing to supply funds based on the estimated post-merger value of the target firm's assets.

The last point deserves emphasis, since the use of such a high-cost form of finance raises the question of why corporate raiders would be willing and able to cover such costs, and why lenders would expect to get paid. Again, the sensible answer would seem to be that both borrowers and lenders of such funds anticipate a rise in the value of the assets of the firm to result from the merger process, whether because the firm is currently underpriced because of poor management or because potential synergies exist.

In many cases the acquiring firm or corporate raider quickly pays off part or all of the debt incurred in the takeover by selling off divisions of the acquired firm. Indeed, it is sometimes the most profitable parts of the firm that are sold. This corporate dismemberment has been difficult for the public to understand and easy for the entrenched managements and intellectual opponents of mergers to denigrate. A simple analogy may illuminate the matter, however.

Consider used auto parts dealers (that is, automobile junkyard operators). Why is it possible for people in this business to purchase cars and sell their usable parts for *more* than the cost of the car, by enough to make at least a normal return on investment and stay in business? The obvious answer is that a junk car can be purchased cheaply (at a price less than the value of its separate parts) *because it is not functioning very well as a unit.* That is, the present value of its anticipated future stream of services is low.

It is also clear that in purchasing such a car and selling its good parts (for a profit) to those who can use them, the dealer is performing a valuable social service. Why, then, is it not also clear, that a corporate raider is often able to acquire a company at a low price (below the value of its separate parts) precisely because it is not functioning very well as a unit, and that in proceeding to sell parts to those who need and can use them, for a profit, the raider is also performing a valuable social function?

Examples of this process are easy to come by. Amar Bhide (1989) cites the hostile takeover of Revlon by Ronald Perelman for $1.8 billion in 1985. Since the death of its founder in 1975, Revlon had been using the cash flow from its cosmetics business to fund acquisitions of health care firms. Perelman quickly sold five health care units for nearly $2 billion, gaining almost $200 million in profit. Bhide also cites the hostile 1985 takeover of the conglomerate AMF for $560 million by Irwin Jacobs. Jacobs recovered his entire purchase price by selling off eight of AMF's units and kept its boat, sporting goods, and energy operations as a reward.

As Bhide goes on to show for 1985–1986, this pattern of purchasing conglomerates and selling off units unrelated to the primary business of the firm is typical of hostile takeovers during the 1980s merger wave. By increasing specialization, focusing managerial attention on the primary business, the effect is generally to increase the efficiency of the firm's operation. Also, the purchasers of the divested units are usually investment groups or the unit's own managers, who intend to operate the business as a single entity, or are single business companies in the same or similar lines of business. Arguably, the hostile takeovers of the 1980s merger wave have primarily been aimed at correcting those conglomerate mergers of the 1960s and 1970s that turned out to be entrepreneurial mistakes.

Three Objections to Hostile Takeovers

The hostile takeovers of the 1980s have in particular generated a flood of published opposition from intellectuals and entrenched managements, and these opponents have not been inarticulate in their objections. One of the central themes of their speeches and publications is that the corporation has social obligations—borne by and vested in the management—to *many* groups other than the stockholders. Such constituencies are argued to include employees, the local community, and even society at large.

This argument has two functions. First, it is aimed at counteracting the claim of equally articulate corporate raiders such as T. Boone Pickens (1988) that raider's actions are expressions of a stockholder revolt against unresponsive and inefficient managements. More importantly, it offers a rationale for management's discretionary use of corporate assets in ways that may *not* benefit stockholders, and for any resulting poor performance in terms of rate of return or share values.

The question of whether the corporation has legitimate social obligations that would not be fulfilled by those efficient production and marketing operations that maximize shareholder wealth is too difficult to treat in depth here. Such claims are hazy, however, and it is hard to see the "social obligation" argument as much more than a plea for managerial discretion without accountability. Indeed, it should be clear that managements that do not act to maximize shareholder returns are usually the ones that also fail employees, local communities, and society.

A closely related theme in the writings of takeover opponents is that managers of actual and potential takeover targets are usually engaged in actions and investments aimed at improving the long-run health and profitability of their firms at the time of takeover attempts. Corporate raiders, in contrast, who care only about short-run profits, apparently (the argument is unclear on this point) take advantage of resulting temporary low share values to initiate hostile takeovers.[2]

Even aside from its cloak of self-righteousness, this argument is defective. It is true that "long term" investments yielding improved future earnings may come at the expense of present profits. Such investments will not reduce current share values of the firm, however (making a takeover profitable) unless the tradeoff between present and future earnings is such as to reduce the expected present value of the whole future earnings stream, in which case the investment is unjustified. If the long-run investment actually represents a more efficient use of the firm's (i.e., stockholders') resources, theory and empirical evidence imply that share values will immediately rise (See McConnell and Muscarella 1985). Motivation for a takeover attempt is reduced in such a case.

Of course, these defenders of the corporate status quo are not arguing that their long term investments are actually reducing the present value of their firm's future earnings stream. Their implicit claim is that farsighted management see the net beneficial effects of their long term actions on the firm's net income stream, but that shortsighted investors do not and therefore act to set present share prices only on the basis of current profits, motivating the takeover attempts.

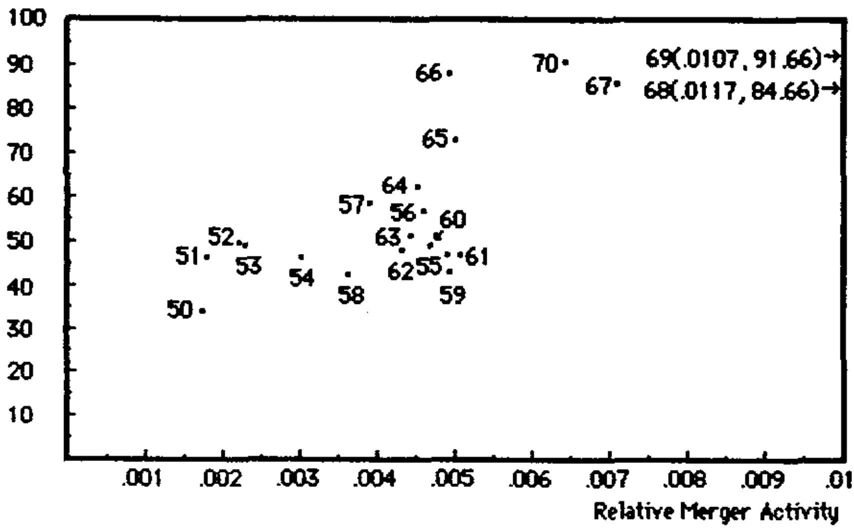
If ever there was evidence of the arrogance of some entrenched corporate managements, and of their contempt for their own stockholders, this argument is it. Worse, direct empirical evidence contradicts the claim that managements of takeover targets have a particularly "long term" perspective. Pound et al (1986) found that target firms typically spend much *less* on research and development than other firms in their industry.

A third theme pervading the published and broadcast arguments of merger and takeover opponents is that the use of funds for corporate acquisitions diverts and reduces the amount available for investment in new capital goods. Broad historical evidence seems to cast some doubt on this claim, however. The period of the 1960s in which the conglomerate merger wave occurred was also a period of rapid investment and output growth, apparently stimulated by the Kennedy administration's tax cuts. In contrast, the decade of the 1970s, in which comparatively few mergers occurred, was a period in which investment, productivity growth, and output growth all fell below their historic postwar trends, to the point that many economists became worried.[3] The expansion of the 1980s, however, in which the latest merger wave occurred, has been led by rapid investment set off by the Reagan administration's tax reductions (Council of Economic Advisers 1986, 37–53).

Yale Brozen argues forcefully that the acquisition of the old assets is not a process that diverts financial capital from the creation of new assets. Indeed, in his view an increase in the demand for old assets encourages the creation of new ones. Curious about Brozen's claim, this author calculated the ratio of total mergers to the total number of corporations in mining and manufacturing to obtain a measure of relative merger activity for the years 1950–1970. Nominal expenditures on new plant and equipment in these industries were then deflated by the GNP deflator for Producers Durable Equipment to obtain a measure of real investment for the same years. These two relative measures for each year are expressed as Cartesian coordinates in graph 2. The relationship is clearly *not* negative, as implied by the arguments of merger critics, but positive. The computed correlation coefficient in the sample is $r^2=.70$.

There is clear logic behind this positive correlation, as Brozen explains. When old assets are purchased from those who invested in them originally as new assets, and who have a comparative advantage in making such investments (but perhaps not in operating the assets), those individuals are provided with funds to undertake more such investments. It should be understood, though, that even if corporate acquisitions were *not* associated with additional investments in new plants and equipment, they would still add to real production and income if the ownership transfers caused existing assets to be used more efficiently.

Graph 2: Relative Merger Activity and Real Expenditures on New Plant and Equipment in Manufacturing and Mining, 1950–1970
Investment, in Billions of 1982 dollars



Sources: *Historical Statistics of the United States, Colonial times to 1970,* and *The Economic Report of the President, 1989*

Corporate Takeovers and Disemployment

The single most disturbing aspect of hostile takeovers to their opponents and the general public is that they are often followed by employment reductions or plant closings or both. Indeed, vocal takeover opponents argue that share price premiums can only be paid and profits obtained in the takeover process by reducing employment in the target firm. Consider, for example, the following statement by John G. Smale, Chief Executive of Proctor & Gamble (1986, 330–331):

> I don't want to imply here that some synergies don't result following forced restructuring. But the word synergies in most cases is basically a euphemism for fewer people. The principal way restructured companies can be more efficient is to lower costs and that means, by and large, fewer employees.
>
> I know. In the flurry of companies being put on the auction block, we've had several opportunities to examine companies "in play." The figures always tell the same story. Justifying paying a premium over market price has to involve a reduction in the number of people the company employs.

Empirical evidence does indeed show that employment reductions follow takeovers. Amar Bhide found evidence of layoffs and plant closings following about two-thirds of hostile takeovers in 1985 and 1986. But this was also true of many acquiring firms, and also of others not involved in takeovers at all. As Bhide notes, large companies in the United States began reducing employment about two or three years before hostile takeovers became widespread. Employment in the Fortune 500 fell approximately 6 percent between 1981 and 1986.

It should be remembered, however, that the employment loss in large firms in this period was more than compensated for by employment growth in small and medium sized firms and entry of new firms. In 1980, before the recession, the employment rate (percent of the population unemployed) was 59.2. The unemployment rate (percent of the labor force employed) was 7.0, and per-capita real disposable income was $9,722 (in 1982 dollars). By 1987 the employment rate had risen to 61.5 percent, the unemployment rate had fallen to 6.1 percent, and real disposable income per-capita reached $11,012. Total employment rose by over 13 million in this period (Council of Economic Advisers 1989, 346, 351, 352).

The argument that the profits of the corporate raiders are taken from the pockets of those disemployed from the target firms has a small element of truth and a large element of myth. Employees, white-collar or blue-collar, are employed to *do* something, that is, to add to the firm's output and revenue. It never increases a firm's profits to release an employee whose addition to firm output has a market value equal to, or in excess of, his cost to the firm, since revenue would then fall as much or more than costs. No corporate raider would be such a fool as to do this.

It pays the firm to release only employees whose addition to firm revenue is less than they cost the firm. Since labor is a scarce resource, with alternate uses, it is clearly not *socially* beneficial for the firm to *retain* such employees. If they cannot be made more productive, such employees should be released to find jobs at which they can provide the consuming public with goods or services having a value at least as high as the sum of their wage plus non-wage employment costs, contrary to the apparent views of Mr. Smale et al.

It may certainly be the case, however, that the retaining of such relatively unproductive employees by (and including) inefficient management is one of the factors causing low returns and share values, which is corrected by a hostile takeover. The resulting logically anticipated increase in future profitability partly accounts for the rise in the value of the target firm and the profits of the corporate raider. In this case, as in others, the raider has performed a beneficial social service.

Alternative Explanations for Mergers

Most attacks on merger activity and the economic theories that find it to be beneficial are clearly self-serving and destructive criticisms, offering nothing beyond greed as an economic explanation. Not all opponents of mergers are unobjective, reflex opponents of market processes, however. A significant minority of economists doubt the social benefit of mergers. Even some strong defenders of the market, such as Murray Weidenbaum, are unconvinced that mergers are beneficial. Weidenbaum (1988 and 1986, 278) notes that many studies show a strong positive correlation between firm size and managerial salaries. From this he concludes that the primary motive for mergers is the desire of professional managers to obtain larger salaries by operating larger firms.

It is really rather surprising that Weidenbaum would offer such a casual explanation for this phenomenon. For one thing, it would seem not to explain hostile takeovers at all. Given the enormous magnitude of profits often made from post-merger asset sales, it seems hard to believe that enhanced salary is the prime motivator of corporate raiders. Indeed, one of the chief complaints by business executives who have felt threatened by takeovers has been that the raiders seldom end up operating the merged firms.

Fundamentally, the whole phenomenon by which the values of target firms rise, and (in cases of dismemberment) parts of such firms so often sell for more than the whole did in the merger, is unexplained by Weidenbaum's hypothesis. Many mergers require some external debt finance, often a great deal. How would individuals simply interested in larger salaries convince the suppliers of this capital that they could benefit by doing so? Why is the default rate on junk bonds as small as it is?[4] And if target firms are not poorly managed and hence undervalued firms, then how are target firms chosen?

The theories of synergies and of the market for corporate control explain all of these phenomena. Weidenbaum's hypothesis does not, unless it is combined with those theories as a statement of *additional* motive for takeovers. That is, those attempting a corporate acquisition may expect to gain both quick profits and a higher salary (if they wish to operate the firm) from the larger firm size and the improved efficiency and consequent appreciation in the value of the acquired assets.

A more popular explanation for mergers among their opponents is that they generate monopoly power. In the case of horizontal acquisitions, the number of firms in an industry is reduced by one, and the merged firm may theoretically control a large enough proporation of industry supply that it can, by restricting output, raise the price to a more profitable level. In the case of conglomerate mergers, the argument goes, the conglomerate may set the price of the product of its acquired firm low, subsidizing its losses through profits earned in other industries, until the acquired firm's competitors leave the market. The acquired firm then gains market power and can set the price high and earn monopoly profits.

This theory at least has the advantage of being able to explain the source of the increased post-merger profitability and value of target firms in terms of basic microeconomic theory. There are many objections, however. A large firm that has no cost advantage over its rivals, and which restricts its own output in order to raise industry price above the competitive level, will lose sales and market share to other firms in the industry because they will be able to underprice it. If the firm is a monopoly, its actions in raising price and profits will attract other firms to enter the market. In either case, the firm will, if it keeps restricting output in an effort to keep the price high, eventually lose both its large market share and ability to control the price.

Advocates of the market concentration doctrine respond that competitors may be prevented from entering the market by some sort of barrier. In the absence of a cost advantage by the large firm, however, the only barriers likely to be effective are governmental restrictions. And if the firm already has competitors in the industry, which is nearly always the case (except where government has prohibited competition), talk of entry barriers is meaningless. The only way the dominant firm could then maintain the high price and profits would be by colluding with its rivals to form a cartel. But then the entry problem would emerge again.

An alternative perspective is that firms that obtain and maintain a large share of the assets and sales in an industry (whether through merger to obtain synergies or scale economies or through innovation in product or production technique) are usually more efficient than their rivals, and therefore have a cost advantage (or a product quality advantage or both). As such firms reduced cost and increased their market share they would add to supply, reducing the product price and lowering the profits of their rivals.

If this theory is correct, the large firms in concentrated industries should earn comparatively high rates of return, but small firms in such industries should earn rather low rates of return. The market concentration doctrine, in contrast, implies that both large and small firms in a concentrated industry should earn above average rates of return. Testing these hypotheses, Harold Demsetz (1973) found that profit rates in large firms were in fact positively related, and profit rates in small firms negatively related, to measured concentration in a large sample of industries.

Since then, other studies such as those by Peltzman (1977) and Smirlock (1985) have supported the view that firms that gain large market shares do so primarily through superior efficiency. On the other hand, such positions of dominance and advantage seem frequently to be transitory. There is a rather large turnover of dominant firms over time, as well as significant instability of market shares in concentrated industries (Hymer and Pashigan 1962). Both of these facts contradict the market concentration doctrine that entry barriers and price conspiracies are frequent and effective.[5]

Another prediction of the market concentration doctrine as it relates to mergers is that prices should rise in industries experiencing merger activity, relative to others that experience little or none. A study by the National Industrial Conference Board (1929) of the merger wave that occurred between 1900 and 1913, however, found that in twenty-six industries experiencing important consolidations prices fell by 13 percent, while in twenty industries in which no consolidations occurred, prices increased by 10 percent. The board also found that this same pattern of relative price changes held up when it contrasted such industries in the period from 1913 to 1925.

Such evidence—in combination with that obtained from studies of more recent merger samples (Eckbo 1985, for example)—strongly contradicts the view that mergers are motivated and explained by resulting increases in market power. It is wholly in accord, however, with the view that corporate acquisitions are part of a competitive market for corporate control that causes resources to be used more efficiently through synergies or improved management, enhancing output and real income in the economy while lowering prices.

The Politics of Mergers

Public apprehension generated by the formation of many large firms through mergers in the late nineteenth century resulted in passage of the Sherman Antitrust Act in 1890 and the creation of the Federal Trade Commission (FTC) in 1914. Since then, mergers have been subject *ex ante* to governmental scrutiny and regulation. Over time, changes in governmental policy resulting from changes in economic theories and from interest group pressures have greatly affected merger activity.

Modern economic theories of business regulation seem to stress the primacy of interest group pressures. The public has been taught that regulators act to protect them from predatory business practices. Many economists now believe, however, that regulatory agencies are either created or "captured" by the dominant interests in the industries themselves, which then use the agencies to obtain competitive advantages that could not be obtained in the market.[6]

The Interstate Commerce Commission and the Civil Aeronautics Board, which regulated the railroad, trucking and airline industries for many decades, are good examples. Instead of protecting the public from monopolistic abuses, these agencies essentially acted as cartel enforcing agencies for the industries themselves. The regulators restricted entry of new firms, set high minimum rates, and specified business practices designed to limit internal competition in these industries.

The modern theory of regulation may understate the power of economic theory and empirical evidence, however. Accumulating evidence of the anticompetitive effect of such regulation, and identification of its nature and source, combined with recognition by some industry members that they might gain from competition, resulted in significant deregulation of the transportation industries after 1978.[7] All of these same forces have operated in merger policy over the years.

In the 1950s and 1960s, merger policy was guided by a strict market concentration doctrine. The Department of Justice and the FTC opposed virtually every horizontal merger that, in their view, might conceivably add to concentration and market power within any industry. This fact partly accounts for the conglomerate character of the 1960s merger wave. Indeed, a larger than normal proportion of those mergers may have been failures, as merger activity was diverted by a misguided public policy into less efficient channels. This merger wave dissipated when the FTC and the Justice Department began active opposition to conglomerate mergers.

In the late 1960s and early 1970s, economists such as Yale Brozen, Harold Demsetz, and Sam Peltzman began making successful theoretical and empirical attacks on the market concentration doctrine. Simultaneously, theories of synergy and of the market for corporate control began to inform professional economic opinion on mergers. In 1980 President Reagan appointed Dr. James Miller III to be head of the FTC, and William F. Baxter became head of the Antitrust Division of the Justice Department. Both were adherents of the new view, and both departments published relaxed merger prosecution guidelines in 1982 and 1984.[8]

The combination of a new regulatory environment, the invention of junk bond financing, and certain favorable tax changes resulted in the 1980s merger wave. As merger activity expanded, however, opposition grew and a regulatory counterattack was launched. Lacking FTC support, this counterattack has been diffused through elements in Congress, state governments, and other Federal agencies, and has only been marginally successful to date.

In 1987 the Federal Reserve System used its power to regulate "margin" purchases of securities (purchases that employ a significant amount of borrowed money) to limit the use of junk bonds in financing hostile corporate acquisitions. This regulation followed a petition by Unocal to the Fed to take such action. Unocal had just been a takeover target of corporate raider T. Boone Pickens (Carney 1987).

In the mid-1980s some state governments, under pressure from corporate managements and a public misinformed by television networks which had (in some cases themselves been takeover targets), began passing anti-takeover laws. They were legally contested, but in April 1987, the U.S. Supreme Court upheld an Indiana anti-takeover law. A similar law passed by the Ohio legislature was lobbied for by executives of Goodyear, who were threatened by a takeover bid from

Sir James Goldsmith (Dwyer 1987). This legislative action ended Goldsmith's takeover effort, with significant loss to Goodyear stockholders.

In July 1989, the House Education and Labor Committee attached to the budget bill a proposal by Congressman Peter Visclosky (D–Ind.) forcing firms to put worker representatives on the boards of trustees controlling pension fund investments (Garland 1989, 204). Pension funds are large purchasers of junk bonds, even though such bonds constitute only 2 percent of fund portfolios. Workers afraid of disemployment oppose corporate takeovers, and Visclosky openly stated that the intention of his proposal was to reduce or foreclose this source of takeover funding.

Add to this the recent persecution through selective prosecution of corporate raiders for white collar crimes, and once again the public is being told that regulation and legislation are being employed to protect their interests from corporate predators. In fact, these and other legal and regulatory actions are aimed, as such actions usually have been, at protecting the dominant corporate interests from competition. In this specific case, entrenched, inefficient corporate managements are being protected from competition for corporate control. If such actions succeed, the public will be the loser again.

NOTES

1. Estimates of the proportion of conglomerate mergers in all mergers in this period run as high as 82 percent.
2. I have done my best here to give logical formulation to a generally hazy argument. For one of the clearest presentations, see Smale (15 March, 1989), 330–332. The same arguments have been adopted by numerous other corporate spokesmen.
3. See, for example, the symposium on the productivity slowdown in the *Journal of Economic Perspectives* 2 (Fall 1988), and the literature cited by those authors.
4. Robert A. Taggert (1988, 12), reports the 1984–1985 default rate on junk bonds averaged 1.53 percent. This is not terribly higher than that on rated corporate bonds, though some estimates place the junk bond default rate somewhat higher. Taggert also demonstrates that the widespread use of junk bonds has *not* caused the corporate debt/equity ratio to deteriorate in the 1980s, as so many professional pessimists seem to think.
5. Hymer and Pashigian actually found market share stability to be *lower* in more concentrated industries.
6. Often attributed to George Stigler, the central idea probably originated with the historian Gabriel Kolko (1963).
7. The Airline Deregulation Act of 1978 was followed by the Motor Carrier Act of 1980. The public benefited immensely from both acts in the 1980s as competition increased in these industries.
8. For a hostile view of these events by an economist who headed the FTC Bureau of Economics for many years and is a strong advocate of the market concentration doctrine, see Mueller (1986, 27–66).

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