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## 57 Mergers and the market for corporate control

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The theory of merger is a subset of the theory of the optimal size and shape of the firm, a relatively undeveloped area in the Austrian literature. A firm seeking to expand its activities, whether into new product lines or within existing ones, can do so either via internal growth or by acquiring another firm. Acquisition will be preferred if the firm believes it can buy and redeploy the assets of an existing firm more cheaply than it can purchase new capital equipment and increase its current operations. In this sense, we can think of merger or takeover as a *response to a valuation discrepancy*: acquisition occurs when the value of an existing firm's assets is greater to an outside party than to its current owners. Put differently, merger can be a response to economies of scope, in that the value of the merging firms' assets combined exceeds their joint values separately. As with any exchange, the transaction is (ex ante) advantageous to both parties and should thus be welfare-enhancing. Such a valuation discrepancy typically exists because the buying firm believes that its management – or a new management team it installs – can operate the target firm more effectively than the target firm's incumbent management. Hence we can also think of mergers as a *form of monitoring institution*: takeover, or the threat thereof, is a disciplinary device that constrains the managers of a firm. If managers fail to maintain the market value of the firm, new owners will quickly arrive and replace them.

Mergers and acquisitions may take a variety of forms. An acquiring firm can try to reach a merger agreement directly with the management and board of directors of a target firm, paying with cash or its own stock, and then submitting the agreement to shareholders for ratification. Or it may appeal directly to the target firm's shareholders, asking them to 'tender' their shares at a stated price. (If the incumbent management resists the tender offer, this is called a 'hostile takeover'.) In either case a new, larger entity will be formed, combining the two initial firms under a single ownership. Corporations can be restructured in other ways as well: under a leveraged buy-out or other 'going private' transaction, a group of investors, often including incumbent management, buys out the firm's equity and replaces it with debt, usually in the form of high-yield ('junk') bonds. This class of transactions, like proxy contests and share repurchases, establishes a new ownership arrangement without necessarily affecting the physical assets of the firm. Additionally, spin-offs and divestitures can be used to break large firms into smaller pieces.

Following convention, we typically refer to all these reorganizations as *mergers and acquisitions* (M & A). The reason for M & A activity is straightforward: as economic theory tells us, in a market economy resources tend to move towards their highest valued uses. Mergers and acquisitions, as changes in the ownership pattern of assets, are simply part of the market process of adjusting the structure of production to meet consumer wants. Resources are shifted, from owners whose stewardship is poor, to those the market believes can do a better job.

While a certain amount of corporate restructuring is expected at all times, aggregate merger activity has tended to be concentrated in particular periods, commonly known as merger waves. (See Shugart and Tollison, 1984, however, for an argument that the timing of merger activity is equally well characterized as a random walk with drift.) The first significant merger movement in the USA occurred from about 1895 to 1904, with a series of horizontal mergers establishing the great trusts, particularly in railroads, coal and heavy manufacturing (Lamoreaux, 1985). The end to this movement is linked with a 1904 Supreme Court case, *U.S. v. Northern Securities*, which established that mergers could be successfully challenged under Section One of the Sherman Act. The 1920s brought a wave of vertical merger activity, primarily in public utilities, banking, food processing, chemicals and mining, as large industrial concerns in these areas integrated backwards into materials and equipment and forwards into marketing and distribution.

Perhaps the most significant, and least well-understood, merger movement in American history is the conglomerate merger boom of the 1960s. The great conglomerates of the period, like ITT, Gulf & Western and Litton Industries, were formed by deliberate strategies of aggressive acquisition into unrelated product lines. ITT, for example, branched out from its original base in telephone switching equipment to buy such companies as Aetna, Avis Rent-a-Car and Sheraton Hotels. As many of the large conglomerates turned out to be unsuccessful, the takeover and buy-out movement of the 1980s is sometimes viewed as an attempt to break such firms up into smaller, more manageable parts (Shleifer and Vishny, 1991). Indeed, product diversification in general has become a much-studied phenomenon in the field of business strategy, though the timing of the conglomerate movement in particular may be explained by non-economic factors, such as aggressive antitrust restrictions on horizontal expansion and the prosperity of the aerospace and defense-related industries associated with the Vietnam era military build-up. Many of the model 1960s conglomerates diversified from their initial areas of specialization precisely to get into more lucrative defense-related work.

**The nature of the firm**

Why, in general, do firms expand and diversify? And why do they sometimes retreat and 'refocus'? In the perfectly competitive model, firms as such do not exist at all; the 'firm' is a production function, its efficient output range and mix given by economies of scale and scope. Outside the textbook model, however, economies of scale and scope cannot explain the size and shape of the firm as *ownership structure*. Economies of scale, for example, imply that certain quantities of output can be produced more efficiently when produced together. But this does not explain why the joint production must take place in a single firm. Absent transactional difficulties, two independent firms could simply contract to share the same plant or facility and jointly produce the efficient level of output.

Ronald Coase, in his celebrated 1937 paper on 'The Nature of the Firm' was the first to explain that the size of the firm depends not only on productive technology, but also on the costs of transacting business. In the Coasian framework, as developed and expanded by Williamson (1975, 1985) and others, the decision to organize transactions within the firm as opposed to on the open market – the 'make or buy decision' – depends on the relative costs of internal versus external exchange. Use of the market mechanism entails certain costs: discovering the relevant prices, negotiating and enforcing contracts, and so on. Within the firm, the entrepreneur may be able to reduce such costs by coordinating these activities himself (though internal procurement will face its own information and incentive problems as well). In short, the boundary of the firm depends on organizational, as well as technological, considerations. These can in turn be broken down into a series of operational factors: the presence of transaction-specific assets, uncertainty and employee opportunism, and the like. Recently, this transaction cost theory of the firm has been challenged and extended by the concept of economic 'capabilities', an explanation for the scope of the firm based on complementarities in knowledge and organizational routine (Nelson and Winter, 1982; Langlois, 1992).

Unfortunately, the growing literature on the theory of the firm has yet to produce a fully satisfactory explanation of the limits to firm size (Williamson, 1985, chapter 6). In Coase's words, 'Why does the entrepreneur not organize one less transaction or one more?' Or, more generally, 'Why is not all production carried on in one big firm?' (Coase, 1937, pp. 42–3). Theorists have offered various span-of-control arguments to account for the limits to internal coordination, but none of these has been completely adequate. Here Austrian theory has an obvious contribution to make, by the application of Mises's theorem on the impossibility of economic calculation under socialism. Rothbard (1962, pp. 545–8) has shown how the need for monetary calculation in terms of market prices not only explains the failures of central

planning under socialism, but also places an upper bound on the size of the firm.

The large, integrated firm is typically organized as groups of semi-autonomous business units or 'profit centers', with each unit or division specializing in a particular final or intermediate product. The central management of the firm uses statements of divisional profit and loss to allocate physical and financial capital across the divisions: more profitable divisions are rewarded and expanded, while those showing lower profits are scaled back. The role of economic calculation can be illustrated as follows. Consider a decentralized, vertically integrated firm with an upstream division selling an intermediate component to a downstream division. To compute the divisional profits and losses, the firm needs an economically meaningful 'transfer price' for the component. If there is a market for the component *external to the firm*, then the firm can use that market price as a benchmark for its own internal calculations. Without a market price, however, a transfer price must be estimated in some way – usually on a cost-plus basis, or as negotiated between the divisions – but these substitute transfer prices will necessarily contain less information than true market prices; firms relying on them will suffer. The firm is thus constrained by the need for external markets for all internally traded goods. In other words, no firm can become so large that it is both the unique producer and user of an intermediate product; then no market-based transfer prices will be available and the firm will be unable to calculate divisional profit and loss and therefore be unable to allocate resources correctly between divisions. Like the centrally planned economy, the firm needs market signals to guide its actions; without them the firm cannot survive. The mainstream literature on the firm has yet to incorporate this Austrian insight, though recognition that the socialist calculation debate covers the main issues of organization theory is beginning to appear (Williamson, 1991).

**Managerial discretion and the financial markets**

As mentioned above, a vital function of mergers and corporate restructuring is to limit managerial discretion. Critics of the corporation, at least since Berle and Means (1932), have argued that the modern firm is run, not by its owners, the shareholders, but by salaried managers, whose interests are different from those of shareholders and include executive perks, prestige and similar rewards. If the corporation is diffusely held, no individual shareholder has sufficient motivation to engage in (costly) monitoring of managerial decisions and hence discretion will flourish at the expense of the market value of the firm (what we would now call a principal-agent problem). Henry Manne's seminal paper, 'Mergers and the Market for Corporate Control' (1965), responded that managerial discretion will be limited as long as there exists an active market for control of corporations. When managers engage in

discretionary behavior, the share price of the firm falls, inviting takeover and subsequent replacement of incumbent management. (Other mechanisms to limit managerial discretion are also present, including the market for managers itself; see Fama, 1980.)

Interestingly, the central insight of Manne's paper is also found in Mises's *Human Action* (1949), in the passage distinguishing what Mises calls 'profit management' from 'bureaucratic management' (pp. 302–4). It is true, Mises argues, that the salaried managers of a corporation indeed hold considerable autonomy over the day-to-day operations of the firm. Nonetheless, the shareholders make the ultimate decisions about allocating resources to the firm, in their decisions to buy and sell stock:

[The Berle–Means] doctrine disregards entirely the role that the capital and money market, the stock and bond exchange, which a pertinent idiom simply calls the 'market', plays in the direction of corporate business .... The changes in the prices of common and preferred stock and of corporate bonds are the means applied by the capitalists for the supreme control of the flow of capital. The price structure as determined by the speculations on the capital and money markets and on the big commodity exchanges not only decides how much capital is available for the conduct of each corporation's business; it creates a state of affairs to which the managers must adjust their operations in detail. (p. 303)

Mises does not identify the takeover mechanism per se as a means for capitalists to exercise control – takeovers were much less popular before the late 1950s, when the tender offer began to replace the proxy contest as the acquisition method of choice – but the main point is clear: the true basis of the market system is not the product market, the labor market or the managerial market, but the capital market, where entrepreneurial judgements are exercised and decisions carried out.

Mises's treatment of the importance of financial markets is also the key to his final rebuttal in *Human Action* to Lange, Lerner and the other market socialist critics of his calculation argument (pp. 694–711). The market socialists had claimed that a central planner could solve the calculation problem by ordering managers of industrial enterprises to fix prices at some level (say, price equal to marginal cost) and then make adjustments up or down according to conditions in the consumer goods market. Mises replied that the market socialists misconceive the nature of the 'economic problem': the main task performed by a market system is not the pricing of consumer goods, but the allocation of capital among the various branches of industry. By focusing on production and pricing decisions within a *given* structure of capital, the socialists ignore the vital role of capital markets. The financial sector, in which decisions are made about what resources will be available to each branch of production, is the true hallmark of a capitalist economy.

### Are mergers efficient?

Mergers and acquisitions, like other business practices that do not conform to textbook models of competition, have long been viewed with suspicion by economists and regulatory authorities. While some critics are hostile to vertical and conglomerate expansion, most discussions of antitrust law and public policy towards mergers focus on horizontal expansion and the accompanying rise in 'market power'. There the debate centers on the presumed trade-off between 'productive' and 'allocative' efficiency. Productive efficiency refers to innovations in technology and process that reduce cost. Allocative efficiency describes the condition that price equals marginal cost. To promote innovation, it is argued, some deviation from the perfectly competitive ideal must be allowed, since monopoly profits are needed to finance research and development. Antitrust law, then, must balance the loss of consumer surplus associated with monopoly power against the gains from technological progress (Williamson, 1968; Bork, 1978).

Austrian economists have long argued that the perfectly competitive model is a hugely inappropriate guide to public policy; estimation of price–cost margins, far from being a useful tool for locating market failure and justifying government intervention, is irrelevant to the real problems of economic organization. In the actual world of uncertainty, error and constant change, allocative efficiency means nothing other than directing resources towards higher valued uses, which can only be measured by the successes and failures of firms as determined by the market. What is good for the firm, then, is good for the consumer. There are also obvious potential benefits from horizontal expansion and even cartel agreements: reduction of uncertainty about rivals' actions, pooling of promotion and distribution costs, establishment of standards, and so on (High, 1984–5). In short, absent legal restrictions on market structure, 'dynamic theory presumes efficiency' (p. 31). Any merger that is not known to be a response to legal restrictions or incentives must be assumed to create value.

The paradox of contemporary merger analysis is the recognition that there seems to be a sharp divergence between market participants' pre-merger expectations about the post-merger performance of merging firms and the firms' actual performance rates. Ravenscraft and Scherer's (1987) large-scale study of manufacturing firms, for example, found that, while the share prices of merging firms did on average rise with the announcement of the proposed restructuring, post-merger profit rates were unimpressive. Indeed, nearly one-third of all acquisitions during the 1960s and 1970s were eventually divested. Ravenscraft and Scherer conclude that mergers typically promote managerial 'empire building' rather than efficiency, and they support increased restrictions on horizontal expansion. Other observers suggest changes in the tax code to favor dividends and share repurchases over direct reinvestment, thus

limiting managers' ability to channel 'free cash flow' into unproductive acquisitions (Jensen, 1986).

But the fact that some mergers – indeed, many mergers, takeovers and reorganizations – turn out to be unprofitable does not imply 'market failure' or prescribe any policy response. In a world of uncertainty, errors will always be made. Even the financial markets, which aggregate the collective wisdom of the entrepreneurs, capitalists and speculators who are the very basis of a market economy, will sometimes make the wrong judgement on a particular business transaction. Sometimes the market will reward, ex ante, a proposed restructuring that has no efficiency rationale. But this is due, not to capital market failure, but to imperfect knowledge. Final judgements about success and failure can be made only ex post, as the market process plays itself out. Throughout this process information is revealed over time, as market forces work to weed out the relatively inefficient organizational forms. Certainly, there is no reason to believe that courts or regulatory authorities can make better judgements than the financial markets. The decisions of courts and government agencies will in fact tend to be far worse: unlike market participants, judges and bureaucrats pursue a variety of private agendas, unrelated to economic efficiency. Furthermore, the market is quick to penalize error as it is discovered: no hearings, committees, or fact-finding commissions are required. In short, that business often fails is surprising only to those committed to static equilibrium models in which failure is defined away. Such models are surely no guide to public policy.

Finally, it is difficult to justify recent proposals to penalize 'insider trading' and reform securities law to discourage takeovers in favor of internal investment. All market participants act on the basis of private information. Their actions benefit third parties as well: where insider trading is allowed, stock prices more accurately represent the true prospects of the firm. In addition, disclosure rules that protect incumbent management naturally weaken the disciplinary role of takeovers, and not surprisingly are favored by established corporations and brokerage houses. But proponents of such restrictions on the market for corporate control have yet to provide a convincing economic rationale for their existence.

#### See also:

Chapter 14: Competition; Chapter 15: Entrepreneurship; Chapter 55: Industrial organization and the Austrian school; Chapter 4: Market process; Chapter 21: Profit and loss

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