European Economic Review 57 (2013) 23–38

Contents lists available at SciVerse ScienceDirect

European Economic Review

journal homepage: www.elsevier.com/locate/eer

Merger policy, entry, and entrepreneurship

Robin Mason [a,b,*], Helen Weeds [b,c]

[a] University of Exeter, United Kingdom
[b] CEPR, United Kingdom
[c] University of Essex, United Kingdom

ARTICLE INFO

Article history:
Received 12 October 2010
Accepted 8 October 2012
Available online 1 November 2012

JEL classification:
K21
L40
M13
G34

Keywords:
Merger policy
Entry
Exit
Entrepreneurship

ABSTRACT

We assess the impact of merger policy on entry and entrepreneurship. When faced with uncertainty about its prospects, and foreseeing that it may wish to leave the market should profitability prove poor, a rational entrant considers possible exit routes. Horizontal merger reduces competition post-merger which, all else being equal, lowers welfare; but merger also provides a valuable exit route. By facilitating exit and thus raising the value of entry, more lenient merger policy may stimulate entry sufficiently that welfare is increased overall. We calculate the optimal merger policy in the form of a low, but positive, profitability threshold below which merger is permitted despite the adverse impact on post-merger competition. This may be viewed as an extension of the "failing firm defence" to include ailing, low profitability firms as well as imminently failing ones. Merger policy is compared with an entry subsidy, and the implications of strategic firm behaviour for the choice of merger policy are also examined.

© 2013 Elsevier B.V. All rights reserved.

1. Introduction

Competition effects are central to merger policy in most major jurisdictions. In the U.S. and the U.K., a merger that results in a "substantial lessening of competition" (SLC) is liable to be prohibited. The merger test in the European Union—whether the transaction constitutes a "significant impediment to effective competition" (SIEC)—has a similar interpretation. Competition effects are typically assessed in a narrow and relatively static manner, taking account of the immediate and likely future impact in the market(s) in which the merging parties operate. The wider dynamic effects of merger policy on competition are typically ignored.

This paper argues that merger policy can have an impact on *ex ante* decisions, such as market entry or expansion, which affect competition in the long run. *Ex post*, horizontal merger creates a more concentrated market structure, reducing consumer surplus and incurring deadweight loss. But the possibility of future merger raises the expected value of entry. This increases firms' willingness to enter or expand, which has a beneficial effect on competition. Taking this dynamic effect into account, the optimal merger policy balances the welfare loss from concentration *ex post* with the welfare gain from entry *ex ante*.

On this dynamic view, optimal merger policy would clear some mergers that currently would be found to cause an SLC (or SIEC) and hence be prohibited. In our model the treatment of such cases is more lenient than existing practice, with merger being permitted at a time when profits are low but nonetheless positive. This could be interpreted as an extension

* Corresponding author at: University of Exeter, United Kingdom.
E-mail address: mason.robin@gmail.com (R. Mason).

0014-2921/$ - see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.euroecorev.2012.10.006

of the ''failing firm defence'' (FFD)—which permits an anti-competitive merger when one party is about to exit the market—to include ailing,[1] as well as imminently failing, firms.[2] But whereas the FFD is interpreted strictly, requiring the target to be on the verge of bankruptcy, the optimal policy in our model takes the form of a low, but positive, profitability threshold below which a merger is to be permitted, despite its negative impact on post-merger competition.

We identify four effects at play when setting merger policy. With the *entry encouragement effect*, more lenient merger policy stimulates entry, increasing competition and expected social surplus in the short-run, and in the long-run when merger does not occur. The *competition effect* reflects the loss of competition when merger takes place, reducing social surplus in the long-run. The *synergies effect* captures the possibility that this loss of competition may be mitigated by merger-specific benefits (e.g. technological synergies), raising welfare compared with the pre-entry situation. Finally, greater entry entails higher expected sunk costs, reducing social welfare; this is the *sunk cost effect*. In order for it to be optimal to use merger policy to encourage entry, the entry encouragement effect must outweigh the loss of competition, net of synergies, and sunk cost effects. We provide sufficient conditions for this to be the case, first when firms cannot manipulate profits to hit the policy threshold; and later, when an asymmetry of information between firms and the policy-maker allows ''gaming'' of the rule. We show that the possibility of strategic behaviour does not negate the role of merger policy in encouraging entry; indeed, in some circumstances it strengthens the case.

Three general conditions are necessary for our policy recommendation to hold. First, entry must be socially desirable, in that the short-run benefits from competition outweigh the social cost of additional fixed costs. Second, merger must increase the profits of the merging firms (in particular that of the entrant), so that the possibility of future merger attracts additional entry. Third, there must be (at least) a short-run increase in competition due to entry. If any of these conditions fail, then merger policy should not be used in the way that we describe. The ''worst case'' for our story is a relatively unconcentrated Cournot oligopoly with homogeneous goods and no merger synergies; in this sort of industry, merger policy may be ineffective in encouraging entry, and excess entry could be a concern. Conversely, the most favourable conditions for our story involve differentiated goods Bertrand competition: here, merger policy to encourage entry can be both desirable and effective. Moreover our focus on merger to monopoly, the situation in which the failing firm defence is typically employed, further supports this hypothesis.

As well as suggesting a more lenient approach to merger control than the current FFD, our analysis questions current policy in more subtle ways. Assuming that the entrant is the acquired party, allowing the target to gain a larger share from merger encourages entry. Similarly, a target with a stronger bargaining position, perhaps due to the strength of a parent company, should be treated more, not less, leniently. Finally, more lenient merger policy incurs greater sunk entry costs; disregarding this, a consumerist policy-maker sets a more lenient merger policy to encourage early entry, whereas a policy-maker who considers industry profits sets policy more strictly.

Although our main focus is on the interaction between merger policy and the entry decision, note that similar considerations apply to any *ex ante* decision made by a firm. For example, the decision to build additional capacity, extend an existing product line, initiate a research and development project or undertake an advertising campaign could be analysed in a similar fashion. Like market entry, such decisions also enhance competition or generate surplus in other ways, benefiting consumers. What matters for dynamic analysis is that the decision involves a sunk cost or is costly to reverse, and that the returns are uncertain and are affected by the prospects of future merger. We have chosen entry as an important example of such a decision, but the analysis can be applied to other business activities.

At an abstract level our argument is familiar: less *ex post* competition tends to bring about more *ex ante* investment, and optimal policy balances these two factors, also taking into account duplication of fixed costs. Patent systems reflect this balance, allowing a temporary monopoly in order to stimulate competition and innovation.[3] Also, again at an abstract level, merger policy in our model works like an entry subsidy. There are, however, some key differences. First, an entry subsidy would not entail the loss of competition and social welfare in the long-run when merger occurs; but instead it incurs a social cost of funding and may have other drawbacks. We consider this further in Section 3. Second, firms may respond strategically to merger policy in a way that does not arise with an entry subsidy; we explore this issue in Section 4.

[1] In the analysis that we present, ''ailing'' is not well-defined. We mean by the term a firm that has positive, but low profitability.

[2] The failing firm defence (FFD) is recognised in many jurisdictions, but the conditions governing its application are strict and it has been successfully used in just a handful of cases, in which firms face the prospect of imminent bankruptcy.

In the U.S., the FFD is explicitly included in the Department of Justice (DoJ) and Federal Trade Commission (FTC) 1992 Horizontal Merger Guidelines. Historically, three cases were important in its establishment and development: *International Shoe*'s acquisition of a financially troubled competitor in 1930; *Citizen Publishing Co*. in 1969, when the Supreme Court rejected a merger with a distressed newspaper company and set out stringent conditions under which the defence would be accepted; and *General Dynamics* in 1974, in which the Supreme Court concluded that the acquisition of a declining coal mining company was acceptable even though it produced a company with a large market share in a concentrated industry.

In the European Union, the formal basis for the FFD is less explicit; yet the Commission's case law has developed the concept of a rescue merger. The merger of *Kali und Salz* and *Mitteldeutsche Kali* in 1993 established the principle of the failing firm defence (Case No. IV/M.308, 1994). The principle was reinforced in 2001 when *BASF* was permitted to acquire its chemical industry competitors *Eurodiol* and *Pantochim*, which were both in receivership.

In the U.K., the Office of Fair Trading (OFT) published a restatement of its approach to failing firms in merger reviews in December 2008. In 2009 the OFT cleared the acquisition of 15 Zavvi stores by rival HMV under failing firm analysis.

[3] There is a long literature on the relationship between innovation and product market competition; see, e.g., Vives (2008).

Download English Version:

https://daneshyari.com/en/article/5067033

Download Persian Version:

https://daneshyari.com/article/5067033

Daneshyari.com