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Cross-border mergers with flexible policy regime: The role of efficiency and market size

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This study provides a theoretical and empirical framework for understanding the determinants of cross-border mergers. Past literature has focused on the effect of trade liberalization as the key factor triggering international mergers. We introduce the idea of flexible policy regime in which optimal policies are sensitive to whether a cross-border acquisition has taken place or not. In a free-trade model given asymmetries in marginal cost, we find that optimal subsidies decline when firms acquire inefficient foreign firms while optimal subsidies increase when firms acquire efficient firms. We also find that as the efficiency of the acquirer increases, the profitability of the acquisition and hence the likelihood that it takes place also increases. We find that the role of market size in triggering cross-border acquisitions may be limited even with free trade. *J. Japanese Int. Economies* **34** (2014) 58–70. Department of Economics, Missouri University of Science and Technology, 500 West 13th St., Rolla, MO 65409, USA; Department of Economics, Southern Illinois University Carbondale, 1000 Faner Dr., Carbondale, IL 62901, USA.

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1. Introduction

Since the 1990s advanced economies have experienced a rise in cross-border merger and acquisition (M&A) deals. Several European firms engaged in cross-border mergers in anticipation of the European Common Market (Barros, 1998). Between 1990 and 1996 there were close to 20,000 cross-border merger deals in Europe International Labor Office Statistics (1990-1996). UNCTAD reports indicate that cross-border M&As are dominating foreign direct investment flows to major advanced economies (UNCTAD, 1998).

A common perception as to why the 1990s and aftermath saw a dramatic rise in cross-border activities is that such investments are triggered by the removal of trade barriers. Neary (2007) argued that trade liberalization can trigger cross-border mergers in which a low cost firm buys a high cost foreign firm. Long and Vousden (1995) and Benchekroun and Chaudhuri (2006) examine how trade policies affect the incentive to engage in cross-border mergers. Bjorvatn (2004) shows that economic integration in terms of lower trade cost and lower investment cost can lead to cross-border mergers. Hijzen et al. (2008) found evidence that lower trade and investment cost facilitated cross-border mergers in 23 OECD countries during 1990–2001. Besides trade policies, Norback et al. (2009) showed that lower profit tax and lower capital-gain tax may trigger foreign acquisitions. The empirical evidence indicates that the size of the financial market (Giovanni, 2005) and institutional factors (Rossi and Volpin, 2004) guide a firm's decision to invest abroad in the form of M&As.

Recent studies argue that the difference in market size between countries is a major determinant of capital flow (Ali and Guo, 2005; Haufler and Wooton, 1999). Barros and Cabral (2000) show that capital flows to a larger country unless smaller countries offer an investment subsidy. Hao and Lahiri (2009) examine the role of market structure, market size and production efficiency in attracting foreign direct investment. Despite these studies, the effect of market size on cross-border M&As has not received much attention. Given the increase in cross-border merger activities in the total value of foreign direct investment, the full understanding of factors driving such investments is a great concern for policy makers as well as for researchers. The purpose of this paper is to form a theoretical and empirical framework to investigate the major determinants of international mergers.

The contribution of this study is to show that the move towards free trade is not a sufficient condition for cross-border mergers. For instance, in the European Union (EU) economic integration did not necessarily lead to the substitution of domestic mergers by cross-border mergers across the EU. Table 1 shows that cross-border M&As are not relatively preferred to domestic mergers in the EU even though these countries have moved towards free-trade. In this paper we use a free trade model to show that, on one hand, increase in efficiency of acquirers increases the probability that a cross-border merger takes place. On the other hand, the role of higher market size in triggering cross-border mergers may be limited even with free-trade.

We use a flexible policy regime to show how market size and production efficiency affect cross-border mergers. A flexible policy implies that the optimal policy adjusts when a cross-border merger takes place. Governments choose policies at the level which maximizes welfare conditional on the

Table 1
Target of EU bidders (% of total number of acquisitions).

Year	Domestic (%)	Other countries within EU (%)
2000	64.2	20.1
2001	65.2	20.0
2002	68.6	18.8
2003	70.5	17.3
2004	69.3	16.8
2005	64.7	19.9
2006	63.7	18.7

Source: Buelens (2008).

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