Don't Revise the Clayton Act, Scrap It!

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Early in 1986, word began to leak out that the Reagan administration was developing a proposal to modify the language of the Clayton Act, one of the pillars of U.S. antitrust law. Accounts published in February suggested that the plan has several basic elements (see, for example, Cohodas 1986). One is to change the litmus test for whether or not a merger violates the law from a finding that the effect of the acquisition "may be substantially to lessen competition" to one of a "significant probability" of an anticompetitive effect. Other proposals would require the antitrust agencies to analyze proposed takeovers within the framework of the current Department of Justice (DOJ) merger guidelines, exempt import-injured industries from the antimerger law for a period of five years, place restrictions on the award of treble damages, and relax somewhat the prohibitions against interlocking directorates. Early reports have touted the plan as a major departure from the "big-is-bad" philosophy, which if adopted would bring the antitrust laws up to date, making them more compatible with the reality that in the modern economy U.S. firms must compete in a world market. Assistant Attorney General Ginsburg, for example, has said that "it is not an immodest goal to try to bring the antitrust laws into the 1980s before they're over" (Cohodas 1986, p. 188).

Although the proposal has some merit in the sense that more mergers will presumably go through under the revised language than under the old, these gains are more than offset by the fact that the administration's plan would institutionalize a merger review *process*

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that is based on outmoded economic thinking and, indeed, substantially harms the efficient allocation of productive resources in the economy. To see these perverse effects, let us consider the two main components of antimerger law enforcement: the DOJ merger guidelines and the Hart-Scott-Rodino premerger notification requirements.

The Reagan Merger Guidelines

The DOJ merger guidelines, first promulgated in 1968 (1 Trade Reg. Rep., Par. 4510, May 1968), establish the analytical model that the government applies in evaluating proposed mergers. The model is unapologetically structuralist, that is, based on the notion that the degree to which competition prevails in a market is directly linked to the number and size distribution of firms in the industry. Thus, whenever a merger is proposed, the first and in many respects the most important exercise is to calculate a numerical index of market concentration. Under the 1968 guidelines, the crucial number was the four-firm concentration ratio, or the share of sales accounted for by the four largest firms in the industry. The revised guidelines issued in 1982 replaced this measure with the Hirschman-Herfindahl Index, which is calculated by summing the squares of the individual market shares of all industry members.[1] In either case, however, mergers proposed in "concentrated" industries—so defined when the numerical concentration measure exceeds a preestablished critical value—are more likely than not to be challenged by the antitrust authorities.

The notion that industry structure represents an important source of market power stands in stark contrast to the conclusions one can draw from the empirical evidence that has been accumulating since the early 1970s. The studies of Brozen (1971), Demsetz (1971), Peltzman (1977), and others suggest that the above-normal profit levels observed in highly concentrated industries are driven by economic efficiency rather than by the exercise of market power.[2] That is, the data imply that high levels of industrial concentration can be better explained by the survival over time of a small number of efficient firms whose profitability is traceable to an ability to economize on the use of productive resources. Profits are high not because prices are high but because costs are low. This of course means that a social policy hostile to high concentration operates to the detriment of consumer welfare.

[1]Subsequent, but unimportant, guideline revisions were made in 1984.

[2]Disbelievers may wish to consult Scherer (1979).

Although the new merger guidelines pay much more attention than did their predecessor to efficiency considerations, technological change, foreign competition, and other factors mitigating the potential anticompetitive effects of merger, they retain the numerical concentration measures that are the meat and potatoes of structural antitrust analysis. More importantly, the structural numerics were not made very much looser. To illustrate the difference between the two sets of merger criteria, consider a merger in a "concentrated" market assuming that the acquiring firm accounts for 15 percent of industry sales. Under the 1968 guidelines, mergers in which the target firm's market share was 1 percent or more would likely be challenged by the antitrust authorities. The threshold market share for an acquired firm in similar circumstances was raised to about 5 percent under the new guidelines. Thus, the screen is now looser, but not by much.

The failure of the Reagan guidelines to relax substantially, if not eliminate, numerical merger criteria is important not because rules for evaluating mergers are by themselves undesirable, but because such criteria preserve the essentials of the structuralist approach to antitrust policy.[3] Given a modicum of creativity on the part of antitrust lawyers and economists, markets can be defined in such a way that any industry becomes "concentrated." For example, Franklin Fisher (1979) reports that in challenging Nestle's acquisition of Stouffer's, the Federal Trade Commission (FTC) defined the relevant market to be that for "high-priced, nonethnic, frozen entrees." Thus, even though more mergers presumably pass muster under the new criteria than the old, the new guidelines do little to change the process of merger analysis. Evidence to this effect is given by the fact that the antitrust bureaucracy took to the new guidelines with remarkable alacrity.

The Reagan administration proposal to codify the merger guidelines in the language of the Clayton Act therefore comes as a major disappointment. If adopted, the plan will at best substitute a "big-is-probably-bad" philosophy for the "big-is-bad" approach that has guided antitrust enforcement for decades. Business as usual will prevail at the antitrust bureaus and, what is worse, future administrations, perhaps bringing with them an inclination toward less government intervention in the affairs of the private economy, will find it more difficult to undercut the enforcement agencies' penchant for discovering monopoly on every street corner.

[3]Another basic issue is whether the guidelines are really guidelines at all. One study has shown that over 20 percent of the mergers challenged under the 1968 guidelines fell *below* the threshold criteria. See Rogowsky (1984).

What explains the administration's apparent acceptance of the structural approach to antitrust policy, that is, who gains from narrow merger guidelines? The answer seems clear. Bureaucratic incentives run strongly in the direction of producing visible output, and tighter screens give the enforcement agencies more mergers to investigate. The more work there is for government, the more opportunities there are for the attorney staff to build the human capital that is rewarded when they subsequently take jobs in big antitrust law firms, and the larger and more secure are the antitrust bureaus. The private antitrust bar gets to defend more clients, and economists working as consultants on both sides of the issue earn larger incomes. Thus, the private interests of those employed in the antitrust industry overcame economics in preserving the status quo.

An interesting sidelight on the political economy of antitrust enforcement is provided by the FTC's reaction to the DOJ's revised merger guidelines. On the same day that the 1982 guidelines were promulgated, the FTC, for the first time in its history, issued a statement of "principles" concerning horizontal mergers (see Federal Trade Commission 1982). Although the staffs of the two agencies had coordinated their efforts while the documents were in preparation and, indeed, Chairman Miller (1982, p. 2) emphasized the "harmony" between the agencies' enforcement philosophies, the FTC statement differed from the DOJ guidelines in an important way, namely, it contained no numerical merger criteria. Chairman Miller justified this approach on the ground "that it would be unwise for the two agencies to publish fairly precise standards that might differ in even minor respects." Thus, although the FTC (1982, p. 2) argued that the weight of economic evidence justified some "revision of market share benchmarks," it chose not to adopt numerical merger criteria so as to avoid any possible confusion between FTC and DOJ standards.

The consequence of this difference was quite dramatic—the FTC's statement was virtually dead on arrival as a matter of public merger policy. Attorneys for the FTC quickly embraced the DOJ guidelines because in contrast to the approach taken by their own agency, the DOJ standards were quite compatible with traditional merger analysis. Quantitative concentration data are much more understandable than the non-numeric, non-market-share considerations contained in the FTC's statement. Thus, although the revised DOJ guidelines required that users learn the arithmetic of calculating a new index of market concentration, the DOJ approach dominated because it was mechanical. Merger analysis could continue to focus on the issue of market definition and market shares.

Premerger Notification

The so-called Hart-Scott-Rodino (H-S-R) premerger notification process, established by the Antitrust Improvements Act of 1976, requires firms above a given size to announce in advance their intention to merge. Designed to give the antitrust enforcement agencies adequate time to assess the competitive effects of proposed takeovers prior to their consummation, the H-S-R rules also penalize firms that have a comparative advantage in discovering undervalued assets in the economy. The penalty is especially heavy when the proposed merger involves two firms in the same industry.

The H-S-R process establishes the following timetable. The acquiring firm first files premerger notification forms simultaneously with the FTC and DOJ that announce to the government its intention to merge and contain preliminary information about the parties involved in the acquisition. The two enforcement agencies then have 10 days to decide which of the bureaus is to have jurisdiction and whether or not to seek additional information from the prospective merger partners. If no such "first request" is forthcoming, the merger may proceed. Assuming that more data are sought, however, a second decision point is scheduled after the firms have complied. This involves whether or not to issue a "second request" for information about the acquisition. Again, the merger can go forward if the agency does not require the parties to produce additional data. But if so, once the second request has been fulfilled the government must act within a specified time limit (10 days for a cash deal and 20 days if the acquisition involves the purchase of stock) if it decides to challenge the takeover. It is worth pointing out that the paperwork burden of second requests can be immense. On occasion, firms have literally been required to produce documents in truckload lots. It is also worth noting that because the time limits in which the government must act to prevent a merger from going forward do not commence until the antitrust agency is satisfied that the parties have complied with information requests, in practice the steps in the review process are measured in months rather than days.

Premerger notification essentially requires firms to announce publicly that they have discovered a profit opportunity in the economy. In cases where the acquisition is postponed while the government seeks additional information from the prospective merger partners, other firms, which had been unaware of the existence of undervalued assets, are given time to step forward with takeover offers of their own. The H-S-R process thus allows these other firms to free ride on the information revealed by the premerger announcement. This tends

to reduce the efficiency with which resources are allocated in the economy for two reasons. First, it lowers the value of information about the existence of profit opportunities to firms operating in the same industry.[4] Second, it promotes conglomerate mergers because such takeovers are less likely to be delayed by the H-S-R process. Both of these consequences are costly to the economy because firms are more likely to discover undervalued assets within their own industry and to employ such resources more efficiently when purchased than companies operating in an unrelated line of business.

Those who want tougher antimerger law enforcement often complain that the administration's policy lets through too many mergers that are too big and do not work. Yet, this is precisely the consequence of combining premerger notification with a narrow set of merger guidelines. It is not by accident that in recent years steel companies have acquired oil companies, or that tobacco companies have merged with soft drink manufacturers. Rather, such acquisitions have been forced on the economy because the firm that typically steps forward when a previously announced merger falls through due to antitrust considerations is one that represents no overlapping markets. The critics cannot have it both ways.

The "cola wars" of 1986 illustrate another cost of premerger notification. Shortly after Pepsico made public its intention to acquire the assets of Seven-Up from Philip Morris, Coca-Cola filed premerger documents announcing an agreement to purchase Dr. Pepper. Subsequent newspaper reports suggested—and a federal district court judge held in granting a preliminary injunction against Coca-Cola's planned acquisition—that the merger announcement had been a sham designed to plant in the minds of the FTC the idea that if it did not challenge the Pepsi–Seven-Up deal, it would be faced with a merger wave in the soft drink industry. Regardless of the merits of either acquisition, it is clear that the disclosure requirements and delay involved provide the opportunity for firms to use the H-S-R process as a competitive weapon.

Conclusion

Under the guise of helping U.S. firms compete in the world market, the Reagan administration proposal to revise the Clayton Act will have the unfortunate consequence of enshrining a merger review process that is out of step with current economic research and, in

[4]In this regard, premerger notification is likely to generate adverse capital market effects similar to those associated with the disclosure requirements imposed on cash takeover bids by the Williams Act. See Jarrell and Bradley (1980).

fact, raises substantial barriers to the efficient allocation of productive resources in the economy. Given the conservative-libertarian orientation of the President's appointees to the antitrust agencies, the plan is nothing short of dismaying.

What is the alternative? A modest proposal with a great deal of merit would allow the market rather than the government to evaluate the pro- and anticompetitive effects of merger. That is, consumers would be much better off with a loose merger screen that permitted all but the most overwhelmingly large takeovers to go forward without government interference. The antitrust authorities could then observe the actual as opposed to the predicted effects, and take action to dissolve the merger when appropriate. More efficiency-enhancing mergers would take place in the economy and antitrust law could be invoked ex post with hard evidence in hand rather than ex ante on the basis of "significant probabilities" and the complaints of competitors. If our only choice is between the administration's proposal and doing nothing, however, it would be far better to leave the Clayton Act alone. By not giving the merger guidelines the force of law, the latter alternative is at least less likely to prevent future administrations from taking bolder steps to truly modernize public policy toward merger.

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