

BOOK REVIEW

MERGERS, CORPORATE CONCENTRATION AND POWER IN CANADA

(Edited by R.S. Khemani, D.M. Shapiro and W.T. Stanbury, Institute for Research on Public Policy, Halifax, 1988)

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This volume contains carefully edited versions of no less than 24 papers presented at a March, 1987, conference organized by the Institute for Research on Public Policy and Concordia University's School of Community and Public Affairs. It is a valuable addition to the Canadian literature on the titled subjects, and its appearance a decade after the *Report of the Royal Commission on Corporate Concentration* is well-timed. The value of some of the papers lies in new research or insights and of others in the reasoned arguments of public officials and participants in political and business life. It is not possible to deal with all the papers in a brief review, and only the more scholarly ones are mentioned here.

The papers by R.S. Khemani, Jorge Niosi and Christian Marfels present previously existing and new material on the share of economic activity in Canada that is in the hands of a few large enterprises, or corporate concentration. It is high in Canada, particularly when compared with that of Canada's leading trading partners. Indeed, as Khemani emphasizes, Canada is marked by high concentration at two other levels as well – at the individual industry level and in stock ownership. In the United States average industry concentration is much lower and the stock of a much higher proportion of companies is widely held. Moreover, while corporate concentration has been declining in the United States, Japan

and West Germany, it has risen in Canada over the past quarter-century. A major source of the rise is found to have been the growth of a few large conglomerates, in part through mergers and takeovers. Concentration is particularly high in the financial sector, the four largest banks accounting for between a third and a half¹ of the assets of all banks, trust, loan and insurance companies. In fact, that represents a modest decline over the past few years, reflecting the growth of a few closely held financial conglomerates and the entry of some smaller banks. However, the growth of the conglomerates involved the acquisition of formerly widely held trust, loan and insurance companies, with a consequent increase in ownership concentration.

Khemani notes the complexity of the issues relating to high corporate concentration along with such concurrent phenomena as the merger wave, ownership concentration, conglomeration, and financial sector regulatory problems. Choices of corrective action, where needed, must meet many tests if the remedy for one problem is not to exacerbate others; questions such as private sector performance, competition, distribution of wealth and government/business relations must all be taken into account.

The papers reveal wide differences of opinion about the effects of high corporate concentration. W.T. Stanbury and Walter Adams reflect the concerns of some economists as well as political scientists and sociologists that giant enterprises exert undue influence on legislators, and on the public through advertising and in some cases by control of mass media. Stanbury explores in some detail the relation between corporate concentration and political influence in Canada as well as the reasons for concern about it. He mentions a number of means to curb corporate concentration including an antitrust policy that would extend to conglomerate mergers, tax measures, and limitations on ownership of

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financial institutions and mass media by commercial enterprises. However, he concludes pessimistically that very few Canadians fear the consequences of concentrated economic power and that their quest for security overrides their interest in reform.

Adams summarizes the findings of his recent book² which was reviewed in the *Canadian Competition Policy Record*, September, 1988. His paper constitutes a scathing attack on the merger wave in the United States and on the Reagan administration's permissive response. To promote decentralization of power, he calls for the prohibition of mega-mergers unless the parties can demonstrate the benefits.

David J. Teece's concerns and prescriptions are totally different from those of Stanbury and Adams. He is influenced by O.E. Williamson's transactions costs approach to the theory of the firm. Williamson has provided new insights into a firm's motivations in extending its range of activities, particularly by vertical integration. More broadly, he and other organizational and managerial theorists have questioned the present day relevance of the orthodox economist's view of the firm; they consider that too much emphasis has been placed upon the firm as a single-unit converter of inputs into outputs, without adequate emphasis upon innovation, learning curves and modern improvements in methods of organization and control.

Those ideas lead Teece, among others, to question what he calls the "traditional views" of competition and to think more in global terms. His policy prescription is for a more permissive approach to inter-firm collaboration in standardization, research, and possibly in commercialization as well. He notes, for example, that:

...orthodox theorists fail to recognize that there is no special machinery in a private enterprise market economy to ensure that investment programs are made known to all concerned at the time of their inception (page 100).

Teece's proposals are directed primarily at the United States, where the relevant aspects of antitrust laws are less permissive than those in Canada. In fact, the Bush administration is reported to be pressing for amendments to ease restrictions on joint production ventures. If taken too far, however, Teece's proposals could well create concerns about permanent cartelization.

Several contributors report on attempts to assess the effects of merger waves by surveying the changes in share prices or profits. The conclusions reached, however, vary widely with the time periods chosen, the statistical methods and the assumptions made. B. Espen Eckbo surveys recent research on the effects of merger or takeover announcements on share prices in Canada, the United States and a number of other countries. He finds that target firms' share prices rose between 29 and 50 per cent, while bidder share prices did not, on average, decline. Those results clearly indicate shareholder gains during the period covered, and in Eckbo's view they also indicate that the market anticipated efficiency gains. Nevertheless, an earlier article of his³ suggested that reduced competition had been a factor in share price increases.

F.M. Scherer surveyed the post-merger profit records of firms that had been acquired between 1950 and 1977. He found accounting profits after adjustments to have been reduced by about one-half and about one-third of the acquired firms to have been subsequently divested. He concludes that most mergers were unlikely to have brought efficiency gains. As with share prices, the use of accounting profits is not without methodological problems. It would be interesting to see the results of both approaches applied to the same sample.

Niosi's paper as well as one by Vijay M. Jog and Allan L. Riding provide evidence that the recent merger waves in Canada have had favourable effects on the firms involved. Niosi found that private sector conglomerates had better profit records than specialized enterprises. Jog and Riding surveyed the post-merger performance of "partially acquired" firms in Canada, i.e., firms that continued to be listed on a stock exchange after partial acquisition. They report that the returns on equity of such firms appeared to have increased and that their stock market performance may have improved.

Michael C. Wolfson examines effective federal and provincial corporate tax rates by corporate asset size groups for the year 1983. He finds an "inverted U" pattern, with large and small corporations paying the lowest effective rates. Indeed, were it not for the small business deduction, the effective rates would have declined almost continuously with increases in corporate

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asset size. He ascribes that pattern to the greater capital intensity of large firms and to the provisions encouraging investment including accelerated depreciation and the investment tax credit. He concludes that the tax system is biased in favour of corporate concentration. With regard to merger incentives, he believes that the importance of the interest deductibility provision may be overstated relative to the provisions allowing capital rollovers and flow-throughs of losses in corporate reorganizations where there is a change in control. Wolfson warns his readers, however, of the dangers of reaching simplistic policy conclusions. For example, it would not be conceptually satisfactory merely to compare the present tax system with one whose only difference was the absence of those merger incentives.

There are several papers on the financial sector. They focus primarily on the proposals respecting ownership rules for financial institutions in the policy document *New Directions for the Financial Sector* that then Minister of State for Finance Tom Hockin tabled on December 18, 1986. A bill incorporating the proposals was withdrawn, apparently because of criticisms. Under the proposals, ownership restrictions would be imposed to prevent further acquisitions or incorporations of trust, loan or insurance companies with capital in excess of \$50 million by applicants with significant commercial interests; an existing company in excess of that size would have to move towards 35 per cent widely held share ownership. Trust, loan, insurance companies and smaller banks without commercial links could remain narrowly held until their capital exceeded \$750 million (equivalent to assets of about \$15 billion in the case of a bank), after which they would have to move towards 35 per cent public ownership; those beyond the \$750 million threshold would apparently be barred from further acquisitions if there were any shareholdings in excess of ten per cent. Shareholdings in excess of ten per cent of a major bank would continue to be prohibited.

In practical terms, commercial/financial conglomerates such as Power Corporation, Imasco and Edper Enterprises would not be permitted to acquire any more financial institutions or to buy parts of new share offerings by the institutions now under their control. Purely commercial

enterprises such as BCE Inc. and Canadian Pacific Ltd. would be barred from entering the financial sector to any significant extent. Laurentian Group, while a purely financial conglomerate, would be barred from further acquisitions because of its size. Financial cooperatives such as the Desjardins Group would probably not be affected because it is widely held. The ownership proposals were advanced in response to concerns about concentration and, more particularly, to reduce the difficulties of controlling conflicts of interest and self-dealing.

D.G. McFetridge and Thomas J. Courchene, in two scholarly papers, raise serious questions about the wisdom of the ownership proposals. In both their views, the results would be to restrict new entry, shrink the market for corporate control of financial institutions, and only marginally assist in the control of conflicts of interest and self-dealing. McFetridge recognizes that self-dealing has occurred in closely held institutions and that in some case solvency has been affected. However, he cautions that mandating widely held ownership carries costs of undetermined magnitude in terms of efficiency, and he believes that self-dealing can be controlled by more cost effective means. He also recognizes that cross-ownership of different kinds of financial institutions or of commercial and financial firms has been associated with conflicts of interest but contends that solvency has not been affected thereby. Moreover, he believes that if conflicts of interest were to pose a serious problem, the market would react against cross-ownership. In point of fact, he cites evidence that market pressures favouring cross-ownership are very strong. While he does not say so explicitly, he appears to support the much more permissive ownership proposals in the 1985 report of the House of Commons Standing Committee on Finance, Trade and Economic Affairs chaired by Don Blenkarn (*Report on the Regulation of Canadian Financial Institutions*). It advocated permitting a single shareholder, with or without commercial links, to have majority ownership of any federally chartered financial institution with assets under \$20 billion, and 50 per cent of share ownership of institutions with assets between \$20 and \$30 billion.

Courchene presents a quite exhaustive treatment of the ownership question and also

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summarizes the various opposing views, often in the words of the participants. He suggests that the record of the major banks underline some of the efficiency costs of mandating wide ownership. In his view, the results have been entrenched and inefficient management, unwise loans including ones to interests of bank directors, and low profit rates for shareholders. He believes, for example, that there would be fewer risks of conflicts of interest and self-dealing if Molson Companies rather than a major bank owned an investment dealer. He considers that the ownership restrictions proposed by Hockin, rather than reducing concentration, would encourage it by restricting entry by large commercial interests that might be capable of offsetting the power of the banks. Indeed, he fears that entry by foreign interests would be favoured and that domestic commercial interests such as Imasco and Power Corporation might find foreign fields more attractive. Moreover, he notes that the provinces are moving in a less restrictive direction, making provincial incorporation more attractive. However, like McFetridge, he stops short of calling for removal of all ownership restrictions. He suggests a number of less restrictive alternatives to the Hockin proposals, one being simply to raise the limits on commercial/financial ownership to the level proposed for purely financial groups. To the extent that concentration is perceived to be a problem, he points to other remedies including succession duties and tax reforms to discourage tax-driven mergers.

Despite the foregoing, those who are concerned about the political and economic consequences of corporate concentration might not regard a transfer of some of the market share held by the major banks to a few giant commercial/financial conglomerates as the best means of achieving a more competitive financial sector or of improving the market for corporate control. While Courchene's concern about the power of the

major banks is shared by others, it is not self-evident that some of the conglomerates whose growth he would encourage are not already equally powerful. Taking Edper Enterprises as the leading example, the financial institutions under its control appear to represent assets within the range of some of the major banks. In addition, the combined sales of Edper-controlled commercial companies appear to make it the largest commercial enterprise in Canada as well. Moreover, Edper is not without representation on the boards of major banks; to cite just two examples, according to 1988 records, the President of John Labatt Ltd. and the Chairman of Noranda Inc. were both directors of the Canadian Imperial Bank of Commerce.

BCE Inc. is the leading example of a commercial conglomerate that will soon enter the financial sector with its acquisition of Montreal Trust (which is seeking provincial incorporation). Sales of BCE-controlled commercial firms make it the second largest commercial enterprise in Canada. The mixture of regulated and unregulated activities carried on under the umbrella of BCE and its predecessor has involved extremely difficult regulatory problems. Its entry into the financial sector is unlikely to make life any easier for the regulators.

In conclusion, this volume presents a diverse range of carefully considered views on some highly topical issues. It provides a valuable basis for informed discussion.

Notes

1. The lower proportion is based upon exclusion of foreign assets of banks and inclusion of estate, trust and agency funds of trust companies.
2. *The Bigness Complex*, by Walter Adams and James Brock, Pantheon Books, New York, 1986.
3. Eckbo, B.E. (1983) "Horizontal Mergers, Collusion, And Stockholder Wealth," *Journal of Financial Economics*, Vol. 11, pp. 241-273.