OIL MERGERS: ECONOMICS 101

The spate of oil company mergers is triggering complaints about the alleged "non-productive" nature of mergers and the "monopoly power" exercised by large U.S. corporations. Critics have expressed concern about the large sums being spent on "paper transfers" rather than exploration and drilling. As a result, Senator J. Bennett Johnston (D-LA) plans to introduce legislation calling for a six-month moratorium on mergers among the nation's 50 largest oil companies. Senator Johnston's proposal seems to be gaining growing support on the Hill. But, before everyone jumps on the "big is bad" bandwagon, they should review Economics 101. For not only are mergers generally undertaken for productive reasons, they may be necessary for the continued survival of U.S. firms in world markets.

Underlying all mergers is a belief by the acquiring firm that it can employ the resources of the acquired firm more profitably than the present owners. There are a variety of reasons why this may be true. The most obvious is that some operations are simply carried on more efficiently in larger numbers. This is due to economies of scale and may be true for either the production or marketing of particular products.

Merger gains may result too from the diversification of a company's product line. Providing a wider range of products may stabilize a firm's earnings over the business cycle, thus aiding long-term planning--of research and development or capital investments, for example. A diversification move may be particularly attractive to a firm whose traditional product line is in a mature (little or no growth) or declining market. It is often much less risky to acquire a going concern than to identify and enter a new market.

Mergers frequently are also a response to excess capacity in an industry. The acquisition of marginal firms can provide a smoother, more rapid transition to a streamlined industry by allowing surviving firms to obtain and retain the more efficient human and capital resources within the industry.

The consolidation of resources in an industry with excess capacity helps explain the recent much berated oil industry mergers. In a March 12 editorial, the Wall Street Journal noted a stagnant demand for oil has led to a reevaluation of the worth of energy reserves. Exploration and drilling for new energy resources has not been abandoned, it has merely been delayed until increased demand for oil justifies the risks and costs involved in attempting to discover and reclaim additional resources.

Mergers may also reflect a simple belief among the management of the acquiring firm that they possess skills superior to those of the acquired firm's management. Perhaps the acquiring management anticipates market opportunities that have not occurred to current decision makers of the acquired firm.

Increasingly competitive world markets undoubtedly are encouraging some recent mergers. As M.I.T. economist Lester Thurow has noted, increased size among U.S. firms may be necessary to compete with producers from countries without antitrust laws. It has been suggested by analysts, for example, that by consolidating their reserves, some U.S. oil companies may be attempting to position themselves to take a stronger stand against OPEC. At the same time, no small group of oil firms will be able to dominate the U.S. market so long as domestic and foreign producers are free to compete here.

Regardless of the reasons for a merger, elementary economics teaches that the funds used to purchase the shares of a firm do not disappear--as some of those who attack mergers seem to suggest. In fact, stockholders profiting from a merger generally reinvest most, if not all, of the money they receive for their shares, thereby providing capital for new or expanding companies. Contrary to the impression given, then, loans made to facilitate mergers are not lost to the larger pool of investment capital. Moreover, it is ironic to hear liberal critics of mergers attacking the allegedly excessive prices offered during takeovers. They seem to be suggesting that oil companies are too generous with their money--a surprising charge. Once again, the critics overlook the fact that stock prices are merely reflecting the takeover firm's assessment of the potential profitability of the firm being bought.

In conclusion, for a number of reasons, mergers may lead to increased efficiencies and a more competitive market. As economist Robert Samuelson recently noted in his column for Newsweek, where problems do exist, they are caused by the current corporate tax system, which skews corporate decisions toward more debt and retained earnings. The corporate income tax is the chief problem, writes Samuelson, because it provides incentives for firms to grow and to borrow. Change is needed to leave government policy neutral toward mergers vis-à-vis internal growth. Yet painting all oil mergers with the broad brush suggested by Senator Johnston, even for a limited time, could unduly penalize U.S. consumers. The economic impact of these mergers should continue to be assessed on a case-by-case basis to avoid an overzealous effort that will throw out the good with the bad.

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For further information:
"Oil Mergers," Wall Street Journal, March 12, 1984.
Robert J. Samuelson, "Subsidized Mega-Companies," Newsweek, March 19, 1984, p. 76.
Lester C. Thurow, The Zero-Sum Society (New York: Basic Books, 1980), pp. 145-150.