

MERGERS AND NATIONAL CHAMPIONS*

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Abstract

The suspicion that national governments were in various forms promoting or defending domestic national champions (or discouraging foreign ones) arose in a long list of recent merger cases. This paper provides an analysis of the determinants of merger policy in international markets. We discuss two approaches. First, we examine the strategic policy arguments that may lie behind ‘national champions’ positions on mergers in an international economy. Second, we study a political economy approach to merger policy, where we move beyond the assumption that governments are pure welfare-maximizers and consider the effects of lobbying by domestic firms. We argue that standard ‘strategic trade policy’ arguments are probably not the most useful in understanding governments’ attitudes towards mergers. Rather, a combination of ‘economic’ and ‘political’ motives helps explaining merger policy in international markets.

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1 Introduction

In recent years, a number of mergers (sometimes between firms located in the same country, sometimes between firms located in different countries) have attracted a lot of media attention because of alleged protectionist positions taken by politicians and authorities of the countries that in one way or another have been involved in such mergers. The European Commission's Directorate General for Competition has often had to intervene, either with declarations or by taking formal actions, asking member states not to hinder mergers involving foreign firms and perceived as undesirable from the point of view of national interests.

During the first two years (22 November 2004 - 21 November 2006) of Mrs. Neelie Kroes' mandate as Commissioner for Competition, she was mentioned in the first page of the Financial Times 18 times, and 6 of them referred to mergers that raised political tensions across countries. Among such mergers, let us recall *ABN-Ambro/Antonveneta* (a Dutch bank's bid to take over an Italian bank was opposed in various ways by the then Governor of Banca d'Italia, the relevant authority at the time for bank mergers), *Hypoverein Bank/Unicredit* (the Polish government tried to block the creation of the large Polish subsidiary of the new Italian-German bank), *E-On/Endesa* (the takeover bid made by the German energy group was hindered by the Spanish government, which instead sponsored a domestic merger between Endesa and Gas Natural), and *Gas de France/Suez* (again sponsored by the French government in reaction to a possible bid by rival Italian energy firm ENEL). This list could of course be complemented by a number of other merger cases, where in various forms the suspicion that national governments were promoting or defending *national champions* arose.

In this paper, we investigate why different countries have opposing interests and try to favour or oppose particular combinations of international firms' assets, and study under which circumstances there might be a conflict between such behaviour and economic efficiency.

Of course, there may be very different arguments behind governments' attitudes towards mergers in an international economy, and some of these arguments may be purely political (perhaps reflecting a purely nationalistic citizens' dislike of foreigners). Here, we focus on economic and political economy arguments, and we shall see that these already offer some possible explanations of the opposing interests on mergers.

One could think that the protectionist attitudes of some governments towards mergers in international markets are just another application of the policy of building "national champions" that has been familiarised by the well-known literature on 'strategic trade policies'. However, we shall argue below that standard 'strategic trade policy' arguments are probably not very helpful in understanding governments' attitudes towards mergers. To go beyond these arguments, we informally present a political economy model of merger decisions, and argue that it can shed light on the conflicting positions often taken by different countries with respect to mergers.

The paper is organised as follows. Section 2 considers strategic merger policy arguments, while Section 3 presents the political economy approach. Concluding remarks follow.

2 Mergers and strategic trade policies

2.1 Standard strategic trade policy arguments

One of the most appealing explanations for the creation of national champions is given by the strategic trade policy literature (Brander and Spencer, 1983 and 1985, Eaton and Grossman, 1986).¹ The main insight of this literature is that when markets are oligopolistic, government intervention can shift profits from foreign to domestic firms.

For instance, a national government may subsidise domestic firms' output or exports, by reducing their costs and therefore making them more aggressive in international markets, where they would increase their market share to the detriment of foreign rivals. The increase in domestic firms' profits will in turn raise national welfare.²

Figure 1 illustrates this argument. Suppose there is a firm h based in country H , and a firm f based in country F . Assume that they sell a homogeneous good (in a third country only for simplicity), they have an identical marginal cost c , and that they are competing in quantities (or, more generally, actions are strategic substitutes), so that their best-reply functions, R_h and R_f are negatively sloped. Absent any subsidy, the quantities sold by each firm are those corresponding to the equilibrium point E . Suppose now that country H 's government subsidises its domestic firm h . This will have the effect of decreasing the marginal costs faced by firm h from c to $c - s$, and making it behave more aggressively in the market. This effect is illustrated by a shift in the best reply function of firm h , from $R_h(c)$ to $R_h(c - s)$, and will in turn move the equilibrium from point E to point E' . At the new equilibrium, firm h has a larger share of the market and higher profits than at point E . In turn, country H 's welfare will also increase, since its welfare is given by the sum of consumer surplus (here zero, as the market is located in a third country)³ and of producer surplus (the subsidies are just a transfer between domestic groups).

INSERT FIGURE 1 HERE

Of course, despite the initial enthusiasm towards such arguments, especially among policy-makers (finally, economic theory could provide reasons to justify economic interventions!), it soon appeared clear that strategic trade policy theories were not that convincing.

¹For a recent survey see Brander and Spencer (2007).

²A similar rent-shifting mechanism occurs when subsidies are given for the R&D activities of domestic firms. Further, to the extent that the subsidies increase sales in the home market, they could also decrease allocative inefficiencies.

³Note that if consumers existed in country H , the subsidy will have an even more positive effect, because it would decrease the allocative inefficiency created by the oligopolistic distortion.

First of all, if several governments used subsidies, all firms in international markets would increase outputs, and all profits would decrease: it would be better for governments to commit to free trade. This is illustrated by Figure 2, which depicts the case where both governments subsidise their domestic firm. At the new equilibrium E' , market shares are like in the absence of the intervention, but now both firms have increased their outputs, so equilibrium prices and profits will be lower: government intervention entails a welfare loss in both countries.

INSERT FIGURE 2 HERE

Second, if raising public money entailed inefficiencies, one would not easily recommend the use of subsidies.

Third, and probably most important, if it is known that a government is willing to subsidise firms in certain sectors, this would trigger inefficient rent-seeking behaviour and it is far from clear that the government would end up ‘helping’ the right firms, rather than distributing aid to unprofitable and inefficient firms which turn out to have more political clout.

Fourth, the nature of these arguments is highly sensitive to the nature of product market competition. Consider again the case where there is only one government which intervenes, but assume that foreign firms react to the domestic firms’ more aggressive behaviour by being *more* aggressive as well (i.e. assume strategic complementarity). In that case, a subsidy would decrease welfare.

This is illustrated by Figure 3, where it is assumed that firms compete in prices (or more generally firms’ actions are strategic complements). The Figure shows that if country H ’s government *taxes* the domestic firm, it will make it less aggressive (for any given price set by firm f , firm h finds it optimal to set a higher price), causing an upward shift of its best reply function from $R_h(c)$ to $R_h(c + t)$. Since by strategic complementarity the rival will react by behaving less aggressively as well, at the new equilibrium both firms will have similar market shares but both set higher prices and enjoy higher profits. In turn, this improves welfare of country H .

INSERT FIGURE 3 HERE

In other words, a subsidy would be optimal when market actions are strategic substitutes, but a tax would be optimal when actions are strategic complements. Since it is impossible to design economic policy on the basis of the mode of competition (which is to a large extent unobservable, and would in any case change from sector to sector), it follows that strategic trade policy provides a weak argument to justify economic interventions.

2.2 Strategic merger policy?

All these qualifications made, it should be said that strategic trade and industrial policy arguments remain very popular, and are often invoked to justify government intervention in the economy and in particular protectionist policies.

Therefore, it is interesting to ask whether strategic policy arguments may lie behind ‘national champions’ positions on mergers in an international economy: for instance, would such arguments explain why a government may want to promote a merger between domestic firms? As a first step to answer this question, consider the effects of a merger in a domestic economy. We shall then build on this benchmark analysis to see what are the effects of mergers in an international economy, and investigate whether ‘strategic trade policy’ arguments make sense in the context of mergers.⁴

2.2.1 Mergers in a domestic economy

To understand the impact of a merger between two firms operating in an oligopolistic industry, it is convenient first to consider the case where the merger does not entail efficiency gains (in other words, the merger does not modify the costs of the firms which take part in it).

No efficiency gains When two competing firms merge, their market power will increase. Before the merger, at the time of deciding which price to set (or which quantity to sell) each of them would face a number of competitive constraints, represented by each of the rival: a given price increase might lead consumers to switch to any of the rivals, determining a certain reduction in profits. After the merger, the merging firms coordinate their decisions, and understand that they face weaker competitive constraints, as there is one less independent rival to which consumers could switch if they decided to increase prices. (Think of a merger to monopoly as the extreme case: before the merger each of the duopolist knows that following a price increase it would lose custom to the rival; after the merger, it can increase prices without fear that customers would switch to any rival.) As a result, the merger will lead to a less aggressive action (a price increase, or a fall in output, depending on which one is the strategic variable) of the merging firms. Depending on the nature of competition in the industry, rivals may react by being also less aggressive (if actions are strategic complements) or by being more aggressive (if actions are strategic substitutes). However, it can be proved that the net effect of the merger is a price increase or a reduction in total output.⁵

⁴We focus throughout on horizontal mergers, that is, mergers between competitors. This is because most of the mergers at the centre of disputes were indeed horizontal. Furthermore, we do not consider the possibility that after the merger the industry might switch to a collusive equilibrium. None of these hypotheses is crucial for the arguments we are going to make, although the mechanisms to be discussed would be very different.

⁵See Motta (2004: Chapter 5) for details. An exception to this general result is when actions are strategic substitutes and the merging firms have a very small share of the market and face large outsiders. In that case, the increase in output by the (large) outsiders may outweigh the decrease in output by the (small) insiders. But mergers between small firms are unlikely to raise the attention of policy-makers and are therefore not considered here.

This means that the merger, absent efficiency gains, will decrease both consumer surplus and total welfare. Interestingly, and important for our analysis later on, if the merger does not entail efficiency gains the profits of the outsiders will increase: this is because the price increase (or output reduction) of the merging firms will benefit the industry as a whole, and above all the outsiders which can free-ride on the less aggressive action of the insiders. (As a matter of fact, it is even possible that a merger would not be profitable when there are strategic substitutes, as the more aggressive reaction by the outsiders would outweigh the benefit of a less aggressive action by the insiders.⁶)

Figure 4 illustrates the effect of the merger for the case where actions are strategic complements (but, as said above, qualitative results would not change under strategic substitutes). The outsiders' best reply function is given, whereas the effect of the merger is to make less aggressive the insiders, shifting their best reply function from R_I to R'_I . As a result, the equilibrium moves from point B (before the merger) to point M (with the merger), leading to higher industry prices and profits, and lower consumer and total welfare.

INSERT FIGURE 4 HERE

Mergers with efficiency gains When the merger entails sufficiently large cost savings (the insiders' costs decrease from c to ec , where $e < 1$ measures the reduction in costs: the lower e the stronger the efficiency gain), the impact of the merger is considerably different. The merger makes the merging firms more efficient: rather than increasing their prices, lower costs will lead the insiders to be more aggressive in the marketplace (they will decrease their prices, or increase their output, depending on their strategic variable). The reaction of the outsider will depend on whether actions are strategic substitutes (in that case, they will be less aggressive) or strategic complements (they will become more aggressive as well), but it can be shown that if efficiency gains are important enough, the final effect of the merger will be to lower industry prices and to increase output. Therefore, with sufficiently important efficiency gains, the merger will increase consumer and total welfare. Note also that in this case the outsiders will *lose* from the merger, since the more competitive insiders will be able to grab a bigger share of the market at the new equilibrium.

Figure 5 illustrates this case. Absent efficiency gains, the merger would lead the insiders to have the best reply function $R'_I(e = 1)$, but the stronger the cost savings the more their best reply function will shift downward. The Figure depicts a best reply function R_I^e associated to a merger with efficiency gains which are important enough for the new equilibrium point after the merger to

⁶See Salant et al. (1983).

be at M^e , where prices are lower than at the equilibrium point B which would prevail absent the merger.

INSERT FIGURE 5 HERE

More generally, the level of the efficiency gains is crucial to understand the impact of a merger. Figure 6 illustrates the effects of a merger in a closed economy as a function of the reduction in costs (from c to $ec \leq c$) created by the efficiency gains. To understand the figure, recall that a lower value of e is associated to a higher level of efficiency gains. In the interval $[e_{\pi_I}, 1]$, that is, if there are small or no efficiency gains, the merger may not take place under strategic substitutes: if firms choose outputs, the insiders would decrease their output but the outsiders would increase it: hence, prices would not increase enough to compensate the insiders for the fall in market share. (However, this region disappears if the actions are strategic complements: the merger would always be profitable for insiders then.)

When e falls in the interval $[e_W, e_{\pi_I}]$, both insiders and outsiders gain from the merger but both consumer and total welfare decrease (this is the case where efficiency gains are small).

When e belongs to the interval $[e_{CS}, e_W]$, efficiency gains are larger, so the increase in profits of all firms outweighs the (small) reduction in consumer surplus, resulting in higher welfare.

Finally, in the area where efficiency gains are very important, that is, $e < e_{CS}$, insiders' profits, consumer surplus and total welfare all increase, whereas outsiders are the only ones who lose from the merger (as the more competitive insiders subtract market shares to them).

INSERT FIGURE 6 HERE

2.2.2 A first look at mergers in an international economy

We can now build on our knowledge of the effects of a merger in a domestic economy to explore whether 'strategic trade policy' arguments may explain protectionist attitudes towards mergers, and in particular the favourable treatment of mergers between domestic firms: are such domestic mergers a way to build national champions?

Given the role played by efficiency gains, it is convenient to consider separately the cases where efficiency gains are absent and where they are sufficiently important.

Merger without efficiency gains If the merger does not entail efficiency gains, i.e. if it does not decrease insiders' unit costs, then after the merger the insiders will be *less* aggressive in the marketplace (that is, the merger will be like a tax on output, rather than a subsidy to it).

If actions are strategic substitutes, that is, if foreign rivals will react by being more aggressive, then domestic firms' profits would decrease. If actions are strategic complements, that is, if foreign rivals will react by being less aggressive, domestic firms' - as well as outsiders' - profits would indeed increase (not by shifting oligopoly rents, but rather by weakening competition in the market place).

However, note that if the product is also sold in the domestic country, then - independently of whether actions are strategic substitutes or complements - domestic consumers would lose from the merger. Unless the domestic market is very small, the fall in domestic consumer surplus would tend to outweigh the gain (if any) in domestic firms' profits. In this case, therefore, there would be no reason for the domestic government to sponsor such a merger.⁷

Merger with efficiency gains If instead the merger did lead to conspicuous efficiency gains, then insiders would indeed become more competitive in international markets and would increase their overall market share and profits (independently of whether actions are strategic substitutes or complements). In this case, there would indeed be a reason for the domestic government to promote the domestic merger, but note that there would be no harm to welfare: more inefficient foreign firms might want to complain, but consumers (wherever they are located) would be better off, and the merger should be approved. Opposing views among different countries might of course arise in this case, but we could not really talk about 'protectionist behaviour' that should be stigmatised.

Further, we feel that it is not (or not only) a drive towards efficiency-enhancing concentrations which inspired governments' actions in most of the mergers mentioned above, and suspect that to understand such actions we would have to move beyond the assumption that governments are welfare-maximisers. To this purpose we propose to study this issue within a political economy approach that we discuss in what follows.

3 A political economy approach

Merger policy, not differently from any other economic policy, is decided in a political economy environment. This simple observation has several important implications. First, as mergers have different effects on consumers, merging firms and non-merging competitors, the location of the relevant market and firms (at home or abroad) matters. Second, antitrust decisions can be fully or partly delegated to independent authorities, but generally governments attempt to exert some influence on merger policy (which, depending on the country, may go from generic pressures to veto power on the final decision). Third, some groups in society are politically better organized than others to pursue their interests because of collective action problems.

⁷In other words, the domestic government could favour the merger among domestic firms only if the actions are strategic complements and the market for the product is mostly located elsewhere. As we shall see below, there may therefore be a conflict with the government where the market is mostly located.

We start by providing an informal description of a model that allows us to capture these features of merger policy.⁸ We define merger policy $x \in \{0, 1\}$ as a simple binary choice, where x can take the value of 0 *-allow the merger-* or 1 *-reject the merger.*⁹ We assume that a merger to be effective needs to be approved by an authority in charge of merger policy. The decision of the authority, however, can in practice be influenced (or reversed) by the government with some exogenous probability, capturing informal political influence or a formal reversal clause that the government might appeal to. This opens the question of how the government formulates its position on the merger. As in the classic works of Bernheim and Whinston (1986) and Grossman and Helpman (1994), we assume that politicians' preferences are shaped by a combination of social welfare considerations and political influence by lobby groups representing the interests of firms.

More precisely, the political economy environment in which merger policy takes place is described by a three stage process (refer to figure 7). At the first stage, the merger is proposed and lobbies representing the interests of firms (insiders and the outsider) offer political contributions to the government contingent on its position on the merger.¹⁰ At the second stage, the antitrust decision is taken. We assume that at this stage the characteristics of the merger are common knowledge. With some exogenous probability $\xi \in [0, 1]$, to be further specified later, merger policy is determined by the government. We assume that the objective function of the government is a weighted average of aggregate welfare and political contributions. The weight on this second term is often referred to as the *political bias*. With probability $(1 - \xi)$, the antitrust authority decides whether or not to allow the merger, based on social welfare considerations only.¹¹ The probability ξ is meant to capture in a general way the influence of the government on the authority, with low values of ξ being associated to weak political influence on antitrust decisions. At the last stage, product market competition takes place, political contributions to the government are paid and profits, consumer surplus and welfare are realized. The political game is solved by backward induction and we limit attention to the equilibrium with truthful contributions (i.e. where payments from firms reflect the effect of merger decisions on their payoffs).

INSERT FIGURE 7 HERE

As discussed in the previous Section, mergers can have substantially different effects in a closed or in an open economy environment. Moreover, in an open economy environment itself there might be important differences, as countries can be part of an international union with a common

⁸For a formal model, refer to our related paper (Motta and Ruta, 2007).

⁹In the real world, authorities also have the possibility to approve mergers subject to certain conditions (called "remedies"). In our simple model, there are no meaningful remedies authorities may resort to.

¹⁰Consumers have weak incentives to lobby the government to influence merger policy because a specific good generally takes a small part of their budget. Moreover, consumers often fail to organize politically because free riding problems are more difficult to overcome compared to business owners (as in Olson, 1965).

¹¹The case of a consumer standard is a straightforward extension of this model.

antitrust authority (as in the EU) or have separate authorities. We, therefore, assume that there are two regions (or countries), A and B , and consider three different scenarios to take into account these possibilities.

- *Domestic mergers*, where the market and the firms are all located within national borders. Here, A and B are regions of the same country. The merger decision is taken by the authority and can be influenced by a "politically motivated" national government with some exogenous probability $\xi_U \in [0, 1]$. This is our benchmark case.
- *Non-EU mergers*, where A and B are fully independent political units, with two separate authorities and national governments. The merger decision is taken by the authority where the market is located -either A or B - and can be influenced by the local government with some exogenous probability $\xi_j \in [0, 1]$, where j is either A or B . The authority maximizes national social welfare, while the objective function of the national government is a linear combination of national welfare and political contributions from domestic firms.
- *EU mergers*, where A and B delegate sovereignty on merger policy to an authority that allows or blocks the merger based on union social welfare considerations. However, the antitrust decision can still be influenced by "politically motivated" national governments with probability $\xi_A \in [0, 1]$ and $\xi_B \in [0, 1]$ respectively (where $\xi_A + \xi_B \leq 1$).

We now take a closer look at these three cases.

3.1 Domestic mergers

This Section deals with a situation where all firms are located in the same country, but two different agents - say, the antitrust authority and the economics minister - are involved in the merger decision process. This situation may well describe several cases where there has been a conflict between domestic decision-makers. For instance, in the *E-On/Ruhrgas* German energy merger, the Bundeskartellamt, which is the relevant competition authority in Germany (and the Monopolkommission, which has an advisory role) did not want to approve the merger, but the German government decided to authorise the merger (under German law, the BKA can be overruled by the economics minister). In the case of the (failed) merger project between *Gas Natural/Endesa*, both Spanish firms, the Tribunal de Defensa de la Competencia (the relevant Spanish competition authority) did not express a favourable opinion of the concentration, whereas the Spanish government openly approved of it.

In this case, A and B are two regions of the same country and merger policy is

$$x = \begin{cases} x_U^G & \text{with probability } \xi_U \\ x_U^A & \text{with probability } (1 - \xi_U), \end{cases}$$

where superscripts G and A stand for government and authority respectively (and the subscript U is for the union of the two regions, i.e. the country in this case). We first look at the decision of the authority and then study the choice of the government.

As the objective function of the authority corresponds to total welfare, the authority approves a merger if and only if the merger is efficient ($e \leq e_U = e_W$). Aggregate welfare maximization implies that only those mergers that involve sufficiently large efficiency gains are approved by the authority, all other mergers (for which $e > e_U$) are rejected.

We next study how special interests influence merger policy preferences of the government. Politicians can be influenced by lobbies representing the interests of merging firms and outsiders.

Recall from the previous section, that for any $e \in [e_{\pi o}, e_{\pi I}]$ (i.e. for low efficiency gains), both merging firms and outsiders will benefit from the merger. In this case, lobbies representing the interests of insiders and competitors might both choose to exert pressures on politicians to have the merger approved. Notice, however, that for $e \leq e_U$, the merger is efficient and a politician would endorse it even in the absence of political pressures. In this case, lobbies optimally set political contributions equal to zero at the first stage, the merger is approved by the authority and the government has no reason to oppose the decision. For $e > e_U$ (i.e. inefficient merger), the authority rejects the merger and lobbies set contributions so as to induce the government to oppose the authority's decision. Because of these political pressures, the government endorses at least some mergers that would be rejected by the authority on the basis of efficiency (those for which the realization of the efficiency level falls in the area $e_U < e \leq e_U^G$, where e_U^G is the threshold efficiency value for the politically motivated government).

On the other hand, for $e < e_{\pi o}$ merging firms and outsiders have opposing interests and will lobby politicians in opposite directions. The government, however, always supports the merger. The reason is twofold. First, consumer surplus is always larger if the merger is approved when $e < e_{\pi o} = e_{CS}$. Second, the lobby of insiders can always offer higher political contributions than the lobby representing the outsider. Figure 8 summarizes the political economy of domestic mergers.

INSERT FIGURE 8 HERE

The main result here is that, even when both the government and the authority belong to the same country, they may have opposing views about a particular (domestic) merger. This is because the government's position is affected by political contributions, which distort its objective function away from total welfare considerations. As a result, politicians may be ready to accept mergers that are not very efficient, but which are profitable enough for firms to lobby the government. This is summarised by different 'intervention' thresholds between the authority and the government.

3.2 Non-EU mergers

We now start addressing the political economy of mergers in international markets. The first case is the one where countries A and B are open to trade, but fully politically independent. Each country has an antitrust authority, that maximizes national welfare, and a politically motivated government that can influence (reverse) the decision of its national authority with probability ξ_j , with $j = A, B$. This case may be useful to understand mergers between non-EU firms, for instance *Gencor/Lohnro*, *Boeing/McDonnell Douglas*, or *General Electric/Honeywell*, but which had important effects in the EU markets and were subject to the European Commission's jurisdiction. In this case, the two decision-makers of our model might be seen as the Directorate General for Competition (as antitrust authority) and the member states' governments as 'political' agent (they can affect the final decision of the European Commission, which is a collegial body where Commissioners belonging to all the member states are present, and whose final decision does not necessarily coincide with the one recommended by the Competition Commissioner), whereas the non-EU governments do not have any saying in the decision.

The location of firms and consumers now matters and, depending on this, the merger has different effects on the welfare of country A and B . To focus ideas, we assume that the insiders are located in country A (representing the non-EU economy), while the outsider and the market are in B (the EU).

The authority in B decides whether to approve or block the merger. This decision can be influenced (or reversed) by the government in B with probability ξ_B . In this case, merger policy is

$$x = \begin{cases} x_B^G & \text{with probability } \xi_B \\ x_B^A & \text{with probability } (1 - \xi_B). \end{cases}$$

There are two contrasting effects on social welfare in country B . For high efficiency levels implied by the merger in country A ($e \leq e_{\pi o} = e_{CS}$), the outsider loses, but consumers gain. This second (positive) effect always dominates and the authority in B approves the merger. The opposite holds true for mergers in the area ($e > e_{\pi o} = e_{CS}$). Therefore, a welfare maximizing authority in B will approve a merger if and only if $e \leq e_B^A = e_{\pi o} = e_{CS}$. Notice, however, that the authority in B approves less mergers than what would be optimal from a (total) social welfare point of view (i.e. $e_B^A < e_W$), as it does not internalize the effect on the profits of the insiders.

The government in B is subject to lobbying by the outsider, as non-merging competitors are always hurt by the decision of the authority. Whether lobbying is successful or not in this case is ambiguous and depends on the political bias of the government (i.e. the weight on political contributions in its objective function). More precisely, the government in B can always be induced by the outsider to endorse the merger if the political bias is sufficiently high (i.e. if the weight on contributions is large).

In this case, there is potentially a stark conflict between the different decision-makers, because the situations where the merger harms welfare coincides with the situations where national profits would increase, and vice versa. Some commentators have suggested that the *Boeing/Mc Donnell Douglas* case reflected a tension between efficiency arguments on one side and protectionist arguments on the other side. Arguably, the merger between the two American firms (located in country A in our example) might have been procompetitive (according to many, McDonnell-Douglas was bound to exit the industry anyhow), and therefore EU consumers would have been better off but rival EU firm Airbus might have been hurt by the merger, which explains why many voices rose against the merger (in our example the EU corresponds to country B). The final outcome decision (after long discussions within the European Commission) to approve the merger subject to some remedy may be compatible with the hypothesis that the Competition Directorate - caring for consumer welfare only - favoured the merger despite some of the opposing views expressed by some member states and possibly represented within the Commission as a collegial body.

Refer to figure 9 for a summary of this case.

INSERT FIGURE 9 HERE

3.3 EU mergers

This Section deals with EU mergers. This includes cases where a domestic merger between two firms located in the same EU country had effects on other EU countries (for instance, *Volvo/Scania* in Sweden) and the many cases where firms of different EU nationalities were involved, such as *E-On/Endesa*, *Edison/EdF* and *HVB/Unicredit*. In these cases, the relevant competition authority (the European Commission) and the EU governments involved took different positions. Note that, even though there may be only one decision-maker (the European Commission) that is formally invested with the power of allowing or prohibiting the merger, member countries' governments might have several ways to affect the final outcome of the merger. For instance, they could try to increase the costs of the merger by changing the market rules, as when the Spanish authorities imposed a number of restrictive conditions (contested by the European Commission) for E-On's (failed) takeover of Endesa, or when the Italian government changed the corporate governance rules of Edison, or when it announced that it would consider unbundling of Telecom Italia's fixed network, following AT&T's interests in taking over TI. Or they could affect the Commission's decision by voicing opposition within the Commission as a whole, through their Commissioner. This motivates our interest in understanding the political economy determinants of the position of member governments' relative to the merger.

Consider a scenario where countries A and B are part of an international union, with a single antitrust authority, and each national government affects the antitrust decision with probability ξ_j .

Merger policy in the international union is as follows

$$x = \begin{cases} x_A^G & \text{with probability } \xi_A \\ x_B^G & \text{with probability } \xi_B \\ x_U^A & \text{with probability } (1 - \xi_A - \xi_B). \end{cases}$$

We will consider two types of mergers that have distinctive features: within-country and cross-border EU mergers. As the union authority maximizes total welfare, it will approve a merger if and only if $e \leq e_U^A = e_W$ (i.e. wherever efficient) and reject it otherwise, independently of the type of merger. Governments of A and B possibly have a different view and we therefore need to address these two cases separately.

3.3.1 Within-country mergers

The position of national governments on the merger is influenced by the location of the market and firms and their political bias. We assume that the market is in country B as this corresponds to the more interesting practical cases. To simplify the discussion, we consider the two limit cases: fully benevolent governments, who only act to maximize national welfare (i.e. with no political bias), and selfish governments, who exclusively care about lobbying contributions (i.e. with maximal political bias).

Benevolent national governments If national governments have no political bias and maximize national welfare, no lobbying takes place. In this case, the location of the market matters.

In country A there are no consumers and the government only takes into account the effect of the merger on the profits of the insiders (which are both located in A). Therefore, the government in A endorses the merger if and only if $e \leq e_A^G = e_{\pi_I}$ (that is, whenever the merger is proposed because profitable to the insiders). As for the benevolent government in B , it endorses the merger if and only if $e \leq e_B^G = e_{CS} = e_{\pi_o}$, as the effect of the merger on consumer welfare always dominates the effect on the outsider. This implies that for $e \leq e_{\pi_o}$, the union authority approves the merger and no national government opposes this decision. For $e_{\pi_o} < e \leq e_W$, the authority approves the merger and the decision is opposed by government B . For $e_W < e \leq e_{\pi_I}$, the authority would block the merger. In this case, the government of A opposes the authority's decision.

The position on the merger of the union authority and the (benevolent) national governments are summarized in figure 10. Notice that no lobbying ever takes place in this case, since we are analyzing the extreme situation where both governments are benevolent, i.e. they care only about their country's welfare. No firm would find it convenient to pay contributions, as it could not affect the position of the government by means of this action.

INSERT FIGURE 10 HERE

Politically motivated national governments The opposite case is the one where national governments only care about political contributions. In this case the location of the market does not matter, as governments pose no weight on the effect of the merger on the general electorate and, hence, on consumer surplus. Moreover, lobbying is always successful: firms can set their contributions slightly positive on the policy option they prefer (say, reject the merger) and zero on the alternative (say, approve the merger). This will always induce selfish governments to follow the wishes of special interests.

For $e \leq e_{\pi_o}$, the authority approves the merger. The insiders in A benefit from the merger and (successfully) lobby government A for endorsement. The outsider in B , on the other hand, loses from the merger for a low realization of e and lobbies its government for rejection. For $e_{\pi_o} < e \leq e_W$, the authority approves the merger. Both the outsider and the insiders gain from this decision. In this case, there is no contrast between the authority and the national governments. Finally, for $e_W < e \leq e_{\pi_I}$, the authority rejects the merger. However, the insiders and the outsider would gain if the merger were to be approved and lobby the government of A and of B respectively to endorse the inefficient merger.

The case of politically motivated governments is discussed in figure 11.

INSERT FIGURES 11 HERE

An interesting example may be the *Aérospatiale-Alenia/De Havilland* merger, the first merger ever prohibited by the European Commission. This was not a purely EU merger, as it involved two EU firms (Aérospatiale and Alenia) and a Canadian firm, and as such our example is not fitting perfectly the formal framework analysed here (but could be easily adapted to reproduce such an environment without major complications). In that case, the competent authority was the European Commission (the merger had a EU dimension, and the relevant market was the world market) but while the Commissioner for Competition (our welfare-maximising authority) was clearly opposed to the merger, some EU governments were favourable to it (in particular, the French government strongly endorsed the merger). In the end, the Commission as a collegial body decided against the merger, which in our framework could be seen as a low realisation of the parameters ξ_j .

3.3.2 Cross-border mergers

Differently from the previous Sections, assume that merging firms are now located in different countries (i.e. one in A and one in B). Moreover, assume that the outsider and the market are located in country A (again, this corresponds to the more interesting recent merger cases). We study first the effect of the merger on national social welfare (i.e. for benevolent national governments) and postpone the discussion of politically motivated governments to the last subsection.

Benevolent national governments When national governments are social welfare maximizers, the location of the market matters. Under this scenario, welfare in country B corresponds to the profits of one of the insiders. For this reason, government B will endorse any merger (i.e. if and only if $e \leq e_B^G = e_{\pi I}$), as whatever merger is proposed must be profitable for the insiders. This clearly implies that, based on national welfare considerations, government B will endorse at least some inefficient mergers (i.e. $e_B^G \geq e_W$).

The situation in country A is more complex as several interests are present: consumers, the outsider and one of the insiders. It can be showed, however, that the effect of the merger on consumer surplus and on the profits of the outsider are always of opposite sign and that the first dominates the second for any level of realized efficiency gain e . This implies that for any merger such that $e \leq e_{\pi o} = e_{CS}$, the benevolent government in A would endorse the merger, as the increase in consumer surplus dominates the fall in the profits of the outsider. However, government A opposes at least some efficient mergers (i.e. $e_A^G \leq e_W$), as the welfare objective of this government neglects the effects of the merger on the other insider.

Figure 12 summarizes this case.

INSERT FIGURE 12 HERE

Notice that we might well have a conflict between domestic governments and union authorities which is simply based on the fact that their welfare objectives differ (i.e. for ‘economic’ and not for ‘political’ reasons).¹² This simple framework also helps us explain why it is important that within the EU whenever there is a merger that affects several countries it is the supranational authority which should decide on the merger: member states may have different positions on the merger due to the possible asymmetric distribution on firms’ assets and market demands. It makes sense that overall welfare is taken into account, to avoid that a national government (or an authority) may block a merger which would be beneficial to the Union as a whole.

Politically motivated national governments In the opposite scenario where governments only care about political contributions from organized interest groups, the effects of the merger on consumer surplus and, therefore, the location of the market does not matter.

Government B will always be induced by the insider to endorse any proposed merger, i.e. any merger such that $e \leq e_B^G = e_{\pi I}$. The situation in country A is more complex as there are realizations of e for which the outsider and the insider have opposing interests. In particular, for low values of e (such that $e < e_{CS} = e_{\pi o}$), the union authority approves the merger and the

¹²However, if such governments/authorities had consumer surplus as objective function, then such tensions would be eliminated in the simple economic model of this section, although they could reappear in the political economy framework.

outsider (domestic insider) has an incentive to lobby government A to oppose (favour) the merger. Whether the outsider can outbid the lobbying contribution of the domestic insider depends on the share of profits of the latter, which in turn reflect the bargaining power of the domestic relative to the foreign insider. For a low bargaining power, the outsider outbids the domestic insider and the politically motivated government of A opposes the (efficient) cross-border merger. This case is discussed in the next figure.

INSERT FIGURE 13 HERE

Our framework may shed some light on several recent merger cases. One highly debated case was *E-On/Endesa*, where the German company E-On intended to take over the most important Spanish energy company Endesa. The Spanish government (as well as the Spanish energy regulator, partly responsible for the merger) strongly opposed the merger, resulting in political tensions with the European Commission which took action against measures introduced by the Spanish government to hinder the takeover. A similar case was *ABN-Ambro/Antonveneta*, where an Italian bank has been the object of an attempted takeover by foreign EU banks. Under Italian law at the time, it was the central bank, as regulator of the banking sector, who had responsibility for the takeover. The then governor, Mr. Antonio Fazio, strongly opposed such takeovers, and tried to organize counter-bids by other Italian banks, also opposed to the entry of foreign rivals which would have jeopardized their profitability.

3.4 An extension: ‘bureaucratic’ bias

While an interesting first step, this political economy analysis should be extended in a number of ways in the future. For instance, we assumed until now that antitrust authorities are always benevolent and are not influenced by lobbies or have concerns other than social welfare maximization. This neglects the fact that bureaucrats, not differently from politicians, face incentives and that their objectives are not necessarily aligned (or perfectly aligned) with those of society at large.¹³ How would this affect our results so far?

Assume that the authority is run by a director who has career concerns and values the visibility that he can gain through interventionism, that is, by being tough on mergers. In other words, whenever the authority rejects a merger, the director obtains a visibility gain (or a prize for being tough). Clearly the bureaucrat also cares about the stated goals of its organization, which under a welfare standard coincide with social welfare. In this case, career concerns of high level bureaucrats might lead them to oppose socially efficient mergers, while inefficient mergers would always be rejected. That is, the political economy distortion of the authority might run exactly in the opposite direction of the bias of the politically motivated government, as shown in the figure below, where

¹³See Alesina and Tabellini (2006).

the intervention thresholds are to the left of the benevolent planner for the bureaucrat and to the right for the politician: $e_U^A \leq e_W \leq e_U^G$.¹⁴

INSERT FIGURE 14 HERE

As it is apparent from figure 14, contrasts between antitrust authorities and governments are the combination of bureaucratic and political biases. More generally, a better understanding of the incentives of antitrust authorities and the interaction of governments and (national and supranational) authorities are important avenues for future research in this area.

4 Conclusions

This paper discusses strategic trade policy and political economy arguments to explain merger policy in open economy. These arguments are (obviously) not exhaustive of the determinants of merger decisions. Other factors might include the need for stability of the system (as in banking), or the security of supply (as in energy markets) -perhaps invoked opportunistically by national policymakers- or mere economic nationalism (i.e. a preference for national firms and/or a distrust of foreign firms). We do not address these factors in the present work.

Independently of the origin of distortions in merger control, it is clear that welfare losses are bound to take place whenever such distortions do occur: bad mergers may happen, or good ones may not (implying allocative, productive and dynamic inefficiencies). An interesting question, that we leave for future research, is to what extent the current regulatory environment is fit to avoid distortions in merger decisions. For instance, do the existing tools of the European Commission suffice to discipline governments of member states? What is certain is that with a better 'culture of competition' citizens would understand the costs of distorted merger policy aimed at preferring inefficient national champions.

¹⁴For simplicity, the figure only refers to domestic mergers. A similar argument should apply to the other cases.

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Figure 1. Subsidy s to firm h (strategic subst.)

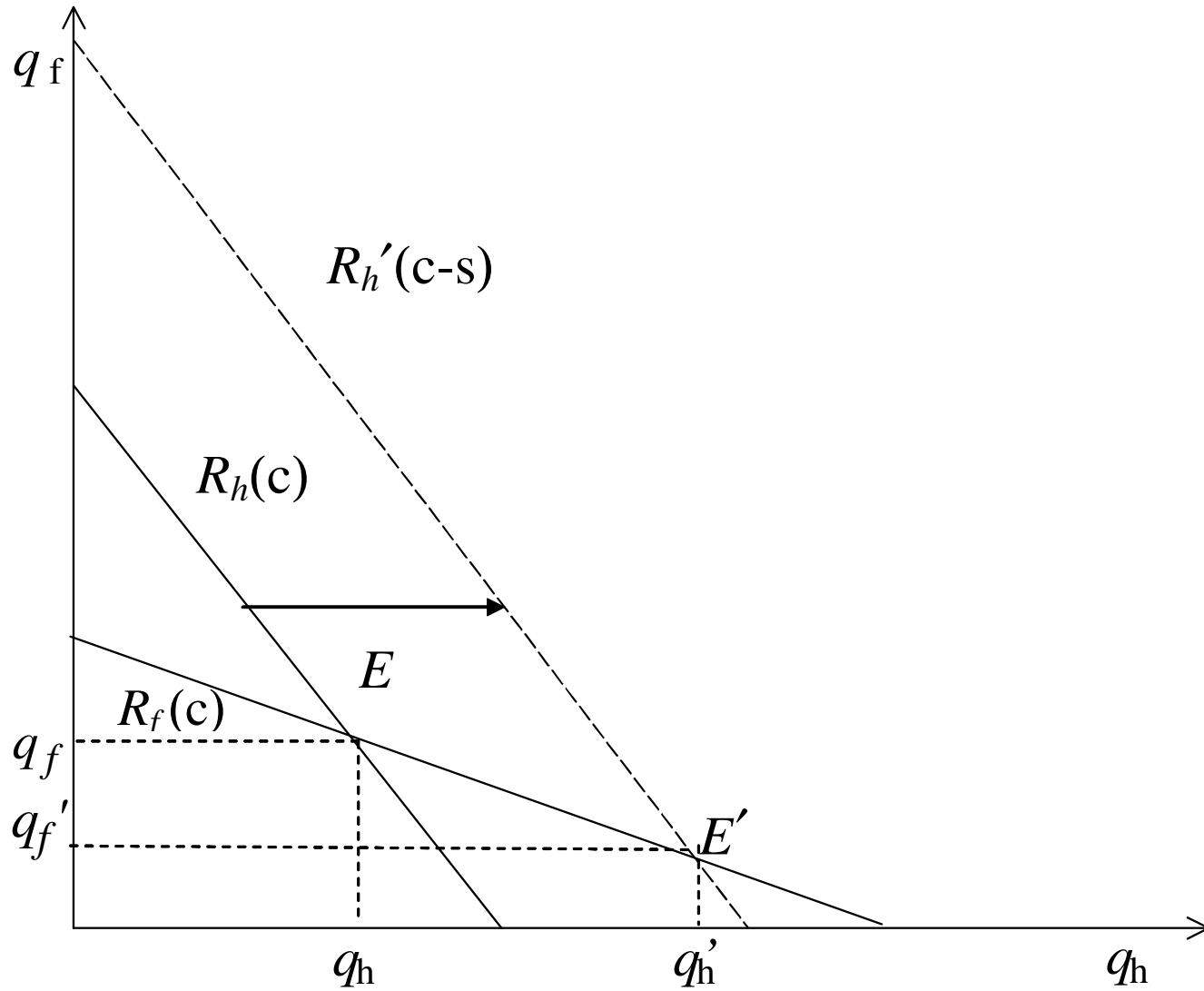


Figure 2. If both governments intervene

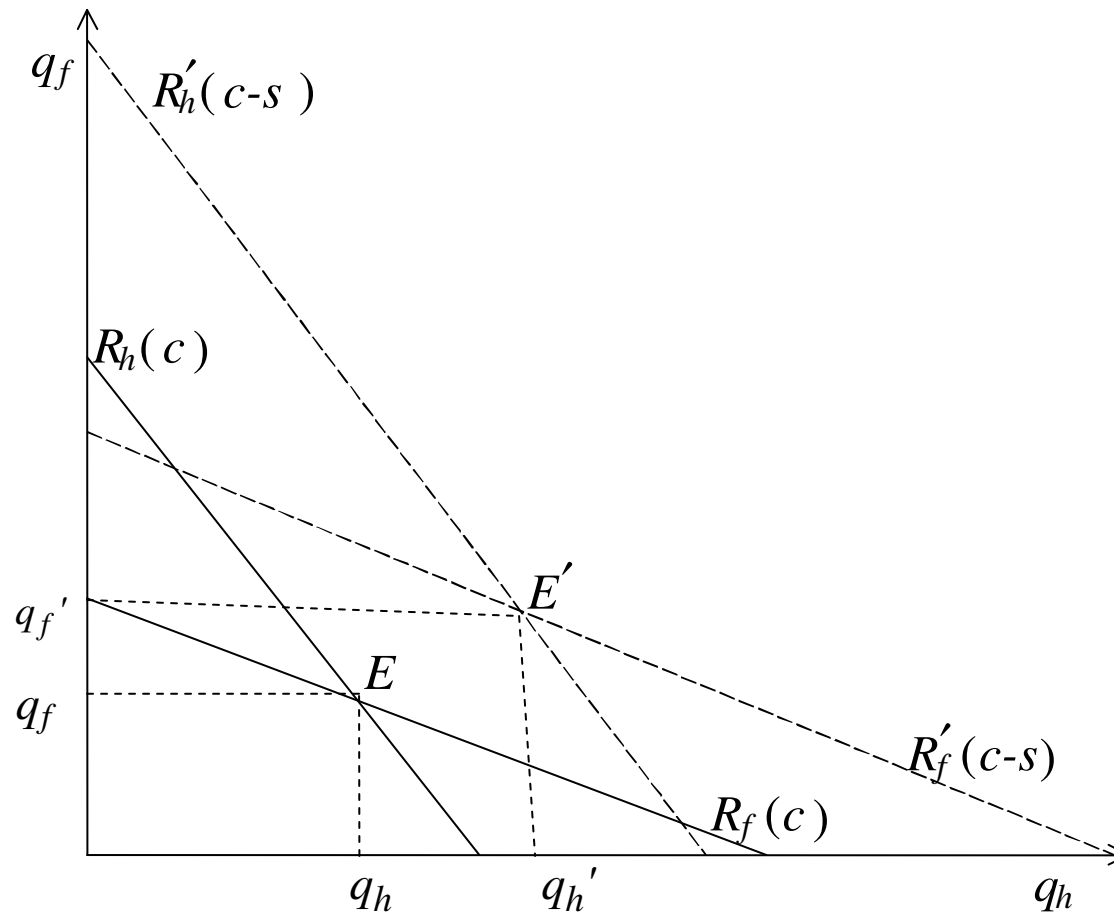


Figure 3. Strategic complements: tax, not subsidy

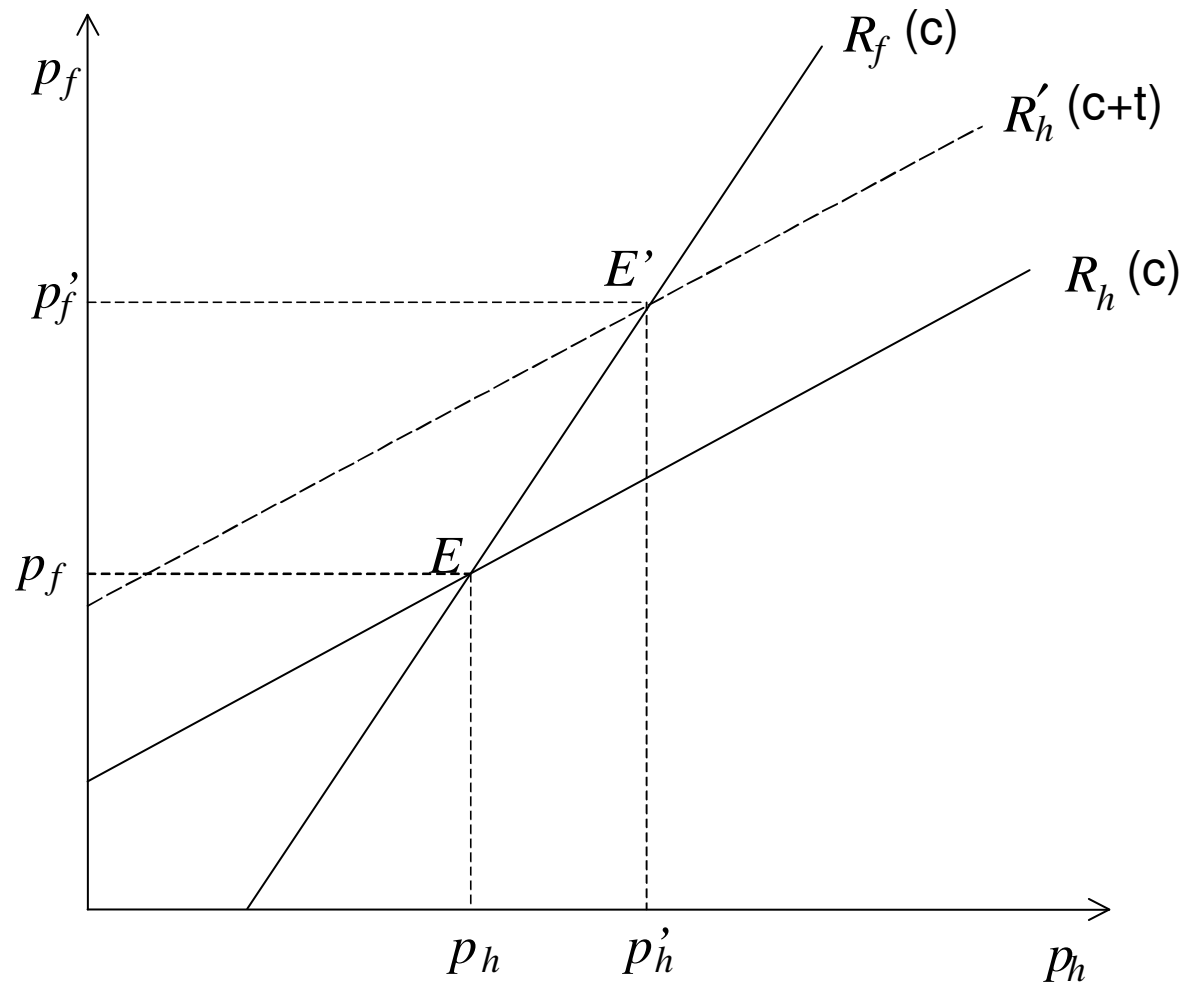


Figure 4. Merger, no efficiencies

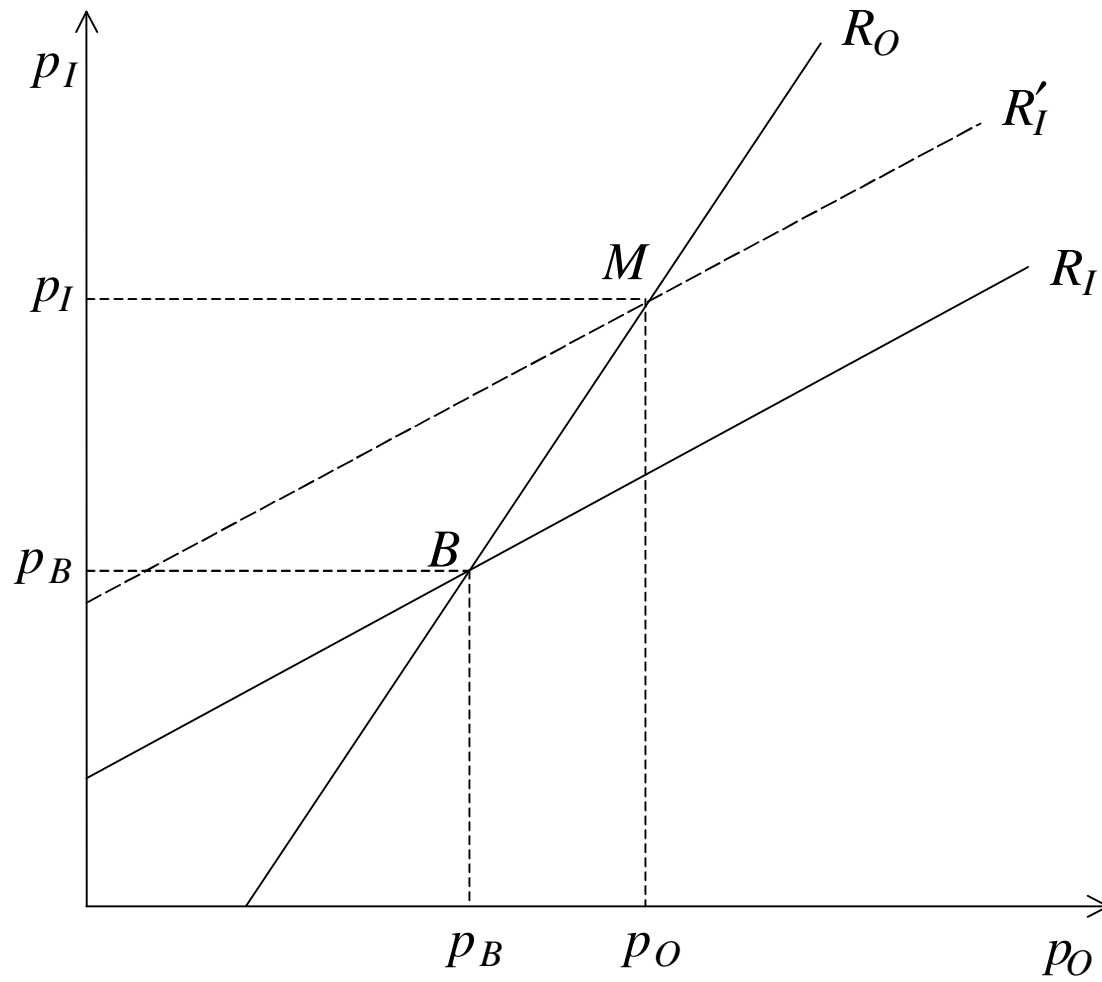


Figure 5. Merger, with efficiency gains

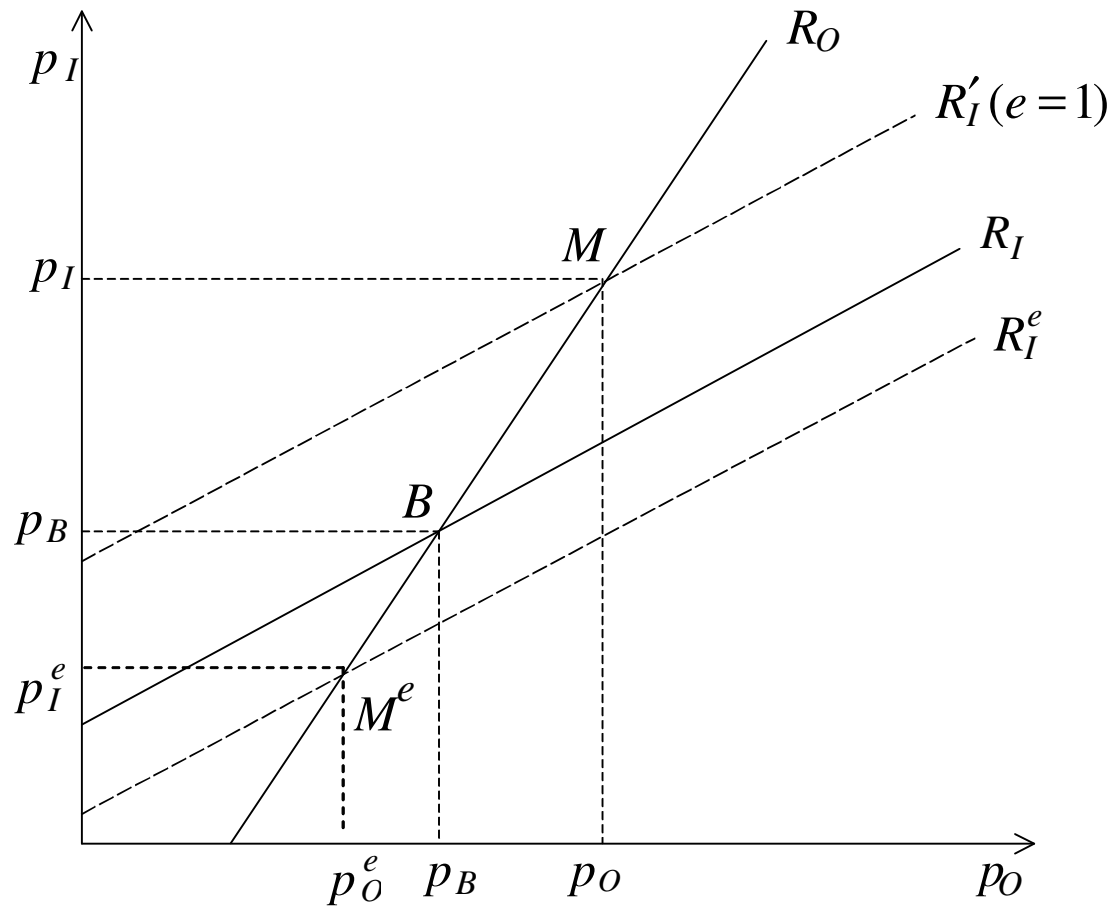


Figure 6. The effects of a merger on profits of insiders, outsiders, consumer surplus and aggregate welfare

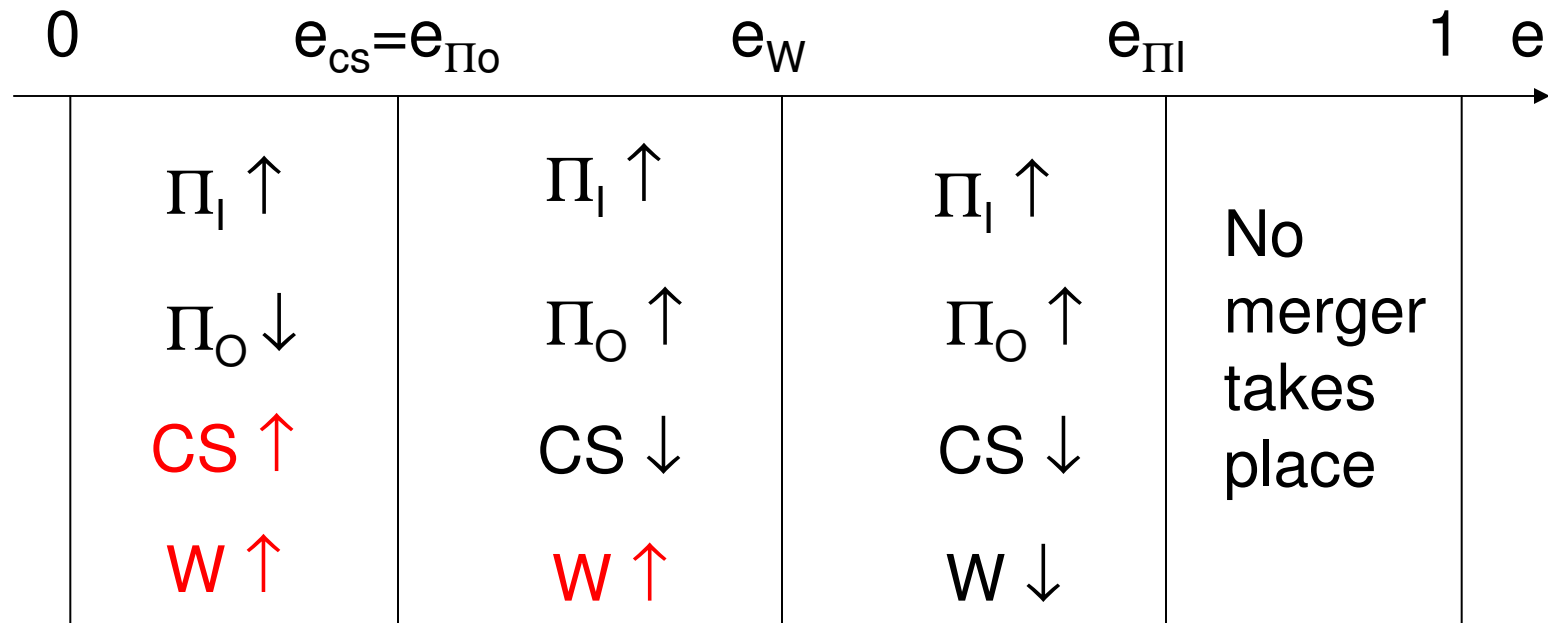


Figure 7. Timing of events

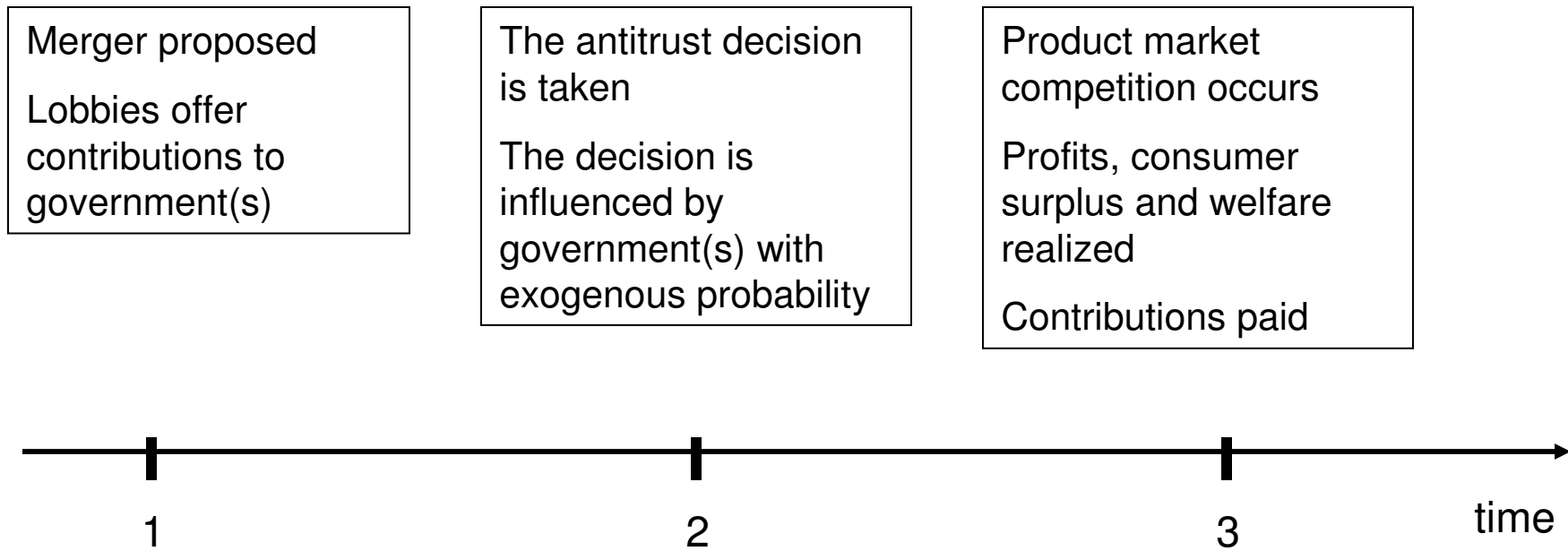


Figure 8. The political economy of *domestic mergers*

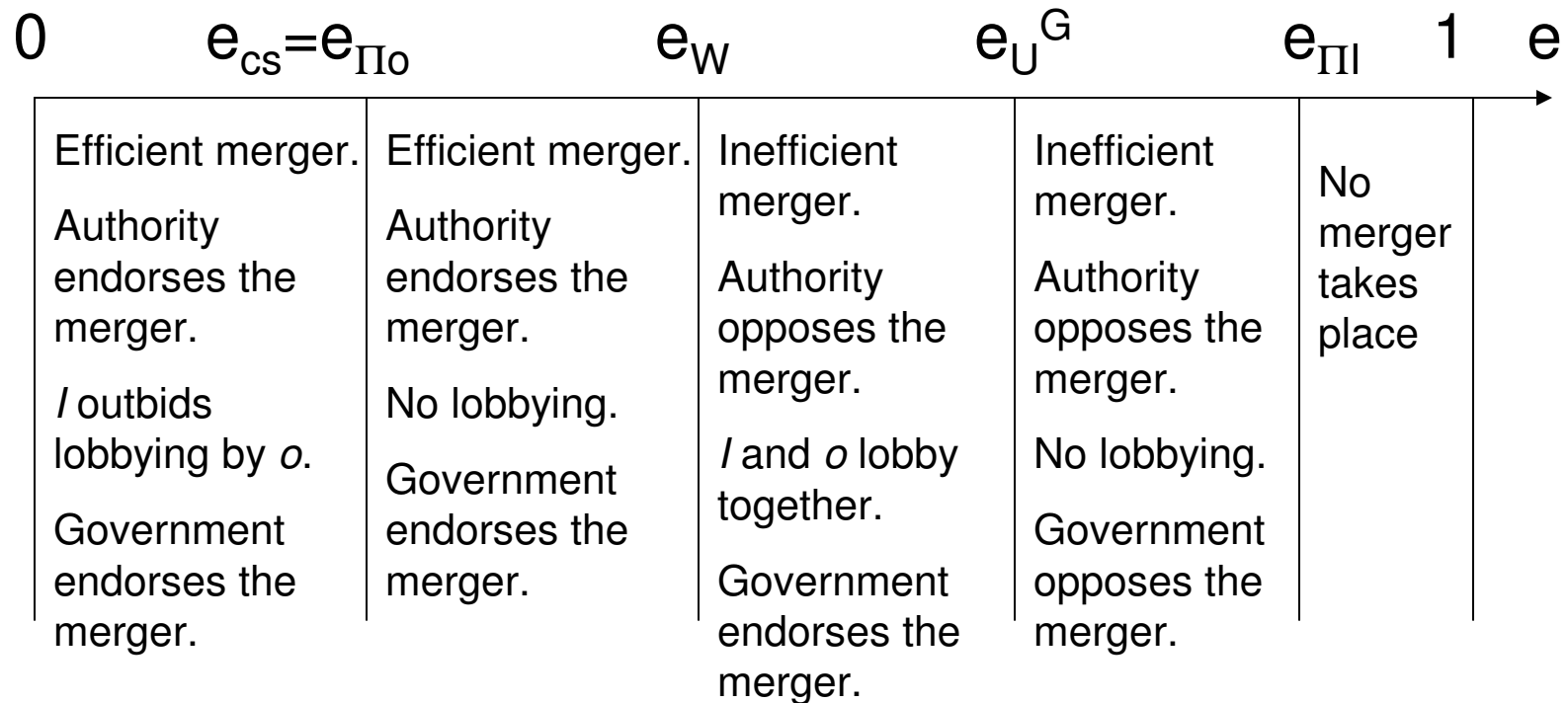


Figure 9. The political economy of *Non-EU mergers*:
 Insiders in A, market and outsider in B

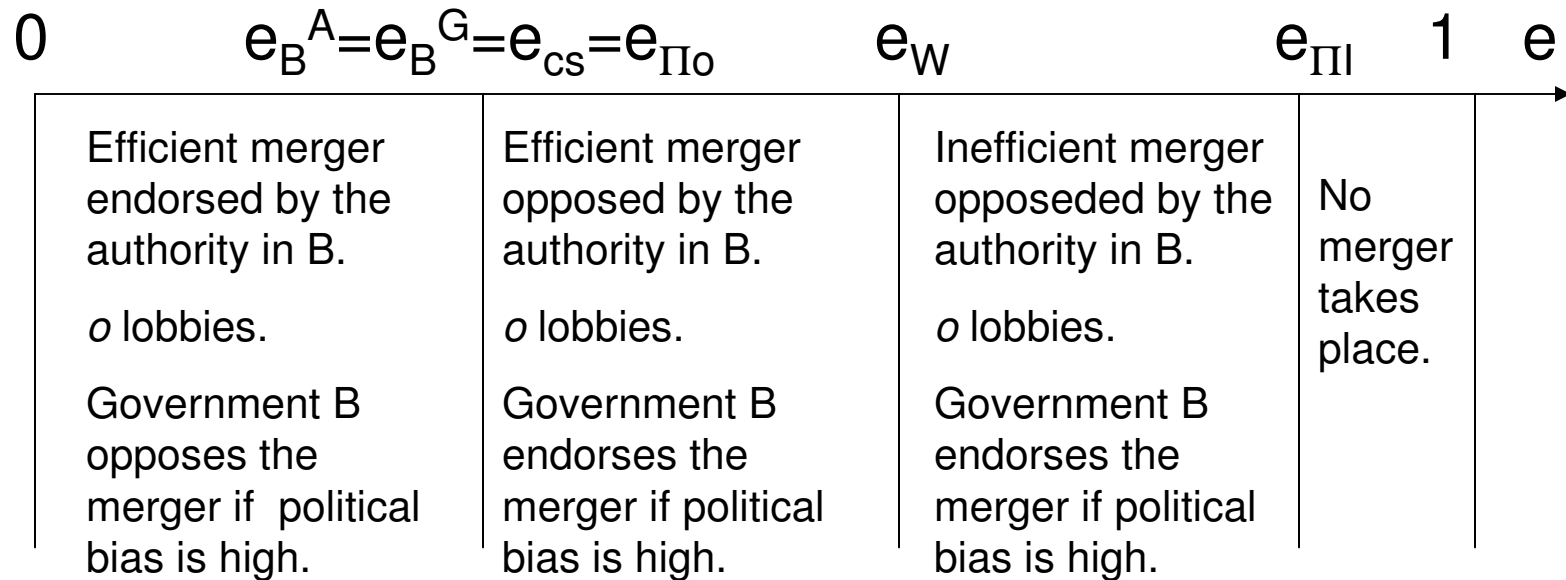


Figure 10. The political economy of *within-country EU mergers*:
 Benevolent governments, insiders in A, market and outsider in B

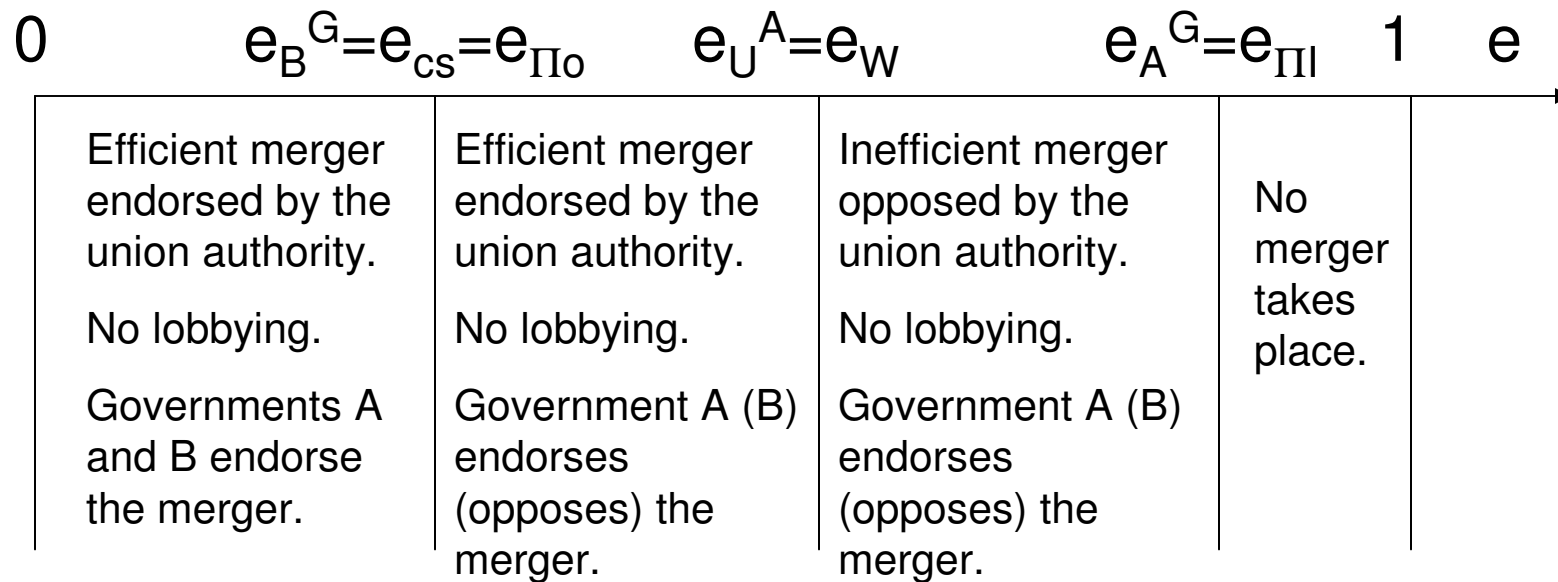


Figure 11. The political economy of *within-country EU mergers*:
Politically motivated governments, insiders in A and outsider in B

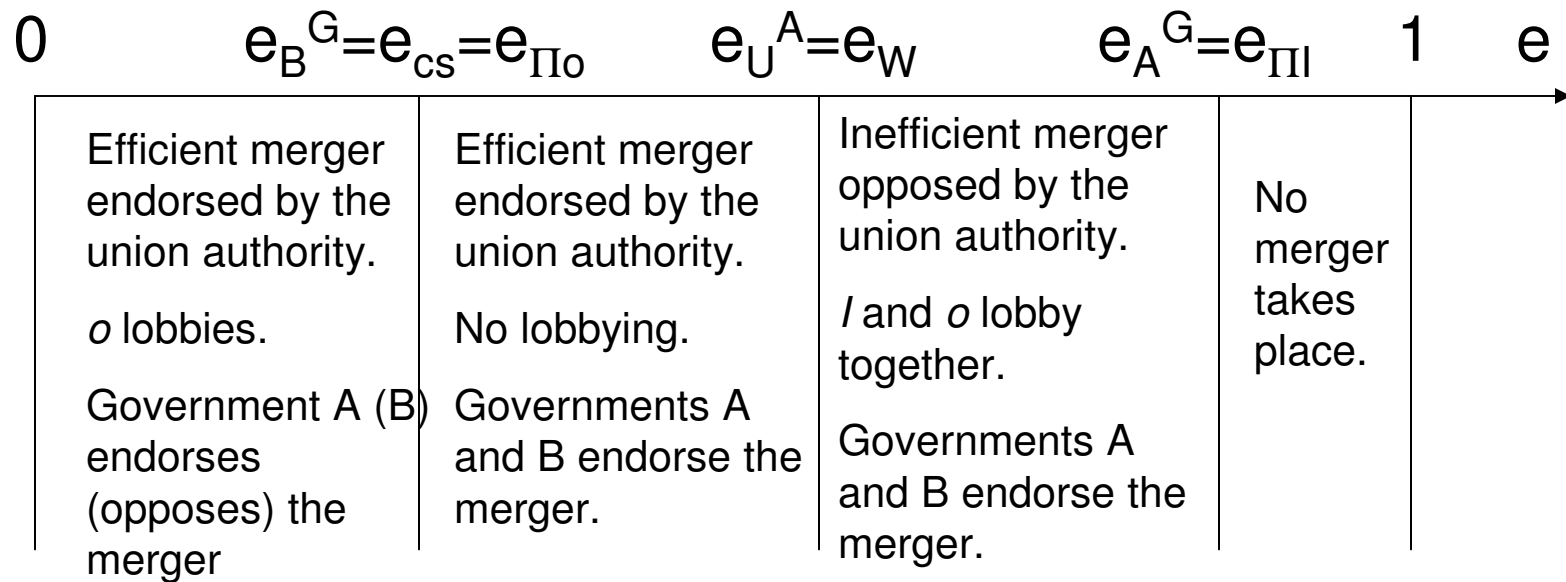


Figure 12. The political economy of *cross-border EU mergers*:
 Benevolent governments, insider in B, insider, market and outsider in A

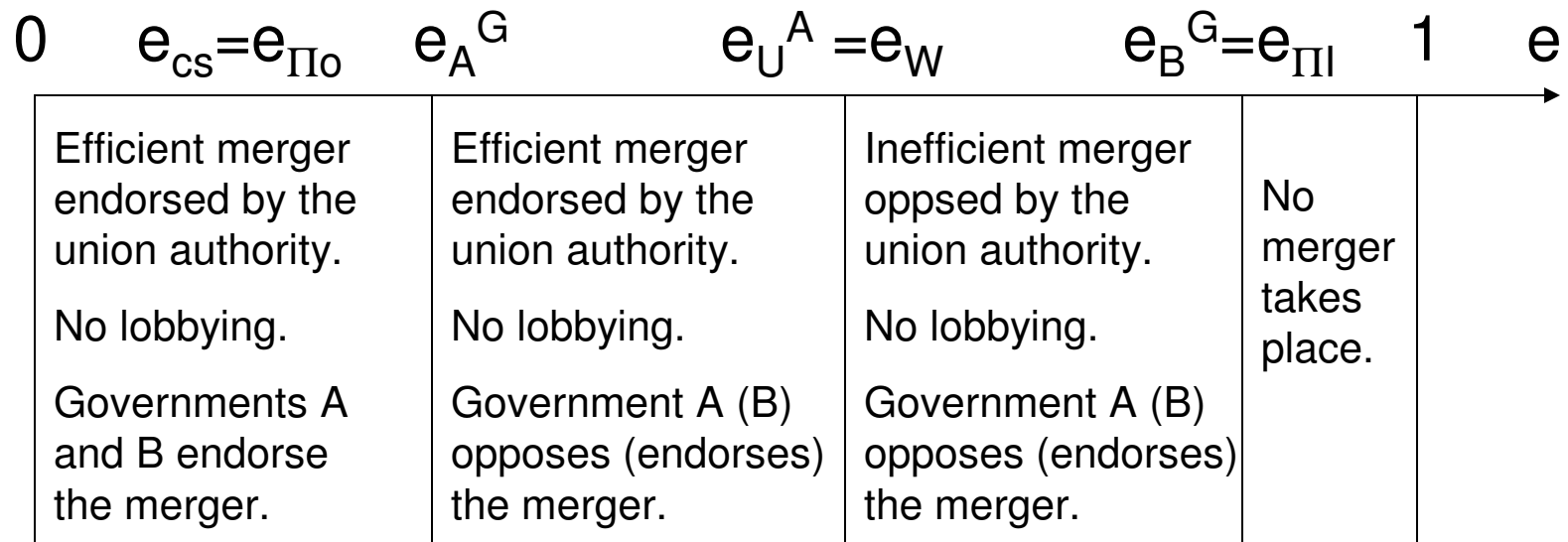


Figure 13. The political economy of *cross-border EU mergers*:
Politically motivated governments, insider in B, insider and outsider in A

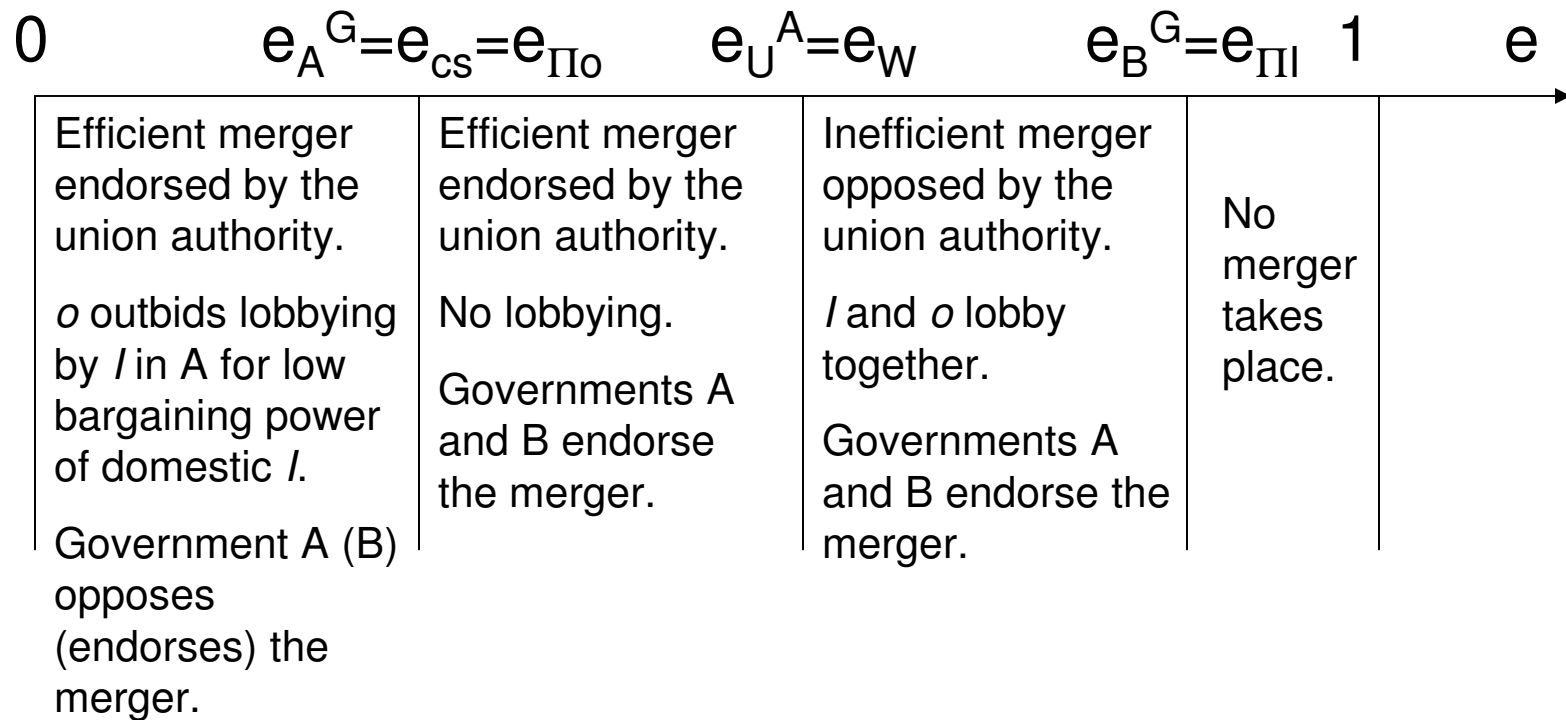


Figure 14. Political versus bureaucratic bias

