Scale Economies and Synergies from Mergers and Acquisitions

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Introduction

The American public is increasingly skeptical of large companies, with particular animus reserved for tech giants. A June 2021 poll from the Pew Research Center found that 56% of Americans support more regulation of tech companies.[1] Following this apparent public concern, lawmakers in Washington have proposed new measures to rewrite America's antitrust laws and make it harder for big companies to acquire and merge with smaller ones. Senator Amy Klobuchar articulated this political hostility toward big tech in November 2021 when she warned that tech giants increasingly "choose to buy their rivals rather than compete."[2]

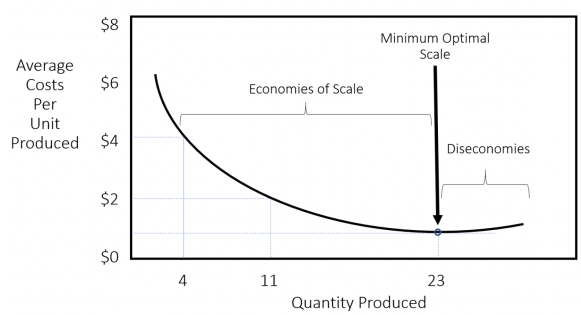
While legislative efforts to reign in mergers and acquisitions might be politically and publicly popular, such rules could negatively impact consumers by denying businesses the opportunity to generate economies of scale that allow them to lower prices and enhance the range of goods and services they provide.

Economies of Scale

Economies of scale are cost advantages reaped by companies when production becomes efficient. Companies can achieve economies of scale by increasing production and lowering per unit costs.

Figure 1 shows the relevant range of production, where a firm's average costs fall as output expands. At the minimum optimal scale, firms can achieve their most efficient level of production and would be a necessary condition for the maximization of consumer welfare.

Figure 1: Lower Costs, Lower Prices



Amazon, for example, can negotiate discounts with the U.S. Postal Service due to the sheer number of packages it sends through its system. These savings are then passed through to consumers in the form of

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[1] Pew Research Center, "56% of Americans Support More Regulation of Major Technology Companies," July 20, 2021. Available Online: https://www.pewresearch.org/fact-tank/2021/07/20/56-of-americans-support-more-regulation-of-major-technology-companies/.

[2] Amy Klobuchar, "Klobuchar, Cotton Introduce Bipartisan Legislation to Protect Competition and Consumer Choice Online," November 5, 2021. Available Online: https://www.klobuchar.senate.gov/public/index.cfm/2021/11/klobuchar-cotton-introduce-bipartisan-legislation-to-protect-competition-and-consumer-choice-online.

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no-cost or low-cost shipping. Generally, economies of scale result in lower prices and make more goods and services available for consumers. For businesses, economies of scale mean greater operational efficiency, which contributes to earnings and the ability to invest in their company.

The optimal scale of production, however, can vary by industry, as the type of business can influence a company's ability to reduce costs, increase production, and standardize its processes. For example, the service industry relies more on labor skills and less capital cannot as easily capture economies of scale in the same way as manufacturers can. For more capital-intensive firms, using economies of scale is a strategic way that can help improve efficiency to drive down costs and prices, thereby helping businesses in the service sector and consumers alike.

Yet, Congress is now considering a bill that could disrupt how companies achieve their minimum optimal scale, thereby creating inefficiencies and potentially forcing consumers to pay more for goods and services.

Current Legislation

Mergers and acquisitions in the United States are currently governed by Section 7 of the Clayton Act, which only prohibits mergers and acquisitions if it "may substantially lessen competition, or to tend to create a monopoly."[3] In addition, in its merger guidelines, the Federal Trade Commission (FTC) and U.S. Department of Justice (DoJ) state that mergers and acquisitions "should not be permitted to create, enhance, or entrench market power."

Following the Clayton Act, Congress passed the Hart-Scott-Rodino Act in 1976, requiring companies to file pre-merger notifications with the FTC and the DoJ's antitrust division.[4]

While new antitrust proposals do not explicitly prohibit companies from taking advantage of economies of scale,[5] they could make it harder for companies to achieve operational efficiencies that would otherwise have occurred from mergers and acquisitions. Blocking mergers could prevent instances when the two firms involved in the merger or acquisition are stronger, more productive, and more efficient together than apart.

Companies can generate economies of scale by merging or acquiring other companies and also can benefit the acquired company by providing it with the capital and business environment to speed its growth. This could provide the acquiring and acquired company a more significant market share and allows them to benefit from optimized modes of production, greater negotiating power, new marketing channels, specialized knowledge, and access to lower borrowing costs.

All of these benefits of scale and scope have the potential to allow companies to sell their goods at lower prices. Mergers and acquisitions also allow companies to expand

[3] *Federal Trade Commission*, "Clayton Act." Available Online: https://www.ftc.gov/legal-library/browse/statutes/clayton-act.

[4] *Federal Trade Commission*, "Hart-Scott-Rodino Antitrust Improvements Act of 1976." Available Online: https://www.ftc.gov/legal-library/browse/statutes/hart-scott-rodino-antitrust-improvements-act-1976.

[5] *See*: U.S. Congress, Senate. *Platform Competition and Opportunity Act of 2021,* S.3197, 117th Cong.,1st session, introduced in the Senate November 4, 2021.; U.S. Congress, House, *Platform Competition and Opportunity Act of 2021,* H.R. 3826, 117th Congress, 1st session, introduced in House June 6th, 2021.

the range of competitive goods and services. For example, in 2005 Google acquired Android. This acquisition allowed the search engine to move into mobile operating systems and compete with Apple.

Current antitrust proposals could prevent large companies,[6] particularly the tech giants, from acquiring other companies and allowing smaller start-ups to grow and generate economies of scale that ultimately benefit consumers.

The House of Representatives and Senate are considering versions of the Platform Competition and Opportunity Act (PCOA). While specific provisions differ, both bills would establish "that certain acquisitions by dominant online platforms are unlawful."[7] If enacted, PCOA would outlaw all but the smallest acquisitions by large technology platforms. Under a narrowly tailored "covered platform" designation, the bill specifically targets a number of platforms—Amazon, Apple, Google, Meta, and Microsoft— based on their sales, capitalization, and user thresholds while excluding other large competitors.

More specifically, once designated a covered platform, they would be prohibited from acquiring directly or indirectly "the whole or any part of the stock or other share capital of another person engaged in commerce or in any activity affecting commerce" or "the whole or any part of the assets of another person engaged in commerce or in any activity affecting commerce."[8]

Unfortunately, the bill does not provide an exemption for mergers or acquisitions that enhance consumer welfare, suggesting that consumer welfare is left on the back burner.

Under the Merger Fee Modernization Act, Congress is also considering increasing federal antitrust agencies' resources by increasing pre-filing merger fees for large mergers (see Figure 2).[9]

Figure 2: Proposed changes in merger filing fee structure

Deal Size	Old Fee	New Fee
Less than $161.5 million	$45,000	$30,000
$161.5 million to $500 million	$125,000	$100,000
$500 million to $1 billion	$125,000 - 280,000	$250,000
$1 billion to $2 billion*	$280,000	$400,000
$2 billion to $5 billion*	$280,000	$800,000
$5 billion and higher*	$280,000	$2,250,000

While increasing resources for the perceived understaffed agencies is not necessarily problematic, doing so without giving appropriate oversight over how the agencies will use these resources is rather concerning.

Additionally, by increasing merger fees, Congress will disincentivize companies from seeking economies of scale and lowering prices for consumers. The increased fees will make it harder for smaller companies to be acquired and leverage the economies of scale and investments large companies can offer. Foreign competitors will not have these disadvantages.

[6] As NERA Economic Consulting finds, proposals to prohibit mergers and acquisitions apply to just five companies, Google, Apple, Facebook, Amazon, and Microsoft.

[7] Platform Competition and Opportunity Act of 2021, H.R.3826, 117th Congress (2021-2022). Available at https://www.congress.gov/bill/117th-congress/house-bill/3826/text.

[8] Ibid.

[9] Merger Filing Fee Modernization Act of 2021, S.228, 117th Congress (2021-2022). Available at https://www.congress.gov/bill/117th-congress/senate-bill/228/text.

Mergers, Acquisitions, and Consumer Welfare

Any bill prohibiting tech giants from mergers and acquisitions would profoundly harm consumers, increase prices, and depress innovation. These factors alone should clearly warn policymakers about the dangers of rewriting the laws governing mergers and acquisitions in the United States.

Without the potential boost from mergers and acquisitions, smaller companies are unlikely to be able to achieve the economies of scale and operational efficiency offered by larger corporations. Amazon's acquisition of Whole Foods serves as a clear example.

In 2017, Amazon acquired the grocery chain Whole Foods for $13 billion,[10] a store that had earned the nickname *Whole Paycheck* because of a public belief that it was expensive and out of reach to most consumers.[11] However, Amazon's acquisition of Whole Foods enabled the grocery store to negotiate lower prices from suppliers and utilize a highly specialized distribution network.[12] As a result, Whole Foods expanded into new markets and slashed prices for consumers by 30%.[13] As a result, more consumers could purchase high-quality and organic groceries from Whole Foods. Today, Amazon Prime members can receive an additional 10% off their purchases in these stores.

Mergers and acquisitions also incentivize innovation. Studies from Bain and Company have shown that entrepreneurs establish start-ups with the explicit goal of being acquired by one of the major tech giants who can scale their products and distribute them to more consumers.[14] Bain and Company found that 58% of U.S. tech start-ups expected to be acquired and that acquisition was the principal reason they founded their start-ups.[15]

Economic analysis supports this finding. Specifically, NERA Economic Consulting found that the immediate effect of the common carrier regulations, and structural separation and line of business restrictions on the five companies currently covered by the proposed bills would cost approximately $300 billion.[16] To make matters even worse, a prohibition on mergers and acquisitions would cut venture capital investment by 12%. Without the incentive of mergers or acquisitions or access to investments, entrepreneurs are less likely to establish new start-ups that bring a range of new goods and services to consumers.

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[10] Seth Stevenson, “It’s Finally Clear Why Amazon Bought Whole Foods,” *Slate*, June 28, 2021.

[11] Kelly Tyko, “Bye-bye, ‘Whole Paycheck’? Amazon’s Whole Foods Market Cutting Prices Starting Wednesday.” *USATODAY*, April 1, 2019. Available at https://www.usatoday.com/story/money/2019/04/01/whole-foods-prices-amazon-announces-cuts-and-more-prime-benefits/3335214002/.

[12] Stevenson, 2021.

[13] Ibid.

[14] Christian Dippon and Matthew Hoelle, “The “Economic Costs of Structural Separation, Line of Business Restrictions, and Common Carrier Regulation of Online Platforms and Marketplaces. A Quantitative Evaluation” NERA Economic. Consulting, March 18, 2022. Available Online: https://www.nera.com/content/dam/nera/publications/2022/Platform_Regulation_Quantitative__03_18_22.pdf.

[15] David Crawford and Michael Schallehn, “Regulate With Care: The Case for Big Tech M&A,” *Bain & Company,* September 20, 2021. Available Online: https://www.bain.com/insights/big-tech-mergers-and-acquisitions-regulate-with-care-tech-report-2021/.

[16] Dippon and Hoelle, “The “Economic Costs of Structural Separation, Line of Business Restrictions, and Common Carrier Regulation of Online Platforms and Marketplaces. A Quantitative Evaluation,” p. 55.

Uneven Playing Field

A principal flaw in Congress' plans to prohibit mergers and acquisitions is that it would only apply to certain companies while exempting others. The language of PCOA is written in such a way to only apply to online platforms, not traditional brick and mortar stores such as Target, Walmart, Best Buy, or Barnes and Noble. This means Congress would be establishing an uneven regulatory environment that supports one form of business over another. Moreover, given trends in shopping and the move toward e-commerce, bills such as PCOA would make it harder for consumers to use a method of shopping they overwhelmingly favor.

Conclusion

With growing public hostility toward tech giants, it is understandable that lawmakers have proposed a raft of new antitrust measures that would alter how they operate. However, for consumers, such proposals that prohibit mergers and acquisitions could deny small businesses the opportunity to grow, innovate, and lower prices for goods and services for the benefit of consumers. As shown by Amazon's acquisition of Whole Foods, the history of mergers and acquisitions is just one case where consumers have benefited. Lawmakers must not let techlash blind them to the potential for consumer benefits from mergers and acquisitions.