We know that freer trade between countries usually increases efficiency by reallocating resources from less productive plants to more productive plants. **Holger Breinlich** finds that it can also have a significant impact on mergers and acquisitions activity – which has important implications for competition policy.

Trade liberalisation and the market for corporate control

What are the effects of freer trade on employment, productivity and other aspects of economic activity? Recent research in the area has shifted attention from broad cross-country comparisons towards firm- and plant-level responses to trade liberalisation. This focus on micro-level adjustment processes has allowed researchers to disentangle the influence of trade from other factors that shape economic activity.

A central insight from these studies is that a substantial part of the impact of freer trade works through a reallocation of resources across individual plants and firms. In particular, the contraction and exit of low productivity establishments and the expansion of more productive ones can explain a sizeable share of aggregate productivity increases (and job losses) found in the wake of trade liberalisations.

But a question that remains unresolved is whether plant closure, contraction and expansion really are all there is to firm-level adjustment to free trade. In particular, only scarce attention has so far been paid to adjustment through the market for corporate control – that is, through mergers and acquisitions (M&As).

This is despite the fact that M&As can, in principle, play a similar role as the adjustment processes highlighted in previous research. Instead of closing down establishments, reducing output or exiting altogether, firms also have the option to search for buyers interested in all or parts of their operations. Similarly, expanding firms can buy and integrate other firms rather than increasing production at existing plants or opening new ones.

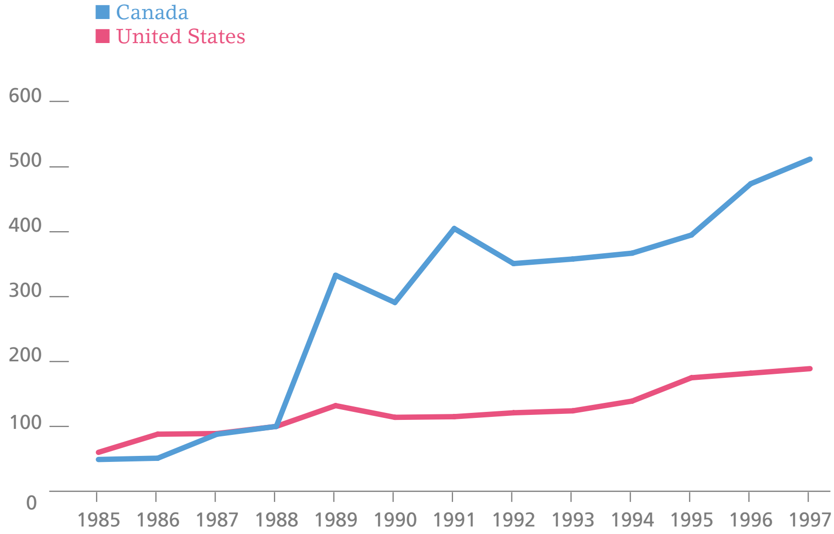
My research tries to fill this gap by evaluating empirically whether M&As do indeed play a role in industrial restructuring in the face of trade liberalisation. This is not only of academic interest but could have much wider implications. Most importantly, M&As are not just another way of transferring resources but are likely to be qualitatively different from the other forms of adjustment in that they are swifter and potentially more efficient.

Instead of workers and capital becoming unemployed for some period before being rehired, acquisitions allow for an immediate transfer into new ownership. M&As also allow the takeover of entire production structures, which may be most efficient if preserved as a whole. These observations might have important implications for the design of competition policy after trade liberalisation.

The first question, however, is whether we can indeed link increases in M&A activity to trade liberalisation. I approach this question by examining the impact of one particular liberalisation: the 1989 Canada-United States free trade agreement (CUSFTA), under which the two countries agreed to phase out their bilateral tariff barriers within a decade. I look at manufacturing firms, since these produce the largest fraction of tradable goods and are thus most directly affected by trade liberalisation.

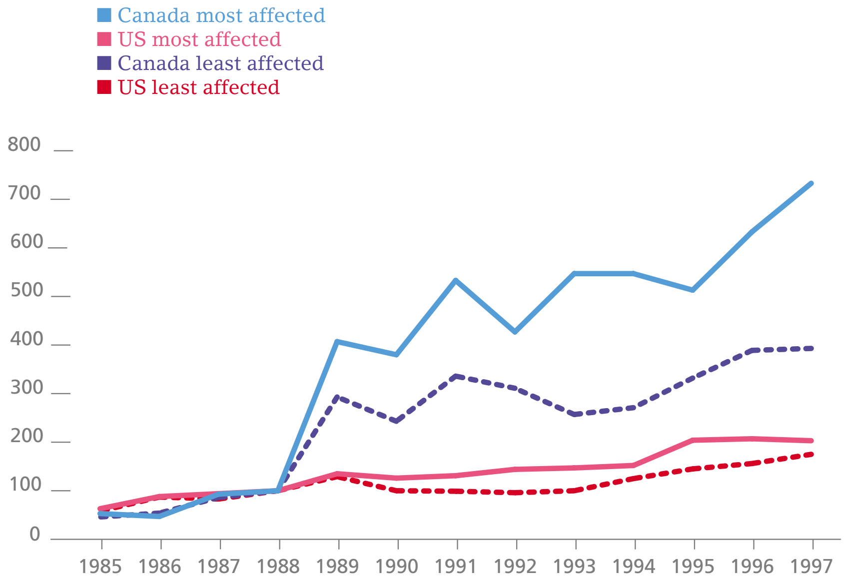
Figure 1 shows that there was a jump

Figure 1:
Number of M&A transactions in manufacturing in Canada and the United States (1988 = 100)



Source: Thomson Financial, author's calculations

Figure 2:
Number of M&A transactions, comparing the manufacturing industries with the highest and lowest tariff cuts as a result of the CUSFTA (1988 = 100)



Source: Thomson Financial, Statistics Canada, author's calculations

Mergers and acquisitions are an efficient way of transferring resources towards more productive owners

Table 1:
Resource transfer in Canadian and US manufacturing firms via contraction, M&A and bankruptcy

Yearly sample averages 1985-97	Canada	United States	Total
(1) Total employment ('000s)	**757.0**	**15496.8**	**16253.8**
(2) Gross job reductions at continuing firms ('000s)	32.6	744.7	777.3
(3) Job reductions through bankruptcy/liquidation ('000s)	0.5	11.2	11.6
(4) Job transfers through M&A ('000s)	14.3	263.3	277.6
(5) Total job transfers ('000s) – sum of (2)-(4)	47.4	1019.2	1066.5
(6) Total job transfers as percentage of employment – (5)/(1)	6.3%	6.6%	6.6%
(7) M&A as percentage of total job transfers – (4)/(5)	30.2%	25.8%	26.0%
(1) Total output (millions of 1995 US$)	**147,448**	**3,007,327**	**3,154,775**
(2) Gross output reductions at continuing firms (millions of 1995 US$)	7,159	96,564	103,723
(3) Output reductions through bankruptcy/liquidation (millions of 1995 US$)	101	1,374	1,476
(4) Output transfers through M&A (millions of 1995 US$)	3,812	42,744	46,556
(5) Total output transfers (millions of 1995 US$) – sum of (2)-(4)	11,072	140,682	151,755
(6) Total output transfers as percentage of output – (5)/(1)	7.5%	4.7%	4.8%
(7) M&A as percentage of total output transfers – (4)/(5)	34.4%	30.4%	30.7%

Note: The table shows the amount of job and output transfers via contraction at continuing firms and via exit by bankruptcy/liquidation and M&A. 'Total employment' and 'Total output' are obtained by summing over all firms active in a given year. 'Gross job/output reductions at continuing firms' are the sum over all employment/output reductions at continuing firms as compared to the previous year. 'Job/output reductions through bankruptcy/liquidation' and 'Job/output transfers through M&A' are the sum over the last available employment/sales figures for firms exiting the dataset in a given year due to bankruptcy/liquidation or M&A.
Source: Compustat, author's calculations

in M&A activity in Canadian manufacturing in 1989, the first year of tariff cuts. Nothing much seems to have happened in the United States but that is consistent with what we would expect. Since the US market is ten times the size of Canada, the trade integration shock was much smaller there. Still, we would like to be sure that nothing else was going on at the time of the CUSFTA's implementation that might have caused this jump, for example, changes in economy-wide activity or stock market valuations.

This is why Figure 2 plots two lines in the figures for both the United States and Canada. The solid line represents M&A activity in the 50% of industries most affected by the CUSFTA, that is, the ones with the highest domestic tariff cuts. Obviously, there will be greater pressure for adjustment after trade liberalisation the larger the increase in exposure to foreign competition, that is, the larger the tariff cuts. We would thus expect this line to be above the dashed one (which represents the remaining 50% of industries) after 1989 but not before it.

Again, this was clearly the case for Canada and much less for the United States. In other words, it seems that M&A activity changed after 1989 in exactly the way we would expect if trade liberalisation drove the changes.

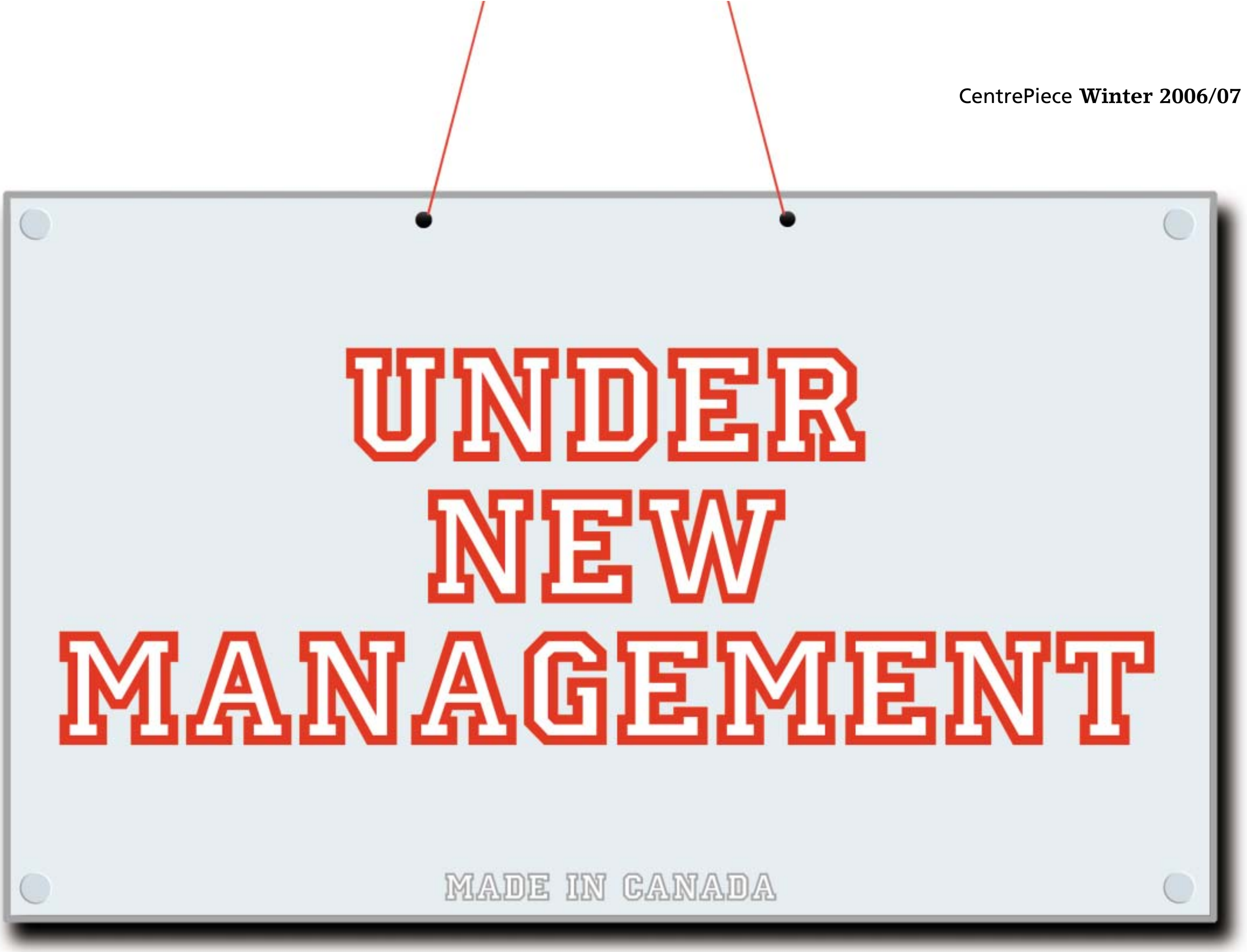
The results from these simple graphs are supported by more complex econometric evidence, quantifying the different effects. In particular, I find that every percentage point cut in domestic tariffs led to an increase in M&A activity in Canada of the order of 10-11%. Given that the average tariff cut across Canadian industries was 7 percentage points, this implies a trade-induced increase in M&A activity of over 70%.

The increase in the United States was again much smaller: an increase in M&A activity of 0.7-0.9% per percentage point in tariff cuts. Given that US domestic tariffs only declined by about 4 percentage points, this yields an overall effect of just 3%.

While the figures for Canada are certainly very large, they are not implausible: the number of domestic M&A transactions in Canada increased by over 300% in the 1990s (and by 150% in the United States). While the CUSFTA thus played a role, it was certainly not the only influence on M&A activity.

Having established that the CUSFTA led to an increase in M&A activity, I now turn to two related questions. First, previous studies focusing on plant closures, contractions or expansions have shown that resources seem to be transferred towards more productive firms and plants after trade liberalisation (since these are the ones that expand). Thus, the question arises whether M&As also transfer resources towards more productive owners.

My research suggests that this is indeed the case: Canadian acquirers were on average 9-16% more productive than



Canadian targets. Since previous research has shown that M&As tend to increase joint productivity levels when the acquirer is more productive, this suggests that the CUSFTA triggered an efficiency-enhancing M&A boom in Canada.

My second question is whether the observed increase in M&A activity is quantitatively important compared with the forms of adjustment previously studied. Table 1 provides some evidence in the affirmative. It reports that in the period studied (1985-97), M&As were responsible for about 30% of output and employment transfers away from contracting firms.

To summarise, it seems that CUSFTA did lead to an increase in M&A activity, that resources were transferred from less to more productive firms in the process and that the magnitude of the overall transfer was quantitatively important.

These findings highlight the fact that adjustment to freer trade can take less drastic forms than firm and plant closure and the associated mass layoffs of workers and liquidation of capital. Indeed, if M&A does represent a swifter and more efficient way of transferring resources between firms, this has important implications for competition policy.

In particular, one would like antitrust authorities to facilitate the necessary transfer of resources by reducing restrictions on acquisitions in the wake of trade liberalisations. Given the generally higher level of restrictions imposed on M&A activity in developing countries, this proposition could be of particular relevance there.

This line of thought is reminiscent of certain strands of research in corporate finance (notably those associated with Michael Jensen), which argue that takeovers represent a far superior way of restructuring industries than internal adjustments or bankruptcy and as such should not face unnecessary legal restrictions.

Trade liberalisations like the 1989 Canada-United States free trade agreement increase M&A activity

This article summarises 'Trade Liberalisation and Industrial Restructuring through Mergers and Acquisitions' by Holger Breinlich, CEP Discussion Paper No. 717 (http://cep.lse.ac.uk/pubs/download/dp0717.pdf).

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