Reply on Comment "Small Firms and the Merger Mania"

Karl Aiginger

ABSTRACT. Research on performance differences between small and large firms is booming. It emerges relatively separated from the mainstream Industrial Organization Literature. Inspired by Levy's comment on an earlier paper we try to bridge the gap between the two areas. Especially we screen non cooperative game theoretical models for predictions on performance differences. Most of them forecast higher profits for larger firms, but there exist also some models which predict the opposite for very specific circumstances.

While it is easy to envision the reasons for integration, it is harder to articulate costs of increased size, Holmstrom and Tirole, 1989

1. Introduction

Levy (1993) has commented on our article in which we tried to bring together the literature on the size-profitability relationship and on the success of mergers (Aiginger and Tichy, 1991). He offers some additional hypotheses why larger size or mergers could be profitable referring to literature offered by Industrial Organization. In section 2 we will react on the comments and relate them to our article and to some empirical trends. In the following sections we will follow Levy's direction and investigate further implications for the profitability-size issue offered in the literature. We will especially investigate what the game theoretical strand of Industrial Organization predicts for the relationship between firm size, concentration and profits (and to some degree on the merger profitability issue).

Final version accepted on October 15, 1992

Austrian Institute of Economic Research
Vienna, Austria

2. Firm specific capital, life cycles and integration

One question industrial organization literature addresses with great intensity is why firms exist. Transaction cost, contractual reasons, firm specific capital are some of the explanations. Levy focusses on "firm specific capital" especially learning by doing, knowledge of a firm about employees capabilities and their efforts. This capital "may be employed . . . in different product lines or . . . areas". This clearly is an important potential for economies of scope. If it is empirically relevant diversified firms should have higher profits (in addition to eventual economies of scale for each product line).

Mergers, Levy continues, may "promote anticompetitive behavior", we will come to this point later. And mergers may also be efficient as "a way of quickly becoming established in another product line". This is a nice *potential* source of efficiency gains of mergers, which does not depend on cost reductions due to larger batch sizes. Whether it is empirically relevant has yet to be investigated. There is some scepticism about "too much diversification" of firms in the empirical literature lately.

Another argument that sounds very attractive, namely that "small firms in young industries" should be integrated, while larger firms in mature industries become less integrated. A quick check of Austrian data (manufacturing, 1988) provides some preliminary evidence. The value added-sales ratio is lower for basic goods (34.5%), than for engineering products (38.2%), the latter probably representing younger products, the earlier comprising mature products. It looks, however, as if larger firms had a higher degree of integration (39.0%) then smaller firms (33.2%). But this hypothesis is open for empirical investigation.

Small Business Economics 5: 27—34, 1993.

SBEJ 92-207