

**MERGER ENFORCEMENT GUIDELINES IN JAPAN:  
DOES JAPAN NEED THE EFFICIENCY DEFENCE?**

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## **ABSTRACT**

Over the past two decades there has been a dramatic increase in merger activity in Japan. In response, the Japan Fair Trade Commission (JFTC) published guidelines to inform stakeholders how it implements the merger provisions of the Anti-Monopoly Law (AML). Recently the JFTC has incorporated an expanded “efficiency defence” available to merging parties. This research provides a critical appraisal of the JFTC’s efficiency defence guidelines. It begins with a review of the development of the AML. This is followed by a description of the recent changes in the type and level of merger activity in Japan. The theoretic foundations for different welfare standards underlying an efficiency defence are explained. The JFTC’s efficiency defence guidelines are set out and are contrasted with relevant guidelines in other countries. Finally, the JFTC’s efficiency defence guidelines are critically evaluated in terms of the need for such a defence, and the workability of the rules.

**Keywords:** economics, mergers; guidelines; efficiency defence; Japan; antitrust policy

*To my parents and Julio*

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# 1 Introduction

Given the recent surge in the number of mergers and acquisitions (M&A) in Japan, the content and enforcement of Japanese antitrust law dealing with mergers are receiving an increasing amount of attention. Considering that there used to be much fewer merger cases to review in Japan, merger policy may require appropriate modifications in order to handle the increasingly large number of cases. To illustrate the magnitude of the current M&A wave, the number of M&A deals in Japan reached 2,674 in 2006 in comparison to about only 500 per year in the 1990s (Miyajima, 2007).

The antitrust environment in Japan is defined by the Anti-Monopoly Law (AML) and the Guidelines to Application of the Antimonopoly Act Concerning Review of Business Combination (the Merger Guidelines). The role of the Merger Guidelines is to provide detailed information on how a merger review is carried out by the enforcement agency, the Japan Fair Trade Commission (JFTC). Therefore, with the recent increase in M&A activity, firms and researchers around the world are paying more attention to the guidelines. Thus, it is important that they are up to the standard of the corresponding guidelines in other countries such as the United States and Canada. If the merger guidelines in different countries are incompatible, this could hinder achievement of the benefits of cross-border mergers.

One section of the Japanese merger guidelines that requires modification is the section on the “efficiency defence” that allows anti-competitive mergers based on efficiency gains associated with them. The main purpose of this paper is to critically evaluate the efficiency defence in the Japanese context.

The merger guidelines of the U.S. and Canada in particular are the most advanced in the world today, and Japan can benefit from adopting features similar to those in their guidelines. In fact, the Japanese merger guidelines have been amended three times in the past decade, and various elements that are similar to those in the U.S. and the Canadian guidelines have been added. Among them were additions of details to the “efficiency defence” in 2004 and 2007. The section on efficiency considerations in the Japanese merger guidelines is now more similar to the corresponding section in the US Horizontal Merger Guidelines. In brief, potentially anti-competitive mergers that would lower production costs, and consequently decrease product prices to benefit consumers can be allowed.

This change is significant because whether firms can defend mergers on the basis of expected increase in efficiency will make a difference in management teams’ mindsets. That is, firms will consciously look for potential mergers that would cause significant cost reductions, rather than mergers that would solely increase their corporate value.

How exactly “efficiency” is defined is key to the discussion of costs and benefits considered in an efficiency defence. There are a number of standards used in the world

today. They include the price standard, the total surplus standard, and the distributional weights standard. Among them, the price standard is the one that only values consumer welfare in deciding whether a merger is allowed, and this is the standard adopted in the US. On the other hand, the distributional weights standard adopted by Canada is of a more neutral perspective because both consumer welfare and producer welfare are valued. At present, the Japanese merger guidelines seem to have the distributional weights standard with more emphasis on consumer surplus than on producer surplus. However, the exact weights are not specified, and there remain great ambiguities that will need to be addressed.

Defining what constitutes efficiency is deeply related to whether enhanced efficiency can be measured. Indeed, one reason for the U.S. to adopt the price standard, and thus to ignore producer surplus, is the difficulty of measuring changes in producer surplus. If mergers are reviewed based on their associated cost reductions alone, firms are likely to exaggerate their cost reductions, and it is impossible or at least very costly for antitrust authorities to prove that the firms are actually exaggerating them.

Overall, antitrust authorities have a responsibility to protect consumers from anti-competitive behaviours of firms, and it is easier for them to simply block all mergers based solely on the resulting market shares than to consider efficiency gains associated with individual merger cases. Nevertheless, as globalization makes international competitiveness a key to a country's economic success, protecting consumers' long-term interest by encouraging efficiency-enhancing mergers has become an important goal for

the state. Having a proper and effective efficiency defence in place can be considered a part of this big goal.

The structure of this paper is the following. In Chapter 2, the history of the development of the merger provisions of the Japanese Anti-Monopoly Law is reviewed. This includes a discussion of the level of enforcement by the JFTC, and how infrequent this enforcement was in the past. Then, Chapter 3 documents the recent changes in the level and characteristics of merger activity in Japan. Also, the chapter attempts to explain the changes in merger activity by discussing various social and economic changes including changes in people's attitudes, changes in laws, and an economic downturn. Chapter 4 examines the efficiency defence in detail. First, the economic theory of efficiency defence is presented. A graphical approach is used to explain a number of welfare standards. Then, the section on consideration of efficiencies in the Japanese merger guidelines is examined. In addition, the Japanese guidelines are contrasted with relevant guidelines in other developed countries. Finally, the Japanese efficiency defence guidelines are critically evaluated in terms of the need for such a defence, and the workability of the rules. Chapter 5 contains concluding remarks.

## **2 History of Merger Regulation in Japan**

### ***2.1 History of the Anti-Monopoly Law***

In this section, the history of the Anti-Monopoly Law is reviewed. In this process, it is helpful to review the history of the relationship between firms and the government in Japan. During the Meiji period (1868-1912), the government controlled the economy through its influence on socially significant industries such as consumer goods industries. Specifically, the government assigned certain families to be in charge of these industries, and controlled the economy indirectly through these families. The Meiji government was aware of the negative effects of the increased market concentration on small businesses and consumers in the economy. However, the most important task, at the time, was to industrialize Japan by achieving scale economies and encouraging heightened innovation by large-scale operations (Beeman, 2002).

Eventually, the families with the strong ties with the government formed “zaibatsu.” They were basically family-based conglomerates that had operations in both industrial and financial sectors of the economy. The largest zaibatsu were Mitsubishi, Mitsui, Sumitomo and Yasuda. With a large influence on the Japanese economy and a close relationship with the bureaucrats, zaibatsu helped the creation of a militaristic government, which led to World War II. Their capabilities to produce weapons were also significant in the war. At the end of WWII, the U.S. considered it necessary to dissolve these zaibatsu.

In 1947, the Supreme Commander of the Allied Powers (SCAP), led by General Douglas MacArthur, created the Law for the Elimination of Excessive Concentration of Economic Power and the Anti-Monopoly Law to break up each zaibatsu into smaller firms. At the same time, the New Constitution was introduced, and economic institutions such as tax systems and labour regulations were regenerated. What was behind these efforts was the concern that Japan might turn communist after WWII (Schaede, 2000). That would have brought major future conflicts with the US. All in all, it was necessary to set up institutions that would bring “economic democratization” to Japan (Schwindt & McDaniels, 2008).

The Japanese Anti-Monopoly Law (AML), prepared by the SCAP, adopted elements from the Sherman Act, the FTC Act and the Clayton Act of the U.S. (Schaede, 2000). The official name of the AML was the “Act concerning Prohibition of Private Monopolization and Maintenance of Fair Trade.” It prohibited unfair trade practices such as boycotting and dumping, and it also deemed all cartels per se illegal. The term “per se illegal” indicates that there is no valid excuse for cartels, and this is in contrast to the “rule of reason” standard where excuses are given consideration.

The major difference between the AML and the corresponding laws in the U.S. was the agency responsible for enforcing the law. In the case of Japan, only the Japan Fair Trade Commission (JFTC), which was also created in 1947, was responsible for enforcing the AML. In contrast, the responsibility was shared between the Department of Justice and the Federal Trade Commission in the US.

The JFTC was an administrative commission. The Japanese staff of the JFTC was gathered from different departments in the government as well as from large firms, and they were not particularly knowledgeable in antitrust. Therefore, the SCAP members had to educate and train the Japanese staff.

Despite these new institutions established by the SCAP, market concentration was increasing in the years after the war. It was partly because many small and medium-sized firms could not survive in the post-war years, and only large companies stayed in business. The whole Japanese economy went into a recession as well. Furthermore, even though zaibatsu were dissolved by the SCAP, many ex-zaibatsu firms re-emerged during the 1960s. Firms that used to belong to the same zaibatsu started to form horizontal alliances that were centered around a bank. These firms were also involved vertically through control of various factors of production. This is called the “keiretsu” system.

On the whole, it was difficult for the Japanese people to understand the link between antitrust and economic growth. It was particularly because, in the years before and during the war, cooperation between firms was indispensable for their survival. It was the culture of cooperation that prevented firms from failing and that helped the markets and the overall economy function smoothly. The government also believed in the power of cooperation. It implemented industrial policies that allowed firms to cooperate. For example, it encouraged mergers and Trade Associations that seemed to have helped Japan’s economic growth. Overall, the government prioritized success of Japanese exports in the world over reducing domestic market concentration. Even after Japan



achieved a certain level of economic growth, mergers were encouraged as a way to protect small and medium-sized firms.

Consequently, the idea that cooperation helps the economy function smoothly stayed as a common sense even after WWII. Schaefer (2000) calls this “cooperative heritage.”

Japanese industrialists believed that antitrust was a temporary movement that would disappear when the American occupation period was over.

In 1949, the AML was amended partly to allow mergers and cross-shareholding in the financial sector because it was a sector that was important for Japan’s economic growth. This amendment actually led to the creation of the main bank system (to be explained presently) which would continue to be a significant economic institution until the 1990s.

In 1953, which is after JFTC was left entirely to the Japanese staff, some more amendments were made to the AML. For example, the “rule of reason” standard was adopted for cartels which used to be per se illegal. This implies that cartels that were likely to lead to economic growth could be allowed. Also, the limit on the proportion of a firm’s stocks that one bank could hold increased from 5% to 10% (Scher, 2001). These changes reflect the Japanese tendency to go back towards the cooperative practices from the pre-war times.

During the 1960s, Japan achieved substantial economic growth through exports thanks to the industrial policies that emphasized exports – mainly in steel, automobile, electronics,

and textiles. According to Beeman (2002), the JFTC was not able to block mergers recommended by the “iron triangle,” or the coalition of ministries, politicians, and industrialists. Given the extremely hostile political influences on the JFTC in the 1960s, the number of formal JFTC actions stayed very low, ranging from 1 to 40 per year (Beeman, 2002). Judging from the low numbers of the JFTC actions, it can be concluded that there was almost no enforcement of the merger provisions of the AML.

However, towards the end of the 1960s, the JFTC started to see the need for more strict enforcement of the AML. It was partly because of the merger between Yawata Steel and Fuji Steel in the late 1960s that was particularly harmful to consumer welfare. The merger, which the JFTC attempted to block, was carried out due to a strong support from the Ministry of International Trade and Industry (Beeman, 2000). This incident made consumers aware of the need to balance industrial policies and competition policy properly. The consumer boom that was also happening in the late 1960s made consumers more interested in antitrust issues. That is, the JFTC started to receive the public support which it had not had before.

Nevertheless, certain events that occurred in the early 1970s required the Japanese government prioritize protection of domestic firms over antitrust enforcement again. First, in 1971, trade between Japan and the U.S. changed significantly as the Nixon government adopted a 10% surcharge on all imports. At the same time, the yen-dollar exchange rate, which had been fixed at 360 yen per US dollar, was suddenly allowed to float. This led to considerable appreciation of the yen against the dollar, and the export

industries in Japan suffered greatly as a result. Therefore, the JFTC decided to relax antitrust enforcement in the hopes that cooperation between the firms would help them survive the downturn.

Then, there was the 1973 oil shock that again increased the demand for good antitrust enforcement. Although the oil shock originated in the Middle East, Japanese firms were partly responsible for the panic within Japan (Schaede, 2000). Taking advantage of the panic in the economy, some Japanese firms formed cartels to further raise prices.

Given this situation where firms raised profits by taking away from consumer welfare, the JFTC found it necessary to enforce the AML more strictly. The oil shock had the effect of raising the general public's awareness of the price impacts of cooperation between firms that operate in the same market. In short, the Japanese people started to understand the link between antitrust and economic growth, and that became a pressure for the JFTC to perform better.

The result was the 1977 amendments to the AML. In general, the amendments made the JFTC more powerful. First of all, the JFTC was now able to break up large firms. It was also made easier to prove that there was anti-competitive behavior. The maximum fine for an illegal anti-competitive activity was raised from 500,000 yen to 5 million yen. Also, the maximum proportion of one firm's stocks that a bank could hold was reduced again from 10% to 5% (Schaede, 2000).

The 1980s can be characterized as a period of “gaiatsu,” or foreign pressures. The U.S., in particular, demanded changes in the Japanese legal and economic systems that would open the Japanese markets to U.S. exports. This led to deregulation in the financial sector which partially caused the subsequent bubble economy (1987-1991). In terms of competition policy, it became more important to have the antitrust environment that was comparable with other developed countries.

According to the JFTC (2006), a period of “aggressive development of competition policy” started in 1990. In 2005, the AML underwent the first comprehensive amendments in the last 25 years. The primary purpose of these amendments was to eradicate cartels. The amendments included an increase in the rate of surcharge for offenders, and the leniency program. The leniency program reduces surcharges for firms that report violations to the JFTC. It is reported that, since the adoption of this program, more than a hundred companies have disclosed information on price fixing in exchange for immunity.

## ***2.2 History of the Merger Guidelines***

When discussing regulation of mergers in Japan in more detail, it is necessary to study not only the AML but also the Merger Guidelines. It is because regulation stated in the AML is only concerned with the general concentration in markets. For example, Article 9 of the AML prohibits incorporation of a company which may cause excessive concentration of economic power, and Article 11 restricts the stockholding by a bank or

insurance company. However, these do not include information on how merger reviews are carried out in specific cases. That information is in the Merger Guidelines.

First of all, the Merger and Acquisition Division, within the Economic Affairs Bureau of the General Secretariat of the JFTC, is responsible for merger reviews. They enforce the “Guidelines to Application of the Antimonopoly Act concerning Review of Business Combination”, more commonly known as the Merger Guidelines. The history of the Merger Guidelines is significantly shorter than that of the AML. These particular guidelines were only launched in May 2004, and were amended most recently in March 2007.

In addition to the Merger Guidelines, there are also other guidelines that are relevant to many mergers. For instance, the “Guidelines for Merger Investigation concerning Cases on Corporate and Industrial Revitalization” were created in April 2003. They are often referred to as the “Special M&A Guidelines.” These guidelines are concerned with potential merger cases where the “Act on Special Measures for Industrial Revitalization” (Sangyō katsuryoku saisei tokubetsu sochihō) may apply. The Act and the guidelines were created in response to the problem of excessive debt and an immediate need for revitalization in certain industries (JFTC, 2003). The purpose of the Special M&A Guidelines is to expedite the process of merger reviews if the industry concerned requires urgent restructuring.

The relatively recent years of launch for these guidelines demonstrate that mergers started to increase only recently. Especially from 1950 to 1970, there were few mergers, and thus there was not much need for merger reviews and enforcement of the AML. The reason for the infrequency of mergers was twofold. First, mergers did not bring significant advantages to firms. Second, the firms found it difficult to implement mergers. The next chapter will explore the reasons behind the sudden increase in M&A activity in Japan.

## **3 Japan's Experience with Mergers**

### ***3.1 M&A Trends in Japan***

In Japan, there were few mergers after the end of WWII up to the 1970s. Although it is difficult to find reliable data on the number of mergers in the post-war period, Odagiri (1997) maintains that the number of mergers in Japan stayed at around 400 per year between 1950 and 1960. But, many of the mergers and acquisitions that occurred in the 1950s and 1960s were merely reformation of zaibatsu, which had been dissolved by the U.S. after WWII. The firms involved in M&A were small and they were also not competing firms in the same markets. According to Miyajima (2007), from the 1960s to the mid-1990s, there were only two to three M&A deals between publicly listed firms per year. Overall, although various sources quote different numbers, it is clear that the number of mergers stayed low before the 1980s.

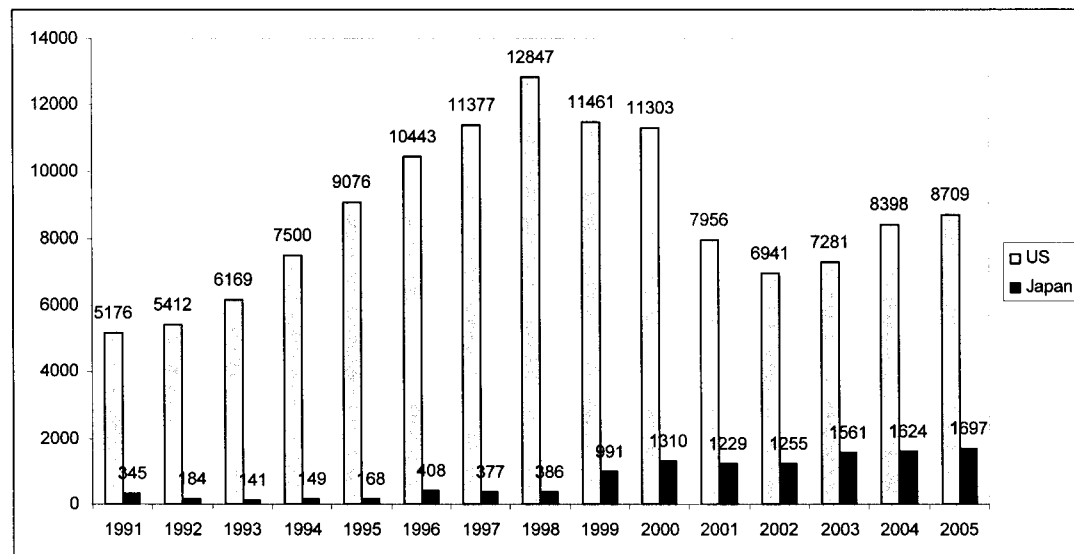
Then, the frequency of M&A increased. Particularly in the past two decades, the growth in M&A activity has been so dramatic that many call it the M&A wave. According to RECOF (2007), the number of M&A deals involving Japanese firms stayed at approximately 500 per year from the 1980s until 1996. However, starting in the late 1990s, the number started to increase sharply, and it reached 2,674 in 2006.

M&A deals can be categorized into three types: In-In, In-Out, and Out-In. In-In indicates M&A between Japanese firms while In-Out indicates M&A of foreign target firms by Japanese acquiring firms and Out-In means M&A of Japanese targets by foreign

acquirers. Among the three types, those between Japanese firms (In-In) clearly make up the majority of the total number of M&A, and their growth is also the most dramatic. However, there also was a sudden increase in M&A initiated by foreign firms (Out-In) in the late 1990s, and the level is still increasing gradually.

Despite the rapid increase in M&A transactions in Japan, the overall number of transactions is still not comparable to those of some other countries, especially that of the United States. Figure 1 shows that the number of domestic M&A transactions (In-In) per year in the U.S. has always stayed well above 5,000 since 1991, and it once reached as high as 12,847 in 1998. This is in stark contrast to the maximum number of 1,697 observed in 2005 for Japan (Jackson & Miyajima, 2007).

**Figure 1: Number of M&A transactions per year, 1991-2005**



Source: Figure constructed from data in Jackson and Miyajima [2007]



It is true that the number of M&A deals should be higher when the size of the economy is bigger, and that explains the higher number of deals in the U.S. and a lower number in Japan. However, although the U.S. economy is about 2.5 times as big as the Japanese economy by Gross Domestic Product, the number of M&A in the U.S. is at least five times as high as that of Japan. In 2006, the sum of M&A transaction values in Japan was approximately 3% of its GDP whereas in the U.S., it was about 10% (“Land of rising sums”, 2007). In conclusion, even with the M&A boom, the level of merger activity in Japan is still much lower than in the US.

Concerning the transaction formats of M&A, it is observed that private negotiations are the most common format in Japan. According to Jackson and Miyajima (2007), 50% of M&A deals between listed companies in Japan from 2000 to 2005 were effected through private negotiations as opposed to around 25% in the U.S., the U.K., France and Germany. This implies that takeover bids are rare in Japan. It is reported that, between 1991 and 2005, there were only 6 takeovers in Japan. In contrast, there were 332 hostile takeovers in the U.S., and 176 in the U.K. over the same period (Miyajima, 2007).

In terms of the sectors in which M&A activity is observed, a few specific sectors have prominently higher frequency of M&A. According to Miyajima (2007), the “banking” sector experienced the highest number of M&A deals in Japan between 1991 and 2005. M&A in the banking sector represented 30.9% of total M&A activity in terms of numbers of deals over this period. The “communications” sector, which is the sector with the highest frequency of M&A in the U.S., was the sector with the second highest number of

M&A deals in Japan with a 14.3% share. Then, “chemicals and allied products” sector and “non-depository credit institutions” sector followed with 5.5% and 4.0% shares, respectively (Miyajima, 2007).

In addition, what is particularly significant to note for this paper is the rise in horizontal mergers (i.e., mergers between direct competitors). Miyajima (2007) reports that, starting in the mid-1990s, an increasing number of firms in mature industries including oil refining, paper and pulp, steel and shipping are engaging in horizontal mergers.

Horizontal mergers are also on the rise in the “growth sectors” as demonstrated by the telecommunications sector. In this sector, mergers between competitors resulted in the creation of “three mega-carriers” – NTT DoCoMo, KDDI, and Softbank Mobile (Miyajima, 2007).

### ***3.2 Explanation of Higher Frequency of M&A in Japan***

The preceding section explained the M&A trend in Japan by presenting information on the frequency of M&A deals. This section explores some explanations of this trend.

Major explanations to be discussed are changes in people’s attitudes, changes in the laws, and changes in corporate practices including life-time employment. In addition, especially considering that the banking sector is the sector with the highest level of M&A activity in Japan, the relationship between the banking crisis of the 1990s and M&A activity is discussed.

### **3.2.1 Changes in Attitudes**

First of all, firm managements' views on M&A seem to have changed over the past two decades. During the 1990s, following the collapse of the bubble economy, there was an immediate need to restructure firms, and M&A was considered a tool to achieve this end. That is, M&A was a method to cooperate with other firms for the purpose of regenerating their operations. However, in the recent years, more and more firms engage in strategic M&A including hostile takeovers. A hostile takeover involves a firm acquiring another firm despite the target firm's unwillingness to be acquired. An example is a sensational case in 2005 where Livedoor – a young IT firm – attempted to take over Nippon Broadcasting Systems – a major radio station established in 1954. It demonstrates how ambitious executives started to use M&A as a strategy to increase their firms' corporate value regardless of social consequences.

Second of all, changes in shareholders' attitudes – particularly their perceptions of what a firm is – are closely related to the M&A wave. In the past, even if firms did not make extra efforts to increase dividends, Japanese shareholders were satisfied as long as the firms themselves were performing well in society. This was particularly true for shareholders who lived through the post-war times when rebuilding the overall Japanese economy was more important than each person's income (Kurube et al., 2007). However, recently, the Western concept that firms are owned by shareholders has caught on with Japanese investors – especially with younger investors. Shareholders' interest is now focused on dividends and potential capital gains than on the firms' culture, history and social reputation.

To illustrate, more “activist funds” are observed in the economy. A number of active stockholders with large funds take over a firm, change its operations, increase the value of its stocks, and sell the stocks at the end to make profits. The most well-known activist who has done this repeatedly in Japan is Yoshiaki Murakami, a head of Murakami Fund. It is possible that such takeovers contribute to increasing target firms’ efficiency and as such, contribute to improved resource allocation in the economy. On the other hand, there is a risk that firms lose long-term management strategy as a result of pursuing short-term returns. If so, this type of takeovers will not serve any purpose other than giving profits to a small group of active investors.

Lastly, how Japanese workers in general view M&A is changing. Legally, a firm is owned by its stockholders. Even so, in the past, it was a common sense that ownership does not give stockholders the right to do whatever they want with a firm especially if the firm has a large influence on society. In Japan, a firm was a self-perpetuating institution that was to pursue service to society first and profits second (“Hostility, of sorts”, 2007). Also, it was often considered as an extension of the family, and disposing a firm for money is considered “slavery – the sale of human beings” (Debroux, 1996). It is true in any country that employees and customers of a firm do not always easily accept its new management team and new stockholders after an acquisition, but it can be said that this problem was especially pronounced in Japan relative to other countries. However, in recent years, workers have grown more tolerant towards M&A.

Evidence is also found in the popularity of a 2007 television series called “Hagetaka” (or “Vulture” in English). It is a series about a fictional U.S. investment fund taking over ailing Japanese firms to change their operations and to eventually sell them to make profits. It also depicts the main bank system to be not functional in saving such firms. To its producer’s surprise, many viewers responded with positive attitudes towards the investment fund – in spite of its ruthlessness towards the Japanese firms’ managements (Fackler, 2007). All in all, M&A is now a socially-approved method for revitalizing ailing Japanese companies, and this has made it easier to implement mergers in Japan.

### **3.2.2 Change in Laws**

There have also been significant changes in the legal environment in Japan that made mergers less costly to implement. These changes include the adoption of the stock transfer system and lifting of the ban on holding companies. More importantly, in 1999, the share swap system was introduced. The share swap system enables acquiring firms to use stocks to pay for their acquisitions, and other minority shareholders are able to transfer their shares to the acquiring firms. The introduction of this system was significant for firms, such as those young firms in the IT industry, which had great growth potential but faced financial constraints (Miyajima, 2007). Indeed, Takafumi Horie, the former head of the aforementioned Livedoor, repeatedly used stock swap mergers to expand his companies.

As has been mentioned in the previous chapter, in 1999, the “Act on Special Measures for Industry Revitalization” was adopted. In addition, the “Special M&A Guidelines” that

complement the Act were created in 2003. The Act and the guidelines together enable firms in ailing industries to quickly find out whether their proposed mergers would be allowed by the JFTC.

Moreover, there were significant modifications in the Japanese merger guidelines, including additions of details on the efficiency defence. These changes will be discussed in Section IV together with detailed explanation of the efficiency defence.

On the whole, it is important to note that all these changes in the legal environment surrounding M&A activity were not entirely exogenous (Arikawa & Miyajima, 2007). In other words, firms that were interested in pursuing M&A strategies asked for legal reforms, and the resulting legal reforms in turn contributed to the rise in M&A activity in Japan.

### **3.2.3 Banking Crisis and the Collapse of the Main Bank System**

Since M&A activity in Japan is concentrated in the financial sector, it is important to discuss the significant changes that occurred in this particular sector in the recent past. There was a long-term banking crisis in Japan in the 1990s, and this changed the relationships between firms and banks.

In the past, the main bank system was prevalent in Japan. A firm's main bank is an institution from which the firm gets its largest share of borrowings (Hidaka and Kikkawa, 2004). In the main bank system, firms' main banks bail them out in times of financial

difficulties. This system emerged after WWII as firms found it cost-saving to delegate financial and managerial monitoring responsibilities to their main bank mainly because the main bank was better informed about the firms' prospects (Milhaupt, 2001). Hidaka and Kikkawa (2004) also maintain that a lack of human resources specialized in corporate monitoring after WWII made it necessary to gather the trained individuals in main banks where they could help a large number of firms. All in all, the main bank system worked in the post-war Japan because it provided effective monitoring to firms. To put it differently, the main bank system eliminated the role of shareholders in disciplining a firm's management.

Then, there was a banking crisis in the 1990s. According to Hosono, Sakai and Tsuru (2007), until the 1980s, all M&A activity in the Japanese banking sector was arranged by the government. The purpose was to make healthy banks acquire failing banks. However, as stock and land prices plunged at the end of the bubble economy in the early 1990s, even healthy banks were no longer able to help failing banks. The result was the 1997 banking crisis where a number of financial institutions actually failed including Hokkaido Takushoku Bank. The banks that did not fail turned to M&A for survival.

At the same time, more and more firms in other sectors had to turn to M&A when their financial conditions worsened because their main banks were no longer able to bail them out. Overall, the banking crisis and the subsequent demise of the main bank system contributed to the rapid rise in M&A activity throughout the economy.

### **3.2.4 The End of Life-Time Employment**

The Japanese corporate system also partly explains why there were so few M&A deals in the past. A prominent feature of the Japanese corporate system is life-time employment. Employees traditionally stayed in one firm for life since the seniority system made their wage increase over time even with no improvement in work performance, and a retirement allowance was guaranteed only if they stayed in one firm until retirement. Life-time employment was preferred by firms and by the government because it brought economic stability and social harmony. It should be noted that the Japanese economic policy has always placed an emphasis on full employment, and life-time employment was consistent with this goal.

This practice lowered the level of motivation for firms to engage in M&A activity. It is because such long-term commitment to employees made M&A not profitable for the acquiring firms that would be stuck with the acquired firms' employees. It was especially troublesome for foreign acquiring firms that would be stuck with Japanese employees. However, in recent years, more and more employees are temporarily hired. This change in the trend in employment style made M&A less costly to implement for the firms involved.

### **3.2.5 Other Factors Affecting M&A Trends**

Cross-shareholding between firms that operate in the same market has been common in Japan, and this had the effect of deterring any takeover attempt. The main bank system strengthened such cross-shareholding because groups of firms often owned a bank which



all of them used as their main bank (Schwindt and McDaniels, 2008). This made mergers very difficult to implement because shareholders would not easily sell their shares to acquiring firms. However, the level of cross-shareholding has decreased as the main bank system collapsed, and it became easier for takeover attempts to come to fruition.

Furthermore, there were changes in the accounting practices that reduced risks associated with M&A in Japan. In 1999, consolidated accounting and market-based accounting were adopted. The result was a higher level of transparency in financial performance of firms including target firms in M&A deals. It became difficult for firms to manipulate numbers to hide their actual financial conditions, and thus it became less costly for acquiring firms to find suitable target firms. It also reduced the likelihood that acquiring firms find target firms' actual financial conditions to be worse than expected after M&A.

Also, the influence of trade unions has been diminished as the practice of life-time employment became less common. Historically, Japanese trade unions often joined firms' managements in fighting attempted takeovers (Debroux, 1996). However, as a higher proportion of workers become contractual or part-time employees, acquiring firms in M&A deals can expect lower levels of resistance from such unions.

### ***3.3 Greater Frequency Implies Need for Enforcement***

In conclusion, this chapter documented the rapid rise in M&A transactions in Japan, and provided explanations for the rise. To summarize, various economic and social factors have made all types of M&A activity more attractive and less costly to implement in the

past two decades. In addition, starting in the 1990s, horizontal mergers started to increase as part of “consolidation of long-established industries” (Miyajima, 2007). Moreover, although Japanese firms historically used horizontal agreements rather than horizontal mergers to exert market power, in the recent past, anti-cartel enforcement has increased to make horizontal agreements more dangerous and therefore less likely (Schwindt & McDaniels, 2008).

Now, the key issue is whether anti-competitive effects of these horizontal mergers are too harmful for the JFTC to allow. The standard that determines which mergers are allowed or not allowed has to be clear and concise so that an increasingly large number of proposed mergers can be reviewed quickly. Also, firms are entitled to know how the JFTC views mergers so that they can predict the outcome of their acquisition strategies. In other words, it is important that the law is predictable and citizens are able to predict how authorities will view their behaviour. And, such standard that benefits society definitely can include the “efficiency defence” that encourages firms to seek mergers that reduce costs.

It should be noted that post-merger integration (PMI) has also become an important issue for merging firms. It is especially because stockholders feel the need to be convinced before the actual merger that effective PMI would follow. Then, even if firms do not actually use the efficiency defence for their proposed mergers to be allowed, proving efficiency gains could be necessary just to convince stockholders that PMI would be successful.

The standards set in the merger guidelines must protect society's interest, and at the same time, maintain a country's international competitiveness. Because of these conflicting goals, there are multiple interpretations to what policy is good to society. In merger review, there are several standards for measuring efficiency gains, such as the price standard and the total surplus standard, and each of them corresponds to different interpretation of what constitutes benefits to society. This issue will be discussed in the next chapter.

## **4 Merger Policy – Efficiency Defence**

### **4.1 *Explanation of the Efficiency Defence***

#### **4.1.1 Different Options**

In this chapter, the efficiency defence is discussed in detail. The efficiency defence compares the magnitudes of the positive impacts and the negative impacts of a proposed merger on the economy, and it defends those mergers whose positive impacts overcome their negative impacts.

To begin with, mergers may have positive impacts on the economy. It is because of economies of scale, economies of scope, and learning economies (Ilzkovitz & Meiklejohn, 2006). As a merger increases the scale of production, there will be a higher level of specialization as well as savings on fixed cost, and thus total cost falls. This is called economies of scale. On the other hand, when different types of production require the same inputs, integrating these operations through mergers may reduce total cost. This is referred to as economies of scope, and the concept of economies of scope is thus the opposite of that of economies of scale. Lastly, learning economies are achieved when merged firms have a higher level of accumulated knowledge which enables them to lower production costs.

These benefits can be both short-term and long-term. Economies of scale, economies of scope, and learning economies could be realized in the short run, but such benefits as technological innovation resulting from increased R&D may be achieved in the long run.

On the whole, the cost reductions caused by mergers make lower market prices possible and benefit consumers.

Nevertheless, reduced costs may not translate into lower prices due to firms' market power. Reduced competition associated with mergers has the effect of increasing firms' market power. Assuming that all firms maximize profits, they will increase prices if their market power is large enough to do so. Also, mergers increase risks of collusion by reducing the number of firms in a market and making it easier for them to collude.

Overall, the social welfare may be increased or decreased as a result of mergers. This is the Williamsonian welfare trade-off. Williamson (1968) maintained that mergers should be allowed if the efficiency gains exceeded the associated loss in consumer surplus (Ilzkovitz & Meiklejohn, 2006).

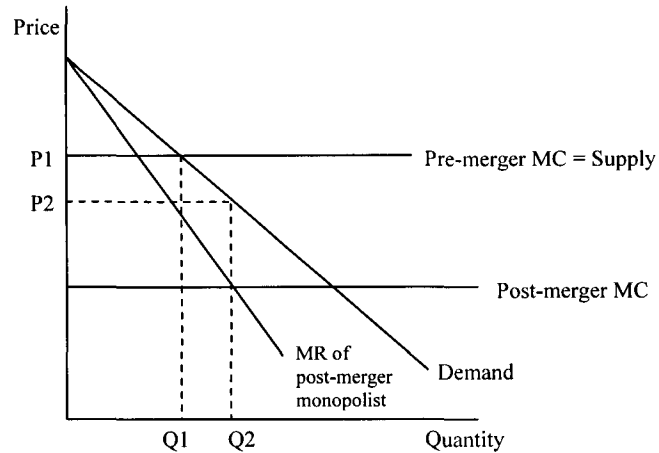
Now, specific methods of measuring changes in social welfare resulting from a merger are discussed. It must somehow be proven that the positive effects of an increase in efficiency offset the negative effects of the accompanying decrease in competition. However, there is no consensus as to which positive effects should be counted in the trade-off calculation. To illustrate, a society can be divided into consumers and producers. Although social welfare includes both consumers' welfare and producers' welfare, the appropriate weight that each should have on the total welfare may differ. This is because while all producers are also consumers, not all consumers belong to a small group of producers of a particular product. So, many claim that antitrust authorities

should only value consumers' welfare, and not that of producers. On the other hand, others claim that consumers' welfare and producers' welfare should be valued equally. This difference in opinion led to the existence of four major standards which will be discussed next.

#### **4.1.1.1 Price Standard**

First of all, there is the price standard. The simple economic model used in this section assumes that the marginal cost of production is constant. If a merger reduces the firm's marginal cost so much as in Figure 2, then the merger will be allowed under the price standard because there will be a gain in consumer surplus. Figure 2 shows that, before the merger, the market price and quantity were  $P_1$  and  $Q_1$  under perfect competition with a marginal cost equal to "pre-merger MC". Then, it is assumed that, after the merger, there is a monopolist in this market that determines the price and the quantity by equalizing MR and MC, thereby earning monopoly rents. This monopoly pricing usually results in a substantial lessening of consumer surplus. However, in this case, the post-merger MC is so much lower than the pre-merger MC that the resulting monopoly price ( $P_2$ ) is lower than  $P_1$ , and the quantity ( $Q_2$ ) is higher than  $Q_1$ . Therefore, consumer surplus, which is the sum of differences between consumers' willingness to pay and the price at each quantity, increases due to a merger. In short, the price standard allows a merger only if it results in a lower price and a higher quantity. One advantage of the price standard is that, since the concern is the resulting market price, demonstrating that firms' marginal cost falls as a result of a merger is not as important as with the other approaches. This is also good for authorities because it is difficult to verify firms' production costs.

**Figure 2: The Price Standard**



The merger passes the price standard.

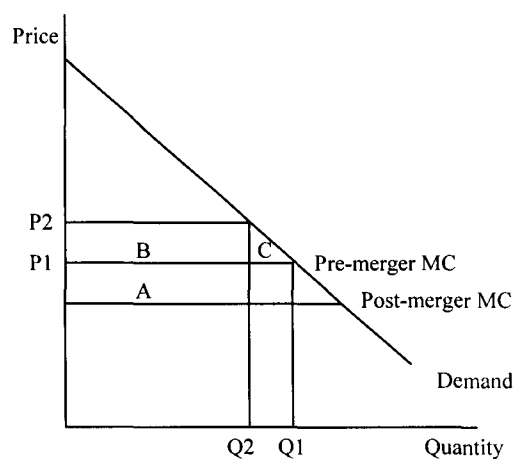
However, the price standard also has shortcomings. A major problem is that a merger rarely reduces production costs as dramatically as in Figure 2. If the standard is excessively strict, no firm can utilize the efficiency defence even when there are significant efficiency gains from a proposed merger.

#### **4.1.1.2 Total Surplus Standard**

The second option is the total surplus standard. In contrast to the price standard that only considers consumer surplus, the total surplus standard considers both consumer surplus and producer surplus in the trade-off calculation. Assuming that there is no fixed cost, producer surplus is the firms' profits, or the sum of the difference between the marginal cost and the price at each quantity sold. Under the total surplus standard, consumer surplus and producer surplus have equal weighting in the total surplus.

Even when the price rises and the quantity falls as a result of a merger, the total surplus standard may still pass a merger on the basis of efficiency gains. This is illustrated in Figure 3. Suppose that there was perfect competition before that merger that made the market price equal to the constant marginal cost of production,  $P_1$ . Then, a merger gives the firm enough market power to charge the price  $P_2$  which is above the marginal cost of production. As a result, allocative efficiency, or allocation of resources to their most valuable use, is disturbed. Overall, the merger creates a deadweight loss of area (C) and a loss in the consumer surplus of area (B). These are definitely negative effects on the social welfare. However, the merger also increases producer surplus by the area of (A) and (B) combined. Therefore, according to the total surplus standard, this merger should be allowed if area (A) is greater than area (C). In conclusion, it is much easier for a proposed merger to pass the total surplus standard than the price standard.

**Figure 3: The Total Surplus Standard**



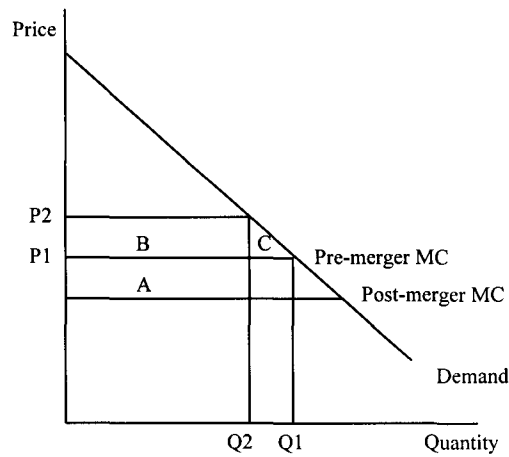
If  $(A) > (C)$ , the merger is allowed.



### 4.1.1.3 Consumer Surplus Standard

The third option is the consumer surplus standard. This approach is different from the total surplus standard in that area (B), or the amount of redistribution of surplus from consumers to producers, is considered only as a loss in consumer surplus, and not as a gain in producer surplus. That is, the redistribution of surplus from producers to consumers caused by a merger is considered only as a negative effect on the economy. Figure 4 summarizes this. In this case the merger is allowed if the increase in producer surplus attributable to cost savings (A) is greater than the reduction in consumer surplus (B+C).

**Figure 4: The Consumer Surplus Standard**



If  $(A) > (B+C)$ , the merger is allowed.

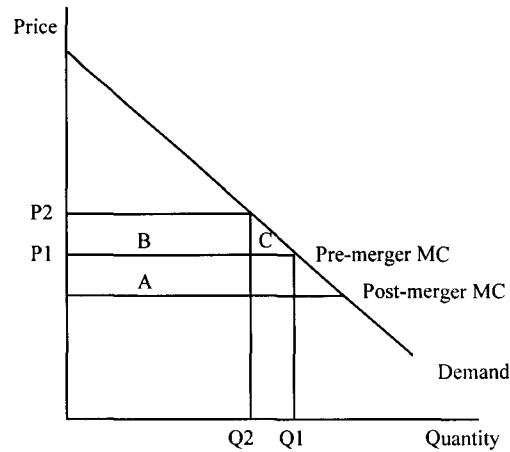
Pittman (2007) considers the consumer surplus standard to be more appropriate than the total surplus standard mostly because potential efficiency gains that firms report are not to be fully trusted. Also, he maintains that welfare of poor consumers is more in need of

protection than welfare of rich producers. These advantages also apply to the price standard, but the consumer standard achieves them without making the efficiency defence as difficult to use as the price standard.

#### **4.1.1.4 Distributional Weights Standard**

Lastly, the fourth standard to be discussed is the distributional weights, or the balancing weights, standard summarized in Figure 5. This standard was adopted in the Canadian merger guidelines in 2000. Although both of consumer surplus and producer surplus are taken into account when determining the effects of a merger on the economy, the weight that each should have depends on the particular merger case concerned. The greater the value of  $W_c$ , the greater the emphasis is on consumers' welfare. Similarly, the greater the value of  $W_p$ , the greater is the emphasis on producers' welfare. If both  $W_c$  and  $W_p$  equal 0.5, the distributional weights standard becomes the total surplus standard. At the extreme,  $W_p = 0$  implies no consideration for producers' welfare. Overall, the distributional weights standard requires a high level of discretion from the antitrust authorities because they will need to decide which group of people is more deserving: consumers or producers.

**Figure 5: The Distributional Weights Standard**



If  $(W_p)(B+A) > (W_c)(B+C)$ , the merger is allowed.  
 $W_c$  = the weight attached to losses in consumer surplus  
 $W_p$  = the weight attached to gains in producers surplus  
 $W_p + W_c = 1$

#### 4.1.1.5 Measurement Problems

All of the standards discussed above face the same measurement problems. First, the relevant market for a proposed merger must be identified correctly. In many countries including Japan, the market is defined using the SSNIP (small but significant non-transient increase in price) test. According to the SSNIP test with a 5% threshold, the relevant antitrust market is defined as the market where a hypothetical monopolist can no longer profitably raise the price by 5%. That is, if the hypothetical monopolist in the market raises price by 5%, consumers will switch to other products, and the resulting fall in the quantity demanded is high enough to make the price increase not profitable. For example, this method concludes that a relevant antitrust market can never be the market of energy, but it can be the market of gasoline. If regulators ever consider the market of

energy to be an antitrust market, it is too broad as a category that a hypothetical monopolist in this market can charge extremely high prices and still earn profit.

Second, information on demand is difficult to obtain. It is especially difficult to estimate elasticities of demand that determine slopes of demand curves. The same is true for obtaining information on supply curves.

In addition, even if there is perfect information about demand, pre-merger and post-merger costs, market prices, and quantities, these are all for one market. Considering that all markets are interconnected, the analysis of a single market to determine the total effects of a merger on the economy is not sufficient. It is because a merger in one market affects other markets – especially the markets of close substitutes and complements. For instance, a price rise in the gasoline market will have negative impacts on the consumers in the automobile market.

In addition, the distributional impacts of a merger are often a great concern for society. Some goods are necessity goods while other goods are luxury goods. If our society is to pursue vertical fairness, a system where consumer surplus of the poor is valued more than that of the rich is needed. Then, the price standard is appropriate for necessity goods while the total surplus standard is appropriate for luxury goods. On the whole, adopting one standard for all markets of various goods and services may not be appropriate.

### **4.1.2 Japanese Efficiency Defence**

Interestingly, the Japanese merger guidelines have been amended three times in the past decade, and the section that deals with consideration of improvements in efficiency has been changed significantly in the process. In brief, the Japanese guidelines have been made more similar to the US Horizontal Merger Guidelines concerning considerations for efficiencies.

The first of the most recent two amendments to the Japanese merger guidelines was made in 2004. Before discussing the most recent version from 2007, some features of the 2004 guidelines, including their treatment of the efficiency defence, are examined. In comparison to the merger guidelines issued in 1998, the ones issued in 2004 are more detailed. That is, they provide more information on how exactly a proposed merger is reviewed. Also, they are made more similar to the US Horizontal Merger Guidelines than the 1998 version. For example, Herfindahl-Herschmann Index (HHI) was adopted as the method of measuring market concentration as in the US counterpart. The HHI is a key touchstone in the merger guidelines of the U.S. and the E.U. (Mehra, 2006). With the HHI, the measurement of market concentration is very specific. The new guidelines, just like the American guidelines, state that the market is “unconcentrated” if the HHI is below 1000, “moderately concentrated” if it is between 1000 and 1800, and “highly concentrated” if it is above 1800. With the adoption of these measures, there is more transparency in the merger procedure.

Nonetheless, it should be noted that adding more numerical touchstones and detailed procedures of the merger reviews does not necessarily make matters simpler for the Japan Fair Trade Commission. This movement towards the American-style administrative merger review may make it more costly to enforce merger guidelines because the JFTC is now more constrained by the guidelines. That is, the JFTC is now forced to do exactly what the guidelines state whereas, in the past, the JFTC relied more on acting informally and getting compliance from firms (Mehra, 2006).

However, overall, it is not surprising that the Japanese merger guidelines are becoming more similar to the US guidelines in recent years as it can just be a reflection of Japan catching up to the US. The history of antitrust policies is definitely much longer in the U.S. than in Japan. In the U.S., after the end of the Civil War in the 1870s, the economy grew very rapidly. At the time, a lack of regulation made the economy go out of control with increasing market concentrations, and there was an immediate need for a well-functioning antitrust environment. As a result, the Sherman Act was enacted in 1890. It was followed by the enactment of the Clayton Act and the FTC Act in 1914. These laid the foundations of the US antitrust policies and they have been one of the most advanced in the world until now. In contrast, as has been discussed in the previous chapter, the history of Japanese antitrust policies is much shorter.

Now, the section of the merger guidelines regarding efficiencies is examined. Although the guidelines from 2004 are generally more detailed than the 1998 version, the section on considerations of efficiency gains was not changed. The guidelines seem to adopt a

distributional weights standard. However, they do not actually mention what the standard is. The entire section on efficiencies only has the following two sentences.

Economy of scale, integration of production facilities, specialization of factories, reduction in transportation costs, efficiency in research and development and other improvements in efficiency caused by the business combinations are examined in terms of their impact on competition. When improvement of efficiency is deemed likely to stimulate competition (for example, a low-ranking company increases its cost competitiveness, financing capability, raw material procurement ability and other fundamentals through a merger, which leads to lower product prices and higher product quality, and in turn promotes competition with high-ranking companies), these positive impacts are considered (JFTC, 1998).

First, it is stated that only those improvements in efficiency that are likely to “stimulate competition” are considered. Stimulation of competition usually benefits consumers and hurts producers. However, it is still not clear whether the “positive impacts” of business combinations that the JFTC would consider are only increases in consumer surplus or increases in both consumer surplus and producer surplus. If it is that these positive impacts refer to increases in both consumer surplus and producer surplus, the guidelines are missing a specification on the weight that each should have on the total surplus. If it is that consumer surplus and producer surplus are equally valued, the standard will be the total surplus standard. In addition, the section is so ambiguous that it can even be interpreted as the price standard considering that they mention “lower product prices”. Also, there is no reference to how firms can demonstrate expected improvements in efficiency resulting from mergers.

The guidelines amended on 28 March of 2007 are more detailed than the 2004 version in general, and they also include more specific conditions for improvements in efficiency.

First of all, as has been said, the previous version states that improvements in efficiency must “stimulate competition” to be considered as positive effects. This expression is slightly modified in the new version that states that improvements in efficiency should “make the company group take competitive conduct” after the merger. This modification explains that “stimulating competition” in the earlier version meant that the merged firm itself would be able to charge lower prices as a result of the reductions in costs. However, what should also be included is how other firms in the market will be affected by a merger. That is, when the merged firm charges lower prices, the other firms need to compete more aggressively. Therefore, the effect of a merger not only on the merging firms’ behaviour but also on the level of competition in the entire market should be examined.

More importantly, in the revised version, three conditions that must be met to successfully claim an efficiency defence are added. They can be summarized as the following.

- i) Efficiency should be improved as an effect specific to the business combination  
The company group needs to provide evidences that the expected efficiency cannot have been achieved by other means that are less restrictive to the competition.
- ii) Improvements of the efficiency should be materialized  
The evidences to prove the improvements can include documents concerning internal procedures leading to the decision of the business combination; explanatory materials for stockholders; and the study created by external specialists
- iii) Improvements in the efficiency contributes to enhance users’ welfare  
The outcome of improvements in efficiency by the business combination must be returned to users through price reduction in products and services, improved quality, supply of new products, efficiency in research and development such as next-generation technology and environment-responsive capabilities, etc. (JFTC, 2007).



The first condition states that improvements in efficiency must be specific to the merger concerned. The same requirement is in the US horizontal merger guidelines and the Canadian merger enforcement guidelines. If some contractual agreements between firms can bring about the same efficiencies as a proposed merger, these efficiencies are not specific to the merger.

Then, the second condition states that expected efficiency gains must be supported by evidence. Examples of documents that can be used for the purpose are listed. They are documents of internal procedures, explanatory materials for stockholders and the study created by external specialists regarding efficiencies. These examples are similar to “plant and firm-level accounting statements, internal studies, strategic plans, management consultant studies and other available data” listed in the Canadian guidelines (Competition Bureau Canada, 2004). Overall, adding this second condition is a significant change from the previous version that basically said nothing about how merging firms can demonstrate potential improvements in efficiency.

Finally, the condition that is most significant to this paper is the third one which states that improvements in efficiency need to enhance consumers’ welfare. While the previous guidelines could be interpreted as adopting the total surplus standard, this version has definitely moved towards the price standard similar to that of the US. They state that a decrease in production costs accompanied by a higher market price is not considered as an improvement. However, if they require the market price to decrease for this condition

to be satisfied is not clearly stated. Therefore, the standard could be interpreted as either the price standard or the consumer standard.

In addition, there is inconsistency in the section. After listing the three criteria for improvements in efficiency, the Act adds a warning that “business combinations that create a state of monopoly or quasi-monopoly are hardly ever justified by their efficiency” (JFTC, 2007). This statement makes the standard more difficult to understand. It suggests that if a significant fall in production costs is to be brought by a proposed pure monopoly, it will not be allowed. If so, the standard is neither the total surplus standard nor the price standard because the Act seems to place an emphasis on the resulting market structure. Indeed, it is true that this kind of inconsistency often exists in law. For example, while violence to some extent may be justified as self-defence, an extreme form of violence like homicide may be per se illegal. Considering that pure monopoly is an extreme case of lessening of competition, it is not surprising to include this warning in the guidelines of the efficiency defence. Even so, in some industries, pure monopoly can be the most efficient market structure, and thus the monopolist is able to offer the lowest possible market price. Therefore, this sentence regarding the resulting market structure could be removed from the guidelines.

### **4.1.3 Comparison with Other Jurisdictions**

#### **4.1.3.1 United States**

In the United States, section 7 of the Clayton Act prohibits mergers that may substantially lessen competition. Unlike the Japanese antitrust system where only the Japan Fair Trade

Commission is responsible for antitrust regulation, the US system has two federal agencies for it: the Department of Justice (DOJ) and the Federal Trade Commission (FTC).

The section of the Horizontal Merger Guidelines concerning efficiencies has been modified several times in the past. To begin with, the guidelines from 1968 stated that efficiency gains are considered only in “exceptional circumstances.” The 1982 guidelines still had essentially the same treatment of efficiencies, stating that they are considered only in “extraordinary cases.” However, in 1984, some significant changes were made concerning consideration of efficiencies and the overall approach to efficiencies became more liberal. Most importantly, the section on efficiency was moved from a defence section to the competitive effects section (Everett & Ross, 2002). That is, consideration of efficiency gains became a factor in determining whether a proposed merger substantially lessens competition.

The most recent version of the Horizontal Merger Guidelines from 1997 states that efficiencies must be “cognizable” to be a factor in determining anti-competitive effects of a merger. They define cognizable efficiencies as “merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service.” In terms of the welfare standard, the guidelines adopt the price standard. Section 4 of the 1997 guidelines clearly states that efficiency gains must be great enough to cancel out its potential harm to consumers. Thus, a merger must not result in any price increase in the market. As discussed earlier, the price standard recognizes an improvement in efficiency

only if a merger is expected to result in a fall in the price and an increase in the quantity. The problem is that commonly there has to be an enormous fall in the production costs for the resulting market price to decrease considering the increased market power of the merged firm. Production costs do not usually fall so significantly. As a result, under a price standard the efficiency defence will rarely be relevant. Yet, some proposed mergers have been passed due to expected efficiency gains under this standard. An example is the case of the U.S. v. Long Island Jewish Medical Center in 1997 where expected cost savings from a horizontal merger of two hospitals were considered to be greater than the expected anticompetitive effects (McQuiston, 1997).

#### **4.1.3.2 Canada**

In Canada, the Competition Bureau is the agency that enforces the merger guidelines. In comparison to about one page on the efficiency defence in the 2007 Japanese guidelines, seven pages of details are dedicated to the Efficiency Exception (Part 8) in the Canadian Merger Enforcement Guidelines. Thus, there are many elements in the Canadian efficiency defence that are missing in the Japanese guidelines. For instance, the Canadian guidelines clearly separate gains in efficiency into three types: allocative efficiency, technical efficiency and dynamic efficiency. Dynamic efficiency refers to the optimal introduction of new products and technology over time (Competition Bureau Canada, 2004). In contrast, the Japanese guidelines do not explain such concept except for stating that “efficiency in research and development” is considered.

In addition, while the Canadian guidelines clearly state that pecuniary economies do not count, the Japanese ones do not mention them at all. Pecuniary economies refer to a reduction in accounting costs associated with a merger. That is, even if the amount of resources used for production is unchanged, an increased bargaining power enables the merged entity to obtain inputs of production at lower prices. This type of cost reductions should not be considered as improvements in efficiency.

The welfare standard employed in the Canadian guidelines definitely takes both consumer surplus and producer surplus into consideration. In other words, they recognize the redistributive effect of a merger, or the wealth transfer from consumers to producers, not only as a negative effect on consumers but also as a positive effect on producers. Nevertheless, the Competition Bureau has altered the weight that each party's surplus should have on the total surplus over time. In 1991, the Merger Enforcement Guidelines still had the "total surplus test" where changes in consumer surplus and producer surplus received equal weights. However, the Competition Tribunal found it questionable to use the total surplus standard in the Hillsdown case of 1992 (Ross & Winter, 2004). In this case concerning a horizontal merger between Hillsdown and Canadian Packers in the market of meat rendering, the Competition Tribunal suggested the use of the consumer standard in an obiter dictum, or a remark that is not part of a court's decision.

Then, there was a controversial case of Superior Propane in 2000 where a merger that substantially lessened competition to create quasi-monopoly in the market of propane was to be allowed due to efficiency gains. The Bureau, faced with the Superior Propane

case, changed the standard from the total surplus standard to a distributional weights standard (Ross & Winter, 2004, p. 255). Regarding Superior Propane, the distributional weights were to be determined by the Competition Tribunal rather than the Competition Bureau. The most recent version of the guidelines, revised in 2004, has the following explanation on the efficiency defence.

There is currently no statutory basis for assuming any fixed set of weighting between redistributive effects, deadweight losses and efficiency gains. Such weighting depends on the facts of a particular case. (Section 8.34)

Therefore, at present, there is no fixed distributional weight specified in the guidelines. In total, it is certain that the Canadian guidelines place a much higher emphasis on producer surplus than the US counterpart. This is particularly due to the North America Free Trade Agreement (NAFTA) which increased the need for Canadian firms' competitiveness against US firms.

#### **4.1.3.3 United Kingdom**

In the United Kingdom, the Office of Fair Trading (OFT) first detects merger cases that may be challenged under the 2002 Enterprise Act. The Act, like those in Canada and the U.S., prohibits mergers that substantially lessen competition. The Competition Commission is in charge of reviewing merger cases that were referred to them by the OFT.

The OFT has published guidelines that explain the process of merger reviews. They state that merging firms must bear the burden of providing evidence for efficiency gains. Like in the US guidelines, the UK guidelines also consider consumer welfare to be the most

significant factor in assessment of efficiencies. The OFT must report to the Competition Commission all merger cases that substantially lessen competition, but not those that bring “customer benefits” that outweigh lessening of competition. “Customer benefits” are defined as lower prices, higher quality, or greater choice of goods or services (Competition Bureau, 2007). Overall, the approach towards efficiencies in the U.K. can be interpreted as the consumer surplus standard.

#### **4.1.3.4 Europe**

For the countries in the European Union, the new European Commission Merger Regulation was adopted in 2004 to replace the previous regulation. In the 2004 regulation, efficiency gains may be used to assess anti-competitive effects of a merger. The European Commission is responsible for merger reviews, and it has published merger guidelines that contain considerations of efficiencies.

The standard adopted by the European Commission is similar to that of the UK. Their guidelines state that, for efficiency claims to be accepted, consumers cannot be worse off as a result of the merger. Thus, they value consumer surplus, and not producer surplus. This can be interpreted as the consumer standard.

Overall, international comparison shows that the efficiency defence in the Japanese merger guidelines is still not as developed as those of other developed countries, particularly Canada and the US. Thus, Japan can continue to adopt elements from the other countries to improve its efficiency defence.

## **4.2 Critical Appraisal of the Defence**

### **4.2.1 Is it necessary?**

#### **4.2.1.1 Background Studies**

This section discusses whether it is necessary to have the efficiency defence. It is obvious that not all efficiency-enhancing mergers are good for society. As has been discussed, mergers can hurt welfare of consumers severely by increasing firms' market power and increasing prices. Then, what is needed is evidence that there have been mergers that were blocked, but should have been allowed with a proper use of the efficiency defence.

It is difficult to find such cases in Japan since firms have not attempted to use the efficiency defence, but a number of examples can be in other countries. According to Ilzkovitz & Meiklejohn (2006), a proposed merger between Volvo and Scania in the European automobile industry is one such example. The European antitrust authorities forbade the proposed merger in 2000, claiming that the market power of the merged firm in many national markets would become too large. However, some, particularly those from the Nordic countries, claimed that negative impacts from market concentration in some national markets would easily be offset by positive impacts from efficiency gains and an increase in the competitiveness of the European automobile sector in the global market.

The European Commission also admits that in certain industries, most notably the aerospace industry, the efficiency gains from economies of scale and learning economies



are so great that the only market structure that is reasonable is monopoly (Ilzkovitz & Meiklejohn, 2006).

International competitiveness is a concern for Japan as it is for Europe. Evidence suggests that investors, who should be well-informed about international markets, consider mergers to have positive effects on Japanese firms. Miyajima (2007) used the cumulative abnormal returns (CAR) of merging firms to investigate this. His results showed that the CAR, or sum of the differences between the expected return and the actual return on its stocks, following the announcement of a merger were positive. This implies that acquiring firms are expected to perform better after the merger. Of course, these results alone do not prove efficiency gains from these mergers. But, at least, “excessive mergers by empire building managers” are not observed in Japan (Miyajima, 2007). His study included observations of positive changes in the CAR of Sumitomo Bank and Sakura Bank when they announced their merger in 1999. The same was true for the CAR of Sanwa, Tokai and Asahi Bank when they announced their merger to form UFJ Bank in 2001.

Economic and Industrial Research Department (2007) also notes that many mergers in Japan since the latter half of the 1990s had failed firms or failing firms as targets. This trend has been prominent especially over the past several years because of government-led corporate rehabilitation efforts. This type of mergers is definitely efficiency-enhancing at least for the targeted firms. Overall, it supports the argument that the efficiency defence would be useful in Japan.

Other than examining the proposed merger cases from the past, it is also important to think about mergers that should have occurred but were not even proposed because of various impediments such as a lack of an appropriate efficiency defence. Miyajima (2007) maintains that, Japanese corporations, after the banking crisis in the 1990s, can be divided into those that are eager to innovate and improve their operations, and those that are bound by traditions and are very slow to implement necessary changes. If so, the efficiency defence can be an incentive for those tradition-bound firms to seek efficiency-enhancing mergers that they need.

In addition, this paper argues that the recent M&A activity in Japan is needed to restructure certain sectors of the economy. These are sectors that were affected by the long-term economic downturn in the 1990s, and are in need of “rationalization,” or changes in existing market structures.

First, it must be noted that a general trend in recent M&A activity in the world is that it is concentrated in a number of industries. According to Miyajima (2007), between 1991 and 2005, the communications sector had the highest number of M&A deals in the US, and the second highest in Japan. The proportions of the total numbers of M&A deals that occurred in the communications sector were 15.3% and 14.3% in the U.S. and Japan respectively. The particularly high levels of concentration in the communications sector across countries are undoubtedly attributable to rapid technological innovation. Overall, many of the sectors with high levels of concentration in M&A are so-called “growth

sectors” and it supports the idea that many of the M&A deals were used for strategic purposes rather than for restructuring purposes both in Japan and the US.

However, in Japan, Miyajima (2007) also observes high frequency of M&A in “mature sectors” such as transportation equipment and food products sectors, and this is not the case in other countries such as the US. In other words, a high frequency of M&A in mature and possibly inefficient sectors is unique to Japan from a global perspective. An econometric analysis by Arikawa and Miyajima (2007) also shows that sectors that experienced negative shocks had higher frequency of M&A activity in Japan. In contrast, only the sectors with positive shocks, such as technological innovation, had high frequency of M&A in the U.S. since the 1990s.

These results demonstrate that a significant proportion of M&A deals in Japan serve the purpose of restructuring and reallocating resources in the economy, especially in sectors that were affected by the long recession of the 1990s. As has been discussed in the previous chapter, the banking sector had the highest number of M&A deals, or 30.9% of all M&A deals, between 1991 and 2005 in Japan mostly due to the banking crisis in the 1990s. Overall, the evidence suggests that it is important in Japan to allow mergers based on potential efficiency gains in order to revive the banking sector and the other mature sectors affected by the economic downturn of the 1990s.

#### **4.2.1.2 The JFTC's Rationale for the Inclusion of an Efficiency Defence**

Competition Policy Research Center within the JFTC is where the JFTC staff and visiting researchers collaborate and produce reports. In one of these reports, a survey of 13 Japanese firms that were involved in 16 horizontal merger deals since the 1990s revealed that the most important factor in the overall economy that prompted them to consider mergers was globalization and the resulting intense international competition (Competition Policy Research Center, 2003). This factor received a much higher importance rating than the other factors including falling domestic demand and mergers between competitors. In the same survey, the 13 firms also ranked "cost reductions" as the number 1 purpose for mergers among other answers such as "strengthening capabilities in R&D" and "increasing market share".

Overall, the results demonstrate Japanese firms' needs to increase competitiveness in the world market and to reduce costs. It is highly likely that these results pressured the JFTC to improve the efficiency defence in the merger guidelines in 2007. Also, the JFTC and external researchers realize that Japan is behind Canada, the U.S. and Europe in research related to efficiency gains from mergers, and intend to do more research particularly in price changes caused by mergers in the future.

In addition, in the face of global anticompetitive forces such as international cartels, there is a need for conversion of antitrust policies across countries. This fact is also reflected in the changes made to the Japanese merger guidelines in 2007 that made the guidelines more similar to those of Canada and the US.

#### **4.2.2 Can it be implemented?**

For efficiency gains to be significant in merger reviews, they need to be verifiable.

Empirical studies often considered increases in accounting profits and share prices after mergers to be measures of efficiency gains. However, this method is defective because these indicators can increase due to both efficiency gains and increases in market power (Ilzkovitz & Meiklejohn, 2006). Changes in profits and share prices need to be considered together with changes in market prices and market shares.

Competition Policy Research Center (2003) in the JFTC has explored methods for measuring efficiency gains associated with mergers. They took past merger cases, and calculated efficiency gains that resulted from them by comparing pre-merger and post-merger cost indicators, profitability indicators and productivity indicators. They find that such financial indicators are likely affected by factors other than the merger concerned, and thus it is difficult to say that improvements in them actually reflect efficiency gains from the merger. However, their overall conclusion is that, despite difficulties, measurement of efficiency gains associated with mergers can be done.

## 5 Conclusion

An increasing number of firms are engaging in M&A activity in Japan in the recent past as it has become a generally accepted tool for industry and corporate restructuring.

Particularly, the increase in M&A activity in the past two decades has been dramatic, and it is often referred to as a major M&A wave (Miyajima, 2007). Evidence suggests that, among other types of M&A activity, horizontal mergers are on the rise. This leads to an immediate need for the Japanese merger guidelines to be improved because horizontal mergers can have large anti-competitive effects that harm consumers. Among other features of merger guidelines, this paper focused on consideration of efficiency gains in merger reviews.

First, in Chapter 2, the history of the Anti-Monopoly Law (AML), and the merger enforcement guidelines in Japan was reviewed. It was demonstrated that the Japan Fair Trade Commission (JFTC), or the sole antitrust enforcement agency in the country, rarely enforced the AML in the years following WWII. It was partly because few firms attempted to engage in mergers as they found horizontal agreements more attractive. It was also because antitrust policies often had conflicts with industrial policies that were concerned with making Japanese economy stronger by creating mega-firms that could compete internationally. Overall, before the 1980s, the merger provisions of the AML did not attract much attention from firms.

However, the level of M&A activity in Japan started to increase in the 1980s, and eventually reached a wave-like level starting in the mid-1990s. Thus, Chapter 3 explored reasons behind the rapid increase in M&A deals in the past two decades. The evidence suggested various social and economic factors such as changes in people's attitudes, changes in laws, the banking crisis in the 1990s, and changes in employment practices to be significant in explaining this trend. In total, the rise in merger activity calls for a more effective merger review process. As part of the effort to improve the merger guidelines, developing the efficiency defence can be beneficial.

Chapter 4 started with a discussion of economic theory of efficiency defence. A number of welfare standards were reviewed. This was followed by an examination of the efficiency defence in the Japanese merger guidelines. It can be observed that the section on efficiencies has been developed by taking elements from the US Horizontal Merger Guidelines. However, international comparison shows that the Japanese efficiency defence is not as developed as those in other countries, especially Canada and the US.

Overall, the current section on efficiencies in the Japanese guidelines is not detailed enough for firms to actually use it. This paper argued that it is important to improve it so that the JFTC can allow mergers based on efficiencies. There were two points to this argument. First, the efficiency defence is necessary in Japan. The evidence for this is in high frequency of M&A activity in traditional sectors that are in need of restructuring through efficiency-enhancing mergers. Also, there is need for Japanese firms to increase their international competitiveness through mergers. The second point was that the

efficiency defence is workable. Despite difficulties and imperfections in calculating efficiency gains and anti-competitive effects, Competition Policy Research Center at the JFTC has concluded that it was possible to implement the efficiency defence.



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