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From the Secretary of State

Prime Minister
The attached draft speech, and the proposed Green Paper, seem sensible. Subject to one small point, the Treasury are content.
Shall I say that you are?
M
27/6

A difficult speech to deliver!

Mike Pattison Esq
Private Secretary
10 Downing Street
London, SW1

26 June 1980

Dear Mike,

INDUSTRIAL STRUCTURE

As you are aware, my Secretary of State intends to publish next Tuesday a Green Paper setting out the Department's proposals to allow companies to purchase their own shares. You will recall that my Secretary of State circulated copies of a draft of this Green Paper to all members of E Committee under cover of his letter of 6 May to the Chancellor. As he noted then, he attaches the highest priority, both economically and politically, to legislating on this matter in the Companies Bill in the next Session.

My Secretary of State considers that the publication of the Green Paper will provide him with an opportunity to deliver a wider speech about the underlying structure of economic activity in this country; its implications for economic performance and the Government's policies which affect it. I attach a copy of the speech he proposes to make.

Apart from the question of demergers, the other main theme of the speech is the Government's attitude towards mergers policy. In recent months there has been much speculation about this since it became clear that we have no plans at present to legislate further in this area. The speech will therefore provide a useful opportunity for clarifying this policy.

I am copying this letter to Martin Hall (Treasury), Ian Ellison (Industry), Murdo Maclean (Chief Whip's Office), Petra Laidlaw (Chancellor of the Duchy's Office), Richard Prescott (Paymaster General's Office) and to David Wright (Cabinet Office).

Yours ever,

Nicholas McInnes

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Private Secretary

26 JUN 1980

DRAFT SPEECH BY THE SECRETARY OF STATE FOR TRADE

I want to talk today about the underlying structure of economic activity in this country; its implications for economic performance and the Government policies which affect it.

In choosing this theme I am assuming that structure has a bearing on performance. I am not suggesting of course that structure is the major influence on performance, or that by manipulating industrial organisation we shall solve all our problems. On the contrary, I am sure there is no magic solution of this kind, and I suspect that too many of our problems have arisen from a belief in simple solutions to deep seated social and economic issues. But there is certainly a body of opinion which holds that the underlying pattern of economic organisation is an important factor in performance.

Those who know something of the Government's economic beliefs and outlook may be wondering why I should think any of this is my business. Surely the pattern of economic organisation is for the market to decide? What have Government Ministers got to do with it? Well, I certainly do believe in the market system. But, the decisions of enterprises are to some extent shaped by public discussion and the climate of opinion, and I think that a Minister with economic responsibilities should enter into such public discussion.

There is a more practical reason; structure is influenced and sometimes determined by Government policies and legislation. The system of corporate taxation is an obvious example. Company law - one of my own particular responsibilities - is another. And for years Governments here and in other countries have found it necessary to intervene to prevent restraint of competition; the competition legislation - another of my own responsibilities - is also relevant to structure, and one of its objects is to ensure that competitive markets are kept competitive and allowed to operate freely. So whether we like it or not the Government is involved in these questions.

But are we really able to say that industrial structure has an influence on important aspects of performance such as innovation and efficiency? Many have thought so. For many it has been an article of faith that a concentration of production into a few large-scale enterprises is vital in a modern industrial economy. Others argue that large scale organisation - especially combined with monopoly - leads to bureaucracy and inefficiency.

I would be reluctant to make any sweeping generalisations on these lines. All I will say is that if we see the market as the means of guiding economic activity and development, it is plausible that the structure of the market will have some effect on the course of events. Factors such as the number of new enterprises, the relationship between enterprises in different sectors, and the ease of entry into new activities or of transferring resources from one activity to another, all seem likely to be significant. At the very least, one might expect

structural rigidities to have a retarding influence on the speed of development, and in an internationally competitive environment the speed of development in a particular country may affect not only the length of its journey but also its destination.

So much for generalisations. What about the facts of our own experience? Here I am venturing into a minefield. The statistics in this area are scanty and difficult to interpret. On many points the conclusions can only be negative or agnostic, but even an agnostic conclusion can have implications for policy.

First, then, I want to consider the question of industrial concentration. There are various measures of concentration, but the basic idea is to measure the proportion of sales or output accounted for by the largest firms in an economy. Concentration may be measured in a particular market, or in the economy as a whole; in the latter case it is often known as aggregate concentration. There is no doubt that production in the United Kingdom has become much more concentrated since the war, both in total and in separate product areas. It is also generally agreed that the share of the largest firms has increased more than the share of the largest individual factories or plants. Firm size has grown more through an increase in the number of plants owned than by an increase in the size of those plants; so it has not arisen solely from economies of scale in production- though I realise that there are other benefits from size to be taken into account. Moreover

firms have grown as much by mergers and acquisitions as by internally generated expansion.

The significance of all this is difficult to assess. Are we, for instance, more concentrated than our competitors? The production statistics suggest that we are, but allowance has to be made for the great increase in competition from imports, and it can be argued that, due in part to the concentration and efficiency of our distribution system, we are more open to imports than our competitors. Firm conclusions are therefore difficult. But we do not seem to be less concentrated than other countries, and that the onus of proof is on those who would argue that we shall become more competitive simply by becoming more concentrated.

Another point is that compared to other countries of similar size, like France and West Germany, we have a relatively high level of aggregate concentration, which means we have more very large firms, and in particular we have more large firms with a diversified, conglomerate product range.

Lest I be thought to be concentrating unduly on manufacturing industry, I should say that we also appear to have high levels of concentration in such activities as retail distribution.

Finally, on the other side of the coin, it appears that the small firm sector of manufacturing industry is smaller in the United Kingdom than in many other countries. We have an

enormous number of small firms, but their combined share of total employment appears to be relatively low. There are suggestions that the rate of generation of new businesses is disappointing, especially in some important sectors of manufacturing.

The picture emerging is of an economy dominated by large units. Should we draw any conclusions from this? It would be easy to generalise and say simply either that "biggest is best" or that "small is beautiful". But even the very tentative points I have made permit us to draw some important conclusions. One is that it is questionable whether the growth of industrial concentration has simply been the inevitable result of economies of scale. Secondly, it is a cause for concern that compared with other countries our small firms sector appears to be relatively small in size. Innovative small firms are our seed-corn for the future; are we sowing enough? Thirdly, the level of aggregate concentration in the United Kingdom does seem high, which is another way of saying that a high proportion of our industry is concentrated in relatively few, often conglomerate, enterprises. I shall say more later about the special issues raised by conglomerates. At the moment I will just suggest that if economic progress involves a process of natural selection among alternatives, it is important that there should be enough alternatives.

May I then consider some of the implications of these points for Government policy. I emphasised that in areas like company law and taxation the Government is bound to be involved in questions of business organisation. Hitherto the main concern of policy has been to allow firms to organise on a large scale if they wish. Our company law is therefore extremely flexible in allowing companies to be established, to acquire subsidiaries, to expand their area of activities, and so on. Taxation law also has been adapted to allow groups of companies to manage their tax affairs on a concerted basis, for instance by spreading losses. But while we have done everything we can to enable firms to expand, diversify, or join together, we have been less concerned with the possibility that firms, having expanded, might wish to divide into independent smaller uints. Surely the least we can do is to ensure that there are no unnecessary legal obstacles to re-organisation of this kind. To use the current jargon, we must facilitate 'demergers'.

One obvious motive for a demerger would be to reverse the effects of an unsuccessful merger. I, for one, accept that many of the mergers that took place in the 1960s and early 1970s have not fulfilled the hopes of those who promoted them. There are no doubt many reasons why that should be so - the difficulties of fusing two different companies may have been underestimated, and concern over organisational questions may have diverted management from other tasks. The result has been mergers where size has not been accompanied by the improved efficiency anticipated. In such cases it would clearly be desirable for companies to have the option of reverting to separate

management if they wish. But I should emphasise that in talking of demergers I am not thinking just of rectifying unsuccessful mergers, but of removing unnecessary obstacles to splitting wherever that makes sound commercial sense.

The Government is already taking steps to remove obstacles to demergers. In his Budget speech the Chancellor announced that legislation would be introduced to remove possible tax penalties which may have deterred demergers in the past and indeed the Finance Committee are debating today a series of amendments which represent a first step towards a more neutral tax policy towards the distribution of assets or shares to shareholders. The approach chosen, involving a clearance procedure to overcome tax avoidance, involves a useful first step to enable the distribution of assets in specie to existing shareholders - giving them a more direct interest in subsidiary activities within a trading group.

In my own sphere of responsibility, I am publishing today a consultative document proposing an amendment of company law to enable companies in certain circumstances to buy their own shares. Until now this has not generally been permitted in the United Kingdom, although in other countries such purchases are allowed, subject to safeguards against abuse, and appear to operate satisfactorily. The arguments for such a change in the United Kingdom are two-fold.

For private companies, enabling such companies to purchase their own shares would make investment and participation in

them more attractive in a number of significant ways. Entrepreneurs considering putting their own money into an enterprise would feel that it would be that much easier to realise all or part of their investment in the future. Other prospective shareholders would feel that the danger of their being locked in to the company through the narrowness of the market in the shares had been much diminished. Existing shareholders would be less wary of attracting new equity investment since they would regard themselves as less likely to lose control of the business. For all these reasons, a liberalisation of the law is likely to encourage expansion, risk-taking and venture capitalism in the firms which I have described earlier as our seed-corn for the future.

Different considerations apply to companies whose shares are dealt with on a market. Public companies with surplus cash resources (which may perhaps result from the disposal of part of the business) could find it useful to be able to buy their own shares and thus return surplus resources to shareholders, thereby removing the pressure on such companies to employ those surplus resources in uneconomic ways. Thus, the change proposed would increase flexibility of organisation, facilitate the establishment and maintenance of independent private companies, and encourage the better use of available investment resources. Following the useful start with the new amendments in Committee today for demergers we must see if it is possible to devise tax proposals which, while providing safeguards against tax abuses nevertheless enable increased opportunities for the use of purchase of own shares as a constructive means of encouraging

small company capital formation and flexibility of structure as well as the distribution of surplus cash beyond the requirements of a company.

Having said something about demergers and greater flexibility in industrial structure I would now like to turn to the Government's policy towards mergers. That policy, concerning itself with structure, is of course only one side of a competition policy: we also have measures to deal with behaviour - restrictive agreements, anti-competitive behaviour and the exploitation of monopoly power, the primary concerns of the monopolies and restrictive practices legislation. The two approaches are interdependent. To the extent that an effective merger policy helps to maintain a vigorous small and medium-sized firm sector in the economy and restrains the process of concentration, the need for measures to deal with the use of monopoly power will be diminished. Conversely, effective control of anti-competitive behaviour may remove some of the obstacles confronting small firms trying to gain a foothold in the market. This is one of the important aims of our recent Competition Act, which provides a means of dealing effectively and swiftly with such practices as the imposition by a dominant firm of terms and conditions which weight the scales against new competitors. I hope that small firms will not hesitate to take advantage of this new protection by approaching the Office of Fair Trading.

However, today I want to concentrate on mergers, because the publication of the Green Paper on monopolies and mergers policy

in 1978 raised questions which call for an answer. In mergers policy there have been demands for greater predictability of how the Government will regard mergers. I sympathise, and indeed we do try where possible to advise firms who approach us about the likely treatment of mergers that they have in mind. In what I say today I will try to throw some light on our intended approach to mergers and the main guiding principles. But there can be no hard and fast rules. The difficult cases have unique features, unforeseen in any rules, and Governments must leave themselves flexibility to weigh up all the factors. Decisions call for political judgment, and full certainty and precision in merger policy is a will o'the wisp.

Let me remind you on mergers first of the main features of our present arrangements. Under the Fair Trading Act 1973, the Director General of Fair Trading has a duty to keep himself informed - in the language of the Act - of all merger situations qualifying for possible reference to the Monopolies and Mergers Commission (MMC). That means transactions involving the transfer of gross assets of at least £15m or that create or enhance a monopoly share of the market (ie a 25% share). Whenever a qualifying merger is proposed or is found to have taken place, the Director General of Fair Trading, after detailed discussions between members of his Office and the firms involved, makes a recommendation to me on the question of reference to the MMC. If I believe that the merger concerned raises issues of sufficient public interest, I refer it to the Commission for a full investigation. The decision, then as to whether a merger should be investigated by the Commission (MMC)

is mine, although I certainly would not expect to depart from the advice of the Director General unless there seemed to me to be overriding considerations to the contrary. Once a reference has been made, the MMC must normally report within a maximum period of six months. If the MMC finds that the merger situation operates or may be expected to operate against the public interest - and I would ask you to note carefully that only an adverse finding gives me the power to take further action - I may make an order to prevent the merger (or to require divestment if it has already taken place) or, as is much more usual, secure the same results by obtaining undertakings from the parties concerned.

Such a regime for merger control can hardly be called burdensome. In the first place the limits defining referable mergers are set sufficiently high to ensure that only the more important mergers come into the net. The figures tell their own story. Since 1955, when merger control was first introduced, there have probably been about 12,000 mergers among publicly quoted companies. The overwhelming majority of these fall outside the legislation. There have however been about 2,000 referable mergers (excluding newspaper mergers) and of these only 55 have been referred to the MMC. We are talking, therefore, of a mere handful of references, ie 3 or 4 cases a year - although the number has been rising in the past year . Nor does reference in itself mean that I have taken a view against a merger, merely that I believe that there are matters needing fuller study than can be given in the short time available to the OFT in making its recommendation to me. Thus in the 55 references

which have been made since 1955, the MMC has found 18 to be against the public interest, 20 were not found by the MMC to be against the public interest and 17 were abandoned before the MMC reported. Thus of all referable mergers less than 1% failed to satisfy the MMC.

Earlier this year I decided to raise the criterion for possible references based on the value of assets from £5m to £15m, thus excluding many smaller mergers from consideration altogether. This was a substantial increase in the threshold at one step but even after taking this decision I have given much thought to the possibility of a further increase. There is after all no automatic connection between the value of assets acquired and the significance of a merger for competition. But I have decided to keep the threshold at £15m for the time being. One important reason for this decision is that to raise the threshold further would make it most difficult to control the piecemeal acquisition of small firms by a much larger firm which however falls short of a 25% market share. At the same time I would be much less concerned about mergers between two firms both of which were of relatively small size - below say /£25m?/ - and I would not normally consider such a case suitable for reference unless there was a demonstrable restriction of competition or other special circumstances.

In practice, then, very few mergers have been held up for full investigation. The policy has operated against the background of the prevailing belief in the 60s and early 70s that extensive mergers were necessary to improve industrial

efficiency. Extensive mergers duly took place, but there has been widespread scepticism about their results. Studies by economists have nearly all shown that on average the results of mergers are disappointing. Of course this is not conclusive, but so far as I know no-one has actually claimed that the evidence is favourable to mergers. Insofar as the legislation and its application have reflected a generally favourable presumption, it therefore seems desirable to re-appraise the policy.

Such a re-appraisal was carried out by an official working party set up by the previous Government under the Chairmanship of Mr Hans Liesner, the Chief Economic Adviser to my Department. Their report on monopolies and mergers policy was published in 1978 as a Green Paper, generally know as the Liesner Report. The Liesner Report suggested changes in both policy and legislation on mergers. The approach towards mergers in general would be neutral, rather than favourable as it had tended to be in the past. There would be a two-stage process in the assessment of mergers. First, there would be an assessment of the effects of the merger on competition. If these were not significant, that would be an end of the matter. But if they were adverse to competition, then some positive benefits of the merger would have to be demonstrated if it were to go ahead. This two stage procedure would be laid down in legislation for the Monopolies and Mergers Commission to follow, and detailed non-statutory guidelines would be published indicating the criteria the Government would follow in making references to the Commission. This procedure was expected to result in a significant increase in the number of references.

Since taking over responsibility for merger policy I have naturally given much thought to these proposals. I have considered the various comments people have made, and of course I have tested the theoretical views on the subject against my own experience of dealing with merger cases. I have not been convinced that there would be any real advantage in the relatively precise and formal procedures proposed in the Green Paper. Let me therefore put an end to uncertainty by saying that I have decided against new legislation on mergers for the time being. The present law may not be ideal in every detail, but it is understood and offers sufficient flexibility to accommodate any shifts of emphasis that may be needed. I see everything to be said for continuity and nothing to be said for constantly changing the rules.

But a decision not to change the legislation is not an end to the matter. I do believe it is necessary to take account of our experience over the last fifteen years or so. This calls for a distinctly more sceptical approach by all of us in assessing the pros and cons of prospective mergers. In saying 'all of us', I mean in the first place those in industry who make the initial assessment of the case for a merger; if they bring more realistic assessment to bear, it may be that some ideas for mergers will not reach first base, as some in the past should not have done.

Nevertheless, for the foreseeable future one must expect there to continue to be a small proportion of merger cases which raise serious issues for the public interest and which cannot simply be left to the parties and the shareholders to decide. I expect the competition authorities to look at such cases first and foremost from the point of view of whether the merger would be detrimental to the maintenance or promotion of effective competition. If it would, then we would have to pay careful attention to the other benefits and disbenefits which would be likely to arise for the economy. And in the light of experience one would be bound to take a hard and sceptical look at any suggestion that a merger would automatically lead to rationalisation, economies of scale, or other miraculous transformations.

This is not a novel policy. I see it as a reaffirmation of the policy embodied in the 1973 Act, which laid down new public interest criteria for both monopoly and merger inquiries and, for the first time, placed the main emphasis on maintaining and promoting competition between suppliers. It underlined the importance of competition as a stimulus to innovation and cost reduction. Though it may not be a panacea, I am sure this emphasis on competition as a safeguard for the public interest is right, and I want to re-emphasise it as the proper basis for applying merger control.

Competition must of course be considered in a broad and practical sense, as indeed the legislation recognises in talking about

effective competition. We are not talking about hypothetical perfect competition, or about mathematical calculation of market shares. The overall and long-term effects of a merger must be considered, on both actual and potential competition. In general we must look very carefully at any mergers which eliminate direct competitors in a market, or which may distort competition through linking supplier with customer. There is no simple rule, though. In some circumstances such a merger could be positively beneficial to effective competition, by enabling smaller suppliers to combine to compete more effectively with larger ones. On the other hand, a merger could be detrimental even if it involved no direct reduction in competition, since its effect might be to eliminate a promising source of future competition or to shelter some activities from market disciplines.

This leads me to the question of so-called 'conglomerate' or diversifying mergers, which on the narrowest view might seem to have few implications for competition. There is nothing sinister in conglomeracy as such: large companies may see their own best interests in diversifying, and that can bring wider benefit, for example by the introduction of new management resources from a large group into an ailing company. But the acquisition of a successful company by a large and unrelated company which is merely shopping around when flush with funds - in an attempt to increase its earnings per share and hence its share price - may in reality involve a diminution of competition and no evident efficiency gain, and a careful assessment by the MMC - difficult though that is - could be necessary. It is

impossible to generalise about such cases. It may be that a successful specialist company would benefit from being taken over by a major diversifying company, for example because funds would be available for investment in R and D or for expansion. Equally, however, the elimination of independent decision centres; or the possibility of the imposition of inappropriate or bureaucratic management styles; or the capacity to use greater financial muscle for cross-subsidisation and possible predatory pricing which distorts the market process and conceals the true competitive position; even when not accompanied by direct reduction of competition these could be factors raising doubts about possible detriments which call for an objective appraisal.

However, we live in a world in which change is rapid and international boundaries increasingly irrelevant to economic activity. Both these facts have implications for competition policy: rapid change means that what applies in one case or at one time may not apply in another. Internationalisation means that markets have to be defined in European or even world terms: acquisition of United Kingdom firms by overseas companies may in some circumstances lead to sharper competition in the domestic market; United Kingdom firms may be able to compete in export markets only if they acquire interests in overseas companies. None of this I see as inconsistent with a vigorous competition policy, which is what its title implies - a policy above all to promote competition. A Government policy towards mergers which throws the competition issues into sharper relief should not, at least in the longer run, lead to

significantly more references, but should ensure that the reasons for an individual reference are more clearly understood; it may also lead the MMC to shift the balance slightly in the number of mergers which they find to operate or to be likely to operate against the public interest. It will, I hope, increase the number of instances in which mergers are better thought out by the parties concerned before they are embarked upon. My overriding concern is that our policy should strengthen the competitive environment in which United Kingdom industry operates and provide that essential spur to improved efficiency on which our prosperity depends.

The time has come - you may think it is overdue - to summarise what I have said. If I have to put it in a single formula, it is that the structure of our industry should be flexible enough to respond to the changing needs of the market. Innovative new firms - many of which will be relatively small - are a vital part of this response. We should also be able to adapt our existing organisations rapidly to new needs, and this includes being able to break structures down into smaller units - and if necessary to recombine them. And, while mergers will continue often to be a beneficial response to change, we must guard against those whose effect is mainly to stifle market forces, and against the needless accumulation of ever larger and more unwieldy concentrations of power and control. In these ways we can help to encourage a structure within which enterprise can more easily flourish.

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10 DOWNING STREET

From the Private Secretary

30 June 1980

Industrial Structure

The Prime Minister has read your letter of 26 June, and the draft speech attached to it which your Secretary of State intends to deliver tomorrow. Subject to the points raised by the Minister of State at the Treasury, as set out in Roy Warden's letter of 27 June, the Prime Minister is content with the draft.

I am copying this letter to Martin Hall (HM Treasury), Ian Ellison (Industry), Murdo Maclean (Chief Whip's Office), Petra Laidlaw (Chancellor of the Duchy's Office), Richard Prescott (Paymaster General's Office) and David Wright (Cabinet Office).

T. P. LANKESTER

Nicholas McInnes, Esq.,
Department of Trade.