CHAPTER-II

THEORETICAL ISSUES

To a major extent, production in Indian industries is carried on under the corporate form of organization which requires huge capital and considerable enterprise. As the organization of such enterprises is not easy, the integration at horizontal or vertical level starts, which ultimately leads to industrial concentration. It is an outcome of advanced capitalization and combinations, collaborations, vertical integration, horizontal mergers, acquisitions, takeovers etc. by big firms.

Industrial concentration can be defined as bringing the creative energy or strength of all factors of production under common control of an individual, either directly or indirectly in the field of production or distribution of a particular product or service. This could be achieved either by owning the factors of production or by controlling them and by means of common management.

Industrial concentration is of two types:-

First is aggregate concentration, which has two possible meanings:-

(i) Control of a large proportion of some aggregate of economic resources or activity by a small proportion of the units which control the aggregate; or

(ii) Control of a large proportion of such an aggregate by a small absolute number of these units.

Second is market concentration which means a situation when an industry or market is controlled by a small number of leading producers who are exclusively or at least very largely engaged in that industry.

The Monopoly Inquiry Commission studied the economic concentration into two different types: -

a) Product-wise concentration “where in respect of the production or distribution of any particular commodity or service, the controlling power is in a single concern or comparatively limited number of concerns or though in a fairly large number of
concerns, these concerns themselves also controlled by a single family or a few families or business houses” and

b) Country-wise concentration take place “Where a large number of concerns engaged in the production or distribution of different commodities are in the controlling hands of one individual or family or group of persons, whether incorporated or not’ connected closely by financial or other business interest” (GOI, 1965).

Other forms of the industrial concentration are mergers, acquisitions, takeovers, vertical integration and diversification. Merger refers to amalgamation or integration of two or more firms. The firms under different ownership and management controls come under one unified firm through merger. The terms acquisition and takeover are also used for merger, which implies that a firm (the bidder or acquiring firm) acquires or purchases assets or stocks in part or full of other firm or firms (the target or acquired firm or firms) to get operational control over them. In legal sense, there is difference between these terms but from the point of view of the economic analysis, these are alike.

The theories on M&As extend over the vast terrains of industrial organization, financial economic and international business studies. Therefore, it has been pointed out that the trends of M&As can be theoretically traced back to particular motives for M&As emphasized by industrial organization theories (i.e., market power and defensive reactions), the financial economic literature (i.e., managerial ego) and international business research (i.e., access to markets or technologies) (Cantwell and Santangelo, 2002). These theories can be classified into four categories:

i) **Mergers as efficiency enhancing measures**: Mergers can lead to increased efficiencies. Such efficiencies can flow from economies of scale, greater control over key inputs, product rationalisation, combining marketing, advertisement and distribution, or from cutting down overlapping Research and Development. International M&As may be regarded as a new cross-border strategy that aims at increasing corporate global competitiveness by pursuing related diversification and by integrating affiliates into a global network.
ii) Mergers as enhancing concentration and monopoly: The immediate effect of a Merger is to increase the degree of concentration as it reduces the number of firms. Another effect of Mergers on competition is on the generation of barriers to entry.

iii) Mergers as driven by macro-economic changes: M&As are undertaken to compensate for instabilities such as wide fluctuations in demand and product mix, excess capacities related to slow sales growth and declining profit margins and technological shocks (Post, 1994; Weston, et al, 1996). Firms may pursue M&As for the sole reason of growing in size, as size more than profitability or relative efficiency is considered to be the effective barrier against Takeovers (Singh 1975; 1992).

iv) Mergers as driven by financial motives: Firms adopt M&As as a route to growth whenever alternative investment opportunities for financing corporate expansion in specific environments are less attractive.

Vertical Integration, also a form of industrial concentration, implies operations by a firm in two or more industries representing successive stages in the flow of materials or products from an earlier or a later stage of production or vice versa. It is the integration among the intermediate products used in production of a commodity. It may be initiated in either way i.e. a firm itself start manufacturing all of them or different firms producing goods at different stages of the process merge together. When there is vertical integration between two or more firms, it means vertical integration between their products. The main motives of vertical integration can be the increase in profitability by fuller utilization of resources and saving of costs through backward or forward integration. The other motives of the vertical integration can be stability and growth, negotiating transaction costs in business contracts among the firms at different vertical levels, more bargaining power which affects the business efficiency of the firm, integrate into the down-stream industry and for other strategic reasons also (Martin, 1989).

Another form of industrial concentration i.e. diversification can be defined as “the spreading of its operations by a business over dissimilar economic activities” (Amey, 1964). A firm is said to diversify, whenever, without entirely abandoning its old lines of product, it embarks upon the production of new products, including intermediate products, which are sufficiently different from the other products it
produces to imply some significance in the firm’s production and distribution programmes. In the process of diversification, a firm makes significant changes in its areas of operations related to technological base, market areas and productive activities. There are four different ways in which a firm can diversify:-

1. When there are additional products within the firm’s existing technological bases and market areas;

2. When there are products involving the existing technological bases but destined to new market areas;

3. When there are products which involve all together new technological bases for the existing market;

4. When there are new products with new technological bases for new market areas (Penrose, 1959).

Thus, diversification can not be conceived of changes in the products only; it implies the other two aspects of the change also i.e. changes in the technological base and market areas. Recognition of diversification has grown in those circumstances when the objectives of the firm can be achieved by increasing the range of activities in which it is engaged. The major objectives behind the process of diversification can be growth, profitability or the stability. A firm’s growth in the existing activities can be restricted by the demand constraint or a high degree of competition. But the firm can grow by diversifying its activities in the other growing areas. If the current operations of a firm are in the relatively stagnant industry, the firm might achieve a higher rate of profitability by diversifying. If a firm has a competitive advantage in technical, managerial or other form in existing as well as in new activities, it can obviously improve its profitability by diversifying.

Concentrating on a single or a narrow range of products makes a firm more dependent on one market and also vulnerable to adverse cyclical changes. Diversification can provide the security against the cyclical instability, if its existing industry is subject to wild cyclical fluctuations.
Huge capital, dynamic enterprise and resourcefulness are required to survive in the present day industry which cannot be procured by the small firms. For achieving efficiency in business management and to maintain the competitiveness, concentration of power is necessary to a certain extent. It helps in securing economies of large scale organization and in increasing productivity. Concentration *per se* is, therefore, not an evil, provided there are checks on its possible abuse by unscrupulous individuals (Kuchal, 1979).

Market imperfections of one kind or another could give rise to patterns of behaviour and performance of individual firms which previously had been associated only with the extreme situations of monopoly. This calls for a detailed empirical investigation of structure in general and market concentration in particular. Although most of the disadvantages of less than perfectly competitive industries could be the result of several firms of market imperfection, the number and size distribution of firms in individual industries are evidently closely bound up with their behaviour and performance. In particular, where a high proportion of total industry output or sales are made by a small number of firms, then the industry’s performance is likely to diverge considerably from that predicted for a perfectly competitive industry.

The presence of concentration in an industry can have some consequences. Firstly, there will be a lack of optimum allocation of resources and price will be in excess of the marginal cost. Due to lack of competition, the profits will be more than the normal profits even in the long run. Higher the level of concentration, lesser will be the output and higher will be the prices and lesser resources will be employed. Secondly, the higher level of concentration also leads to fall in the efficiency of the firms. Even those firms which experience fall in profits due to inefficiency can survive because of lack of competition. Thirdly, the concentration leads to deterioration in distribution of income as greater share of income is enjoyed by bigger firms in concentrated industries (Utton, 1970).

The above three effects of concentration can be at the industry level but, in the broader sense, the concentration of economic power can have important economic, social and political consequences which are discussed as follows:-
i. Exploitation of consumers through unfair trade practices including monopolistic and restrictive trade practices.

ii. When the market is not competitive the producers may not seriously try to improve the quality and productivity.

iii. The large firms may try to block the entry of new and small entrepreneurs.

iv. Concentration of economic power might further tend to increase the economic disparities causing social tensions.

v. Concentration of economic power may tempt to corrupt the political and administrative system.

vi. Concentration of economic power may hinder the growth of managerial class more especially at the top level of management.

vii. It is also argued that the Concentration of economic power might lead to misdirection of investment.

viii. Concentration of economic power may lead to exit of small firms (Cherunilam, 1984).

In order to understand and interpret the statistical information on concentration, it is essential to discuss the factors that lead to concentration and its sustainability. The concentration may result from a particular factor or a mixture of them. Some factors may have positive and others may have negative impact on concentration. Some factors may lead to improvement in allocation of resources or growth of output and some factors may cause fall in efficiency or a barrier to technical progress or competitiveness. In a concentrated industry, the larger firms have sufficient resources and inducement to invest in research and development activities as it leads to higher profits and control over the market. Therefore the individual firms may be interested in maintaining the higher level of industrial concentration and even government may facilitate it. But in a concentrated industry, the larger firms are also interested in removing the ease of entry to the new firms with the help of selling cost, product differentiation etc. to maintain or even raise the level of concentration.
The factors causing change in concentration may vary from industry to industry. In some industries, the desire on the part of the firms to operate plants that are efficient i.e. operate at their optimum levels, can lead to high level of concentration. Whether or not this is the case in an industry will depend on two factors: the size of an optimum plant and size of the market. In those industries where average cost does not rise sharply in plants of less than optimum scale, it may be possible for smaller plants to exist alongside larger competitors without incurring too much of cost disadvantage. This helps to maintain a lower level of concentration in the industry. But in some industries it appears that average plant costs are likely to remain constant over a considerable range of output, once the minimum cost output level has been reached, it leads to a much higher levels of concentration without the loss of efficiency. Where there are further economies open to a firm which grows beyond the scale of the single technical unit and makes the operation of several plants more efficient than one alone, then it will have even higher level of concentration (Utton, 1970).

In India, during the pre-liberalization period, the system of controls in the form of industrial licensing, import restrictions, exchange controls helped the big-business houses and firms. The system of industrial licensing restricted the freedom of entry and the policy of big business houses to pre-empt the capacity by obtaining multiple licenses were the major cause of industrial concentration. The big business houses were also at an advantage in getting financial assistance from banks and other non-banking financial institutions.

During post-liberalization period, development of the joint stock companies and the economies of scale arising out of technological advances are the main causes of the growth of industrial concentration in India. The inter-company investments, inter-locking of directors, mergers, takeovers, amalgamations etc. have also contributed to the concentration of economic power.

Recent literature highlights the idea that the economic growth may be impeded not simply because of lack of resources such as capita, skilled labour and entrepreneurship but also because available resources are misallocated. The high level of state ownership and ownership by traditional private firms in India raise the question of whether existing resources could be allocated more efficiently and whether
remaining barrier to competition jeopardize the effectiveness of reform measures that have been put in place. While rates of return across ownership groups do not display significant dispersion, it is not clear whether the rates of return for the incumbent groups are driven by monopoly power that comes with high industry concentration, or through inherent efficiency. A related issue that also arises is whether privatization in the context of high industry concentration may simply replace state-owned monopolies with private ones as it has done in the case of many countries in Latin America.

More concentrated industries are likely to successfully lobby the government to restrict. Liberalization is also less likely in profitable, concentrated industries because firms have an incentive to protect their monopoly profits. Incumbent firms have an incentive to oppose liberalization if entry causes a decline in profits (Stigler, 1971). However, while firms in industries with declining growth rates and profitability may have an incentive to oppose entry liberalization, they may lack the ability to influence the government (Kroszner and Philip, 1999). Cash-rich incumbent firms in high-growth or profitable industries may be more influential. From the private interest perspective, the pattern of liberalization will therefore depend on the relative lobbying strength of incumbent firms in profitable versus declining industries. According to the public interest hypothesis, a welfare-maximizing government should liberalize entry in uncompetitive industries that earn monopoly profits. However, from a welfare perspective declining industries also may benefit from more competition; hence neither the private nor the public interest views yield a straightforward prediction for the unconditional effect of profitability (Chari and Gupta, 2006).

Conditioning profitability on industry concentration presents a potential avenue for distinguishing between the private and public interest hypotheses. Under the private interest hypothesis, concentrated industries that are more profitable are more likely to oppose liberalization to protect monopoly profits. In contrast, the public interest hypothesis suggests that industries that earn monopoly profits are the ones that ought to be liberalized.

Therefore, the process of liberalization can have a vital impact on the market structure. Market structure, to a great extent, determined the behavior of firms in an industry. The term market structure refers to a selected number of organizational characteristics of a market that establish inter-relationship between the buyers and
sellers of a particular product. It is a study of the organizational feature of a market or industry that is believed to have significance for the conduct and performance of the firms comprising the market. Market structure determines the behaviour of the firms and that behaviour in turn determines the quality of the industry’s performance (Caves, 1967).

There are different approaches to study industrial organization, of which the widely used approach is the “structural approach” or structure-conduct-performance paradigm. The structure-conduct-performance paradigm advocates a direct link between market concentration and the degree of competition. A higher market concentration allows firm to exploit their market power by earning higher profits. For the formal beginning of structure-conduct-performance paradigm the credit goes to Mason (1959), who suggested some policy measures regarding Monopoly and Imperfect competition through the empirical examination of the organization of market structure of the firms. However, as the study of industrial organization developed, an extensive literature beginning with Bain (1951) has examined the relationship between market structure, as measured by market concentration and firm’s market share, and the exercise of market power. Since then, there have been many studies in the industrially advanced countries based on structure-conduct-performance paradigm, especially to study the relationship of industrial concentration with profitability, size, growth and other factors but most of the studies examined structure-performance relationship.

The three aspects of the industrial organization viz. structure, conduct and performance are inter-related and a full structural model incorporates simultaneous causation between them. Structural factors may result in high profitability which on the one hand might attract new entry and on the other enable the existing firms to invest in strengthening the barriers to entry (Apte, et al, 1982). The particular types of market structure are associated with particular types of market behaviour and performance. The dimensions of market structure are the degree of seller and buyer concentration, extent of product differentiation and barriers to entry in the market. The other dimensions of market structure can be product diversification, vertical integration etc. (Devine, et al, 1985). But the most important dimension of market structure is industrial concentration and other dimensions of the structure generally
lead to it. It has been suggested that the main differences observed in market structures in different industries are due to scale economies, market size and growth rates, government policies, merger activities by participating firms and chance factors (Mueller, 1974).

The concentration and market performance relationship has diverse hypotheses. The general hypothesis of economic theory is that a larger firm enjoying larger share in a concentrated market have higher rate of profitability, larger share in sales, larger share in assets, grow faster, has better short and long term solvency, better research & development capabilities and so on. The most frequently used form of the structure-performance model has been one that relates various dimensions of market structure to one performance indicator i.e. profit (Devine, et al, 1985). The structure-performance relationship causing high profitability may lead to fall or rise in the level of concentration in the particular industry. Since then, there were many diverse studies on the relationship, some of which were based on price-cost margin as the measure of profitability. But no generalization could be made about the concentration as the determinant of profitability though major support came for its being a positive factor as per the theory (Barthwal, 2000). The classical Structure-Conduct-Performance (S-C-P) approach to industrial organization also argues that higher concentration leads to increased market power, which in turn affects the performance of the industry. Practitioners of S-C-P measure the relationship between profitability and concentration indexes to test their theories of causation between concentration and the exploitation of market power.

There can be a causal relationship between other variables / indicators of performance that can be used to study the structure-performance relationship like size and growth of the firms, innovative activity, advertising activity technological changes, financial ratios etc. and also a vast and diverse literature is available on it. But the relationship between structure, conduct and performance is not all that straight forward as theory suggests. In other words, the line of causality is not structure determining performance through conduct. On the contrary both structure and conduct are determined by host of government policies which are itself mutually exclusive (Mani, 1993).