A Theory of Optimal Expropriation, Mergers and Industry Competition*

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Abstract

We model a competitive industry where managers choose quantities and costs to maximize a combination of firm profits and private benefits from expropriation. Expropriation is possible because of corporate governance 'slack' permitted by the government. We show that corporate governance slack induces managers to choose levels of output and costs that are higher than would otherwise be optimal. This, in turn, benefits consumers because the equilibrium price is lower. The model shows that for every economic system, and depending on industry structure and the government's objective, there is an optimal level of expropriation that maximizes social welfare. Some mechanisms suggested by the literature as effective at improving investor protection—legal change, firms voluntarily opting into more protective systems, domestic mergers—do not work once competition is considered. We provide a theoretical argument showing the efficacy of cross-border mergers. The stronger corporate governance of a foreign acquirer, imposed on the domestic target firm, benefits merging shareholders and those of competing unmerged domestic firms.

KEYWORDS: corporate governance, market regulation, mergers and acquisitions

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