Vertical Integration (Ch. 12)

Vertical Integration: production, distribution (marketing) of goods/services

e.g. ***Perdue(1950s chicken supplier)***
began to mix own feed
1961: bought soy bean plant firm
1968: bought processing plant (kill, dress, deliver)
1969: own t.v. ads

Input supplier-----------------Manufacturer------------------Distributor----------------Retailer ← upstream → downstream

Not Integrated: open market (no restrictions on suppliers)

e.g. ***wheat brokers***

Vertical Restrictions: long-term contracts btw manuf. & distrib. (price, behavior: territory, inventory requirements, min. retail prices)

- Achieves some advantages of VI

Most firms "partially" integrate

e.g. ***restaurant baking pies***

I. Choosing VI (Buy vs. Make)

- Choice of structure is a strategic decision
- Costs vs. benefits
- Affects pricing and promotional behavior

1. Lowers transaction costs (size)
   e.g. ***computer production***
   - Economies of scale vs. negotiation & legal fees
   - Writing, enforcing contracts:

   Alchian and Demsetz (1972); Klein, Crawford, Alchian (1978)

2. Ensures quality
   e.g. ***Tandy***

3. Prevent holdups (VIB)
   e.g. ***Toyota: "just-in-time" delivery of input***

4. Evade government restrictions (profit rates, taxes)
   e.g. ***telephone: local services vs. phone selling (shift profits)***
   steel mill (price controls)

5. Raise/lower market power (VIF)
   (VIF) Monopolize final product market
   (VIB) Get rid of monopsony supplier

6. Price discriminate
   e.g. ***aluminum ingot (wire and airplanes); VIF to prevent resale***

7. Minimize oppt. behavior (taking advantage when allowed by circumstances)

   "If you want something done right, do it yourself."

   Likely when…

- Complicated contracts (bounded rationality)
- One-way dependence (captive: raise P w/greater D)
- Specialized asset (tailor made for few specific buyers)…
  - Specific physical capital (dies/molds and machine press) *S-er owns*
  - Specific human capital (contractor vs. employee) *deadline, D more $*
  - Site-specific (costly to relocate) e.g. airplane manufacturer

Stops demanding input

II. Fixed vs. variable proportions industries (profits rise?)

Fixed: NO subs for inputs, changes in relative factor prices do NOT matter
(NO gain from integration)

Variable: subs available, changes in relative factor prices affect efficiency
(GAIN from integration)