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

<table>
<thead>
<tr>
<th>Input supplier</th>
<th>Manufacturer</th>
<th>Distributor</th>
<th>Retailer</th>
</tr>
</thead>
<tbody>
<tr>
<td>← upstream</td>
<td></td>
<td></td>
<td>→ downstream</td>
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</table>

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)…  
     o Specific physical capital (dies/molds and machine press) S-er owns  
     o Specific human capital (contractor vs. employee) deadline, D more $  
     o 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)