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Abstract

The transactions-costs literature on vertical integration emphasizes that nonintegrated firms tend to make socially sub-optimal relationship-specific investments due to ex-post opportunism. This literature views vertical integration as a contractual remedy to overcome this underinvestment problem. In this paper, we demonstrate that integrating firms may inefficiently reduce non-specific investments for strategic reasons, e.g., to raise rival firms' costs. We construct a simple equilibrium model of investment-reducing vertical integration, which also shows that anticompetitive vertical integration (both for consumer welfare and for aggregate efficiency) can arise in equilibrium without making the troublesome assumption of price commitment by the integrating firms. Our results hold under both Bertrand and Cournot downstream competition.

JEL classifications: L12, L13, L42.

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