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Institutional Determinants of Vertical Integration in China

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Where legal systems and market forces enforce contracts inadequately, vertical integration can circumvent these transaction difficulties. But, such environments often also feature highly interventionist government, and even corruption. Vertical integration might then enhance returns to political rent-seeking aimed at securing and extending market power. China offers a suitable background for empirical examination of these issues because her legal and market institutions are generally weak, but nonetheless exhibit substantial province-level variation. We report that Chinese firms in the 2000's are more vertically integrated than the U.S. firms in the 1990s. We find that vertical integration is more common where legal institutions are weaker and where regional governments are of lower quality or more interventionist. Further, firms led by insiders with political connection are more likely to be vertically integrated. Finally, vertical integration among politically unconnected firms is associated with elevated per capita GDP level and growth, while vertical integration among politically connected firms is unrelated to local economy performance.

JEL Classification: L22; P14; G38; P16

Key Words: Vertical Integration; Rent seeking; Institutional Development; Government

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