Extending Market Power through Vertical Integration

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This paper derives a model of vertical integration when it is difficult to write binding long-term supply price contracts. Thus, a vertically separated monopolist is vulnerable to hold-up. Without integration, we demonstrate that a bottleneck monopolist has an incentive to encourage more firms in a related segment than would arise in a pure monopoly. Having more firms mitigates the hold-up power of any one. This, however, distorts the cost structure of the industry toward greater industry output and, hence, lowers final good prices. Vertical integration mitigates the hold-up problem faced by the monopolist. It allows it to generate and appropriate a greater share of monopoly profits. Horizontal competition mitigates the anti-competitive effects of integration.

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