Why do large firms tend to integrate vertically?

Noriaki Matsushima*
Graduate School of Business Administration, Kobe University
and
Tomomichi Mizuno
Graduate School of Economics, Kobe University

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Abstract

We provide a theoretical framework to discuss the relation between firm size and vertical structures. The framework is based on a Hotelling model with three downstream and three upstream firms. We show that vertical integration enhances the degree of product differentiation and show the strategic complementarity of product positioning. We also show that the downstream firm that has the largest market share is more likely to integrate vertically. Enhancing the degree of product differentiation is more beneficial for the large firm than for the rest of the downstream firms because the large firm supplies a large amount of product.

JEL classification: L22, L13, R32

Key words: vertical integration, asymmetry, product differentiation, location

*Correspondence author: Noriaki Matsushima, Graduate School of Business Administration, Kobe University, Rokkodai 2-1, Nada, Kobe, Hyogo 657-8501, Japan. Phone: +81-78-803-6981, Fax: +81-78-803-6977, E-mail: nmatsush@kobe-u.ac.jp