

Upstream Privatization, Downstream Merger Subsidy and Entry License

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Abstract

In the literature of horizontal merger, Perry and Porter (1985) and Farrell and Shapiro (1990) focused on cost synergies of mergers. Davidson and Mukherjee (2007) examined horizontal mergers in Cournot oligopoly with free entry, while Spector (2003) discussed horizontal mergers in a price setting oligopoly with free entry. Recently, Cato and Matsumura (2013) investigated how horizontal mergers affect the optimal entry barrier (tax) in the presence of free entry and exit. They showed that the government should raise the entry tax when a merger reduces the total number of firms entering.

We construct a vertically related market to analyze the privatization of the upstream semi-public firm, and the merger subsidy and entry license fee of the downstream firm. We demonstrate that under free entry of inefficient downstream firms, a merger subsidy is employed, and license fee may be chosen in the vertically related market when the market size is relatively large; however, when the market size is relatively small, merger tax is imposed on the dominate merged firm coupled with no license fee to ensure enough competition. The optimal privatization policy of upstream public firm is partial privatization. More policy emphasis should be placed on the coordination of privatization, merger subsidy and entry license fee.

Keywords: Partial privatization, Free entry, Merger subsidy, Entry license fee

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