

**Bypassing Intermediaries via Vertical Integration:
A Transaction-Cost-Based Theory**

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Abstract

We provide a theory of vertical integration motivated to bypass intermediaries and contract directly with workers or customers in order to reduce double marginalization of rents. Non-integration results in inefficiencies that cannot be overcome via sophisticated contract design if supplier costs are nonverifiable, owing either to weak accounting systems or collusion between intermediaries and lower layer agents. Vertical integration generates benefits by lowering these inefficiencies, but incurs bureaucratic costs in order to control intrafirm collusion. We discuss predictions of our theory concerning determinants of benefits and costs of integration, compare these with Transaction Cost and Property Rights based theories, and with available empirical evidence.

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