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# VERTICAL INTEGRATION: economies of scope

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## tl;dr

*Vertical integration allows businesses to innovate more. It may be bad for certain competitors, but it is rarely bad for competition.*

**The Debate:**

Vertical integration refers to businesses performing a number of different and important roles in the supply chain for a particular product — for example, a manufacturer that sells its products directly to the public in its own stores. While all businesses are vertically integrated to some extent, some worry that vertical integration in digital markets prevents smaller businesses from competing.

**But…** empirical research has consistently found vertical integration to be good for consumers through a number of mechanisms that allow for reduced costs and better product quality.

## KEY TAKEAWAYS

### COMPREHENSIVE REVIEWS OF RECENT EMPIRICAL RESEARCH SUPPORT EARLIER CONCLUSIONS IN FAVOR OF VERTICAL INTEGRATION.

Vertical integration by businesses has been consistently found in a series of reviews to produce benefits for consumers, and predictions about vertical mergers raising prices have been extremely unreliable, at best.

### VERTICAL INTEGRATION WORKS BY ALLOWING TECHNOLOGY TRANSFER BETWEEN FIRMS AND REDUCING THE INEFFICIENCIES AND DISCOORDINATION THAT CAN OCCUR IN SUPPLY CHAINS.

These include transaction costs, where the difficulties of different parties dealing with each other raise costs of production; holdup problems, where attempts by each party to extract greater profits raise costs overall; moral hazard, where certain parties (e.g., retailers) run down the value of a brand that represents the whole supply chain; and other risks and costs that can arise when the external costs of businesses' actions are not borne by the businesses themselves.

### THE VALUE OF NEW INNOVATIONS CAN "LEAK" LESS FROM VERTICALLY INTEGRATED BUSINESSES, CREATING STRONGER INCENTIVES FOR BUSINESSES TO INVEST IN NEW TECHNOLOGY.

Vertical integration can be a mechanism that allows innovative businesses to prevent their inventions from being copied by rivals, giving them greater returns on their R&D investment and giving society more innovation overall.

**VERTICAL INTEGRATION CAN HARM COMPETITORS WHO HAD PREVIOUSLY BEEN PART OF THE SUPPLY CHAIN MIX, BUT THIS IS NOT THE SAME AS HARMING CONSUMERS.**

When Apple vertically integrated digital sales from the iTunes Store and the iPod, it may have harmed the manufacturers of CDs, but it benefited consumers by providing an easier to use product with a greater selection to choose from.

**WHERE ANTITRUST AGENCIES CAN IDENTIFY A POTENTIAL HARM TO COMPETITION FROM A VERTICAL MERGER, THEY CAN PROHIBIT THE SPECIFIC BEHAVIOR CONCERNED.**

Behavioral remedies are a less interventionist way of avoiding potentially anticompetitive behaviour than blocking mergers outright, which prevents the realization of any and all merger efficiencies, not just potentially harmful conduct.

For a fuller explanation of these and related issues, see Geoffrey Manne's recent submission to the U.S. House of Representatives Committee on the Judiciary, Subcommittee on Antitrust, Commercial, and Administrative Law, "Correcting Common Misperceptions About the State of Antitrust Law and Enforcement."

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