

# Use industrial economic theory to assess the extent

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Vertical integration is the process of combining firms, usually under a single ownership, that are different parts of a larger production scale. This could be anything from two firms to all of the firms that make up the supply chain.

Due to combining multiple smaller firms, this form of integration has an effect on the market power that the firm(s) has (Riordan, 2008). This differs to horizontal integration which is the combination of firms or expansion of a single firm at one particular point of the production process (Black, Hashimzade, & Myles, 2009, p. 206-7).

Vertical integration is usually carried out in one of two ways. Upstream, which can be referred to as backwards, and downstream, or forward, and the definition is linked to the ownership or controlling party. Upstream is to your suppliers and downstream is to your buyers (Enz, 2009, p. 214). Although vertical integration is usually upstream or downstream it can also be balanced which is where ownership or control is shared between the firms in the supply chain. There are multiple benefits associated with vertical integration but some of the benefits may differ between upstream and downstream.

Some benefits that may arise are improved coordination between firms throughout the supply chain, cost savings through internalized transactions and an increased market share (Fairburn, & Kay, 1989, p. 10). There are many examples of both upstream and downstream integration in industry throughout history. In the 1970's and 80's many crude petroleum extracting companies acquired downstream firms such as refineries and distribution networks ("Idea: Vertical Integration", 2009).

This is mirrored today with many oil companies such as Shell and BP owning all parts of the supply chain from extraction to the petrol stations supplying the consumers. Smithfield Industries are a meat producing firm that has benefitted from upstream vertical integration. They have integrated with a variety of farms, slaughterhouses as well as other firms that make up the entire supply chain. They now have ownership or decision making power, such as changes to production levels to match changes in demand for the final products, in all the firms that supply them.

As a result they now have 26% of the meat and poultry market (Pepall, Richards, & Norman, 2008, p. 449) as well as receiving other benefits such as maintaining a sustainable supply for larger numbers, having control over product quality (such as the leanness of the meat) and they have designed warehouses and barns for their subsidiaries to improve their operational efficiency. Most of these benefits are predominantly in favour of the retailer Smithfield as much of these benefits are associated with lowering costs across the supply chain which lowers their final input costs.

These benefits, that are associated with lowering input costs, all indicate that Smithfield do not suffer from double marginalisation as a result of their vertical integration. Double marginalisation is when all the integrated firms set a price above the marginal cost (MC) which then creates two sets of surpluses that are incurred, also reducing consumer surplus to make all parties worse off. Pepall, Richards & Newman state that this is not possible if there is competition either upstream or downstream in the chain (2008, p. 438).

This is because competition can cause the wholesale price of inputs to be at the MC to either keep the upstream firm competing or the downstream firms

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final price competitive. Competition upstream that causes production at the MC can help the downstream firm, in this case Smithfield, achieve abnormal profits if they have monopoly power and the ability to discriminate their prices. Although most of the benefits are for Smithfield, the subsidiaries will benefit from having more efficient processes and economies of scale that may be gained from the integration due to investment received from the parent firm.

The profitability of the integration is linked to the level economies of scale obtained from it as the ability to coordinate the adoption of new technologies associated with lower marginal costs for the subsidiaries will define how much profit can be made (Avenel, 2008, p. 248). As well as this they will benefit from having a reliable retailer that will have a consistent demand for their products. Although they will have a consistent buyer for their products the subsidiaries will have to receive a lower unit price for their products as a result of bringing down their costs after the integration.

This is not a negative as the demand for their product is consistent and the fall in market price will be proportional to the fall in costs. As well as Smithfield, other meat and poultry production firms have benefitted from having highly integrated production chains such as Tyson, ConAgra and Swift (Pepall, Richards, & Norman, 2008, p. 449). The integration of these firms is consistent with Lieberman's views (1991, p. 452) of why upstream integration may take place. The main reason which is applicable to this situation is that if the inputs in question account for a large proportion of total cost (which animals being bred for meat will do) then the downstream firm is more likely to integrate. Although all these firms are highly integrated and

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could offer much lower prices than they already do to the consumers they choose not to. Having a higher mark up allows them to receive higher profit margins from the lower input costs while keeping similar market prices for their final output. This is a form of non-price competition in order to receive higher profits and an example of Nash equilibrium.

Nash equilibrium is where a set of price levels or production levels for each firm will not be changed based on the decision of the other competing firms (Pepall, Richards, & Norman, p. 197), meaning that if one lowers their price the rest of the competitors will retaliate and all start undercutting theirs but could end up resulting in loss of profits based on how much the prices change. Nash equilibrium is common in large oligopolistic markets which are also the most common for vertical integration to take place in.

This is an example of how the benefits of this integration will not be asymmetric as the final retailer can increase its profits relatively by a much larger amount than the subsidiaries they are purchasing their inputs from. All the benefits previously mentioned which are mainly associated with lower costs and prices also cause another benefit by causing barriers to entry. These are things that make it difficult to enter the market (Black, Hashimzade, & Myles, 2009, p. 29).

In this case the low costs due to higher efficiency will make competition for a new entrant difficult and will in turn detour others from attempting to enter the market which will keep the level of competition for the existing firm lower, especially in the case of the meat and poultry market where many of the largest firms are highly integrated. Partnerships are a form of integration that does not include control or ownership but can still provide many

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benefits, usually cost orientated, that may be associated with conventional integration.

Partnerships often occur when both firms involved are large and it would not be cost-effective to attempt to buy them. McDonalds are a company that as well as being highly integrated they also have many partnerships with companies such as Coca-Cola, Heineken and Microsoft. In the case of the Microsoft partnership some of the benefits are streamlining operations and reducing the total cost of operations (“ Microsoft Partners with McDonald’s for Global Point-of-Sale Solution”, 2005).

As well as this Microsoft will also benefit by improving their brand awareness, specifically for their Microsoft Smarter Hospitality system. In conclusion all parties will benefit from vertical integration. But the benefits are not asymmetric. In an upstream integration the majority of the benefits are gained by the retailer that sells the final product. This is because they can increase their market share as a result of the integration as well as their costs can be greatly reduced while keeping their price relatively similar and hence creating more profits.

The subsidiary firms may still end up with higher profit margins but the proportional increase is unlikely to match that of their owner firm. Another reason that the benefits are not asymmetric and are greater for the retailer is that they gain control over the subsidiary and the subsidiary has to relinquish some or all control to the owners. This allows the retailer to dictate what is produced in preparation for possible changes in demand or product portfolio which could lead to the supplier being left with excess stock.

The benefits from barriers to entry will not be asymmetric. In many cases, including the poultry market, the upstream markets are more monopolistic and more competitive as opposed to a more oligopolistic structure downstream (associated with higher barriers to entry) which is shown by the fact that a single downstream firm will own multiple upstream suppliers. Also the fact that the downstream firms will get more cost/price benefits show that the added difficulty for new firms to compete will be harder. Bibliography Answers. (2011).

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