Port Econ J (2012) 11:1–20
DOI 10.1007/s10258-011-0074-z

ORIGINAL ARTICLE

Vertical integration, market foreclosure and quality investment

Roberto Hernán González · Praveen Kujal

Received: 3 February 2010 / Accepted: 4 May 2011 / Published online: 15 June 2011
© Springer-Verlag 2011

Abstract We study incentives to vertically integrate in an industry with vertically differentiated downstream firms. Vertical integration by one of the firms increases production costs for the rival. Increased production costs negatively affects quality investment both by the integrated firm and the unintegrated rival. Quality investment by both firms decreases under any (vertical integration) scenario. The decrease in quality invesment by both firms softens competition among downstream firms. By integrating first, a firm always produces the high quality good and earns higher profits. A fully integrated industry, with increased product differentiation, is observed in equilibrium. Due to increase in firm profits, social welfare under this structure is greater than under no integration.

Keywords Vertical integration · Quality investment · Market power · Product differentiation

JEL Classification L15 · L22 · L42

R. Hernán González
Economic Science Institute, Chapman University,
One University Drive, Orange, CA 92866, USA
e-mail: roberto.hernangonzalez@gmail.com

P. Kujal
Departamento de Economía, Universidad Carlos III de Madrid,
Calle Madrid 126, 28903 Getafe, Spain
e-mail: kujal@eco.uc3m.es