

# Determinants of Vertical Integration: Financial Development and Contracting Costs\*

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May 16, 2007

## ABSTRACT

We study the determinants of vertical integration in a new dataset of over 750,000 firms from 93 countries. We present a simple model of the effects of financial development and contracting costs on cross-country differences in the extent of vertical integration. The focus of the model is on the interaction effects of financial development and contracting costs. In particular, the model suggests that vertical integration should be higher when contracting institutions are weak so that within-firm transactions are preferred to arm's-length relationships, while at the same time there is sufficient financial development so that upstream and downstream firms can vertically integrate. In the data, there is a correlation between vertical integration on the one hand and financial development and the quality of contracting institutions on the other hand. But these correlations appear to be spurious and entirely accounted for by differences in industrial composition across countries, and thus do not offer support to theories that emphasize the main effects of financial development and contracting institutions on the internal organization of the firm. However, we find relatively robust empirical support for the interaction effects suggested by our simple model. First, there is a robust interaction effect of financial development combined with contracting costs—vertical integration is significantly greater in countries with higher contracting costs *and* greater financial development. Second, we find a differential effect of contracting costs across industries; countries with higher contracting costs are significantly more vertically integrated in industries that are more capital intensive.

**JEL classification:** G30, G34, L22, L23

**Keywords:** credit, finance, institutions, internal organization of the firm, vertical integration.

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\*We acknowledge the helpful comments of John McMillan, Robert Stambaugh (the editor), and an anonymous referee. We thank David Autor, Joseph Fan, and Nathan Nunn for providing data. We are particularly grateful to Jacques Cremer and Jianye Yan for pointing out an error in an earlier version of the paper.

# 1 Introduction

Casual empiricism suggests the presence of significant differences in the organization of production across countries. For example, firms are often thought to be larger and more vertically integrated in less-developed countries. Khanna and Palepu (1997, 2000) provide evidence consistent with this view and suggest that this is because market and contractual relationships are more costly in less-developed countries. Nevertheless, there has not been a systematic analysis of cross-country differences in vertical integration and their causes. Our primary aim in this paper is to make a first attempt at such a systematic analysis and to investigate the relationship between important institutional characteristics and vertical integration across countries.

Two well-established theories offer predictions on how differences in (specific) institutional characteristics of countries should affect the internal organization of the firm in general and vertical integration in particular. First, according to the highly influential Transaction Cost Economics (TCE) theory pioneered by Williamson (1975, 1985), the internal organization of a firm is designed to improve incentives and limit agency costs. Vertical integration is perhaps the best known application of this theory. Vertical integration encourages specific investments and reduces holdup problems when markets are imperfect. According to TCE, vertical integration should therefore be more prevalent when it is harder to write long-term contracts between upstream and downstream firms. This prediction is not entirely unambiguous, however. The more sophisticated approach to vertical integration developed by the Property Rights Theories (PRT) of Grossman and Hart (1986) and Hart and Moore (1990) emphasizes that vertical integration will also create “transaction costs” since employees, like outside suppliers, need to be given incentives to invest, and the fact that they do not have the property rights to tangible assets may weaken their incentives. In the PRT whether better contracting institutions should induce more or less vertical integration is not entirely clear.<sup>1</sup>

A second body of work emphasizes the importance of contracts and other relationships between firms and financial intermediaries. In this view, credit market imperfections affect the organization of the firm. Monitoring and contract enforcement are costly, so entrepre-

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<sup>1</sup>See the surveys by Holmstrom and Tirole (1989), Joskow (2005), and Whinston (2001). Other important theoretical contributions in the area of vertical integration include Klein, Crawford and Alchian (1978), Bolton and Whinston (1992), Aghion and Tirole (1997), Baker, Gibbons, and Murphy (2002), and Legros and Newman (2003). See Acemoglu, Aghion, Griffith and Zilibotti (2004) for a more detailed discussion of the empirical predictions of the PRT approach and an empirical test using UK data.

neers need collateral in order to obtain financing (Banerjee and Newman, 1993, Legros and Newman, 1996), and they may need to rely on bank financing (Diamond and Rajan, 2005, Diamond, 2004). When credit markets have greater imperfections and when a lack of financial development limits the pool of potential entrepreneurs, there should be less entry and, most likely, larger firms in a country (Rajan and Zingales, 1998, Kumar, Rajan and Zingales, 1999). Because larger firms are more likely to produce some of their own inputs or market some of their own outputs, the financial view suggests that better financial institutions and credit markets may be associated with less vertical integration. Nevertheless, the effect of financial development on vertical integration is not unambiguous either. In particular, it may be that a lack of financial development prevents firms that would otherwise like to vertically integrate from doing so (see, for example, McMillan and Woodruff, 1999). Therefore, both the effects of financial institutions and contracting institutions on vertical integration are potentially ambiguous and a better understanding of these relationships requires an empirical investigation of the links between the quality of contracting institutions, financial development, and vertical integration.

While the relationship between the effect of financial and contracting institutions on vertical integration is potentially ambiguous, we argue that there are more robust predictions regarding the interaction between the quality of contracts and financial development. In particular, we present a simple model highlighting that it is higher contracting costs *in combination* with greater financial development that should lead to greater vertical integration. The intuition for this prediction is simple: higher contracting costs in a country may create a demand for vertical integration in certain sectors, but without sufficient financial development, firms may not have the required credit to make the necessary acquisitions (McMillan and Woodruff, 1999). Second, our model predicts another interaction effect of contracting costs and industry characteristics. Specifically, we predict a disproportionate effect of contracting costs on the vertical integration decision in industries that are more susceptible to holdup problems.

We investigate the cross-country determinants of vertical integration using a new dataset of over 750,000 firms from 93 countries. Our methodology follows the finance literature in taking the United States as a benchmark (Rajan and Zingales, 1998), and we combine our firm-level data with the U.S. input-output tables (which are assumed to accurately describe the technological possibilities in other parts of the world). While there are some limitations to our data, they nonetheless provide a new opportunity to understand how the organization

of production differs across countries.

First, we look for the main effects of financial development and contracting costs on the degree of vertical integration across countries. Although both cross-country differences in financial development and contracting institutions are correlated with vertical integration, it turns out that these correlations are largely spurious. These cross-country differences in vertical integration are entirely accounted for by differences in industrial composition across countries. Once we control for differences in industrial composition, contracting costs and credit market development have little explanatory power for differences in vertical integration. Thus, it is not the case that countries with greater contracting costs or credit market imperfections tend to be more vertically integrated in a given sector. Rather, such countries tend to be concentrated in sectors that are naturally vertically integrated wherever they are in the world. We also investigate whether differences in financial development and contracting costs may be the reason for the differences in industrial composition and find no compelling evidence to support this hypothesis.

Our main results, on the other hand, focus on the interactions between financial development and contracting costs. Consistent with our simple model, we find that financial development and contracting costs together have a robust interaction effect on the level of vertical integration in a country. Vertical integration is more likely when both contracting costs and financial development are high. This result is significant even when we control for industrial composition. In addition, we conduct a number of robustness checks and find that the result is robust in a wide variety of specifications. The strong interactive effect of contracting costs and financial development suggest that both factors in combination may be important for the equilibrium organization of production.

Finally, our third set of results focuses on the effects of contracting costs across different industries. Our model predicts that contracting costs should have a greater effect in industries that are more subject to holdup problems. Employing capital intensity as a proxy for the degree of holdup problems, we find that higher contracting costs are associated with greater vertical integration in industries that are capital intensive. We also find this result to be robust to a series of alternative specifications. These results suggest that lack of efficient contract enforcement mechanisms may lead to greater vertical integration especially in relatively capital intense industries.

Despite the congruence between our theoretical predictions and the empirical results, it should be emphasized that the interaction results reported in this paper cannot be interpreted

as causal relationships. Instead, it may be some other (omitted) characteristics that lead to the relationship between vertical integration and the interaction of industry characteristics and contracting costs. A more detailed investigation of potential causal effects requires either a more structural approach or an instrumental variables strategy, which we view as an important area for future work.

Our paper relates to the existing literature in a number of ways. The comparative finance literature finds that countries with less financial development will tend not to develop in industries requiring greater external finance (Rajan and Zingales 1998), but has not investigated cross-country differences in vertical integration or in the internal organization of firms.<sup>2</sup>

Also related to our paper are cross-country comparative studies, including Bain (1966), Pryor (1972), Scherer (1973), Nugent and Nabli (1992), Kumar, Rajan and Zingales (1999), Desai, Gompers, and Lerner (2003), Fisman and Sarria-Allende (2004) and Klapper, Laeven, and Rajan (2006).<sup>3</sup> These papers typically focus on concentration, firm size, and entry. Earlier papers use OECD data, while more recent papers use data from the Amadeus database for Western and Eastern Europe, or from the Worldscope database, which contains information only for relatively large publicly traded firms. Our dataset is, to the best of our knowledge, unique in allowing us to look at a relatively broad cross-section of countries and a large sample of firms, including both private and public companies and medium-size as well as large firms. In addition, none of these studies focuses on the internal organization of the firm or vertical integration.

The paper proceeds as follows. The next section presents a simple model to motivate our empirical work. Section 3 describes the data used for the study. Section 4 presents results on the main effects of financial development and contracting costs on vertical integration.

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<sup>2</sup>There is a large literature on vertical integration in specific industries in the United States, including Joskow's (1987) seminal paper on ownership arrangements in electricity generating plants, Stuckey's (1983) study of integration between aluminium refineries and bauxite mines, Monteverde and Teece's (1982) investigation of integration in the automobile industry, Masten's (1984) work on the aerospace industry, Ohanian's (1994) work on the pulp and paper industry, Klein's (1988) work on the Fisher Body and General Motors relationship, Baker and Hubbard's (2001, 2003) study of the trucking industry, Lerner and Merges' (1998) work on the biotech sector, and Chipty's (2001) paper on market foreclosure in the cable television industry. Woodruff's (2002) work on the Mexican footwear industry is the only paper we are aware of that provide a systematic study of vertical integration in a developing economy. Finally, Antràs (2003) studies the relationship between capital intensity and outsourcing using 23 U.S. industries.

<sup>3</sup>Another well-known approach, the market foreclosure theory, views vertical integration as a method of increasing monopoly power by downstream firms (e.g., Perry, 1978, Aghion and Bolton, 1987, Hart and Tirole, 1990, Ordober, Salop, and Saloner, 1990, and Chipty, 2001). We show that our results are robust to controlling for measures of antitrust regulations (as in Dutz and Hayri, 1999). However, because the available data on cross-country differences in antitrust regulation are more limited, we do not focus on antitrust issues in this paper.

Section 5 presents our major results, which focus on the predictions of our simple model concerning the interaction effects. Section 6 concludes.

## 2 Motivating Theory

In this section, we present a simple model of vertical integration in the presence of contract enforcement problems and imperfect capital markets. Our purpose is not to provide a comprehensive theory of vertical integration, but to derive a number of simple predictions to confront with data. For this reason, we make a number of simplifying assumptions and try to communicate the main ideas most effectively.

### 2.1 Environment

Consider the following simple game between a supplier and a producer. Both parties are risk neutral and maximize expected profits. The supplier can produce an input of quality  $q$  at the cost  $c(q)$ . We assume that  $c(\cdot)$  is strictly increasing, convex and differentiable with  $c(0) = 0$ , and that it satisfies the following *Inada conditions*,  $c'(0) = 0$  and  $\lim_{q \rightarrow \infty} c'(q) = \infty$ . Using this input, the producer can manufacture and sell output worth  $q$ . The skills necessary for the production of the input are specific to the supplier and the skills necessary for manufacturing are specific to the producer. Hence the production of the final good is not possible without the participation of either of these two parties. The outside options of both the supplier and the producer are normalized to zero.

We consider two possible organizational forms:

- Non-integration.
- Vertical integration, with the supplier buying the producer.

Under non-integration, the game form is as follows:

1. The supplier makes an offer to the producer,  $(q_c, p_c)$ , which implies that the supplier will deliver an input of quality  $q_c$  and receive a price of  $p_c$ .
2. The producer decides whether to accept the contract.
3. Following acceptance of the contract, with probability  $\gamma$ , the contract is upheld. With probability  $1 - \gamma$ , the contract is not upheld, and there will be bargaining between the producer and the supplier.

4. After this uncertainty is revealed, the supplier chooses quality  $q$ .
5. If the contract is upheld, the producer receives the input and if the input is of the specified quality  $q_c$ , the supplier receives the specified price. Otherwise, the supplier receives zero payments (and the producer still acquires the input).
6. If the contract is not upheld, the supplier and the producer bargain over a price that the producer has to pay for the input of quality  $q$  that the supplier has produced. At this point, they both have zero outside options and we assume that they engage in asymmetric Nash/Rubinstein bargaining with the bargaining power of the supplier equal to  $\beta$ .<sup>4</sup>
7. Transactions take place and the producer manufactures and sells the final good.

Note that this game form introduces a form of incomplete contracts, since it is not possible to perfectly contract on quality and payments. In particular, when  $\gamma = 0$ , the contracts are fully incomplete as in the standard incomplete contracts models of Williamson (1975, 1985) or Grossman and Hart (1986) and Hart and Moore (1989). However, our interest here is not on incompleteness because of technological reasons, but because of contract enforcement problems resulting from weak institutions, especially from the failure of courts to enforce contracts. Thus, we interpret  $\gamma$  as a measure of the quality of courts and the extent of contract enforcement. The higher is this parameter, the more likely are contracts to be enforced in the society under consideration.<sup>5</sup> Notice also that we have assumed the contract offer is made by the supplier. This is to ensure symmetry with the vertical integration offer below, which will also be made by the supplier.

Under vertical integration, the supplier owns the producer.<sup>6</sup> The game form in this case is simple: the supplier makes an offer of a wage  $w$  to the producer for his services. Whether these services have been rendered or not is observable at some cost  $\eta(\gamma)$ , which may potentially depend on the contracting institutions in the society, i.e.,  $\eta(\gamma)$  could be increasing in  $\gamma$ . The

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<sup>4</sup>The Nash bargaining solution generally differs from the subgame perfect equilibrium of Rubinstein's (1982) bargaining game when there are outside options. However, with zero outside options, Rubinstein's game with a specific ordering of moves and discount factors gives the same solution as the asymmetric Nash bargaining solution, which we use below.

<sup>5</sup>This formulation is similar to that in Acemoglu, Antràs, and Helpman (2007), where the quality of contracting institutions is proxied by the fraction of tasks that are contractible.

<sup>6</sup>For brevity, we only consider vertical integration with the supplier buying the producer. See Acemoglu, Aghion, Griffith and Zilibotti (2004) for a discussion of backward and forward vertical integration in a related model. The innovation here relative to that model is to consider the implications of credit market frictions and the interaction between credit market frictions and contracting institutions, which will also be our focus in the empirical work.

producer receives the wage only if it provides the services. The supplier also chooses its own investment in quality,  $q$ . The fact that the cost of vertical integration is taken as given, as equal to  $\eta(\gamma)$ , makes the approach to vertical integration here more similar to the TCE approach of Williamson than to the PRT approach of Grossman-Hart-Moore.

We now proceed to characterizing the subgame perfect equilibria of this game under vertical integration and non-integration. We will then look at the decision to integrate and at that point also describe potential credit market imperfections facing the firms.

## 2.2 Equilibrium Under Vertical Integration

Let us write the objective function of the supplier as

$$\pi_s(q, w, a^p) = (q - c(q) - w - \eta(\gamma)) a^p,$$

where  $w$  is the wage offer to the producer,  $\eta(\gamma)$  is the cost of insuring compliance by the producer under vertical integration, which the supplier will have to incur, and  $a^p \in \{0, 1\}$  denotes whether the producer accepts the offer. Since the producer's outside option is equal to zero, he will accept the offer, i.e.,  $a^p = 1$ , as long as  $w \geq 0$ . This implies that the optimal contract for the supplier is

$$w^{VI} = 0 \text{ and } q^{VI} = q^*,$$

where  $q^*$  is the first-best quality level uniquely determined by

$$c'(q^*) = 1. \tag{1}$$

The uniqueness of  $q^*$  is an immediate consequence of the strict convexity of  $c$  (which implies that  $c'$  is everywhere strictly decreasing). The existence of an interior solution is guaranteed by the Inada conditions.

Therefore, vertical integration achieves the first-best quality. This conclusion is in line with Williamson's (1975, 1985) theory of vertical integration, which emphasizes the contractual distortions in arm's-length relationships, but not those that arise within vertically integrated organizations.

The profits of the supplier and the producer under vertical integration,  $\pi_s^{VI}$  and  $\pi_p^{VI}$ , are therefore

$$\begin{aligned} \pi_s^{VI} &= q^* - c(q^*) - \eta(\gamma), \\ \pi_p^{VI} &= 0. \end{aligned}$$

The strict convexity of  $c$ , together with (1), implies that  $q^* - c(q^*) > 0$ . However, whether  $\pi_s^{VI} > 0$  will depend on the size of the transaction cost associated with vertical integration,  $\eta(\gamma)$ . Naturally if  $\pi_s^{VI} < 0$ , vertical integration will never take place in equilibrium.

### 2.3 Equilibrium Under Non-Integration

To characterize the subgame perfect equilibrium in this case, let us start by backward induction. First consider the subgame in which contracts are upheld. According to the timing of events specified above, the supplier makes the offer and the producer has the option not to accept this offer and receive zero. This implies that the contract  $(q_c, p_c)$  must be such that

$$p_c = q_c,$$

since if  $p_c > q_c$ , the producer would turn down the offer and if  $p_c < q_c$ , the supplier could increase the price for given quality  $q_c$  and make more profits. Moreover, since  $c(\cdot)$  satisfies the Inada conditions, there will exist a contract with  $p_c = q_c$  that is profitable for the supplier.<sup>7</sup> Given that the contracts are being upheld, the supplier will indeed choose  $q = q_c$  and receive  $p_c$ .<sup>8</sup> Consequently, in the subgame in which contracts are enforced, we must have  $p_c = q_c$  and the supplier will choose quality  $q_c$ . This will lead to zero profits for the producer and to a profit of  $q_c - c(q_c)$  for the supplier.

Now consider the subgame in which contracts are not upheld and the supplier chooses some quality  $q$ . Recall that there is now asymmetric Nash bargaining, with weights  $\beta$  and  $1 - \beta$  and with zero outside options, where  $\beta \in (0, 1)$ . This implies that in this case, the producer and the the supplier will agree to exchange the input of quality  $q$  at the price

$$p = \beta q.$$

Therefore, after learning that the contracts will not be upheld, the supplier maximizes

$$\beta q - c(q),$$

which has a unique solution given by  $\hat{q}_\beta > 0$  such that

$$c'(\hat{q}_\beta) = \beta. \tag{2}$$

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<sup>7</sup>In particular,  $q_c - c(q_c)$  is strictly positive for  $q_c$  sufficiently small.

<sup>8</sup>If, after the signing of the contract, it supplied an input of quality lower than  $q_c$ , then the supplier would receive zero payment. In particular, choosing any  $q < q_c$  will necessarily give lower profits to the supplier, since it would not receive the payment  $p_c$ . Moreover, under contract enforcement it does not have an option to withhold the input.

Again, uniqueness follows from the strict convexity of  $c$ . The fact that the solution is an interior solution, i.e.,  $\hat{q}_\beta > 0$ , is guaranteed by the Inada conditions. Moreover, the strict convexity of  $c(\cdot)$  ensures that  $\hat{q}_\beta$  is increasing in  $\beta$ , and as long as  $\beta < 1$ , we have

$$\hat{q}_\beta < q^*,$$

so that when contracts are not upheld, there will be *underinvestment* in quality.<sup>9</sup>

Therefore, before the uncertainty about whether contracts will be upheld or not is resolved, the expected payoffs of the two firms are

$$\begin{aligned}\pi_s^{NI}(q_c) &= \gamma(q_c - c(q_c)) + (1 - \gamma)(\beta\hat{q}_\beta - c(\hat{q}_\beta)) \\ \pi_p^{NI}(q_c) &= (1 - \gamma)(1 - \beta)\hat{q}_\beta,\end{aligned}$$

where we have imposed the result, obtained above, that  $p_c = q_c$  so that the producer makes zero profits when contracts are upheld and the supplier receives  $q_c - c(q_c)$  (probability  $\gamma$ ). We have also incorporated the optimal investment  $\hat{q}_\beta$  of the supplier and the resulting profits when contracts are not upheld (probability  $1 - \gamma$ ).

The only choice variable for the supplier is then  $q_c$ . Maximizing  $\pi_s^{NI}$  with respect to this implies that the contractually specified quality  $q_c$  must equal the efficient quality  $q^*$  as given by (1) and

$$p_c = q_c = q^*.$$

Consequently, the ex ante payoffs can be written as:

$$\begin{aligned}\pi_s^{NI} &= \gamma(q^* - c(q^*)) + (1 - \gamma)(\beta\hat{q}_\beta - c(\hat{q}_\beta)) > 0, \\ \pi_p^{NI} &= (1 - \gamma)(1 - \beta)\hat{q}_\beta > 0,\end{aligned}\tag{3}$$

where the fact that both expressions are strictly positive again follows from the convexity of  $c(\cdot)$  and the fact that  $\hat{q}_\beta > 0$ . The social gain from vertical integration can now be obtained as

$$\begin{aligned}\Delta\pi^{VI} &\equiv (\pi_s^{VI} + \pi_p^{VI}) - (\pi_s^{NI} + \pi_p^{NI}) \\ &= (1 - \gamma)[(q^* - \hat{q}_\beta) - (c(q^*) - c(\hat{q}_\beta))] - \eta(\gamma).\end{aligned}$$

This expression implies that if the transaction costs of implementing the vertically integrated organizational structure,  $\eta(\gamma)$ , are not very large, vertical integration will produce strictly more surplus than non-integration.

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<sup>9</sup>Here a lower  $\beta$  reduces investments, since  $\beta$  is the share of the supplier, which is the party that is undertaking the investment. In view of this, we will identify “lower  $\beta$ ” with “more severe holdup problems”.

## 2.4 Vertical Integration Decision

We now consider the vertical integration decision. The producer and the supplier start out as separate firms, and before stage 1 in the above timing of events, the supplier makes an offer to buy the producer by paying an amount  $t$ . If the producer accepts this offer, it receives  $t$ , and there is vertical integration. If it rejects the offer, there are no transfers and the producer and the supplier play the non-integration game above.

The only additional complication is that the supplier is potentially credit constrained. Thus every dollar paid at the beginning of the game costs the supplier  $(1 + \delta)$  dollars, where  $\delta \geq 0$  is a measure of credit market frictions.

The payoffs of the two parties at this stage of the game can then be written as:

$$\begin{aligned}\Pi_s(A_p, t) &= (1 - A_p) \pi_s^{NI} + A_p (\pi_s^{VI} - (1 + \delta) t) \\ \Pi_p(A_p, t) &= (1 - A_p) \pi_p^{NI} + A_p (\pi_p^{VI} + t),\end{aligned}$$

where we use capital letters to distinguish them from the payoffs after the organizational form has been determined, and we also condition the payoffs on the strategies at this stage  $A_p \in \{0, 1\}$ , which denotes the decision of the producer whether to accept the vertical integration offer of the supplier, and on  $t$ , which denotes the offer from the supplier ( $t = 0$  here corresponds to a “no offer” from the supplier, since it will necessarily be rejected in view of the fact that  $\pi_p^{NI} > 0$  from (3)).

Clearly, the producer will accept,  $A_p = 1$ , only if

$$\pi_p^{VI} + t \geq \pi_p^{NI}.$$

Given the above expressions, this happens only if

$$t \geq \hat{t} \equiv (1 - \gamma)(1 - \beta) \hat{q}_\beta.$$

Therefore, the supplier, if she wishes to go ahead with vertical integration, will offer  $\hat{t}$ .

Is vertical integration profitable for the supplier? Clearly this depends on whether

$$\pi_s^{VI} - (1 + \delta) \hat{t} \geq \pi_s^{NI}.$$

Using the expressions derived above, this is equivalent to:

$$q^* - c(q^*) - \eta(\gamma) - (1 + \delta)(1 - \gamma)(1 - \beta) \hat{q}_\beta \geq \gamma(q^* - c(q^*)) + (1 - \gamma)(\beta \hat{q}_\beta - c(\hat{q}_\beta)).$$

Rearranging this expression, we obtain that there will be vertical integration in equilibrium if

$$(1 - \gamma) [(q^* - c(q^*)) - (\beta \hat{q}_\beta - c(\hat{q}_\beta))] - (1 + \delta)(1 - \gamma)(1 - \beta) \hat{q}_\beta \geq \eta(\gamma). \quad (4)$$

Inspection of (4) shows that if  $\delta = 0$  and  $\eta(\gamma) = 0$ , that is, if credit markets are perfect and there are no transaction costs associated with vertical integration, there will necessarily be vertical integration. This follows from the observation in the previous subsection that vertical integration reaches the efficient level of input quality, while non-integration leads to underinvestment. However, with imperfect credit markets or transaction costs of vertical integration, non-integration can arise in equilibrium.

Further inspection of this condition establishes the following results:

**Proposition 1 (Main Effects)** *Vertical integration is more likely when credit market imperfections are limited, i.e., when  $\delta$  is lower.*

*The effects of the extent of contract enforcement and holdup problems,  $\gamma$  and  $\beta$ , on vertical integration are ambiguous.*

**Proof.** These results follow from (4). Higher  $\delta$  reduces the left-hand side and has no effect on the right-hand side, thus making (4) less likely to hold. To obtain an expression for the impact of higher  $\beta$  (which we will utilize below), consider the derivative of the left-hand side of (4), denoted by *LHS*, with respect to  $\beta$ :

$$\frac{\partial LHS}{\partial \beta} = \delta(1 - \gamma) \hat{q}_\beta - (1 + \delta)(1 - \gamma)(1 - \beta) \frac{\partial \hat{q}_\beta}{\partial \beta}, \quad (5)$$

where we have used the fact that  $c'(\hat{q}_\beta) = \beta$  from (2). This condition shows that the impact of  $\beta$  on the vertical integration decision is ambiguous.

Finally, to see that the impact of  $\gamma$  is also ambiguous note first that its effect on the left-hand side of (4) is ambiguous and depends on  $\delta$  and the gap between  $q^*$  and  $\hat{q}_\beta$ , and second that the right-hand side of (4) also depends on  $\gamma$ . ■

This proposition shows that there is no immediate relationship between the extent of contract enforcement,  $\gamma$ , and the vertical integration outcome. This is both because the extent of contract enforcement affects the price that the supplier has to pay the producer to ensure vertical integration and also because the quality of contracts might also affect the efficiency of vertically integrated organizations. On the other hand, credit market imperfections make vertical integration less likely. Nevertheless, as discussed in the introduction, there are reasons for being cautious in interpreting this result, since other mechanisms that would lead to a

positive relationship between credit market imperfections and vertical integration are absent in our model (recall the effects emphasized by Rajan and Zingales, 1998, and Kumar, Rajan and Zingales, 1999). We therefore interpret the results in Proposition 1 as suggesting that there are no robust predictions regarding the (main) effects of contracting institutions and financial development on vertical integration.

The next proposition, on the other hand, shows that there are clear predictions regarding the interaction effects between certain variables.

**Proposition 2 (*Interaction Effects*)** *Vertical integration is more likely when there are both more developed credit markets and more severe contract enforcement problems, i.e., when both  $\delta$  and  $\gamma$  are lower.*

*Moreover, if more severe holdup problems (low  $\beta$ ) encourage vertical integration, then this effect becomes stronger when there are also severe contract enforcement problems, i.e., when both  $\beta$  and  $\gamma$  are lower.*

**Proof.** The proof again follows from (4). To obtain the first result, note that

$$\frac{\partial LHS^2}{\partial \delta \partial \gamma} = (1 - \beta) \hat{q}_\beta > 0,$$

so that the left-hand side of (4) will be greater when both  $\delta$  and  $\gamma$  are lower, while the right-hand side does not depend on  $\delta$ . This establishes the first claim.

Next the cross partial of the left-hand side with respect to  $\beta$  and  $\gamma$  is

$$\frac{\partial LHS^2}{\partial \beta \partial \gamma} = -\delta \hat{q}_\beta + (1 + \delta)(1 - \beta) \frac{\partial \hat{q}_\beta}{\partial \beta}. \quad (6)$$

This expression is positive if and only if (5) is negative. Recall that (5) being negative implies that more severe holdup problems, i.e., lower  $\beta$ , makes vertical integration more likely. Since the right-hand side of (4) does not depend on  $\beta$ , the cross partial in (6) then implies that when this is the case, (4) is more likely to hold when both  $\beta$  and  $\gamma$  are lower, that is, when there are both more severe holdup problems and worse contracting problems. This establishes the second claim. ■

Intuitively, severe contract enforcement problems make vertical integration more likely, but suppliers will only be able to acquire producers *if they can raise enough finance*. Thus some degree of financial development combined with weak contracting institutions is conducive to greater vertical integration.<sup>10</sup> In addition, the effect of contracting institutions

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<sup>10</sup>This result is robust to considering situations in which producers acquire suppliers. Moreover, if we

should be more pronounced when we look at situations in which potential holdup problems are more important (that is, situations in which holdup problems in arm’s-length relationships already favor vertical integration).

In the empirical work below, will start by looking at the main effects, but our focus will be the two interaction predictions in Proposition 2.

### 3 Data and Descriptive Statistics

Our firm-level data come from WorldBase. This database, compiled by Dun & Bradstreet for the primary purpose of providing business contacts, contains information on millions of public and private firms around the world. For each firm, WorldBase reports the 4-digit SIC code of the primary industry in which the firm operates, and the SIC codes of up to five secondary industries, listed in descending order of importance.<sup>11</sup> WorldBase includes data for 213 different countries. We exclude 19 of these because they are not defined as countries in the World Bank’s World Development Indicators database.<sup>12</sup> In addition, because not all of the countries in WorldBase include reporting of secondary industries, our analysis is restricted to 93 countries for which this information is available.

Our sample consists of all firms in these countries in the September 2002 WorldBase file, with a maximum of 30,000 per country (a limit imposed due to cost constraints). For those countries with more than 30,000 firms, the 30,000 largest are selected, ranked by annual sales. We include firms from all industries, except those operating only in “wholesale trade” and “retail trade” (we explain this omission below). After these adjustments to the data, we have a base sample of 769,199 firms from 93 countries.

We use the benchmark input-output accounts published by the Bureau of Economic Analysis (BEA) to calculate the degree of vertical integration for each firm in our sample (see Lawson, 1997, for a discussion of the accounts). Our methodology follows the approach of Fan and Lang (2000).<sup>13</sup> The input-output accounts report the dollar value of each input

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enriched the incentive problems along the lines of the PRT of Grossman and Hart (1986) and Hart and Moore (1990), there will also be underinvestment problems under vertical integration. Nevertheless, to the extent that these within-firm distortions are independent of contracting institutions, they should have no effect on the comparative static results in Proposition 2.

<sup>11</sup>In the entire sample, approximately 64% of firms report one SIC code, 24% report two codes, 8% report three codes, 2% report four codes, 1% report five codes, and less than 1% report six codes. Note that we do not have the breakdown of sales by SIC for firms active in multiple industries.

<sup>12</sup>This excludes 15 non-independent territories, three independent countries below the World Bank size threshold, and one disputed territory. Taiwan is retained and treated as though it were a separate country despite not being in the World Bank database.

<sup>13</sup>See also Acemoglu, Aghion, Griffith and Zilibotti (2004) for an application of a similar methodology on UK data.

used to produce the output of 498 different industries in the U.S. economy. We use the 1992 input-output accounts because these are the most recently published at the 6-digit input-output (IO) code level. Input-output tables from the U.S. should be informative about input flows across industries, to the extent these are determined by technology. For example, in all countries, car makers need to obtain tires, steel, and plastic from plants specialized in the manufacture of those goods.<sup>14</sup>

We begin by matching the 4-digit SIC codes from each firm in our sample with the appropriate 6-digit IO code, using the BEA’s concordance guide (see Lawson, 1997). Following Fan and Lang (2000), we exclude IO codes 69.01 and 69.02 (wholesale and retail trade) from our analysis because the input-output classification system does not define these categories finely enough to allow meaningful vertical integration calculations – almost all 4-digit SIC codes between 5000 and 5999 map into just these two IO codes.

For every pair of industries,  $IO_i$  and  $IO_j$ , the input-output accounts allow us to calculate the dollar value of  $IO_i$  required to produce a dollar’s worth of  $IO_j$  in the United States. This amount, which we call the vertical integration coefficient,  $VI_{ij}$ , represents the opportunity for vertical integration between  $IO_i$  and  $IO_j$ , i.e., when it is higher, there is more use of input  $i$  in the production of output  $j$ .

Using the full set of vertical integration coefficients (i.e.,  $VI_{ij}$  for every  $IO_i$  and  $IO_j$ ), we calculate a vertical integration index for each firm in our dataset. The index is denoted by  $v_{cif}$  for firm  $f$  in industry  $i$  in country  $c$ , and is defined as

$$v_{cif} = \frac{1}{|N_f|} \sum_{j \in N_f} VI_{ij},$$

where  $N_f$  is the set of industries in which firm  $f$  is active and  $|N_f|$  denotes the number of these industries. In words, we first sum the  $VI_{ij}$  coefficients between the firm’s primary industry and all industries in which the firm operates. This sum represents the dollar value of inputs from industries in which the firm operates that is required to produce one dollar’s worth of the firm’s primary output. We then create a similar index  $v_{cif}$  for secondary industries in which a firm operates. The vertical integration index is then the average of these sums for each firm, and as such represents the average opportunity for vertical integration in all lines of a business in which the firm is active.<sup>15</sup>

<sup>14</sup>The use of the same input-output table across countries is justified when all countries share the same technology frontier and when either all production functions are Leontief or there is factor price equalization. However, even when these stringent assumptions are not satisfied, we expect there to be a correlation in the input use patterns across countries.

<sup>15</sup>We also conducted extensive robustness checks using only the primary (SIC) industry of each firm. The

Across all 769,199 firms in our dataset, this index ranges from 0 (i.e., no vertical integration) to 53.5 (i.e., an average of 53.5 cents worth of the inputs required to produce one dollar’s worth of output are produced by industries in which the firm operates).

For an example of how the vertical integration index is created, consider a Japanese auto maker in our data (primary code 59.0301) which also has two secondary sectors in the WorldBase data: automotive stampings (41.0201) and miscellaneous plastic products (32.0400). The  $VI_{ij}$  coefficients between these industries are as shown in the following table:

		<i>Output (j)</i>		
		Autos	Stampings	Plastics
<i>Input (i)</i>	Autos	.0043	.0000	.0000
	Stampings	.0780	.0017	.0000
	Plastics	<u>.0405</u>	<u>.0024</u>	<u>.0560</u>
	SUM	.1228	.0041	.0560

The table shows that, for example, the  $VI_{ij}$  coefficient for stampings to autos is 0.078, indicating that 7.8 cents worth of automotive stampings are required to produce a dollar’s output of autos, and this automaker has the internal capability to produce those stampings. (Notice that industries have  $VI_{ij}$  coefficients with themselves; for example, miscellaneous plastic products are required to produce miscellaneous plastic products.) The bottom row shows the sum of the  $VI_{ij}$  for each industry, for example, 12.3 cents worth of the inputs required to make autos can be produced within this firm. The vertical integration index for this firm,  $v_{cif}$ , is then the average of the sums in the bottom row.<sup>16</sup> The first row of Table 1 reports descriptive statistics for the vertical integration index at the firm level, and the third row of Table 1 reports statistics for countries’ average level of vertical integration.

Table 1 also provides descriptive statistics for the other country-level measures we use as independent variables. In Row 5 we report our measure of financial development. This is the value of domestic credit provided to the private sector (as a percent of GDP), taken from World Bank data for the year 2000. This measure has been used frequently in other work (see, e.g., Rajan and Zingales, 1998). Rows 6 through 9 report our different measures of contracting institutions. Row 6 reports the procedural complexity index, which is an index of the complexity in collecting a commercial debt valued at 50% of GDP per capita. This variable comes from the World Bank (2004). Row 7 reports the number of procedures required to collect the same contract, again from the World Bank (2004). Row 8 is a similar

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results are essentially unchanged.

<sup>16</sup>The index could also be constructed putting greater weight on the more important industries. While it seems natural to emphasize the primary industries in the index, WorldBase does not report sales breakdowns by industry, so the weightings would be somewhat arbitrary. We have constructed the index using different weighting schemes and find little difference in the results.

measure of the number of procedures required to enforce a contract, but it reflects procedures for collecting a debt valued at 200% of GDP per capita, a variable also reported by the World Bank. Row 9 reports legal formalism, which is an index of formality in legal procedures for collecting a bounced check. This variable comes from Djankov et al (2003).<sup>17</sup> For all measures of contracting costs, a higher value reflects greater costs or greater complexity in enforcing contracts in that country.

Other variables reported in Table 1 include the log of country population (Row 10), which is taken from World Bank data for the year 2000. Row 11 is the log of GDP per capita in 2000. Our GDP estimates are PPP adjusted and are taken from the World Factbook.<sup>18</sup> Appendix Table A1 reports correlation coefficients of the country-level variables. The other rows of Table 1 report summary statistics on the number of employees per firm (Row 2) and the vertical integration propensity by country (Row 4, discussed in the next section). Rows 12 through 18 report characteristics of relevant industries from U.S. data (discussed in Section 5).

## 4 Main Effects of Financial Development and Contracting Costs

In this section we study the main effects of financial development and contracting costs on the level of vertical integration across countries. First, Proposition 1 of our model predicts a positive association between credit market development and vertical integration, although other theories based on the effect of credit market constraints on entry would suggest a negative association. Second, our model's prediction for the effect of contracting costs on vertical integration is ambiguous. However, theories emphasizing the role of contracting institutions in the internal organization of the firm, such as Williamson (1975, 1985), would suggest a negative correlation between vertical integration and the quality of contracting institutions. We turn to our firm-level dataset to investigate whether any main effects of financial development or contracting costs are apparent in the data.

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<sup>17</sup>As an additional check on our results, we also use a country's legal origin as an explanatory variable. Countries with legal systems based on French civil law have been shown to have higher contracting costs (Djankov et al, 2003; Acemoglu and Johnson, 2005), so legal origin may be considered as an indirect measure of contracting institutions. The results with legal origin are similar to those with the four direct measures of contracting institutions and are not reported to save space (details available upon request).

<sup>18</sup>On the web at: <http://www.cia.gov/cia/publications/factbook/>. This covers a larger sample than the World Bank GDP estimates, and the two estimates are very similar for the countries for which they overlap.

## 4.1 Main Results

In the odd-numbered columns of Table 2 we estimate the following equation:

$$v_{cf} = \mathbf{x}'_c \boldsymbol{\beta} + \mathbf{z}'_f \boldsymbol{\phi} + \varepsilon_{cf}, \quad (7)$$

where  $v_{cf}$  is vertical integration in firm  $f$  in country  $c$ ,  $\mathbf{x}_c$  is the set of country-level covariates, specifically, our measures of financial development or contracting costs, and  $\mathbf{z}_f$  is a set of firm-level covariates, in particular, firm size, as measure by the log of the number of employees.

Note, however, that equation (7) does not account for cross-country differences in industrial composition. The extent of vertical integration varies markedly across sectors. Not controlling for industrial composition may lead to a spurious relationship between country characteristics and vertical integration. Consequently, our preferred specifications are presented in the even-numbered columns of Table 2 and include a full set of industry fixed effects, i.e.,

$$v_{cif} = \mathbf{x}'_c \boldsymbol{\beta} + \mathbf{z}'_f \boldsymbol{\phi} + \delta_i + \varepsilon_{cif}, \quad (8)$$

where  $v_{cif}$  is vertical integration of firm  $f$  in industry  $i$  of country  $c$ ,  $\mathbf{x}_c$  and  $\mathbf{z}_f$  are country-level and firm-level covariates as before, and the  $\delta_i$ 's are a full set of industry fixed effects (dummies). These fixed effects enable us to capture cross-industry differences in the technological or other determinants of vertical integration. The industry dummies are defined at the two-digit IO level, which results in a set of 76 dummy variables.<sup>19</sup> The inclusion of a full set of industry dummies implies that in equation (8), all cross-country comparisons are relative to the “mean propensity to integrate” in a particular industry. In other words, this regression looks at, for example, whether firms in a country with worse contracting institutions are more of vertically integrated relative to firms in a country with better contracting institutions in the *same* industry. In the regressions in Table 2, because the variables of interest, financial development and contracting costs, vary only at the country level, the standard errors are corrected for clustering at the country level.

The inclusion of firm size as a control variable in both (7) and (8) is important because a potential concern with the results in this paper is sample selection. Our dataset contains different numbers of firms from different countries, and this variation in the selection of samples of firms could be a source of variation in vertical integration. The main source of the problem would be potential correlation between vertical integration and firm size (combined with

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<sup>19</sup>We use the primary industry of each firm, i.e., the IO code matched to the SIC code that comes first in WorldBase.

differential selection on firm size across countries). For example, it could be that relatively larger companies are more vertically integrated and from countries with weaker institutional environments we only observe relatively larger companies. Estimating the relationship between vertical integration and contracting or financial institutions at the firm level, while also controlling for firm size, partially alleviates this sample selection concern.<sup>20</sup>

Column 1 of Table 2 reports a statistically significant correlation between credit market development and vertical integration. The coefficient on domestic credit to the private sector is -0.34 with a standard error of 0.15. The finding that greater financial development is associated with less vertical integration is contrary to Proposition 1, although it is consistent with theories emphasizing the effect of financial development on entry. Column 2, however, shows that once we control for industrial composition, the significant effect of financial development on vertical integration disappears. The correlation between financial development and vertical integration (when not controlling for industry composition) appears to be spurious, and is almost entirely accounted for by differences in industry composition across countries.

Columns 3 through 10 investigate the effect of contracting costs on vertical integration using our four different measures of contracting costs. The odd-numbered columns show a positive correlation between our measures of contracting costs and vertical integration, as would be predicted by TCE. For two of the four measures of contracting costs this positive correlation is statistically significant. However, the even-numbered columns show that after we control for industry composition, the significant effects of contracting costs disappear. Therefore, as with the results for financial development, the raw correlation between contracting institutions and vertical integration appears to be spurious and accounted for by cross-country differences in industry composition.

We conduct a series of robustness checks to ensure that this general pattern persists in alternative specifications. In additional tests (not reported) we find similar results when we limit the dataset to manufacturing industries, when we exclude the most and least vertically integrated industries, and when we limit the analysis to industries that appear in 90% or more of the countries in the dataset. In all cases, there is a correlation between financial development or contracting institutions and vertical integration without industry controls, but this correlation disappears once we control for industry composition by including a full set of industry dummies.

The lack of a correlation between our institutional measures and vertical integration after

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<sup>20</sup>We also experimented with regressions controlling for second, third and fourth order polynomials in firm size, and found very similar results (details available upon request).

controlling for industrial composition can be interpreted in different ways. One possibility is that our measures of specific institutions do not adequately capture cross-country differences in these factors. Naturally, the various proxies for contracting costs and financial development are imperfect and potentially measured with error. Nevertheless, in addition to the results in Table 2 that do not control for industry, previous work shows that these indices do have significant information content, and are correlated with economic outcomes (see, e.g., Djankov et al, 2003). Moreover, we will show below significant and robust results consistent with the predictions of Proposition 2 using the same measures. Thus the lack of correlation between these measures and vertical integration is unlikely to be driven by measurement error.

Another possibility is simply that these specific institutions have no impact on average vertical integration across countries. Such an interpretation would be a challenge to many of the theories discussed in the introduction, which (implicitly or explicitly) suggest that differences in contracting costs or credit market development should have a major effect on cross-country patterns of the internal organization of the firm and vertical integration. However, as shown in Section 2, somewhat more refined theories make more robust predictions about interactions rather than main effects. In Section 5 we show that the data provide considerable support for these interaction effects.

Before turning to the interaction effects, one other interpretation also needs to be discussed. It may be that the lack of significance of financial development and contracting costs after controlling for industrial composition reflects a more subtle effect of these specific institutions on the internal organization of firms. Perhaps these institutional factors influence the industrial composition as a way of preventing the transaction costs and the underinvestment problems that are more prevalent in certain sectors. For example, countries with worse contracting institutions or more limited financial development may be more concentrated in industries that typically have higher vertical integration, such as mining (ferrous and non-ferrous), petroleum and gas, leather, fabrics, chemicals, apparel, and electronic components, precisely as a way of preventing the costs of weaker contracts and less developed financial markets. We investigate this possibility in the next subsection and show that this mechanism does not seem to be responsible for the lack of an effect from contracting and financial institutions to the internal organization of the firm.

## 4.2 Vertical Integration Propensity

To study why the significant correlation between vertical integration and our measures of specific institutions disappears when industry dummies are included in the regressions, we

calculate, for each country, the propensity to vertically integrate according to industrial composition:

$$\hat{V}_c = \sum_i \hat{\delta}_i \frac{S_{ci}}{S_c},$$

where  $\hat{\delta}_i$ 's are the estimates of the industry dummies (reported in Table A2) from a firm-level regression of vertical integration on industry dummies using U.S. data,  $S_{ci}$  is total sales in industry  $i$  in country  $c$ , and  $S_c$  is total sales in country  $c$ . The dummies  $\hat{\delta}_i$ 's measure the average level of vertical integration in industry  $i$  in the U.S., so  $\hat{V}_c$  measures the average tendency for vertical integration in the country due to its industrial composition. In other words,  $\hat{V}_c$  measures the extent of vertical integration in a country if the country had the average level of vertical integration in the United States corresponding to each industry.<sup>21</sup> Consequently, the source of variation in  $\hat{V}_c$  arises purely from the industrial composition of the country.

We estimate the following simple model:

$$\hat{V}_c = \mathbf{x}'_c \boldsymbol{\beta} + \varepsilon_c, \tag{9}$$

where  $\hat{V}_c$  is the vertical integration propensity for country  $c$ ,  $\mathbf{x}_c$  is a vector of country-level variables including either financial development or contracting costs as well as the log of population (to control for country size) and the log of GDP per capita, and  $\varepsilon_c$  is an error term capturing all omitted factors.

In Table 3, we report results from regressions estimating equation (9). In the odd-numbered columns of Table 3, we report results without per-capita GDP as an explanatory variable. Column 1 of Table 3 shows a significant negative correlation between financial development and vertical integration propensity. The remaining odd-numbered columns demonstrate a significant positive correlation between all four measures of contracting costs and vertical integration propensity. The magnitude of the coefficients in the odd-numbered columns implies that a one standard deviation increase in financial development is associated with about a 1/3 standard deviation fall in a country's vertical integration propensity, and that a one standard deviation increase in contracting costs is associated with about a 1/4 to 1/3 standard deviation increase in vertical integration propensity.

These results illustrate why the correlations between vertical integration and contracting and financial institutions disappear when we control for industrial composition (industry dum-

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<sup>21</sup>In alternative tests we have also calculated the industry dummy coefficients using data from all G7 nations and also using data from all 93 countries in our dataset. The results are very similar to our baseline results and are available upon request.

mies). Countries with weaker institutions, as measured by contracting costs or credit market development, tend to be concentrated in industries with higher (technological) propensity for vertical integration. This pattern is therefore consistent with a major effect of contracting institutions or financial development on industry composition.

However, the even-numbered columns of Table 3 strongly weigh against this interpretation. These columns show that the relationship between contracting and financial institutions and the vertical integration propensity disappears once we control for (log) GDP per capita. There appears to be a strong negative correlation between per-capita GDP and vertical integration propensity. In each of the even-numbered columns, the inclusion of GDP per capita entirely eliminates the significant effect of financial development and contracting costs. This evidence therefore suggests that differences in industry composition and the resulting differences in vertical integration propensity across countries are more likely to be due to differences in the stage of development rather than a direct consequence of weaker contracting institutions or lower levels of financial development.

## 5 Interaction Effects

The results in the previous section may suggest that there are no robust regularities in cross-country vertical integration patterns once we control for industrial composition. In this section, we turn to interaction effects to show that this is not true. Here we focus on the interaction effects predicted by our model in Proposition 2. We first study the interaction effect of financial development combined with contracting costs, and then focus on the differential effects of contracting costs across industries.

### 5.1 The Interaction of Financial Development and Contracting Costs

The first implication of Proposition 2 is that vertical integration should be more prevalent in countries that have both higher contracting costs and greater financial development. To test this implication we conduct additional regressions of the type shown in equation (8), with some modifications. As an additional country-level regressor ( $\mathbf{x}_c$ ) we include our variable of interest, the interaction of financial development and contracting costs. In addition, as control variables for size and development we include among  $\mathbf{x}_c$  log population and the log of per-capita GDP. Industry dummies are included in all specifications.

Table 4 presents the results on the interaction of financial development and contracting costs. The four columns in the table correspond to the four different measures of contract-

ing costs. The first two rows of Table 4 report the main effects of financial development and contracting costs. The third row reports the coefficients for our variable of interest, the interaction of financial development and contracting costs. Table 4 shows that for all four measures of contracting costs, the coefficient on our interaction term is positive and statistically significant. The magnitude of the coefficients suggests, for example, that in countries with the weakest financial development, a one standard deviation increase in contracting costs is associated with only a small increase in a country's average vertical integration index, but that in the countries with the strongest financial development, a one standard deviation increase in contracting costs is associated with roughly a 3/4 standard deviation increase in a country's average vertical integration index (depending on the contracting measure). The coefficients on per-capita GDP and population are positive and generally significant; the inclusion of these variables demonstrates that financial development and contracting costs are not picking up other effects associated with the size or development of countries. It is also worth noting in Table 4 that the main effects of contracting costs are now positive and usually significant, even though industry dummies are included in the regression. The main effects of financial development, on the other hand, are not significant.<sup>22</sup> Table 4 shows that financial development and contracting costs do have a significant correlation with a country's level of vertical integration, but that it is the interaction of these two institutional factors that has the greatest importance.

In Tables 5 and 6 we report additional tests to assess the robustness of the results presented in Table 4. In Table 5 we repeat the regressions of Table 4, but also include the interaction of GDP per capita with contracting costs and with financial development as additional explanatory variables. The motivation for including these terms is that existing work demonstrates that financial development is correlated with the stage of economic development, and moreover, the results in Table 3 show how controlling for GDP per capita changes the relationship between contracting and financial institutions and vertical integration propensity. Consequently, we would like to make sure that the interaction of financial development and contracting costs is not just proxying for other factors associated with the stage of development interacted with contracting costs or financial development. Table 5 is reassuring in this respect. It shows that the results are robust to inclusion of these additional interaction terms. In Columns 1 through 4 we include the interaction of log GDP per capita and contracting costs. In all four columns, the coefficient on the interaction of financial

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<sup>22</sup>The main effects are evaluated at their sample mean values to allow proper interpretation.

development and contracting costs is positive, statistically significant and also of a similar magnitude to the estimates in Table 4. For example, with the procedural complexity measure the coefficient estimate of the interaction term is 0.21 (standard error = 0.09) compared to 0.24 in Table 4. In all cases, the interactions of contracting costs with GDP per capita are always small and insignificant. In Column 5 we include the interaction of GDP per capita and financial development. The coefficient on the interaction between financial development and the procedural complexity measure of contracting costs remains positive and significant. Finally, in Column 6 we include both the interactions of financial development and GDP per capita and contracting costs and GDP per capita. The coefficient on the interaction between financial development and the procedural complexity index remains very similar to the baseline and is statistically significant (0.23, standard error = 0.09), while the GDP interactions continue to be insignificant.<sup>23</sup>

In Table 6 we again repeat the regressions of Table 4, but we now include squared terms for financial development and contracting costs. Our motivation is to assess whether the interaction of financial development and contracting costs proxies for non-linear effects of the institutional factors. Table 6 shows that the results are generally robust to inclusion of the squared terms, but that the coefficients on the interaction of financial development and contracting costs are somewhat smaller. In all four columns the coefficient on the interaction term remains positive. In two cases, the coefficient continues to be statistically significant, but it loses significance in the other two (with contract enforcement procedures for a 200% debt and legal formalism as the measures of contracting costs).

Overall, the results in Tables 4 through 6 demonstrate a relatively robust effect of the interaction of financial development and contracting costs on vertical integration. The results are consistent with the theoretical results in Proposition 2, and suggest that contracting costs do affect the incentives for vertical integration, but that a certain degree of financial development is necessary to permit firms to vertically integrate in response to their country's contracting environment.

## 5.2 Country-Industry Interactions

The regression equations so far impose a “constant effect” of specific institutional characteristics on vertical integration. Another possibility is that these characteristics have differential effects across industries. This is the second implication of Proposition 2. In particular, our model predicts that contracting costs will have a larger impact on the vertical integration

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<sup>23</sup>The results with the other measures of contracting costs are similar and not reported to save space.

decision in industries that are more susceptible to supplier holdup problems. As a proxy for the extent of holdup problems in a particular industry, we use the industry’s capital intensity. We estimate regressions of the following form

$$v_{cif} = \alpha y_c m_i + \beta x_c m_i + \mathbf{z}'_f \boldsymbol{\phi} + \delta_i + \eta_c + \varepsilon_{ci}. \quad (10)$$

where  $y_c$  represents (log) income per capita,  $x_c$  represents one of our measures of contracting costs, and  $m_i$  represents industry-level characteristics that proxy for severity of holdup problems. The main effect for  $m_i$  is already taken out by the full set of industry dummies, the  $\delta_i$ ’s. The main coefficient of interest in this specification is  $\beta$ , and for this reason, we also include in this equation a full set of country dummies,  $\eta_c$ . The term  $y_c m_i$  is included to investigate whether the interaction is between the specific institutional features and industry characteristics as opposed to some other factor related to income per capita (for example, a broader notion of institutional differences). We also include firm-level characteristics, specifically the log of the number of employees as a measure of firm size ( $\mathbf{z}_f$ ).

Following the methodology in Rajan and Zingales (1998), all of the industry-level measures are based on U.S. data. In doing so we are assuming (analogous to assumptions made in Rajan and Zingales, 1998) that characteristics of industries in the U.S. economy are representative of (or at the very least correlated with) the characteristics of the same industries in other countries. In Table 7 our industry characteristic is capital intensity, which we measure as the log of the ratio of fixed assets to sales for firms in the particular industry in the U.S. Although capital intensity is clearly not a perfect proxy for the severity of holdup problems, others have emphasized the connection between capital intensity and vertical integration (e.g., Chandler, 1976; Antràs, 2003) and have used measures of capital intensity as proxies for asset specificity or the incentive to vertically integrate (e.g., MacDonald, 1985; Lieberman, 1991). In addition, holdup problems related to capital intensity may be precisely those for which vertical integration is a good remedy. In contrast, the problems arising from more intangible characteristics of sectors or firms might lead to the countervailing incentive problems within firms as emphasized by the PRT approach of Grossman and Hart (1986) and Hart and Moore (1990).

In all of the results reported below, we calculate capital intensity using the Compustat database. We aggregate the data by first taking the average ratio of fixed assets to sales across all years 1990-1999 for each firm in Compustat, and then by taking the median of this ratio across all firms in each industry. In later tables, we employ alternative measures of capital intensity. Descriptive statistics for all industry-level measures are found in Rows 12

through 18 of Table 1.

Estimates from equation (10) are reported in Table 7. The four columns correspond to the four different measures of contracting costs, as noted in the table. Each of the columns in the table reports a positive coefficient on the interaction of contracting costs and capital intensity. In three out of the four regressions, the positive coefficient on the interaction term is statistically significant. The magnitude of the significant coefficients suggests, for example, that in the lowest capital-intensive industries, an increase in contracting costs is associated with only a small increase in vertical integration, but that in the highest capital-intensive industries, a one standard deviation increase in contracting costs implies approximately a 3/4 standard deviation increase in the country's average vertical integration index. The coefficient on per-capita GDP interacted with capital intensity is also positive but not significant; the inclusion of this interaction ensures that the interaction of contracting costs and capital intensity is not just proxying for other institutional factors related to development. Overall, the results in Table 7 suggest that a country's level of contracting costs does have a significant correlation with average vertical integration in the country, and that this effect is more pronounced in industries that are more capital intensive.

In Tables 8 through 10 we report additional tests to assess the robustness of the significant interaction effect of contracting costs and capital intensity on vertical integration. In Table 8 we repeat the regressions of Table 7 but add additional interaction terms to assess if the significance of contracting costs and capital intensity is subsumed by other potential interaction effects. In Column 1 of Table 8, we add the interaction of financial development and an industry's dependence on external finance. Our model, and existing theory, suggests that financial development matters for the organization of production, and, as argued by Rajan and Zingales (1998), the effect of financial development may be more pronounced in industries with greater dependence on external finance. As with our capital intensity measure, external dependence is calculated from the Compustat database, and it is defined as in Rajan and Zingales (1998). Column 1 of Table 8 reports a significant effect on vertical integration from the interaction of financial development and external dependence, but this effect does not subsume the effect of contracting costs interacted with capital intensity, which retains a significant positive effect.

In Columns 2 and 3 of Table 8 we add other combinations of the interactions used in Column 1. In Column 2 we include contracting costs interacted with external dependence, and in Column 3 we include financial development interacted with capital intensity. In both

columns, the interaction of contracting costs and capital intensity retains its positive sign and statistical significance, although the coefficient is only marginally significant in Column 3. In Column 4 we include all three alternative interaction terms as controls. With all three controls included, as well as the interaction of per-capita GDP and capital intensity, this is a stringent test of the robustness of our interaction prediction. Column 4 shows that the coefficient on the interaction of contracting costs and capital intensity retains its positive sign and is significant at the 5% level. In Columns 5 through 7 of Table 8 we repeat the test in Column 4 using the three other measures of contracting costs. With contract enforcement procedures (50% debt) as the measure of contracting costs, the coefficient on the interaction of contracting and capital intensity is positive and significant. For the other two measures, the coefficients are positive, but the coefficient on the interaction of legal formalism and capital intensity loses significance relative to the results in Table 7.

In Table 9 we repeat the regressions of Table 7 using alternative measures of capital intensity. The first two measures, the ratio of fixed assets to total assets and the ratio of fixed assets to employees, also come from the Compustat database and are calculated in analogous fashion to the ratio of fixed assets to sales. The next two measures, the ratio of capital stock to employment and the ratio of capital stock to value added, are calculated from the NBER productivity database. Because this measure is available only for manufacturing industries, the number of observations in regressions using this variable is smaller. The final measure, the ratio of capital to output, is taken from Autor, Katz, and Krueger (1998), who calculate capital intensity from the National Income and Product Accounts (NIPA) for the year 1990. We use the concordance that these authors developed to map the NIPA industries to our IO industries. All capital intensity measures are in logs.

Table 9 reports the results of estimating equation (10) with the alternative measures of capital intensity. The five columns in the table correspond to different measures of capital intensity as noted. In each column, the coefficient on the interaction of contracting costs and capital intensity retains its positive sign, and in four out of the five cases, the coefficient is statistically significant. Table 9 shows that this significant interaction effect is robust to alternative definitions of capital intensity.<sup>24</sup>

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<sup>24</sup>We also experimented with estimates of equation (10) using an alternative measure of holdup problems used and constructed by Nunn (2007) that is intended to proxy for the degree to which industries rely on relationship-specific investments. Nunn (2007) uses data from Rauch (1999) to identify relationship-specific inputs as those not sold on organized exchanges or reference priced in trade publications. We repeated our regressions using this measure of relationship specificity as the industry characteristic, but the results (not reported) were generally not significant, and when significant they tended to be non-robust. While we do not know the exact reason why the results are different with capital intensity and the measures of

As a final set of tests, in Table 10 we report additional robustness checks of the significant effect of contracting costs interacted with capital intensity. In Panel A of Table 10 we limit the sample to manufacturing industries. The coefficient on the interaction of contracting costs and capital intensity retains its positive sign in all columns, and is statistically significant in all but one of the columns. In Panel B of Table 10 we exclude industries that are naturally the most and least vertically integrated (based on U.S. data). We exclude those industries that fall in the highest and lowest 5% in level of vertical integration. The motivation for this test is to assess if our results are driven by a small number of industries with extreme levels of vertical integration. The results in Panel B are similar to previous results. All coefficients on our interaction term of interest are positive, and all but one of the coefficients are significant at standard levels. In Panel C of Table 10 we limit our sample to industries for which there are existing firms in most (90% or more) of the countries in the sample. The motivation for this test is to ensure that our results are not driven by a few relatively uncommon industries. The results in Panel C again show positive coefficients on our interaction term of interest in all cases, with statistical significance in all but two of the columns.

Overall, the results in Tables 7 through 10 show that there is a relatively robust association between vertical integration with the interaction of contracting costs and capital intensity is robust. These results are again consistent with Proposition 2, which suggests that contracting costs should have a differential effect on the organization of production in capital intensive industries.

## 6 Conclusion

In this paper, we study the cross-country determinants of vertical integration in a new dataset of over 750,000 firms from 93 countries. Our focus is on the effect of specific institutional features on the vertical integration decisions of firms. This focus is motivated by both empirics and theory. Casual empiricism and existing work suggest that there are large differences in the organization of production and firms across countries and that this may be related to

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relationship specificity, a number of explanations are possible. First, capital intensity of a sector in the United States, which is a broadly technological characteristic, may be a better predictor of capital intensity in other countries than the measure of relationship specificity, which is the result of market interactions and not a technological characteristic. Second, as noted above, capital intensity might be better suited to assess the view of Williamson (1975, 1985) and Klein, Crawford, and Alchian (1978), in which vertical integration resolves contracting problems, whereas relationship specificity might lead to the types of problems emphasized in the PRT approach of Grossman and Hart (1986) and Hart and Moore (1990), in which the effects of vertical integration are more complex. Put differently, it may be that high capital intensity leads to contracting problems that vertical integration resolves in a relatively straightforward manner, while other forms of contracting problems are more difficult to resolve with vertical integration.

contracting problems. Relatedly, a body of influential theories suggest that contracting costs and credit market development should be important determinants of vertical integration. We present a model which builds on these existing results. While our model suggests that the main effects of institutional features may be important for vertical integration, the more compelling aspects of our model are the predictions for interaction effects of these institutional factors. In particular, our model suggests an important interaction effect of contracting costs combined with financial development. In addition, it predicts that contracting costs will have a greater effect in industries with the potential for more severe holdup problems.

Our empirical results do not confirm the importance of the main effects of financial development and contracting costs. Although vertical integration is correlated with contracting institutions and financial development, we find that these correlations are spurious and entirely driven by cross-country differences in industrial composition. In particular, countries with higher contracting costs or more limited financial development are concentrated in industries with a high propensity for vertical integration. Once we control for differences in industrial composition, none of these factors seem to affect vertical integration.

Nevertheless, the predictions of our simple model concerning interactions receive substantial empirical support. We find a robust differential effect of contracting costs across industries: countries with higher contracting costs are significantly more integrated in industries that are more capital intensive. We also find that the interaction of contracting costs and financial development has a significant relationship with cross-country differences in vertical integration. In short, contracting costs may have a strong impact on vertical integration, but the effect is more pronounced in relatively capital-intensive industries, and stronger financial development may be a prerequisite for firms to efficiently integrate in response to high contracting costs.

We view our study as a first step in understanding the cross-country patterns of organization of firms. Despite the importance of the organization of production for productivity and the existence of various influential theories, we know very little about these patterns. The dataset and the approach in this paper can be useful in investigating other dimensions of differences in the organization of firms across countries.

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Table 1  
Descriptive statistics

	Mean	25th Pctile	Median	75th Pctile	St. Dev.	N
<i>Firm-level variables</i>						
(1) Vertical integration index	4.87	0.46	3.34	6.79	5.58	769,199
(2) Number of employees, log	3.86	2.56	3.74	5.00	1.87	676,046
<i>Country-level variables</i>						
(3) Vertical integration index, average	4.98	4.38	4.93	5.50	1.00	93
(4) Vertical integration propensity	-11.81	-12.33	-11.84	-11.30	0.96	93
(5) Financial development (Domestic credit/GDP)	0.54	0.29	0.54	0.87	0.43	73
(6) Procedural complexity index	5.83	4.58	5.56	7.03	1.56	56
(7) Contract enforcement procedures, 50% debt (/10)	2.47	1.70	2.20	3.10	0.97	56
(8) Contract enforcement procedures, 200% debt (/10)	2.80	2.20	2.70	3.50	0.94	61
(9) Legal formalism	3.66	2.75	3.47	4.57	1.18	62
(10) Population, log	14.95	12.39	15.52	16.96	2.75	93
(11) GDP per capita, log	9.03	8.21	9.17	9.98	1.00	93
<i>Industry-level variables (from U.S.)</i>						
(12) Fixed assets/sales, log (Compustat)	-0.63	-1.11	-0.81	-0.17	0.80	74
(13) Fixed assets/total assets, log (Compustat)	-0.74	-1.05	-0.69	-0.32	0.32	74
(14) Fixed assets/employees, log (Compustat)	4.35	3.78	4.04	4.75	1.00	74
(15) Capital stock/employment, log (NBER)	3.60	3.33	3.59	3.92	0.55	52
(16) Capital stock/value added, log (NBER)	0.28	0.08	-0.86	-0.58	0.55	52
(17) Capital/output, log (Autor, et al)	-0.72	-1.00	-0.86	-0.58	0.55	67
(18) External dependence on finance (Compustat)	0.23	-0.25	0.20	0.69	1.26	74

The table presents descriptive statistics of data used in subsequent tables. Firm-level data and the vertical integration propensity measure come from the Sept. 2002 WorldBase database. Other country-level variables come from the World Bank's World Development Indicators and Doing Business dataset. Industry-level variables are calculated from U.S. data from the sources noted, with industries based on 77 BEA-defined categories.

Table 2  
Main effects of financial development and contracting costs

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
<i>Contracting measure:</i>			Procedural complexity		Contract enforcement procedures (50% debt)		Contract enforcement procedures (200% debt)		Legal formalism	
	<i>Dependent variable is the vertical integration index</i>									
Financial development	-0.34 (0.15)	0.02 (0.13)								
Contracting costs			0.10 (0.06)	0.03 (0.04)	0.24 (0.09)	0.01 (0.07)	0.28 (0.10)	0.02 (0.07)	0.13 (0.07)	0.00 (0.06)
Log number of employees	0.27 (0.05)	0.04 (0.03)	0.27 (0.05)	0.05 (0.03)	0.27 (0.05)	0.05 (0.03)	0.27 (0.05)	0.05 (0.03)	0.28 (0.05)	0.04 (0.03)
Industry dummies	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes
R-squared	0.01	0.40	0.01	0.40	0.01	0.40	0.01	0.40	0.01	0.41
Number of Countries	73	73	56	56	56	56	61	61	62	62
Number of Observations	648,157	648,157	661,580	661,580	661,580	661,580	661,747	661,747	642,253	642,253

The table presents coefficient estimates from regressions of a firm-level vertical integration index on measures of contracting costs and financial development. Contracting costs are measured alternately as procedural complexity, contract enforcement procedures, or legal formalism, as noted. Even-numbered columns include a full set of industry dummies based on 77 BEA-defined industries. Robust standard errors, adjusted for clustering within countries, are in parentheses.



Table 4  
The interaction of financial development and contracting costs

	(1)	(2)	(3)	(4)
		Contract enforcement procedures (50% debt)	Contract enforcement procedures (200% debt)	Legal formalism
<i>Contracting measure:</i>	Procedural complexity			
<i>Dependent variable is the vertical integration index</i>				
Financial development	-0.01 (0.16)	-0.12 (0.14)	-0.08 (0.18)	-0.09 (0.17)
Contracting costs	0.10 (0.05)	0.38 (0.12)	0.28 (0.12)	0.13 (0.08)
Financial development × Contracting costs	0.24 (0.08)	0.74 (0.16)	0.45 (0.16)	0.39 (0.13)
Log GDP per capita	0.17 (0.07)	0.27 (0.09)	0.34 (0.11)	0.19 (0.07)
Log population	0.05 (0.04)	0.12 (0.04)	0.10 (0.04)	0.06 (0.04)
Log number of employees	0.05 (0.03)	0.04 (0.02)	0.04 (0.03)	0.05 (0.03)
Industry dummies	Yes	Yes	Yes	Yes
R-squared	0.40	0.40	0.40	0.40
Number of Countries	54	54	57	57
Number of Observations	638,217	638,217	638,348	618,362

The table presents coefficient estimates from regressions of a firm-level vertical integration index on measures of contracting costs and financial development. Contracting costs are measured alternately as procedural complexity, contract enforcement procedures, or legal formalism, as noted. Also included but not reported are a full set of industry dummies based on 77 BEA-defined industries. Robust standard errors, adjusted for clustering within countries, are in parentheses. Interaction terms are created using demeaned variables.

Table 5  
The interaction of financial development and contracting costs, per-capita GDP interactions included

	(1)	(2)	(3)	(4)	(5)	(6)
<i>Contracting measure:</i>	Procedural complexity	Contract enforcement procedures (50% debt)	Contract enforcement procedures (200% debt)	Legal formalism	Procedural complexity	Procedural complexity
	<i>Dependent variable is the vertical integration index</i>					
Financial development	-0.03 (0.17)	-0.13 (0.14)	-0.08 (0.18)	-0.10 (0.17)	0.00 (0.16)	-0.03 (0.16)
Contracting costs	0.09 (0.05)	0.37 (0.11)	0.29 (0.12)	0.13 (0.08)	0.10 (0.05)	0.09 (0.05)
Financial development × Contracting costs	0.21 (0.09)	0.68 (0.18)	0.48 (0.20)	0.38 (0.13)	0.28 (0.08)	0.23 (0.09)
Log GDP per capita × Contracting costs	0.04 (0.06)	0.07 (0.12)	-0.03 (0.09)	0.01 (0.07)		0.18 (0.17)
Log GDP per capita × Financial development					0.14 (0.15)	0.01 (0.01)
Log GDP per capita	0.17 (0.07)	0.26 (0.09)	0.35 (0.11)	0.19 (0.07)	0.18 (0.07)	0.18 (0.07)
Log population	0.05 (0.04)	0.11 (0.04)	0.10 (0.04)	0.06 (0.04)	0.05 (0.04)	0.05 (0.04)
Log number of employees	0.05 (0.03)	0.04 (0.02)	0.04 (0.03)	0.05 (0.03)	0.04 (0.03)	0.04 (0.03)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.40	0.40	0.40	0.40	0.40	0.40
Number of Countries	54	54	57	57	54	54
Number of Observations	638,217	638,217	638,348	618,362	638,217	638,217

The table presents coefficient estimates from regressions of a firm-level vertical integration index on measures of contracting costs and financial development. Contracting costs are measured alternately as procedural complexity, contract enforcement procedures, or legal formalism, as noted. Also included but not reported are a full set of industry dummies based on 77 BEA-defined industries. Robust standard errors, adjusted for clustering within countries, are in parentheses. Interaction terms are created using demeaned variables.

Table 6  
The interaction of financial development and contracting costs, squared country-level measures included

	(1)	(2)	(3)	(4)
	Procedural	Contract	Contract	Legal
<i>Contracting measure:</i>	complexity	enforcement	enforcement	formalism
		procedures	procedures	
		(50% debt)	(200% debt)	
	<i>Dependent variable is the vertical integration index</i>			
Financial development	-0.29	-0.32	-0.09	0.10
	(0.30)	(0.38)	(0.64)	(0.56)
Contracting costs	0.64	0.31	0.49	0.81
	(0.26)	(0.37)	(0.48)	(0.31)
Financial development <sup>2</sup>	0.12	0.11	-0.01	-0.12
	(0.35)	(0.21)	(0.38)	(0.32)
Contracting costs <sup>2</sup>	-0.05	0.02	-0.05	-0.09
	(0.02)	(0.08)	(0.10)	(0.04)
Financial development × Contracting costs	0.200	0.81	0.37	0.21
	(0.096)	(0.26)	(0.37)	(0.15)
Log GDP per capita	0.21	0.27	0.33	0.22
	(0.07)	(0.09)	(0.11)	(0.07)
Log population	0.06	0.12	0.10	0.06
	(0.04)	(0.04)	(0.04)	(0.04)
Log number of employees	0.05	0.03	0.04	0.05
	(0.03)	(0.02)	(0.03)	(0.03)
Industry dummies	Yes	Yes	Yes	Yes
R-squared	0.40	0.40	0.40	0.40
Number of Countries	54	54	57	57
Number of Observations	638,217	638,217	638,348	618,362

The table presents coefficient estimates from regressions of a firm-level vertical integration index on measures of contracting costs and financial development. Contracting costs are measured alternately as procedural complexity, contract enforcement procedures, or legal formalism, as noted. Also included but not reported are a full set of industry dummies based on 77 BEA-defined industries. Robust standard errors, adjusted for clustering within countries, are in parentheses. Interaction terms are created using demeaned variables.

Table 7  
The interaction of contracting costs and capital intensity

	(1)	(2)	(3)	(4)
<i>Contracting measure:</i>	Procedural complexity	Contract enforcement procedures (50% debt)	Contract enforcement procedures (200% debt)	Legal formalism
Contracting costs × Capital intensity	0.10 (0.04)	0.18 (0.06)	0.05 (0.08)	0.13 (0.05)
Log GDP per capita × Capital intensity	0.12 (0.08)	0.12 (0.08)	0.05 (0.10)	0.13 (0.08)
Log number of employees	0.03 (0.02)	0.03 (0.02)	0.03 (0.02)	0.03 (0.02)
Industry dummies	Yes	Yes	Yes	Yes
Country dummies	Yes	Yes	Yes	Yes
R-squared	0.41	0.41	0.41	0.41
Number of Countries	56	56	61	62
Number of Observations	661,082	661,082	661,249	642,043

The table presents coefficient estimates from regressions of a firm-level vertical integration index on the interaction of contracting costs and capital intensity. Contracting costs are measured alternately as procedural complexity, contract enforcement procedures, or legal formalism, as noted. Capital intensity (the log of the ratio of fixed assets to sales) comes from the Compustat database. Also included but not reported are a full set of industry dummies (based on 77 BEA-defined industries) and a full set of country dummies. Robust standard errors, adjusted for clustering within country/industry pairs, are in parentheses.

Table 8  
The interaction of contracting costs and capital intensity, additional controls

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
					Contract enforcement procedures (50% debt)	Contract enforcement procedures (200% debt)	Legal formalism
<i>Contracting measure:</i>							
		Procedural complexity					
Contracting costs × Capital intensity	0.09 (0.04)	0.10 (0.04)	0.079 (0.042)	0.083 (0.042)	0.15 (0.07)	0.01 (0.08)	0.10 (0.06)
Financial development × External dependence	0.13 (0.06)			0.09 (0.07)	0.15 (0.07)	0.14 (0.08)	0.11 (0.07)
Contracting costs × External dependence		-0.04 (0.02)		-0.03 (0.02)	0.02 (0.03)	0.01 (0.04)	-0.01 (0.03)
Financial development × Capital intensity			-0.07 (0.19)	-0.08 (0.19)	-0.09 (0.19)	-0.16 (0.19)	-0.13 (0.20)
Log GDP per capita × Capital intensity	0.11 (0.08)	0.12 (0.08)	0.14 (0.09)	0.14 (0.09)	0.14 (0.09)	0.08 (0.11)	0.15 (0.08)
Log number of employees	0.03 (0.02)	0.03 (0.02)	0.03 (0.02)	0.03 (0.02)	0.03 (0.02)	0.03 (0.02)	0.03 (0.02)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.40	0.41	0.40	0.40	0.40	0.40	0.41
Number of Countries	54	56	54	54	54	57	57
Number of Observations	637,727	661,082	637,727	637,727	637,727	637,858	617,890

The table presents coefficient estimates from regressions of a firm-level vertical integration index on the interaction of contracting costs and capital intensity. Contracting costs are measured alternately as procedural complexity, contract enforcement procedures, or legal formalism, as noted. Capital intensity (the log of the ratio of fixed assets to sales) and external dependence (i.e., dependence on external finance as in Rajan and Zingales, 1998) come from the Compustat database. Also included but not reported are a full set of industry dummies (based on 77 BEA-defined industries) and a full set of country dummies. Robust standard errors, adjusted for clustering within country/industry pairs, are in parentheses.

Table 9  
The interaction of contracting costs and capital intensity, alternative measures of capital intensity

	(1)	(2)	(3)	(4)	(5)
<i>Capital intensity measure:</i>	Fixed assets/ total assets (Compustat)	Fixed assets/ employees (Compustat)	Capital stock/ employment (NBER)	Capital stock/ value added (NBER)	Capital/ output (Autor, et al)
Contracting costs × Capital intensity	0.12 (0.04)	0.09 (0.03)	0.11 (0.05)	0.14 (0.07)	0.05 (0.04)
Log GDP per capita × Capital intensity	0.15 (0.07)	0.14 (0.08)	-0.04 (0.13)	-0.07 (0.17)	0.29 (0.08)
Log number of employees	0.03 (0.02)	0.03 (0.02)	0.17 (0.02)	0.17 (0.02)	0.04 (0.02)
Industry dummies	Yes	Yes	Yes	Yes	Yes
Country dummies	Yes	Yes	Yes	Yes	Yes
R-squared	0.41	0.41	0.41	0.41	0.43
Number of Countries	56	56	56	56	56
Number of Observations	661,082	661,082	267,931	267,931	544,655

The table presents coefficient estimates from regressions of a firm-level vertical integration index on contracting costs (measured as procedural complexity) interacted with capital intensity. Capital intensity measures are in logs and come U.S. data from the Compustat database, NBER productivity database, or Autor, Katz, and Krueger (1998), as noted. Also included but not reported are a full set of industry dummies (based on 77 BEA-defined industries) and a full set of country dummies. Robust standard errors, adjusted for clustering within country/industry pairs, are in parentheses.

Table 10  
The interaction of contracting costs and capital intensity, other robustness checks

	(1)	(2)	(3)	(4)	(5)
	Fixed assets/ total assets (Compustat)	Fixed assets/ employees (Compustat)	Capital stock/ employment (NBER)	Capital stock/ value added (NBER)	Capital/ output (Autor, et al)
<i>Capital intensity measure:</i>					
<b><i>Panel A: Manufacturing industries only</i></b>					
Contracting costs × Capital intensity	0.20 (0.06)	0.06 (0.04)	0.11 (0.05)	0.15 (0.07)	0.203 (0.101)
Log GDP per capita × Capital intensity	0.06 (0.15)	0.01 (0.11)	-0.04 (0.13)	-0.09 (0.18)	0.26 (0.27)
Log number of employees	0.18 (0.02)	0.18 (0.02)	0.18 (0.02)	0.18 (0.02)	0.18 (0.02)
R-squared	0.41	0.41	0.41	0.41	0.41
Number of Countries	56	56	56	56	56
Number of Observations	253,222	253,222	253,577	253,577	253,577
<b><i>Panel B: Most and least vertically integrated industries excluded</i></b>					
Contracting costs × Capital intensity	0.13 (0.04)	0.10 (0.04)	0.12 (0.05)	0.139 (0.069)	0.07 (0.06)
Log GDP per capita × Capital intensity	0.16 (0.07)	0.14 (0.08)	-0.04 (0.13)	-0.08 (0.17)	0.35 (0.14)
Log number of employees	0.04 (0.02)	0.04 (0.02)	0.17 (0.02)	0.17 (0.02)	0.05 (0.02)
R-squared	0.33	0.32	0.38	0.38	0.34
Number of Countries	56	56	56	56	56
Number of Observations	543,427	543,427	258,577	258,577	433,264
<b><i>Panel C: Industries appearing in at least 90% of countries only</i></b>					
Contracting costs × Capital intensity	0.13 (0.04)	0.11 (0.04)	0.11 (0.05)	0.13 (0.08)	0.04 (0.05)
Log GDP per capita × Capital intensity	0.14 (0.08)	0.13 (0.09)	-0.10 (0.13)	-0.18 (0.18)	0.31 (0.09)
Log number of employees	0.02 (0.02)	0.02 (0.02)	0.20 (0.03)	0.20 (0.03)	0.03 (0.02)
R-squared	0.39	0.39	0.38	0.38	0.42
Number of Countries	56	56	56	56	56
Number of Observations	567,027	567,027	184,647	184,647	458,928

The table presents coefficient estimates from regressions of a firm-level vertical integration index on contracting costs (measured as procedural complexity) interacted with capital intensity. Capital intensity measures are in logs and come U.S. data from the Compustat database, NBER productivity database, or Autor, Katz, and Krueger (1998), as noted. Also included but not reported are a full set of industry dummies (based on 77 BEA-defined industries) and a full set of country dummies. "Most and least vertically integrated industries" refers to the 5% most and 5% least vertically integrated industries. Robust standard errors, adjusted for clustering within country/industry pairs, are in parentheses.



Table A2  
Estimated industry dummies for vertical integration

Industry (brief description)	Estimated dummy coefficient	Industry (continued)	Coefficient (continued)
Health/Education Services	-5.93	Radio/TV Broadcasting	-1.68
Maintenance Construction	-5.53	Manufacturing, Misc.	-1.56
Furniture, Household	-5.42	Machinery, Farm	-1.50
Household Appliances	-5.39	New Construction	-1.31
Automotive Service	-5.10	Machinery, Service Industry	-1.27
Wood Containers	-4.70	Industrial Equipment	-1.18
Eating/Drinking Places	-4.31	Utilities	-1.15
Furniture, Commercial	-4.27	Food	-0.91
Lodging/Personal Services	-4.23	Rubber	-0.84
Ordnance	-3.90	Paints	-0.79
Machinery, Industrial	-3.73	Textiles, Fabricated	-0.63
Ag/Forestry/Fishery Services	-3.72	Finance/Insurance	-0.49
Screw Machine/Stamping	-3.63	Mining, Chemical	0.05
Electrical, Misc.	-3.55	Engines	0.09
Footwear/Other Leather	-3.47	Motor Vehicles	0.38
Electric Lighting	-3.44	Real Estate	0.65
Scientific Instruments	-3.31	Transportation	1.26
Mining, Nonmetallic	-3.04	Metal Containers	1.44
Printing/Publishing	-3.04	Aircraft	1.53
Other Transportation Equipment	-2.89	Iron/Steel Manufacturing	1.57
Heating/Plumbing Fabrication	-2.87	Petroleum Refining	1.79
Optical Equipment	-2.81	Drugs/Cleansers	2.38
Machinery, Special	-2.68	Glass	2.66
Audio/Video Equipment	-2.65	Plastics	2.90
Machinery, Metalworking	-2.56	Computer/Office Equipment	3.31
Paperboard Containers	-2.52	Mining, Coal	4.71
Stone/Clay	-2.37	Electronic Components	4.91
Forestry/Fishery	-2.19	Nonferrous Metal Manufacturing	5.91
Lumber and Wood	-2.13	Apparel	6.19
Machinery, Mining	-2.13	Mining, Iron	6.50
Professional Services	-2.12	Communications, Not Radio/TV	6.94
Electrical Equipment	-2.03	Chemicals	9.02
Other Agricultural	-2.02	Fabrics	9.58
Other Fabricated Metal	-2.01	Amusement	10.06
Tobacco	-2.01	Livestock (omitted in regression)	10.88
Paper	-1.99	Leather	11.70
Textiles, Misc.	-1.96	Petroleum and Gas	13.33
Machinery, Misc.	-1.83	Mining, Nonferrous	17.08

The table reports estimated dummy variables in a firm-level regression of vertical integration on industry dummies using U.S. data.