A Stigler-Smith-Young Approach to Vertical Integration
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Objectives
- Present a new approach to vertical integration
- To recast Young’s insights into the division of labor into externalities from the perspective of a commons
- To establish the value of the division of labor as a way to analyze productive activities
- To re-introduce classical economic notions of dynamic change where firms innovate to enter and survive

Key elements
- Theory of the firm
- Theory of competition
- Division of labor
- Growth
- Externalities

The division of labor explains how production activities are reorganized through ever greater specialization
- Implies increasingly narrowly defined activities
- In a modern process it need not imply more separate labor activities because of non-linearity of organizational forms

Division of labor
- Two processes
  - At input level:
    - Labor with new training
    - Production of new machines
  - At transformation level:
    - New organization
    - New technology
- Innovation
- Evolving (generally increasing) number of steps

Smithian competition
- Suppliers need to be accountable to buyers
- Few suppliers promote necessary trust relations
- Those suppliers are known either by
  - Locality
  - Branding
- Suppliers compete through innovation
Theory of the firm

- Multiple activities
- Activities have to be efficiently performed
- Activities determined by division of labor
  - Internal
  - External
- Set of activities evolves through division of labor

Structure of the model

- Competitive Cycle

Innovation

Firm internalizes what is not available exogenously
Not necessarily efficiently, but creates a vertical structure

Other firms enter on innovations applied to a subset of activities

Those other firms take advantage of subsets of activities that they can do more efficiently

This creates a dynamic process
Which repeats itself, fostering continuing innovation

Where there is competition, the innovator has an incentive to become a mercantilist who creates externalities that affect other sectors
The effect:
- Some integration at the innovation stage
- Disintegration follows

Utility:
- Shows ephemeral character of monopoly
- Vertical integration not a generic issue
  - Innovation based
  - Portfolio
  - Anticompetitive strategy
- Analyze the layering of vertical structures

Competitive Cycle:
- External Innovation
- New Organization
- New Redefined Activities
- New Technology
- New Labor Specialization
- New Machines
- Scale

Distinctiveness:
- A dynamic model
- Division of labor gives an ex ante view
- Differentiation between the transformation of inputs and the use of those inputs
- Demonstrates the layering vis. activities
- Distinct from a neoclassical production function

Value gained from reconsidering Smith and Young:
- Critique of Stigler
- Reconsideration of division of labor
- Introduction of “Smithian” competition
Coherence with a commons approach

- A global view with the market subsumed within a greater view; i.e. the commons
- Focus on:
  - Governance
  - Dynamism
  - Externalities