Welfare improving horizontal mergers in the presence of vertical relationships

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Abstract: We study welfare effects of horizontal mergers in a successive oligopoly model with general demand and find that downstream mergers can increase welfare if they reduce input price. In an environment with asymmetric upstream firrms, the lower input price reallocates some input production from cost-inefficient upstream firms to cost-efficient ones. In presence of fixed cost and free entry, the lower input price rationalizes the upstream sector and decrease average cost of production for each upstream firm. Both reallocation and rationalization can improve welfare. We identify necessary and sufficient conditions for welfare-improving horizontal mergers and explore how demand curvature, market structure and Herfindahl index (in case of asymmetric firms) affect these conditions. Qualitative nature of our findings remains unchanged for upstream mergers.