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# The Priorities of Development of Vertically Integrated Structures

**ABSTRACT**

Ways of attainment of the competitiveness are different for each enterprise, but, at the same time, they have a mutual feature, i.e. an enterprise cannot become a competitive one without the implementation of strategic plans of its development. Despite the diversity of strategies enterprises frequently choose the strategy of external increase, which includes a type such as the vertical integration strategy. A purpose of the research is the determination of the main priorities of development of vertically integrated structures and the examination of the main directions of enhancement of their efficiency.

The vertically integrated structures creating the complete technological cycle "production – processing – realization" is the most effective and adjusted to modern conditions of the market economy.

The application of vertical integration enables to overcome the apartness of producers of raw materials and processing companies, trade and other companies, to eliminate the competition between producers and distributors of products of the same type. All of this is very important for the formation of the single price policy. Moreover, the application of vertical integration allows the optimization of prices and conditions of production and distribution of products, taking into consideration the application of damping policy regarding the foreign competitors. Due to the creation of vertically integrated structures a system of taxation of final products may be put in order. Simultaneously, the practice of double or triple taxation in the process of movement of products from suppliers of raw materials to processing and distribution companies is eliminated.

The incentive reason of the vertical integration is, firstly, the savings in transactional costs related to, in particular, the preparation and drawing up a treaty. The decrease of transactional costs also occurs in the process of usage of highly specialized resources, since the market of these assets is factually monopolized, and a company-producer deals with the uncertainty regarding the timely delivery of such resources.

The vertically integrated structures is an important element of the company development, which enables to significantly decrease costs for additional legal aspects of a commercial activity, to save resources, to enhance the quality of a finished product due to the deeper specialization of some treads of a structure, and to completely detect the economic potential of a state. The advantages of these integrations together with the incentive reasons of vertical integration create a synergic interconnection, which prevent disproportions of production and provide a maximally possible income under the high quality of products.

**Key words:** *vertically integrated structures, vertical integration.*

**Formulation of a Problem.** Under contemporary conditions there are different levels of social and economic development being inherent to countries of the world. Such differences are stipulated by a set of factors containing economic, demographic, informational, legal, managerial, psychological factors etc. The instability and the impulsivity of the market economy considerably complicate the development of fields of the economy and diminish the competitiveness of enterprises and, as a result, their efficiency. Ways of attainment of the competitiveness are different for each enterprise, but, at the same time, they have a mutual feature, i.e. an enterprise can not become a competitive one without the implementation of strategic plans of its development. Despite the diversity of strategies enterprises frequently choose the strategy of external increase, which includes a type such as the vertical integration strategy. The modern world economy is mainly an economy of a corporate type, which consists of different single entities associated by decades of integration relationships. These worldwide tendencies are presented in the economy of Ukraine. Consequently, the vertically integrated structures are more and more inherent to it. Thus, the implementation of vertically integrated structures is sufficiently important matter on the pass to successful prosperity of the domestic economy.

The index of competitiveness for a certain enterprise expresses an aggregated result of work of almost all departments (i.e. a state of its internal environment) and also a reaction of an enterprise to a change of external factors of the influence. The comparison of some parameters of functioning and results of an activity of enterprise with the same figures of the main competitors enables not only to obtain a "prompt photo" of a state being inherent to a field and a "strategic group", but also to determine advantages and disadvantages of an enterprise regarding the main competitors, to prognosticate possible variants of development of a situation, to develop appropriate strategies of strengthening positive tendencies and diminishing negative tendencies. Simultaneously, one of the main problems is a choice of indices and methods of estimation of a competitiveness level. Such indices and methods, in turn, should be based on a strong theoretical basis contemplating unambiguous understanding the sense of this concept, its types, forms of realization, and factors of influence.

**Analysis of the Last Researches .** The phenomenon of vertical integration is frequently considered in the contemporary domestic scientific literature, mainly, in applied researches of product sub-complexes. A set of publications of M. Ilchuk, T. Mostenska, O. Yerankina, N. Duhanets, D. Tolstopiatov etc. are dedicated to this matter. In working papers of the mentioned scholars the vertical integration is considered only as a way to solve problems of enterprises occurring because of the low quality of consumed resources, the optimization of profit gaining, and the increase of competitiveness. Simultaneously, the vertical integration is perceived as an imperative of doing business without the substantiation of the necessity of application of this strategy. In foreign scientific works, among which are working papers of O. Hurt, D. Moore, J. Stacy, D. Blair, P. Joskow, M. Adelman, K. R. Harrigan etc., this process is considered ambiguously because of the usage of the methodological basis of the theory of games and the theory of contracts, which

define the process of formation of the vertical integration as a result of some arrangements on parameters of the interaction.

**A Purpose of the Research** is the determination of the main priorities of development of vertically integrated structures and the examination of the main directions of enhancement of their efficiency.

**Results of the Research.** Vertical integration is a connection of companies associated by a mutual technological chain or a merger of companies performing production at different stages of a technological chain and the obtainment of control over them by one company. The added value is added to the primary value of products, and products move along a chain to a final consumer.

Another definition based on the main distinction of vertical integration states that the vertical integration is a degree of control of one company over other company appearing due to the connection of different stages of an added value chain. From M. Adelman’s point of view a company is perceived as vertically integrated one, whether there is the movement of products, which can be sold in the market without further processing, within its thresholds. In other words, the author contemplates the whole control of companies over some stages of production (Adelman, 1995). This definition contains the diversity of forms of vertical integration and, also, an opportunity to apply quasi-integration strategies. A more expanded definition is proposed by K. R. Harrigan, who determines the vertical integration as a way to increase the added value in the process of product creation and product promotion in order to achieve a final consumer (Harrigan, 1985).

According to a direction of integration the vertical mergers are divided into the “forward” integration or the direct integration contemplating the connection of production and distribution and the “backward” integration or the reverse integration contemplating the connection of production with previous stages of a technological chain. According to a degree of integration the vertical integration is divided into the whole one and the quasi-integration. The last one can exist, obtaining forms such as: long-term contracts, joint ventures, and strategic alliances (companies, which join to attain a certain result remaining independent regarding other matters); licenses on a right to use technologies; the possession of assets at different stages of a technological chain, which are managed by external suppliers; franchising.

Causes of the existence of vertically joined structures are differently defined in the theory of firms. From the standpoint of the neoclassic theory of firms a size of a company depends on technological thresholds containing horizontal and vertical thresholds, which stipulate an action of the scale effect. The vertical integration of companies provides the scale effect arising from an output at several factories and, also, on account of the effect of combination of output in the process of work of several factories within one entity. This enables to use a more specialized staff, to attain a higher level of specialization for a certain product line at each factory, to concentrate assets and to allocate costs for production and distribution and, also, a financial risk of a bigger amount of output, to gain the higher return to costs for the development and the promotion of products and other measures of marketing.

The vertically integrated structures creating the complete technological cycle “production – processing – realization” is the most effective and adjusted to modern conditions of the market economy.

The application of vertical integration enables to overcome the apartness of producers of raw materials and processing companies, trade and other companies, to eliminate the competition between producers and distributors of products of the same type. All of this is very important for the formation of the single price policy. Moreover, the application of vertical integration allows the optimization of prices and conditions of production and distribution of products, taking into consideration the application of damping policy regarding the foreign competitors. Due to the creation of vertically integrated structures a system of taxation of final products may be put in order. Simultaneously, the practice of double or triple taxation in the process of movement of products from suppliers of raw materials to processing and distribution companies is eliminated.

Advantages of vertically integrated companies consist of: the centralization of the main managerial functions; the existence of a single credit and investment policy; the technological, the economic, and the legal interrelation of members of the vertical integration; the necessity of connection of the principles related to equivalence of all types of interaction of members with the strategic priority of their development for the vertically integrated structure in general; the consolidation of capital and the single interaction of members as a ground of doing business; the connection of the operative and production independence of integration subjects with the simultaneous economic dependence.

Despite the advantages, the vertical integration also has some disadvantages (Table 1).

**Table 1**  
**Negative Aspects of the Vertical Integration**

Negative aspects of the vertical integration	Overcoming negative aspects of the vertical integration
Centralization of financial resources in the head company	Creation of transparent conditions with the participation of an administration and corporate structures in order to effectively use financial resources of integrators
Possible unilateral secession of an investor-integrator from a company	Drawing up a treaty between members of the vertical integration, which are in the parity state. A system of estimation of the financial responsibility for unfulfilled obligations
Excessive centralization of managerial decisions	Allocation of managerial functions between a parent company and subsidiary companies
A loss of management of a field at district and regional levels	Submission of reports regarding the work of integrated structures to district and regional authorities on time
Cessation of an activity and liquidation of unprofitable industries	Settlement of strong statistical, financial, and tax reporting on an activity of an integrated structure. Transparency of Balance sheets and a financial position of a company

In general, the main advantage of vertically integrated structures consists of the whole technological independence and self-sufficiency. The main competitive advantage of such structure is its adaptiveness to changes of a business environment. Whether a structure of management is developed on the basis of the modern methodology, for instance, the methodology of project management, it may be projected as Enterprise Project Structure or a project structure of a company. In terms of Enterprise Project Structure tasks of the informatization of an account policy are successfully solved on the basis of both the information technology 1C “Enterprise”

and individually developed software.

In spite of the negative aspects of the vertical integration, the number of the vertically integrated structures is considerable. The existence of such mergers is stipulated by positive reasons of their creation.

Such structures protect domestic vine producers from the penetration of dumping products of foreign suppliers, especially in terms of the Ukrainian membership in WTO. At the same time a risk of entrepreneurship decreases on account of the renovation and the expansion of assortments and the provision of high quality and safety of products for consumers. Such structures will determine new directions of the development of market trade. They will conduce to the reduction of transport costs and to the improvement of logistics. Competitive conditions in the internal and, especially, in the external market will make vertically integrated companies look for ways for mutual realization of a more flexible marketing policy. Besides, such structure is able to provide the technical re-equipment on account of the creation of special investment and innovative funds at a quick pace.

The incentive reason of the vertical integration is, firstly, the savings in transactional costs related to, in particular, the preparation and drawing up a treaty. The decrease of transactional costs also occurs in the process of usage of highly specialized resources, since the market of these assets is factually monopolized, and a company-producer deals with the uncertainty regarding the timely delivery of such resources.

Secondly, the incentive of the vertical integration is the asymmetry of information on the quality of equipment, since the long-time usage of unqualitative equipment causes pre-conditions of the provision of unqualitative products to the market. Whether costs related to checking the equipment quality are high, the vertical integration becomes a way to the improvement of information exchange on the quality and prices between parties.

Thirdly, the vertical integration conduces to the increase of profits on account of solution of the problem of "double markup" appearing in terms of the imperfectness of competition in the markets of finished and interim products. As a result, costs of a producer of finished products for an interim product reduce, an amount of market products increases, and prices of finished products decrease.

Fourthly, the reason of vertical integration of enterprises is an attempt of enterprises to diminish a pressure of the state regulation due to, for instance, the reduction of tax payments. An amount of gained profit may be distributed among departments of a company, whether a state implements restrictions of a rate of return of some goods or services of a company. An amount of paid indirect taxes (e.g. an amount of the value added tax) for vertically integrated companies will be smaller than an amount paid by independent companies.

The fifth reason may be the usage of an effective system of the price discrimination. Appointing different prices for different customers, producers of interim products obtain an opportunity to expand amounts of sales and to increase profits. The reduction of an interim product price for customers with a high elasticity of demand is possible only in case of merging to create one company. This is important in local markets of food and, also, within a product chain of sugar (Ignatjuk, 2009).

**Conclusions.** The vertically integrated structures is an important element of the company development, which enables to significantly decrease costs for additional legal aspects of a commercial activity, to save resources, to enhance the quality of a finished product due to the deeper specialization of some treads of a structure, and to completely detect the economic potential of a state. The advantages of these integrations together with the incentive reasons of vertical integration create a synergic interconnection, which prevent disproportions of production and provide a maximally possible income under the high quality of products.

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