

# **FINANCIAL DEVELOPMENT AND VERTICAL INTEGRATION: THEORY AND EVIDENCE**

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## **Abstract**

Existing evidence is mostly inconclusive on the relevance of financial development as a determinant of vertical integration. This paper presents evidence that, once industry heterogeneity in firm size distribution is taken into account, financial development is an important determinant of cross-country differences in vertical integration. Financial development fosters entry of firms and increases competition in the industry. This reduces vertical integration of larger firms, but also leads smaller, non-integrated, firms to exit the industry. As a result, higher financial development reduces vertical integration in industries where a high share of output is produced by small firms. The positive effect of financial development on entry also reduces vertical integration by fostering the development of input markets. (JEL: D23, L11, L22, O14)