13. Vertical Integration

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1. INTRODUCTION

Understanding the factors that determine which types of transactions are mediated through markets and which within hierarchical organizations called firms has been an important subject of theoretical and empirical work in microeconomics generally and central to work in New Institutional Economics (NIE) in particular for at least the last 25 years. This essay reviews research that examines the choice between governance of vertical relationships involving suppliers of intermediate goods and services ("upstream") and the purchasers of those goods and services ("downstream") through some form of market-based contractual arrangement versus governance within an organization through vertical integration. My primary emphasis is on the transaction cost economics (TCE) framework for understanding the choice of governance arrangements, though I will briefly discuss several other theories of vertical integration as well.

The essay proceeds in the following way. First, I discuss the general comparative governance framework that is a basic feature of transaction cost economics (TCE) analysis and within which theoretical and empirical analysis of vertical integration associated with the NIE has proceeded. Next, I discuss traditional "neoclassical" theories of vertical integration that rely on market imperfections associated with market power, free riding, uncertainty, and economies of scale as explanations for vertical integration. I then proceed to discuss theories of vertical integration from a TCE perspective, focusing on the role of incomplete contracts and relationship specific investment. This section includes a brief discussion of the "property rights" (PR) approach to vertical integration, emphasizing the similarities and differences between the TCE and PR frameworks. Finally, I provide a brief discussion of the extensive empirical literature on vertical integration that has been stimulated by this theoretical research, focusing on key methodological issues (Peter Klein's chapter in this volume reviews empirical studies of the "make of buy" decision in more detail).

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 319–348.

2. Comparative Governance Arrangements from a Transaction Cost Economics (TCE) Perspective: The Basic Story

I want to emphasize at the outset that there is not and will never be one unified theory of vertical integration. While the literature on vertical integration tends to focus on a simple dichotomy between the decision to "make" internally or "buy" through the market, from a TCE or NIE perspective we must be sensitive to the fact that there are a wide array of market-based governance arrangements that represent alternatives to both simple anonymous repeated spot market transactions and vertical integration. These two governance arrangements are polar cases. Theoretical and empirical research in the NIE tradition examines not only the determinants of the boundaries between firms and markets but also the origins of various "hybrid forms" of governance structure that lie between simple anonymous spot market transactions and unified hierarchical organizations with varying expanses of vertical and horizontal control. These hybrid forms include various types of long term contracts, joint ventures, dual sourcing (partial vertical integration), holding companies, and public enterprises. In addition, NIE research examines the attributes of internal organizations with different internal structures, incentive arrangements, vertical, horizontal and multi-product dimensions (Williamson, 1996, 2000). Accordingly, vertical integration is only one of many potential vertical governance arrangements that transacting parties may choose from and represents only one component of broader theories of the governance of contractual relationships and theories of the firm. Indeed, except in cases where there are significant market imperfections "... market mediation is generally to be preferred over internal supply ... " (Williamson, 1971, p. 113)

Virtually all theories of vertical integration turn in one way or another on the presence of market imperfections of some type. Traditional approaches to vertical integration have tended to focus (though not exclusively as I discuss further below) on vertical integration as a response to pre-existing market power problems or as a strategic move to create or enhance market power in upstream or downstream markets. While not excluding these rationales for vertical integration, the NIE approach to the analysis of alternative market and internal organizational governance arrangements is much broader. It focuses on a well-defined array of attributes of individual transactions between buyers and sellers of goods or services and how they affect the performance (total cost) of alternative governance arrangements. It recognizes that there is a wide array of governance structures through which transactions can be mediated—from anonymous spot markets to internal administrative procedures within hierarchical organizations. It recognizes further that the task of consummating transactions must confront a variety of potential transaction costs, contractual, and organizational hazards, which are related to the attributes of the transactions at issue and their interplay with the attributes of alternative governance arrangements. These transactions costs involve the direct costs of writing, monitoring and enforcing contingent contracts as well as the costs associated with the ex ante investment and ex post