5 Vertical Integration and Related Variations on a Transaction-Cost Economics Theme

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I INTRODUCTION

That vertical integration is to be understood in large measure as a transaction-cost economising outcome has been generally conceded since Ronald Coase advanced the argument in 1937. The argument was forcefully restated by Kenneth Arrow as part of his assessment of the market failure literature (1969, p. 48). It was not, however, until 1971 that the underlying mechanics were described (Williamson, 1971). The argument has since been elaborated (Williamson, 1975, 1979; Klein, et al., 1978). Of equal if not greater importance, the same underlying transaction cost reasoning applies broadly – which is to say that vertical integration is a paradigm problem. Such apparently unrelated phenomena as the employment relation, aspects of regulation, vertical market restrictions, and even family organisation are variations on a theme.

This last has a bearing on F. A. Hayek’s observation that whenever the capacity of recognizing an abstract rule which the arrangement of these attributes follows has been acquired in one field, the same master mould will apply when the signs for those abstract attributes are evoked by altogether different elements. It is the classification of the structure of relationships between these
abstract attributes which constitutes the recognition of patterns as the same or different (1967, p. 50).

Milton Friedman’s remarks about the fruitfulness of a theory are also germane: ‘A theory is . . . more “fruitful” the more precise the resulting prediction, the wider the area within which the theory yields predictions, and the more additional lines for further research it suggests’ (1953, p. 10).

Thus although transaction-cost economics languished for almost 35 years – to such a degree that Coase observed that his 1937 article was ‘much cited and little used’ (1972, p. 63) – the past decade has witnessed renewed attention. Much of this, moreover, deals directly or indirectly with the research agenda for industrial organisation that Coase set out at the conclusion of his 1972 essay (p. 72):

what is wanted in industrial organisation is a direct approach to the problem. This would concentrate on what activities firms undertake, and would endeavor to discover the characteristics of the grouping of activities within firms . . . . In addition . . . , studies should also be made of contractual arrangements between firms (long-term contracts, leasing, licensing arrangements of various kinds including franchising, and so on), since market arrangements are the alternative to organisation within the firm.

Coase contrasts his preferred programme of research with that which prevailed in the early post-war period, which he characterised as the applied-price-theory era. Joe Bain and George Stigler were the leading practitioners (Coase, 1972, pp. 61-2); the study of inter-firm competition, with emphasis on oligopoly, rather than intra-firm organisation or non-standard contracting, was emphasised.

There is no reason, in principle, why the study of transaction-cost issues and work on applied price theory should not proceed in tandem – as, more recently, both have. Coase’s concern was that transaction cost economics had been so thoroughly neglected that it was not progressing at all. Two kinds of responses to this condition of neglect have appeared over the past decade. In addition to work of the kind herein described, a mathematical-economics literature has developed in which the study of internal organisation and contracting has come under scrutiny. This second literature deals with the formal analysis of information and incentives and is associated with the research of Robert Wilson (1968), Joseph Stiglitz (1975), James