Abstract

This study examines process innovation in a transaction cost framework. The basic premise is that decisions to invest in a new process are based first on a cost comparison between in-house production and market supply, but also that supplier asset specificity can stimulate a buyer to invest in a new process to avoid transaction costs, akin to arguments in the literature on technical change. The data come from a component fabrication division that is similar to but not the same as that studied by Walker and Weber (1984). The results show that supplier asset specificity does predict buyer process innovation and that such innovation gives the buyer a production cost advantage over the supplier’s market price. Further, a close replication of Walker and Weber’s (1984) model shows that only production costs influence the make or buy decision. The effect of transaction costs on vertical integration is therefore indirect through their influence on buyer process innovation which lowers the buyer’s production costs compared to the supplier’s price and justifies internalizing the activity. The implications for research on the relative importance of transaction costs and organizational competences are discussed.