Chapter IV

IT Outsourcing Theories

Based on outsourcing definitions explored in Chapter II, we can identify taxonomies, or schools of IT outsourcing. The primary purpose of this framework is to guide executives on choice to initiate outsourcing projects according to goals, organizational character, and technological, behavioral, or economic biases. This approach is adapted from Earl (2001).

Each school is proposed as an ideal type based on theory. No claims are made that any one school outperforms others. Each represents a particular theoretical orientation and a different form of organizational intervention at IT outsourcing. The schools are not mutually exclusive. Indeed, two or more of them sometimes can be observed in the same outsourcing arrangement. Furthermore, there may be other schools that our literature review has not encountered. We identified the following theory-based schools in IT outsourcing: the transaction cost school, the school of neoclassical economics, the contractual school, the school of core competencies, the agency school, the resource-based school, the school of partnership and alliance, the relational exchange school, the stakeholder school, the school of firm boundaries, and the school of social exchange. Each of these 11 schools are presented in this chapter and compared at the end of the chapter.

Transaction Cost Theory

In his seminal paper, Coase (1937) identifies transaction costs as the primary determinant of the boundaries of the firm. Ideally, contracts between buyers and sellers provide adaptation strategies for all possible contingencies. However, this requires either certainty regarding the future economic environment or unbounded rational reasoning
(knowing all possible future states). Transaction costs arise because complete contracting is often impossible, and incomplete contracts give rise to subsequent renegotiations when the balance of power between the transacting parties shifts (Williamson, 1979). Transaction costs include the costs associated with writing contracts as well as the costs of opportunistic holdup at a later date. Although internal organization or hierarchies are posited to offer lower costs of coordination and control and to avert subsequent opportunistic behavior, related problems can occur in decentralized firms. A major concern is the loss of high-powered incentives when the pay-for-performance link is attenuated by internal production (Anderson, Glenn, & Sedatole, 2000).

Firms are hypothesized to choose organizational boundaries to minimize the sum of production and transaction cost (Williamson, 1979). Five attributes of business exchange are positively associated with transaction costs: (1) the necessity of investments in durable, specific assets; (2) infrequency of transacting; (3) task complexity and uncertainty; (4) difficulty in measuring task performance; and (5) interdependencies with other transactions. The necessity of early investments in durable, transactions-specific assets (e.g., human and physical capital) shifts the balance of power between transaction participants, because in later renegotiations these costs are sunk costs of the party that incurs them. Infrequent transactions increase the likelihood of opportunistic behavior in later periods by reducing the threat of retribution. In situations where broader market reputations are at stake, infrequent transactions may be sustainable. However, even long-term contracts often do not provide sufficient adaptation mechanisms, and inflexibility may actually induce holdup. Task complexity, uncertainty, and measurement problems exacerbate the problem of identifying and contracting for contingencies. Interdependencies introduce contingencies among transactions that suggest co-location (e.g., system-level sourcing) or that require high-level coordination (Anderson et al., 2000).

The five transaction attributes indicate settings in which opportunistic behavior is likely. If transactions costs offset production cost advantages of the external supplier, the firm subsumes the activity—an outcome termed vertical integration or insourcing. Empirical research indirectly tests transaction cost theory by relating observed sourcing decisions to transaction attributes that proxy for transaction costs. Evidence on the relation between transaction-specific investments, contract duration, and technological uncertainty generally supports the theory. The consistency of the empirical results seems startling in light of two problems with the hypothesis that firms take sourcing decisions to minimize the sum of production and transaction costs. First, production and transaction costs are rarely neatly separable. For example, the choice of production technology (and subsequent production costs) is often inextricably linked with production volume, which in turn depends on whether the firm produces some or all products internally. Second, decision makers are likely to be affected by wealth effects associated with sourcing, and thus are unlikely to take decisions that strictly maximize firm profit (Anderson et al., 2000).

Because production costs are objectively calculated by the accounting system, while transaction costs are assessed subjectively through indirect indicators, functional managers are likely to differ in the importance that they assign to reducing transaction costs. Consequently, the effect transaction costs have on a make-or-buy choice can partly reflect the influence exerted by the purchasing manager. Production cost differ-
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