Maturing IT Outsourcing Relationships: A Transaction Costs Perspective

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Abstract. Outsourcing of information technology truly started in the early nineties. This market has grown substantially since that time. A substantial part of this market is application management. This publication provides lessons learned based on six case studies. Three historic case studies describe outsourcing engagements in the 1990s, and three recent case studies describe outsourcing engagements in the 2000s. By comparing the two, the transformation of service providers into service integrators becomes clear. This transformation resulted in substantial reductions in the total cost of ownership by investing in retained organization, resulting in an increase of the coordination costs, improved performance and more predictable cost patterns, which in turn resulted in a decrease of the production costs.

Keywords: application management, offshore outsourcing, output obligations, outsourcing, service integrator and transaction costs theory.

1 Introduction

IT outsourcing is handing over the responsibilities for the execution of IT services to an outside service provider [26, 24 and 40]. Excluded from the scope of this definition are public-private partnerships [13] and other joint venture-type of engagements [28 and 46], as these relationships are sourcing relationships, not outsourcing relationships. Offshore outsourcing is a specific type of IT outsourcing. In offshore outsourcing, the execution of the IT services is located in low-cost countries [9, 10 and 34]. Cost is not the only driver for offshore outsourcing; the availability of IT professionals is also important [6]. The level of proficiency and the number of available IT professionals in countries such as Brazil, Russia, India and China (BRIC countries) and countries such as the Argentina, Hungary, Mexico, Philippines, Poland or South Africa is very high [19, 35 and 36]. The increasing global demand for IT services can only be met by leveraging these developing countries.

Application management includes maintaining the application, bug fixing and improving and adjusting the application by the implementation of change requests, i.e., application development [30 and 36]. Application management is
different from infrastructure management, such as server, desktop or network management, which requires less interaction with the client and vicinity to the locations of the client than application management. Application management includes two types of applications. The first type is the standard software package such as Enterprise Resource Planning (ERP) software, Management Information Systems (MIS) or Database Management software: Commercial Off The Shelf (COTS) software. These standard applications are implemented and frequently modified to meet the specific requirements of a client. Application management also includes a second type of software development: dedicated software developed for the unique specifications of a particular client. This dedicated software is 100.

2 Transaction Cost Theory

Implementing new business models, such as outsourcing application management, has implications for companies strategies. One important question we have already encountered is whether one should produce a certain good or service oneself or buy it from an external supplier. In part, this depends on the efficiency of the transaction involved. According to transaction cost theory, companies engaging in exchanges with external companies incur several kinds of costs, collectively called coordination costs. Transaction cost theory can also be applied to outsourcing information technology services. Also included in transaction costs are a) operations risk costs, which arise from the possibility that one partner may misrepresent the situation, withhold information or underperform, and b) opportunism risk costs, referring to partners wanting to renegotiate after the other side has already made certain investments, or simply because there are few alternatives (i.e., switching costs). For some application management, these costs are higher than for other IT services, as application management requires, above all, the transfer of tacit knowledge. But companies will always weigh production costs against coordination costs, that is, the advantages of internal management (also called the hierarchy), against those of external procurement governed by a market mechanism.

Two aspects of inter-business relationships play a role in application management: transaction aspects, such as uncertainty, exchange frequency, the specificity and complexity of the products and services delivered, and behaviour aspects, in particular, bounded rationality and opportunism. There are three aspects to transactions that exert a powerful influence over the decision whether to insource or outsource: asset specificity, product complexity and transaction frequency. The asset specificity of a transaction refers to the degree to which it is supported by assets that are specific to this transaction alone and that cannot be used otherwise or elsewhere without incurring a significant reduction in their value. For instance, if you need trained personnel for the transaction, this is called human capital specificity. Application management

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1 This section is based on Beulen et al., 2011: pages 188-190.