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An assessment of the use of Transaction Cost Theory in information technology outsourcing

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ABSTRACT

Transaction Cost Theory (TCT) has been widely used in information technology outsourcing (ITO) research to explain and predict outsourcing decisions and outsourcing-related outcomes. This research, however, has led to mixed and unexpected results in terms of the effects of transaction attributes on outsourcing decisions and outcomes. This study assesses the empirical literature employing TCT-based ITO models in terms of its faithfulness to the precepts of TCT, and argues that one possible explanation for the mixed results is that the extant models do not capture all the essential elements of TCT. First, there are core TCT constructs that the extant models do not take into account; second, the linkages among constructs that the IT outsourcing models have hypothesized are not always in line with TCT precepts; and third, the normative nature of the theory is not always captured by the extant models. This paper, therefore, aims to provide one possible answer to the question: “Why have the appropriations made of TCT to study IT outsourcing produced mixed results?”

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1. Introduction

Whether to make or buy is a fundamental issue that organizations must address with regards to a variety of products and services. When the issue concerns the firm's information technology (IT) services, several organizations opt for outsourcing, or a “situation in which part or all of the IT activities an organization needs are performed by one or more external suppliers” (De Looff, 1995, p. 282). Over the years, two main IT outsourcing (ITO) research streams have formed. The first examines the potential determinants or antecedents that can be used to explain and predict the IT outsourcing decision and/or outcome (e.g. Dedrick and Kraemer, 2010; Nam et al., 1996; Thouin et al., 2009), and the second studies the post-outsourcing phase, examining how the outsourcing relationship is managed (e.g. Choudhury and Sabherwal, 2003; Ho et al., 2003; Kern and Willcocks, 2000). This study falls into the first stream of research, as it is concerned with the antecedents and consequences of the IT outsourcing decision.

One of the key theoretical foundations for explaining ITO decisions and outcomes is Transaction Cost Theory (TCT) (Whitten and Wakefield, 2006). Several conceptual and empirical IT outsourcing studies have used TCT as their theoretical foundation, either alone or in combination with other theories. This is because TCT explicitly addresses boundary decisions and is “based on an economic rationale” that provides an alternate view to that of social, political and institutional theories (Lacity and Hirschheim, 1993). In its essence, TCT posits that there are several characteristics of a given transaction – or

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activity – that determine the appropriate type of governance structure for the transaction (Williamson, 1979, 1981). These characteristics are asset specificity (second-best use of a transaction), frequency (repetitiveness of a transaction) and uncertainty surrounding the transaction. These characteristics impact the total transaction and production costs attributable to an activity (transaction) and these costs, in turn, determine the governance structure (e.g. outsourcing or internal organization) that is the most efficient for the activity. If the right decision is made based on the transaction characteristics, then the transaction is likely to be conducted in a cost-efficient manner.

The TCT-based IT outsourcing research has led to contradictory results across studies and unexpected results within studies. For example, Aubert et al. (2004) found a positive influence of asset specificity on the IT outsourcing decision, while Poppo and Zenger (2002) found a negative influence. Miranda and Kim (2006) hypothesized a negative influence of uncertainty on the proportion of the IT budget being outsourced, but, contrary to their TCT-based hypothesis, they found a positive link.

Several explanations have been proposed for such mixed results. In a review of the TCT-based ITO research, Lacity et al. (2011) offer four categories of explanations that authors provide for the anomalies in their research results: research methods, boundary conditions, TCE assumption violation explanations, and alternate theory explanations. Studies of the first category mainly attribute the lack of support for TCT to “measurement problems” or the “inherent difficulty of measuring core TCT constructs” (p. 9). Studies in this category also attribute the mixed results to how the models are tested and argue that, most of the time, one of the independent variables captures most of the variance. Studies in the second category, boundary conditions, attribute the mixed results to the “distinctive context of ITO,” “distinctive research settings” or the “distinctive attributes of the collected data” (p. 10). Studies of the third group either found evidence that some TCT behavioral assumptions – e.g., bounded rationality, opportunism, or the transaction as the unit of analysis – were violated in some IT outsourcing contexts. Finally, studies in the fourth category argue that alternate theories may have assumptions that better fit the IT outsourcing context, or have more power than TCT to explain ITO results.

From these explanations, Lacity et al. (2011) argue that researchers have to depart from TCT and build a theory that is endogenous to ITO, the foundations of which they lay in their article. Although the call by Lacity et al. (2011) for endogenous ITO theories is appealing, we argue that for these foundations to be stable, they need to rest on firm ground. Pursuing the building analogy, we suggest that until we have evidence that entirely faithful appropriations of TCT in the context of ITO lead to results in directions opposite to those hypothesized by TCT, the foundations of a new model risk being set on unstable ground. We will illustrate this with an example from Lacity et al.'s (2011) framework, which is based on a review of the empirical ITO research from 1992 to 2010 (Lacity et al., 2010). As mentioned by Lacity et al. (2011), because ITO researchers have appropriated theories from reference disciplines, theoretical constructs from several reference disciplines are evident in the framework they propose. Because a number of the empirical studies from which the framework was built were TCT-based, the framework does indeed include TCT components – uncertainty and transaction costs under transaction attributes, in particular. We presume that these two components were included in the framework because they had received support from the reviewed studies, and that transaction attributes such as specificity and frequency were left aside because they had not been supported by empirical studies.

We argue here that it is possible that specificity – or frequency – should indeed be part of the framework rather than being abandoned for lack of empirical support. We posit that the reason ITO research has not produced consistent results for specificity may lie in its misappropriation of TCT. In sum, our position is that until we ensure that ITO studies that are completely faithful to TCT do indeed fail to find support for TCT hypotheses, our endogenous theories risk being laid on shaky ground.

We are not suggesting that research should wait for another round of TCT empirical tests that would be more faithful to TCT before undertaking to build an endogenous ITO theory. We would nevertheless suggest that TCT remains relevant to the study of ITO decisions and outcomes, whether we call this a real test of TCT or we select some of its constructs to build other theories. We believe that the assessment presented in this paper could contribute to this endeavor.

We therefore seek to answer the question “Why have the appropriations made of TCT to study IT outsourcing produced mixed results?” by referring to the fundamental concepts and precepts of TCT as defined and conceptualized by Oliver Williamson and examining how TCT has been used to develop ITO models.

The next section reviews the key concepts and basic precepts of TCT. An assessment of the extant TCT-based IT outsourcing models will be presented, followed by the implications for research and practice.

2. Transaction cost theory

Because most of the IT outsourcing studies that have employed TCT are based on Williamson's work (Williamson, 1979, 1981, 1985, 1996, 1998), the theoretical foundations reviewed in this section are also mainly based on this work. Williamson's seminal work on TCT is based on the fundamental premise that the “transaction cost approach... regards the transaction as the basic unit of analysis... transaction cost economizing is central to the study of organizations” (Williamson, 1981, p. 548). In other words, TCT is aimed at identifying the governance structures of different types of exchanges between parties in order to maximize the economies for a given organization. Williamson (1981) originally focused on transactions between the firm and the market. Completing a transaction usually involves a series of activities, such as searching for suppliers, negotiating contracts, monitoring and evaluating performance, and adjusting a contract by re-arranging transaction items.

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