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The influence of exchange hazards and power on opportunism in outsourcing relationships

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ABSTRACT

Service provider opportunism is widely noted as a principal risk with outsourcing. Indeed, economic theory regarding the factors which influence the outsourcing decision, treats opportunism as a core behavioral assumption. It is assumed that if given the opportunity, outsourcing providers will act in a self-serving manner despite the potentially negative impact it may have on their customer. Other researchers have suggested that opportunism is not an unwavering human behavior, but rather can be substantively influenced by the management practices which define the relationship. Building on these arguments, this study investigates the validity of these divergent positions. Hierarchical linear regression is used to examine dyadic data on 102 information technology, logistics, and other business process outsourcing relationships. We test a model which hypothesizes that the buying firm's reliance on different bases of inter-firm power will have differing effects on the risk of opportunism (shirking and poaching). These hypotheses are evaluated while concurrently examining the influence of exchange hazards (relationship-specific investments and technological uncertainty) on provider shirking and poaching. The results offer strong evidence that buyer reliance on mediated forms of power (i.e. rewards, coercive, legal legitimate) enhance the risk of both provider shirking and poaching, while non-mediated power (i.e. expert, referent) is associated with a diminished level of opportunistic behavior. Interestingly, relationship-specific investments have a significant effect on some forms of opportunistic behavior but not on other forms of opportunistic behavior. Technological uncertainty did not have a significant impact on provider opportunism.

1. Introduction

In 2006, the Texas Department of Information Resources (DIR) entered into an $863 million, 7½ year outsourcing contract with IBM to consolidate and manage the state's data center operations. The initiative was projected to save the state $178 million by 2014 (Garrett, 2010). However, according to a consultant hired by the state, savings had accumulated to a mere $10 million in the first two years (Garrett, 2010). Moreover, the contract called for server consolidation to be complete by the end of 2010. As of July 2010, only 10% of the consolidation had been completed (Thibodeau, 2010). As a result, the Executive Director of the Texas DIR presented IBM with a "Notice to Cure" alleging 15 contractual breaches (Garrett, 2010; Thibodeau, 2010). According to the notice "The accumulated effect of under-investment by IBM, poor performance, and continual disregard for the protective obligations of the MSA [Master Service Agreement], has resulted in harm to State agencies, exposure to unnecessary risks, and failure to achieve the objectives set and agreed by IBM" (Robinson, 2010). Among the allegations cited are "IBM failed to provide sufficient and suitably qualified personnel" and "IBM fails to perform all obligations for technology refresh... has not developed or provided plans to migrate systems for which IBM has financial and operational responsibility to newer platforms" (Robinson, 2010).

While these *alleged* IBM actions appear remarkable, opportunistic provider behavior has broadly been noted as a central concern with outsourcing (Holcomb and Hitt, 2007; McIvor, 2009). The IBM–Texas DIR example, illustrates the concern that providers may be inclined to withhold resources or "under-invest" in the relationship if they believe the outsourcing firm is unable to detect such action (i.e. shirking). An equally serious risk faced by outsourcing organizations involves intellectual property protection and confidentiality. A Deloitte Consulting study of business process outsourcing found that 26% of participants identified "intellectual property and confidentiality issues as the leading risks of

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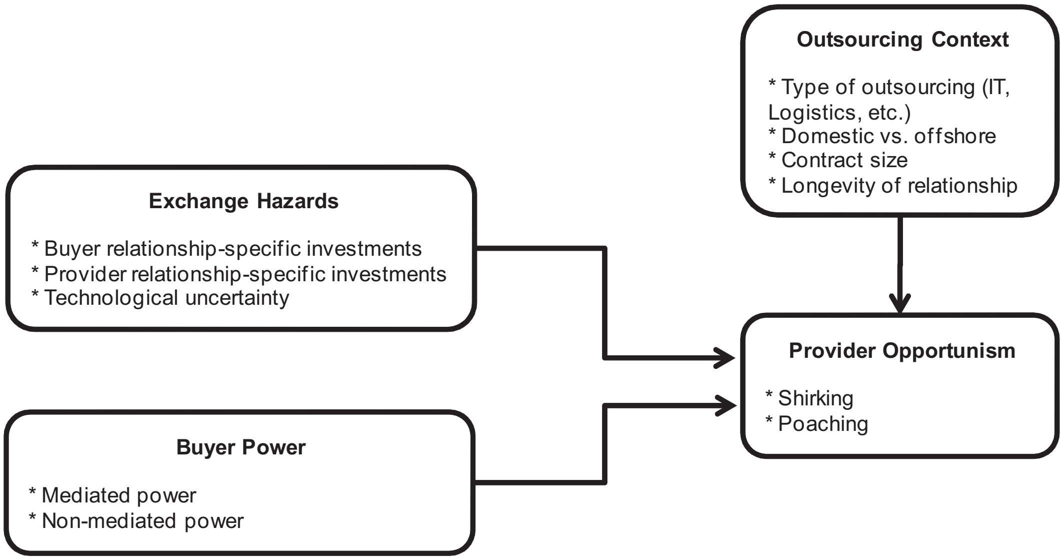

Fig. 1. Conceptual model.

outsourcing" and 10% of respondents had explicitly experienced "confidentiality and intellectual property rights violations" (Landis et al., 2005, p. 10). For instance, one outsourcing firm reported that its vendor was caught selling proprietary software to other clients. These concerns for confidentiality and intellectual property protection highlight the second form of outsourcing provider opportunism that will be explicitly evaluated in this study, poaching.

Surprisingly, a review of the extant literature reveals that empirical research on the drivers of opportunistic behavior is rather limited. In this study, we test a model (see Fig. 1) which hypothesizes that the buying firm's reliance on different bases of inter-firm power will have differing effects on the risk of provider opportunism. These hypotheses are evaluated while examining and controlling for the influence that relevant exchange hazards have on opportunism. This concurrent consideration of power and exchange hazards is critical, and has not been studied previously. Additionally, this study contributes valid and reliable scales for shirking and poaching; two forms of opportunism. This facilitates the execution of the current study, and also contributes new scales for meaningful outsourcing risks. By incorporating shirking and poaching as two distinct forms of opportunism, more exact insights and guidance can be developed concerning the effect of exchange hazards and relationship management practices on the total cost of outsourcing.

This paper is structured as follows. In Section 2, the literature related to exchange hazards, inter-firm power, and opportunism is discussed. Section 3 provides the theoretical underpinnings for the research hypotheses. Subsequently, details of the research methods and analysis are covered in Sections 4 and 5. Section 6 discusses the research findings and managerial implications. Concluding comments and future research directions are presented in Section 7.

2. Related literature

One of the most heavily relied upon perspectives utilized to explain the demarcation of firm boundaries is transaction cost theory (TCT) (Macher and Richman, 2008; Rindfleisch et al., 2010). According to TCT, the most efficient form of governance for a particular business activity is conditional on salient characteristics of the exchange or transaction (Coase, 1937; Holmström and Roberts, 1998; Williamson, 1975). One of the key behavioral assumptions underlying TCT is *opportunism* (Grover and Malhotra, 2003; Holcomb and Hitt, 2007). Opportunism is defined as "self-interest seeking with guile" (Williamson, 1975, p. 6). The behavioral assumption of opportunism in TCT presupposes that if given the opportunity, individuals will naturally act in a deceitful, self-serving manner (Ghoshal and Moran, 1996; John, 1984). Critics of TCT often cite the assumption that opportunism is an innate human characteristic as a fundamental limitation of the theory (Wathne and Heide, 2000). Maitland et al. (1985, p. 64) remark that "opportunism neither is ubiquitous nor is it very unusual". If one can accept that opportunism is not an unwavering human characteristic, but rather is substantively dependent upon the exchange context and management practices employed, then seeking to understand the factors which exacerbate or attenuate the proclivity for opportunistic behavior is a worthy research endeavor.

The contributions of the current study lie at the nexus of three profound bodies of literature: inter-organizational exchange hazards, power, and opportunism. Table 1[1] provides a representative sample of the core empirical literature surveyed for this study, and also conveys the positioning of the current study relative to this prior research. The primary contribution is that this is the first study to simultaneously consider how exchange hazards and differing power bases influence the risk of opportunism. This study is also the first to investigate these relationships in the context of business process outsourcing. Table 1 additionally illustrates that ours is one of the few studies conducted in a dyadic way. That is, paired data is collected from both buyer and provider organizations. Finally, whereas prior studies of opportunistic behavior relied on broad measures of opportunism, the current study explicitly considers two salient forms of opportunism. The following sections serve to review the prior contributions and develop the conceptual domains for inter-organizational exchange hazards, power, and opportunism.

[1] The focus here is on empirical TCT studies that explicitly include opportunism as the dependent variable of interest and this table is not intended to exhaustively cover all empirical research testing propositions of TCT as this would necessitate an entire paper unto itself. The interested reader is referred to David and Han (2004) for an excellent review.