

Chapter 1.9

Information Technology Outsourcing

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INTRODUCTION

Organizations have used external vendors to supply information technology (IT) functions since the first commercial implementations. In the sixties, the use of facilities management, contract programmers, and contract project management were common, but during the 70s, many organizations relied increasingly on internal delivery of IT services. The term “outsourcing” arose in the late 80s. Since that time industry has seen a fundamental change in the way information technology (IT) services are organized and delivered, with increasing reliance on external, outsourced providers. Managing outsourced IT service delivery has now become a core competence for organizations

BACKGROUND

According to Willcocks and Lacity (1998, p. 3), outsourcing involves “handing over to a third party [the] management of IS/IT assets, resources and/or activities for required results”. There is general consensus that outsourcing involves delegating the responsibility for “how” to produce definable outcomes to an external party, while retaining responsibility for specifying “what” is to be delivered. Instead of controlling the behavior of service staff directly, the purchaser controls performance through a contract or service agreement, which articulates the services required, and the performance criteria.

The rise of the term “outsourcing” occurred when, in the 80s, several large U.S. corporations announced they were handing over control of their IT function to one or more vendors. The most prominent of these was Eastman Kodak. At that time, it was common in the trade literature

(and some academic literature) to argue that IT had become a commodity. By outsourcing IT, it was asserted that organizations could more easily concentrate on core business. In the early 90s, announcements like Eastman Kodak's tended to produce a rise in share price, as the market anticipated consequent cost savings or improved organizational performance. Thus, the stock market response was an important outsourcing driver. Another significant driver was the growth of communications technologies, which enabled vendors to provide services remotely.

A less-frequently acknowledged reason for the rise in outsourcing was IBM's entry into the IT services arena, joining Electronic Data Systems (EDS), which had been spun off as a separate IT service vendor from its parent, General Motors. The dwindling profitability of hardware and software sales acted as an impetus, as outsourcing provided a relatively stable and long-term source of income and profits. Thus, in many ways, outsourcing is a vendor-driven phenomenon.

In the fifteen years since IT outsourcing emerged as an academic topic, the phenomenon has grown and adapted, and now embraces a range of variants. These include "business process outsourcing" (BPO), "off shore outsourcing" or "offshoring", and "application service provider" services (ASPs). Gartner (2005) reports that outsourcing is the prime driver for the IT services market, estimated to be around \$US600 billion in 2004. While growth in the IT outsourcing market has slowed, the growth in new outsourcing forms (offshoring, and BPO) is reportedly strong, so the topic is likely to remain important in the IS discipline for some time.

THEORETICAL UNDERPINNINGS

There is no generally agreed "theory" of outsourcing but a range of theories drawn from economics, strategy, marketing, and public policy have been used to understand the phenomenon.

Economic Theory

Economic theories tend to view outsourcing as a variation on the "make or buy" decision that organizations must take and to view sourcing decisions as being based on relative costs. Outsourcing is seen to lead to lower cost of delivery under certain circumstances.

The most influential economic theory, and probably the most widely used in outsourcing research, is *transaction cost theory (TCT)* (Williamson & Masten, 1999). This theory predicts when decision makers will choose the *market* to deliver services and when they will choose in-house delivery through the organizational *hierarchy*. These are seen as polar forms of service provision, although a range of hybrid forms are possible.

According to TCT, the relative costs for these two strategies depend on two types of costs: production costs—usually reduced in markets because of competition—and transaction costs; and the costs of finding, contracting with and dealing with vendors in the market. Transaction costs are difficult to measure and can be so high as to outweigh the outsourcing savings associated with reduced production costs. TCT predicts that several factors will influence whether outsourcing leads to cost savings, including level of uncertainty, frequency of transactions, and extent to which the services are "asset specific", that is, tailored to a specific vendor or purchaser and so not easily deployed elsewhere. Some TCT propositions have been confirmed for IT outsourcing (Aubert, Rivard, & Patry, 2004) though it is also argued that many of the TCT constructs are difficult to operationalize and so the theory is difficult to disprove (Ghoshal & Moran, 2005).

Resource dependency theory, and the *Resource-based view (RBV)* of the firm are two economic theories that underlie the "core competency" argument discussed next. Resource dependency theory argues that organizations will

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