

Chapter 2

Theoretical Foundations

IT outsourcing as a theoretical as well as practical discipline is based on several other concepts and disciplines, as well as the relations between them – such as international business, marketing, psychology, technology management, strategic management, project management, knowledge management, finance, economy, organizations, traditional management, political science, and the behavioral sciences. Even though IT outsourcing is a practical issue in the end, organizational and management theories can be applied to enlighten the emerging business practices of outsourcing.

In this chapter, eleven organizational and management theories are presented according to attributes like outsourcing focus, aim, the unit of analysis, outsourcing philosophy, and critical success factors. A comparison of theories is presented in Table 1 and a comprehensive literature review of IT outsourcing based research is presented at the end of the chapter. The primary purpose of the chapter is to strengthen the theoretical understanding of IT outsourcing. This approach is adapted from Earl (2001). No claims are made that any one theory outperforms others. Each represents a particular theoretical orientation and a different form of organizational intervention of IT outsourcing. The theories are not mutually exclusive, and two or more of them can be applied to the same outsourcing arrangement. Application of different theories in a practical decision-making situation can lead to different outcomes.

NEO-CLASSICAL ECONOMIC THEORY

Focus, Aim, Unit of Analysis

Neo-classical economic theory regards every business organization as a production function (Williamson, 1981), where their motivation is driven by profit maximization. This means that companies offer products and services to the market where they have a cost or production advantage. They rely on the marketplace where they have disadvantages. Neo-classical economic theory posits that firms outsource IT to attain cost advantages from assumed economies of scale and scope possessed by vendors (Ang & Straub, 1998).

In neo-classical economic theory, outsourcing may arise in two ways. First, outsourcing may arise through the substitution of external purchases for internal activities. In this way, it can be viewed as a discontinuation of internal production (whether it be production of goods or services) and an initiation of procurement from outside suppliers. To the extent this type of outsourcing reduces a firm's involvement in successive stages of production substitution-based outsourcing may be viewed as vertical disintegration. This seems to be the most commonly understood type of outsourcing. Outsourcing may also occur through abstention. Outsourcing need not be limited to those activities that are shifted to external suppliers. On the contrary, outsourcing may also arise when a firm purchases goods or services from outside organizations even when those goods or services have not been completed in-house in the past. In neo-classical economic terms, Gilley and Rasheed (2000) posed the question, "Making more by doing less?" Their study empirically examined the extent to which outsourcing of both peripheral and near-core tasks influenced the firm's financial and non-financial performance. In addition, the potential moderating effects of firm strategy and the environment on the outsourcing-performance relationship were examined. Results indicate that both firm strategy and environmental dynamism moderated the relationship between outsourcing and performance, whereas there was no significant direct effect of outsourcing on firm performance.

In neo-classical economic theory, both the distribution of income and the composition of output are endogenously and simultaneously determined by a general equilibrium of supply and demand. The underlying data on the supply side are parametrically given resource inputs and a given technology of production for transforming inputs into outputs; on the demand side, the data are specified in terms of a given distribution of ownership of inputs and a given pattern of preferences for final outputs (Gram, 2003).

Contribution to the Understanding of IT Outsourcing

Companies will justify their sourcing strategy based on evaluating possibilities for production cost savings. Thus, the question of whether or not to outsource, is a question whether the marketplace can produce products and services at a lower price than internal production. In the context of IT outsourcing, a company will keep its IT-function internally if this has production cost advantages, and it will outsource when the marketplace can offer production cost savings. However, defining outsourcing simply in terms of procurement activities does not capture the true strategic nature of the issues (Gilley & Rasheed, 2000). IT outsourcing is not only a purchasing decision – all firms purchase elements of their operations. This is done to achieve economic, technological, and strategic advantages. However, the economies of scale and scope argument would predict that outsourcing has little to offer to larger

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