Chapter 6
Costs, Benefits, and Risks

Managing costs successfully requires more than traditional cost accounting. It requires an understanding of cost-influencing factors based on cost-explaining theories, such as production and transaction economics, hidden costs, and contract termination costs. Managing IT outsourcing successfully implies that costs are not judged in isolation. Rather costs are compared to benefits, before judgments on cost level and development occur. In this chapter, we discuss production and transaction economics, hidden costs and contract termination costs, and we will also take a look at benefits and risk behavior.

PRODUCTION AND TRANSACTION ECONOMIES

The neo-classical economic perspective of a firm regards an organization as a production function motivated by profit-maximization. The choice of alternative IT sourcing arrangements is thus treated as a traditional make-or-buy decision, hinging on efficiency considerations of production costs savings or operational advantage. Seeking economic efficiency, firms will attempt to obtain all factors of production at the lowest possible price to achieve the least costly methods of operations. From this theoretical standpoint of production economic efficiency, the decision to outsource IS services are determined by the

DOI: 10.4018/978-1-60566-796-6.ch006

relative production costs of market versus internal operations. Since IT providers may reap economics of scale via specialization or possess special skills, knowledge or technology in managing and operating IT, we would expect that the greater the production cost advantage of IT service-providers, the more likely the firm will outsource its IS services (Ang, 1993).

Transaction cost economics extends the neo-classical economic perspective of the firm by contending that market transactions are not frictionless. Transaction costs are those costs incurred to ensure proper execution of the contracting process. Transaction costs include the costs of creating and maintaining an exchange relationship, that is, the effort in negotiating, writing, monitoring, and enforcing contracts between buyers and their suppliers. Although outsourcing may yield production cost savings by exploiting scale economies in outsourcing, additional costs in the form of transaction costs are incurred when a firm enters into an outsourcing relationship with a service provider. Accordingly, transaction cost economics posit that, in addition to production cost efficiencies, transaction cost efficiencies must be considered in evaluating alternative organization schemes. From the transaction cost perspective, economic activities are governed by the market, hierarchies, or a hybrid form. Transaction cost economics posits that sourcing decisions for IS services are based on transaction costs. For example, even if a particular external IT service-provider can provide IT operational services at the most competitive price, if the same provider requires a great deal of supervision and monitoring during the course of the contract, the advantages of a cheaper price may be eroded by the excessive monitoring costs incurred by the firm. Here, excessive transaction costs can cause market failure. Thus, as market exchanges and firms lose their production cost advantage to transaction diseconomies, firms would turn to internal sourcing to meet their needs. Therefore, we would expect that the higher the transaction costs with IT service-providers, the less likely the firm will outsource its IS services (Ang, 1993).

Transaction cost theory maintains that the organization of economic activity depends on balancing production economics, such as scale, against the cost of transacting. Transactions are here the exchanges of goods and services between economic actors, who are technologically separate units, inside and/or outside the organization (Williamson, 1981). The analysis of transactions focuses on achieving efficiency in their administration. In this perspective, organizational success depends on managing transactions efficiently. Organizations exist to mediate the economic transactions among members inside and/or outside the organization. The transaction cost approach offers a method of evaluating the relative advantages of the different internal and external organization forms for handling transactions. This theory also provides an excellent framework for analyzing the outsourcing options, since the essential choice here is between using an outsourcing service provider (a market mechanism) and providing in-house services (an organizational hierarchy). First, the theory seems to be very useful for investigating the outsourcing option as an economic reorganization of IT departments. Second, the theory appears to be useful for formulating an action plan to reduce transaction cost and thereby improves the benefit one can realize through outsourcing (Grover, Teng, & Cheon, 1998).

A focus on comparative economic theories and models can improve our ability to explain outsourcing within the larger context of business strategy and environment. Specifically, productions cost, transaction cost and financial slack often influence the outsourcing decision (Ang & Straub, 1998):

- *Production cost advantage*. Neo-classical economics regards any business organization as a production function motivated by profit maximization. Organizations provide goods and services to markets where they have cost advantages and rely on the marketplace for goods and services in which they have comparative cost disadvantages. Neo-classical economics predicts that firms