# POLITICS AND FIRM BOUNDARIES: HOW ORGANIZATIONAL STRUCTURE, GROUP INTERESTS AND RESOURCES AFFECT OUTSOURCING

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**Keywords:** Outsourcing; Firm boundaries; make or buy; transaction cost economics; politics; resource dependence; organizational decision-making; offshoring; information technology.

**Acknowledgements:** I am very grateful to Heski Bar-Isaac, Henrik Bresman, Forrest Briscoe, Diane Burton, Isabel Fernandez-Mateo, Martin Gargiulo, Bob Gibbons, Javier Gimeno, Adam Grant, Quy Huy, Michael Jacobides, Sarah Kaplan, Jackson Nickerson, Joanne Oxley, Sean Safford, Felipe Santos, Brian Silverman, Andrew von Nordenflycht, Christoph Zott, seminar audiences at London Business School and the Rotman School, Nick Argyres and three anonymous reviewers for their comments and suggestions on various drafts of this paper. I am particularly grateful to all of the employees of the Bank who spent so much time talking with me and sharing the data that led to this paper.

## ABSTRACT

How does managers' pursuit of their own intra-organizational interests affect decisions about what work to outsource and how to contract with vendors? I study this question using a qualitative study of outsourcing in the IT department of a large financial services firm.

Traditional transaction-cost-based theories argue that decisions about which transactions to outsource should reflect the characteristics of those transactions, yet I find only a weak link between transaction characteristics and outsourcing decisions. Qualitative evidence suggests that managers' pursuit of their own intra-organizational interests helps to explain why outsourcing decisions were often divorced from transaction characteristics. I found that the consequences of outsourcing projects were consistent with the assumptions of transaction cost and capabilities based theories: managers had less authority over outsourced projects than internal, those projects were subject to weaker administrative controls, and outsourced vendors provided different capabilities than internal suppliers. However, the way that those consequences were evaluated often reflected managers' own interests rather than those of the organization.

I highlight three aspects of organizational structure that affected how managers evaluated outsourcing: the nature of differentiated goals and responsibilities, the administrative controls that managers faced, and the pressures caused by interdependent workflows within the organization. I also show how the distribution of authority and other resources shaped which projects were outsourced. The analysis highlights the value of understanding make or buy decisions as an endogenous consequence of the structure in which those decisions take place, rather than as isolated decisions that are maximized regardless of their context.

Firm boundaries are becoming increasingly complex, making it ever more important for us to understand how firms decide what to outsource and how to contract with suppliers. Research in transaction cost economics (Williamson 1985), property rights theory (Grossman and Hart 1986), and the capabilities-based view of the firm (Argyres 1996) has made great progress in explaining when firms should make versus buy and how they should structure contracts. Empirical studies support those theories' predictions that make or buy decisions should reflect transaction characteristics such as asset specificity (Klein 2005; Macher and Richman 2008; Shelanski and Klein 1995), and show that correctly aligning make or buy decisions with transaction characteristics leads to better transaction performance (Anderson 1988; Poppo and Zenger 1998).

While this research supports the idea that firms should align make or buy decisions with transaction characteristics, there remains scope to develop our understanding of how make or buy decisions are made in practice (Dow 1987:27-28). Most approaches to understanding make or buy decisions are based on a model of the organization as a unitary actor that calculates the option that minimizes the costs and maximizes the benefits to the overall organization (Monteverde and Teece 1982; Williamson 1991). In reality, of course, organizations are not unitary decision makers. Instead, a defining feature of organizations is that they are structured into different groups, each of which pursues a unique set of goals. How, then, might those groups' pursuit of their own intra-organizational interests affect what firms make versus buy and how firms write contracts with counterparties?

Prior work has documented conflicts between buyers and suppliers within organizations (Vaast and Levina 2006; Walker and Poppo 1991) and offered some examples of managers pursuing their own interests in outsourcing decisions (Lacity and Hirschheim 1993); despite primarily studying internal transfer pricing, Eccles and White (1988) argued that managers may prefer to outsource because buyer-supplier conflicts create such intense political problems when they occur within the firm, and Goodstein et al (1996) explored how conflicts between market and professional norms affect firm boundaries. We still lack, though, a well-developed articulation of how groups' pursuit of their own intra-organizational interests affects firm boundaries. For example, what elements of outsourcing decisions might lead

different groups to reach different conclusions as to whether to make or buy? And what aspects of organizational structure shape groups' interests and influence in ways that could affect the outcome of make or buy decisions?

In this paper, I use an inductive study of the Information Technology (IT) department of a large financial services firm ("the Bank") in order to examine how managers' intra-organizational interests affect decisions about what to outsource and how to contract with vendors. Drawing on extensive qualitative data on outsourcing at the Bank, I describe how managers' intra-organizational interests affected how they evaluated outsourcing, and how conflicts among groups shaped outsourcing decisions. The analysis suggests that managers' pursuit of their own intra-organizational interests disrupted the link between transaction characteristics and decisions about what to outsource. Rather than being based solely on the nature of the different projects, decisions about both what to outsource and how to write contracts frequently reflected different characteristics of the organizational structure in which the managers were embedded, characteristics such as the differentiated goals and responsibilities assigned to the managers, the managers' interdependences with other groups, the administrative controls on their activities, and the authority and other resources that they could use to advance their interests. In some cases, I found that these structural interests created new costs and benefits of outsourcing for managers; in other cases, these interests directly determined whether project were outsourced.

The study highlights how outsourcing decisions can be an endogenous consequence of the structure that the organization adopts, and specifically of the intra-organizational politics that the structure creates, rather than the product of transaction characteristics alone. This perspective contributes to literature that examines make or buy decisions at the level of the organization. Some of that literature has shown how the effects of make or buy decisions can extend well beyond the immediate transaction (Bradach 1997; Jacobides and Billinger 2006). I emphasize instead how structure's effects on managers' interests can also shape decisions about what and how to outsource. I also add to prior analysis that shows how the interaction of structure and decision can lead to misaligned boundaries (Bidwell 2010) by exploring the particular role of managers' interests in driving make or buy decisions. The analysis also

extends insights of transaction cost economics to the internal processes that shape decisions about what to make versus buy, suggesting new variables related to the structure of the organization that may affect firm boundaries and showing how ideas from resource dependence might be integrated into transaction cost economics-based explanations of firm boundaries.

## THEORETICAL BACKGROUND

Research in transaction cost economics and the capabilities-based view of the firm details three sets of changes that take place when transactions are outsourced. The first change is a loss of authority. Managers have considerable authority over internal transactions, based on their ability to control the firm's assets (Grossman and Hart 1986; Rajan and Zingales 1998), and their legal right to direct employees (Masten 1988). When a project is outsourced, managers lose those sources of authority and must instead rely on contracts for governance. Although those contracts can grant managers some authority over cross-firm transactions (Makadok and Coff 2009; Stinchcombe 1990), they are less flexible than the pervasive authority exercised within the firm.

The second change concerns the incentives and administrative controls used to regulate transactions. Incentives tend to be much stronger in markets than in firms, and often reward different activities (Holmstrom 1999; Williamson 1985). The weaker incentives found within firms are often balanced by stronger administrative controls, which define what employees can and cannot do (Holmstrom and Milgrom 1994; Williamson 1991:279-280).

A third change that happens when transactions are outsourced is that firms gain access to capabilities that are different from those present in the firm (Argyres 1996). Firms often differ substantially in their ability to produce different kinds of products and services for a given cost or quality, because the complexity of coordinating organizational activities makes learning a slow, path dependent, hard to replicate process (Barney 1991; Langlois and Foss 1999; Winter 1988). Outsourcing allows firms to access other organizations' capabilities, which may be better suited to a given transaction.

Research in transaction cost economics and the capabilities based view of the firm has drawn on those changes to explain when firms should outsource transactions and when they should carry them out internally (Williamson 1985; Winter 1988). Those predictions about how firms will decide what to make or buy are generally based on a model of the firm as a unitary actor: the firm is assumed to have a single set of goals and will make the decision that maximizes the benefits to the organization as a whole. Within transaction cost economics, this perspective led to the core prediction that firms will align outsourcing decisions with transaction characteristics in ways that minimize transaction costs, internalizing transactions that involve relationship-specific investments and high levels of uncertainty (Williamson 1991). More recent refinements of these arguments have explored how maximizing decisions might lead to misalignment when governance spillovers across transactions prevent firms from aligning individual transactions (Argyres and Liebeskind 1999). Other work has started to draw linkages between make or buy decisions and the broader organizational structure, exploring how outsourcing some transactions might improve the management of internal activities. For example, Bradach's (1997) account of franchising found that the synergies between franchise and company units were central to explaining the organizational form, while Jacobides and Billinger (2006) documented some of the ways in which buying and selling intermediate products on the external market can improve the internal management of the organization. Such work expands the set of factors that unitary organizations might consider when outsourcing, but retains a focus on the kinds of decisions that will most benefit the overall organization.

**Politics: The Study of Intra-Organizational Interests**

Although research on firm boundaries is usually based on a model of the organization as a unitary actor, much other research has explored how intra-organizational interests affect how decisions are made. Following the work of Allison and March, I use the word "politics" to refer to groups' pursuit of narrow, sub-organizational goals (Allison and Zellikow 1999; March 1962) [1]. Internal goal differences have been

[1] Other scholars have defined organizational politics as the exercise of non-legitimate power within organizations (Mintzberg 1983), or as covert attempts to influence decision-making (Eisenhardt and Bourgeois 1988). My focus on the broader topic of intra-organizational conflict is consistent with many other scholars (Dean and Sharfman 1996; Pettigrew 1973; Pfeffer 1981).

shown to affect many kinds of decisions within organizations, including staffing of independent contractors (Bidwell 2009), decisions about which research projects to pursue (Kaplan 2008; Markham 2000) and the progress of new product development (Voyer 1994). Intra-organizational differences in interests are also a core concern of agency theory and organizational economics, which emphasize the pervasiveness of influence costs within organizations (Gibbons 1999; Milgrom and Roberts 1988). Transaction cost economics has itself explored which organizational structures best manage internal opportunism and sub-goal pursuit (Argyres 2009; Williamson 1981), although it has not explored how that opportunism might affect how firms decide what to make or buy.

Two streams of research are particularly useful for understanding the effects of interest differences within organizations: the Carnegie tradition of organization theory, and later work on resource dependence. Work from the Carnegie school advanced the argument that organizations are best understood as coalitions of multiple groups, each of whom have their own distinct interests (March 1962). Some interests, such as the survival of the organization, may be shared by all members of the organization. Many interests, though, are only held by a subset of the groups. Moreover, no single group usually has the ability to make decisions on its own, leading those decisions to reflect interactions among multiple groups (Allison and Zellikow 1999; Cohen et al. 1972). Understanding decision outcomes therefore requires us to understand the factors that shape both the interests of the different groups and their ability to influence decision outcomes.

The Carnegie school emphasized that group interests were often determined by the structure of the organization (March and Simon 1958:141; Pettigrew 1973:17). Perhaps the most important determinant of those group interests was the goals and responsibilities assigned to the different units. The cognitive complexities of managing large organizations require those organizations to be divided into different groups, such as hierarchical layers, product groups, functional groups, regional groups, and so on (March and Simon 1958). Those groups are rewarded for achieving the specific goals assigned to them, such as achieving functional excellence or raising sales and profits in a particular product area. They also bear the costs of performing the relevant activities.

Other elements of structure that shape intra-organizational group interests are the mechanisms used to coordinate internal activities, such as demands from other interdependent groups and administrative controls (Thompson 1967). Demands from other groups reflect the structure of workflows within the organization and are critical for managing interdependencies, yet they are a central source of conflict, particularly when those demands are a disruptive source of uncertainty in groups' operations (Gresov and Stephens 1993; Pfeffer and Salancik 1978). Similarly, groups often resist administrative controls that constrain their ability to meet their goals (Gresov and Stephens 1993).

Organizational structure also influences the allocation of the resources that groups can use to influence decisions. Although much of the recent work in the Carnegie tradition focuses on how cognitive biases affect learning and decision making (Gavetti et al. 2007; Ocasio 1997; Powell et al. 2011), some work has developed the Carnegie school's arguments about conflicts in organizations. In particular, resource dependence theory argues that groups' influence over decision outcomes depends on the resources that they can exchange in return for influence (Pfeffer and Salancik 1978). For example, hierarchical authority gives managers the ability to impose their interests on the organization through fiat (Williamson 1985), drawing on their ability to deprive others of access to valuable resources (Rajan and Zingales 1998). Groups whose activities solve critical problems for the organization also have more influence (Crozier 1964; Pfeffer and Salancik 1978), as do groups whose position provides them with greater access to information about the effects of a decision (Pettigrew 1973). Control over agenda setting can also provide a valuable resource (March 1994; Pfeffer 1981). Sometimes, groups can use their control over agenda-setting to frame the choices that others make. In other cases, groups might use their agenda-setting control to limit their own discretion to respond to other groups, allowing them to fend off those groups' influence attempts (Pfeffer and Salancik 1978).

These literatures therefore emphasize the central role of structure in shaping the determinants and outcomes of politics within organizations. It is important to recognize, though, that these political dynamics represent only a subset of organizational structure's effects. Structure also shapes flows of communication (Cyert and March 1963), determines how organizations process information (Galbraith

1974), guides the different styles by which units are managed (Lawrence and Lorsch 1967), and directs attention (Ocasio 1997). By examining how politics affects firm boundaries, I investigate how one portion of structure's effects, the way that it shapes groups' intra-organizational interests and influence, might affect what gets outsourced and how external vendors are managed.

## RESEARCH SETTING AND METHODS

I explored how intra-organizational interests shape the management of firm boundaries using an inductive study of a single organization. Although the literatures on firm boundaries and organizational politics are well developed, we know much less about the possible interactions between these domains. Case studies can therefore be useful for stimulating and illustrating theory development in this new area (Siggelkow 2006). Using a single organization allows me to examine intra-organizational processes, by providing a situated understanding of the interests of multiple different groups and of the strategies that they pursue to further those interests (Dyer and Wilkins 1991).

I studied the determinants of outsourcing decisions by examining how managers described their rationales for those decisions. Studying qualitative accounts of decision-making can uncover organizational dynamics that were not previously part of our theories, and has expanded our understanding of such topics as strategic exit (Burgelman 1994), transfer pricing (Eccles and White 1988) and make or buy decisions (Argyres 1996). There is a risk that such qualitative analysis can reflect self-serving accounts by managers. Qualitative work is also poorly suited to conclusively establishing the relative influence of different factors in shaping outcomes. Nonetheless, such descriptions of decision making can usefully complement other empirical methods in expanding our knowledge of management.

The specific setting for this study was the IT department of a financial services institution ("the Bank"). The Bank was a very large organization; the IT department alone employed around 10,000 individuals, and was divided into multiple units that were aligned with each of the Bank's business units. The basic work of these units involved supporting the Bank's computer applications, fixing any problems and carrying out new development. Firm boundaries at the Bank were very actively managed, with some

IT work being carried out within the firm and other work being carried out by other companies. Such variation made the Bank a valuable site for understanding how firm boundaries are managed.

Most of my research examined a single large business unit called "Consumer," which had an IT workforce of around 2,000. I also carried out a number of interviews and surveys in two additional business units: "Specialist," which was a much smaller business unit, and had a correspondingly smaller IT workforce; and "Institutional," which was a medium sized business unit.

**Internal and External Resources at the Bank**

The vast majority of internal IT development at the Bank was carried out by employees reporting directly to the project manager responsible for the work (I refer to such development as "in-house"). A few internal projects in Consumer used a second organizational form, known as "insourcing", where project managers had work carried out for them by developers employed by a different group within the Bank that didn't report to them. Those groups to which work was insourced generally had expertise in particular technologies or were in low wage locations. [2]

The Bank also used a number of external IT vendors. "Offshore" vendors were based in lower-wage locations overseas (primarily in India), and therefore offered much lower costs than internal development. These vendors' experience with working overseas and managing projects across long distances allowed them to manage offshore work much better than the Bank would have been able to. During the course of the study, offshore vendor personnel made up around 10-15% of the Bank's IT headcount. I studied the use of offshore vendors within the Consumer, Specialist, and Institutional units.

The Bank also engaged high-end consulting firms known as "system integrators" who provided technical, business and project management expertise. A history of specializing in this kind of work gave

[2] As well as large numbers of employees, the Bank also employed many independent contractors on its internal projects. From many perspectives, these contractors were also an external resource; in particular, they had arms-length formal relationships with the Bank that lent themselves to market governance. Yet these contractors were also very different from the outsourcing vendors I discuss in this paper. Unlike outsource personnel, the contractors were not managed by anyone other than the project managers, and were often treated like employees. For the purposes of this paper, I focus on decisions to use outsourcing vendors. I explore the differences between contractors and employees in more detail in Bidwell (2009) and Bidwell (2010).

the integrators unique capabilities. The integrators were more expensive than internal resources and used sparingly as a consequence. I explored how managers within Consumer were using systems integrators.

**Internal Organization of the Bank: The Key Groups**

Outsourcing at the Bank primarily involved three main groups of managers: project managers, senior and staff managers, and business clients. I summarize their relationships in Figure 1.

Project managers were responsible for managing the maintenance and development of specific groups of applications. Project managers faced a variety of incentives in how they carried out their work. Good performance could lead to a promotion, while recurring layoffs provided a very real threat of termination for poor performance. Project managers also received bonuses of 20-50% of their pay based on subjective evaluations that included the assessments of clients and their record in meeting development targets. In practice, project managers' roles led to a strong focus on keeping applications running and delivering projects on time. Keeping costs down was a lower priority. One project manager told me that he didn't even know whether one of his outsourced projects had come in over budget, and that there were no consequences for doing so. Another said:

> "Ultimately, I am here to get the work done. I am less sensitive to the dollars than maybe I should be, and most concerned about delivering what I am supposed to."

Project managers were formally responsible for deciding how projects would be sourced, although in practice this authority was heavily constrained by the restrictions placed on them by other groups.

The senior and staff managers within the IT department also influenced outsourcing decisions. Different senior managers supported each business unit. They were accountable to their business clients, as well as to the Chief Technology Officer (CTO). They also faced strong pressure to reduce costs to meet substantial budget cuts, making them more sensitive to costs than the project managers. The senior managers were assisted by various staff functions whose role was both to assist project managers and to enforce compliance with organizational policies. For example, sourcing managers helped project managers to engage outsourcing providers, structured contracts, and monitored the use of vendors. Human Resources played a similar role for employees, while Finance managed the budgets.

The final group that influenced sourcing decisions was the IT departments' clients, often referred to as "the business." These were the people who would actually use the IT systems in their work. The business liked the IT group to be responsive, while being resistant themselves to providing detailed requirements to support their requests. Each business unit was allocated a budget that could only be spent on IT; reducing costs could allow them to get more for their money, but would not allow them to spend the money on other things, or improve their bottom line. This budget structure made them less sensitive to costs than they might otherwise have been.

**Data Collection and Analysis**

***Data collection.*** I conducted interviews at the Bank over 18 months during 2002 and 2003, and spent two months during that period working on-site alongside the vendor management group. I conducted semi-structured interviews with 64 informants involved in decisions about the use of internal and external resources, many of them several times. The informants came from many parts of the organization and included 9 senior managers, 4 human resource (HR) managers, 13 sourcing managers, 6 finance managers, 22 project managers, 7 developers, and 3 vendors. Most of the interviews were not recorded (when I attempted to record interviews the subjects became uncomfortable), so instead I took copious notes. All interviews were written up the same day. I also attended many meetings, focus groups and training events relevant to project staffing.

In addition to those interviews, I also surveyed project managers about 56 specific projects, gathering qualitative and quantitative data on the differences between internal and outsourced projects. Additional information on the survey is included in the Appendix. I also reviewed many documents, including the Master Service Agreements between the Bank and its vendors, and all 70 of the individual project agreements between the Consumer division and its main outsourced vendor.

***Data analysis.*** The data analysis followed a number of stages. My early data analysis focused on understanding how managers perceived the differences between working with external and internal resources. Although my initial theoretical expectations were shaped by transaction cost economics, I was

struck by the way that the organization's structure, group interests and internal conflicts often affected decisions about the use of external vendors.

I then conducted a more focused analysis to understand how organizational politics shaped firm boundaries. Because my quantitative survey had not focused on understanding the role of intra-organizational interests, I analyzed the qualitative descriptions of decision-making. I studied my interview notes to develop a detailed understanding of three questions: What did managers consider to be the effects of outsourcing projects? What was the relationship between the different groups I was studying, and how did those groups perceive their interests? And how did those intra-organizational interests affect decisions about which projects to outsource and how to write contracts with external vendors? My aim was to identify the different kinds of interests that shaped firm boundaries, as well as to understand why those interests shaped firm boundaries.

I used these questions to code my interview notes. I then compared the codes that addressed each of these questions in order to look for similarities and differences. Through this process, I was able to aggregate these codes into second order themes (Gioia & Thomas 1996; Strauss & Corbin 1998), and then develop a theoretical model of how these themes related to one another. I sought to validate each of the constructs by ensuring that they were supported by multiple respondents, in order to allay concerns that particular managers' descriptions might be unduly influenced by self-serving biases. Wherever possible, I compared across business units and types of decisions to validate the themes.

I then returned to the literature on firm boundaries and organizational politics to sharpen my insights and build a stronger understanding of what was taking place at the Bank (Eisenhardt 1989). As I progressed, I looked for disconfirming evidence that would force me to refine my concepts. This process was assisted by repeated feedback on the paper by colleagues, seminar audiences and journal reviewers. Their input encouraged me to reframe and refine the theoretical model several times, combining and disaggregating different categories and clarifying the relationships between them, in order to better express how my findings connected to existing theory.

## DATA

My survey of outsourced and internal projects allowed me to examine whether outsourcing decisions were aligned with project characteristics in the way that transaction cost economics suggests.[3] Specifically, I asked a number of questions about the kinds of relationship-specific investments that the projects required and how much uncertainty they faced, both characteristics which should make firms less likely to outsource. Summary statistics from the survey are in Table 1.

The table shows that outsourced projects involved significantly less time modifying existing applications than did internal projects, reducing the vendors' need to make investments in firm-specific skills as transaction cost economics would suggest. Overall, though, the table shows very strong similarities between the outsourced and internal projects along a number of dimensions of asset specificity, project importance and ability to write complete contracts. Even where there were significant differences in project characteristics, those differences were small compared to the standard deviations within each group. Although these similarities may partly reflect a lack of statistical power, or inadequacies in the survey, they offer preliminary evidence that the traditional factors described in transaction cost economics were not the sole drivers of decisions about what to outsource.

Nor do common alternative explanations appear to account for what got outsourced. Contrary to the predictions of capabilities theories, need for expertise or innovation had little bearing on whether projects were outsourced. Argyres and Liebskind (1999) argue that transaction misalignment can sometimes occur due to governance spillovers, when contractual commitments and shifts in bargaining power constrain future governance decisions. However, there was little evidence of such spillovers in this case: each project was contracted on separately; where bargaining power did change, it was because the vendor acquired specific skills during the projects – yet these are exactly the kind of specific investments that transaction cost economics charges companies to avoid.

[3] Part of the difference between internal and external projects may reflect when they were carried out. Internal projects were carried out around a year earlier than external projects, on average. Had the internal projects been carried out later, it is possible that some of them would have been outsourced. The set of internal projects can therefore be interpreted as a sample of all of the projects that the firm carries out. The comparison with outsourced projects tells us whether external projects represent a systematic subset of this overall sample.

My research suggests that the explanation for the weak correlations between transaction characteristics and outsourcing decisions lay instead with the way that outsourcing decisions were made at the Bank. When describing outsourcing decisions, managers remarked on the ways that different parts of the organization often pursued their own interests rather than those of the organization as a whole. As I demonstrate below, a variety of evidence suggests that pursuing such group interests may have played a role in shaping what projects were outsourced as well as how contracts were written. Where those interests differed from those of the organization, the result would be poor alignment between transaction characteristics and outsourcing decisions.

I present evidence below about two distinct ways in which group interests affected outsourcing decisions. First, I describe how group interests affected the costs and benefits to managers of outsourcing. Much of my data explored how managers evaluated outsourcing, shedding light on the calculus that they used to make decisions. Their descriptions highlight the importance of the structural elements of differentiation, interdependences and organizational rules in determining their evaluations of outsourcing.

Second, I describe the specific effects of conflicts between groups on decisions about what to outsource and how to write contracts. Conflicts often arose because of the differences in how groups evaluated outsourcing. What got outsourced, and how contracts were written was shaped by the way that those conflicts were resolved, which often itself depended on the structural allocation of resources.

**Group Interests and the Evaluation of Outsourcing**

Prior research has examined how outsourcing can affect the ability of the organization to meet its goals. Managers suggested various ways that outsourcing also affected the ability of different groups to meet their narrower, intra-organizational goals. I summarize those effects in table 2. As the table shows, how managers weighed up the costs and benefits of outsourcing was often affected by elements of the organization's structure, including (1) the goals and responsibilities assigned to each group by the differentiated organization, (2) the rules that constrained their ability to meet those goals, and (3) the critical interdependences that the groups sought to manage. I will discuss each in turn.

***Differentiated Interests and the Evaluation of Capabilities.*** Much of the evidence that intra-organizational interests shaped how groups evaluated outsourcing came from the way that managers would often disagree on the merits of outsourcing. Different groups – notably project managers on the one hand and senior and staff managers on the other hand – would have very different preferences about whether to outsource, based on how they thought that the vendors' capabilities would allow them to meet their goals and affect the costs to them of outsourcing.

None of the vendors offered capabilities that were uniformly stronger than those of the Bank. Rather, the different vendors offered strengths in some areas and weaknesses in others. For example, offshore vendors cost much less than the Bank's internal IT department, due to their expertise in operating in lower wage countries. Yet those vendors were also perceived as having less experience and less knowledge of the financial services industry than domestic workers. The constraints of working across several time zones also made communication on offshore projects more difficult, as did the need for more formalized relationships. One project manager explained the resulting problems to me:

> "I think you may have to put more time in the project plan, for milestones and the finished product. There are time differences, delays in communication, misunderstandings. The design document needs to spend more time to get it spelt out exactly. What used to be a minor change gets turned into another level. Now it's a 6 week turn around, instead of 4."

These capabilities aligned very differently with the goals and responsibilities of project managers versus senior and staff managers. Project managers' first priority was getting the work done. The reduced experience and greater communication problems involved in offshore outsourcing made getting the work done more difficult, so that project managers would usually prefer to keep work in-house. Senior and staff managers, in contrast, were experiencing intense pressure to reduce their costs; offshoring work helped them do so. Moreover, the senior and staff managers did not directly bear the increased management costs of running projects offshore – those problems were the responsibility of the project managers. The senior and staff managers therefore heavily promoted offshore outsourcing, setting targets, running workshops and creating new units to increase the rate of offshored work. One sourcing manager

even described offshoring to me as "the CTO's baby". These conflicting approaches to offshore outsourcing were highlighted by one sourcing manager:

> "They have a benchmark that 15% of their development work should be offshore. When I reported that to my team there were a lot of groans. They all said 'We only used them for 2% last year and they bollixed that up. Now we have to do 15%?'"

Conflict also occurred around systems integrators, but along almost exactly the opposite lines to the conflicts over offshore outsourcing. Systems integrators provided high-level expertise which was very helpful to project managers for getting their work done, and could make their jobs easier. Yet those same firms were much more expensive than domestic employees, increasing the Bank's costs. As a consequence, project managers would often seek to hire systems integrators, while senior and staff managers would resist their use.

These conflicting preferences over outsourcing were even reflected in the way my study was viewed within the organization. Sourcing managers supported my study because they hoped they would learn more about what projects could be offshored, allowing them to outsource more work. They were also interested in learning why project managers were using so many systems integrators, so that they could find ways to limit the use of these expensive resources. In each case, the sourcing managers' reactions reflected the way that vendors' capabilities aligned very differently with their goals versus the goals of project managers, and the way that sourcing managers did not directly bear the costs of managing the work. I develop below how the resulting conflicts affected what got outsourced.

***Arbitraging Organizational Rules*.** Managers' evaluations of outsourcing could also reflect the way that outsourcing helped them to overcome internal organizational problems. For managers, an important difference between internal and outsourced projects was the way that they were subject to different rules within the organization. One benefit of outsourcing could then be the way that outsourcing allowed managers to evade the rules governing internal transactions.

For example, hiring employees was more tightly controlled at the Bank than engaging external vendors, because laying off employees was more difficult and costly than terminating vendor contracts. When these restrictions made it difficult for managers to get enough internal resources to do their work

properly, they might turn to external vendors. Sometimes such limits would lead managers to hire independent contractors (Bidwell 2010). Over time, though, approval to hire independent contractors became more difficult to obtain and project managers shifted to systems integrators – even though senior and staff managers were trying to reduce the use of those systems integrators. One manager explained his continuing use of systems integrators to me this way:

> "…the pain of bringing in an internal resource – either an independent consultant or an employee -- is ten times more difficult than to keep the vendor on for three more months, even if you have the budget to bring the people in. The buckets are not the same, and the approval process and the bureaucracy for a vendor is far less difficult than it is to bring on an employee. From a corporate bureaucracy role, it is easiest to bring in an [outsourcing vendor – including systems integrators], next easiest to bring on an independent consultant, then an employee."

In some cases, it might have made sense to use outside suppliers in order to retain a buffer against downturns in demand. Yet the blanket controls applied to internal resources prevented consideration of whether positions were inherently short term or long term. Managers therefore outsourced to evade internal rules, even when outsourcing was not suitable. The same project manager quoted an example of such behavior, where a project that should have been done internally was outsourced to evade headcount controls. According to the manager, it would have been more cost effective to do the project internally, and the knowledge developed would eventually need to be transitioned inside as it was specific to the organization. Although there was some value to the external expertise, more work was outsourced than was necessary. The project manager explained that:

> "If we had the resource we would move it in house sooner… If I had the resource in house, we would then bring the project in-house. We have a very difficult time ramping that resource up though."

Differences between internal and external controls extended to other areas. For example, accounting rules placed much tighter constraints on the terms of agreements with internal developers than on contracts with external vendors. Because the IT department was organized into cost centers, all work that was carried out on internal projects had to be charged directly back to the sponsor; these rules prevented managers from using any kind of incentives or cost guarantees. Outside the firm, there was much greater flexibility in the kinds of payment terms that project managers could use, and contracts with vendors frequently used penalties, incentives and fixed price provisions.

Although I did not find examples of projects that had been outsourced purely to take advantage of this greater flexibility in setting payment terms, some managers described this flexibility as a benefit of outsourcing. For example, managers could write fixed price contracts with external developers to shift the risk of cost overruns to the vendor. In terms of the overall goals of the Bank, such risk-shifting had little advantage; as a very large organization, the Bank could bear those risks at a lower cost than its vendors. In terms of the goals of the individual project managers, though, such risk-shifting was valuable; it reduced the prospects that project problems would interfere with other work they were doing or lead them to substantially overshoot agreed budgets. As a consequence, one project manager in Specialist told me:

> "I would still have wanted to outsource the work, even if there were no cost constraints. Another thing that makes it attractive is that it is Fixed Price. As a result, it is not my problem if they have to fix things. This did actually happen – they screwed up some of the architecture and then had to fix it themselves."

***Contracting Externally to Reduce Internal Uncertainty.*** A third way in which project managers' intra-organizational interests' affected their evaluations of outsourcing was in the way that outsourcing could help them reduce the uncertainty that came from their interdependences with other groups, because of the way that it limited their day to day control over the work. A central problem for the project managers was getting clear, stable requirements from end users. Changes to requirements in the middle of a project could disrupt their plans and lead much of the work to be repeated. Poorly documented and changing business requirements were a constant complaint of project managers, and were the most important problems that they described in my project survey.

An important effect of outsourcing was to reduce the project manager's authority, as the project became governed by contracts and was increasingly formalized, requiring the development of more detailed specifications up front. While the greater formalization required by outsourced projects often made development more complex, some project managers reported that it also had the benefit of reducing the uncertainty created by the business. Because outsourcing required a more formalized, documented process, it helped them in forcing business users to develop clearer requirements. The contractual difficulties of changing requirements provided an excuse for managers to insist on more formal documentation initially and resist business demands for changes. In this way, outsourcing became a way

for project managers to increase project formalization, ultimately reducing their authority and reducing the uncertainty that came from the business. A manager within Consumer told me:

> "It has been a very painful process to get the idea adopted that we need to document things, and that the business needs to document things. For example, now we will not give an estimate until we have a spec from the business. The business say, yes, we understand, how cute, but still we need an estimate by this afternoon. It is hard to change the way that they are doing things. Using [the outsourced vendors] helps. When we went through the knowledge acquisition process, a key deliverable that we insisted on for the end of the process was documentation for the application, so we did make some progress on that."

A project manager within Institutional similarly explained how use of offshore vendors had helped him to manage the project by helping him to refuse to make changes during the project:

> "We held the line - more strict than usual - we operate that way as a rule when things go offshore. It's a benefit of what we do [going offshore] - a way of enforcing [with the business]- 'This is what you are going to get, so you'd better get it right the first time.'"

The formalized relationship also forced communication to take place through certain channels, in order to establish clear accountability for any work the vendor did. Although that lack of communication could be a problem for getting the work done, it could also reduce business interference in the work. As all interactions went through project managers, their control over the process increased (Burt 1992). A project manager within Specialist explained:

> "Some people are very hung up about this [outsourcing offshore] – that they can't go to this developer and talk to him. I guess that my feeling is that as long as my interface to the business guy is good, then I'm getting the right information to my [offshore outsourced] person, and what these guys want is getting built and brought back … The last thing you want is the business people being able to talk to them. That's the problem you have today. The business people can pick up the phone and talk to the developer."

Further evidence of the value of external contracts in managing relationships with the Business came from the insourcing group. Unlike outsourcing, insourcing did not involve formal contracts. As a consequence, the insourcing group lacked the ability to define clear agreements that both parties would abide by. One insourcing manager explicitly cited this as a weakness of internal transactions.

> "The business organizations are very powerful, and so they can pound the desks and say "I need it in July". However, this kind of pressure can really wreck a methodology. You end up just working as fast as possible and throwing all of the controls out, and so you don't end up delivering effectively. It would be much better to have some sort of recourse to being able to say "no, that's just not possible." Every vendor really wants the work, but they still sometimes say "no - we'll end up in court if we sign up to that." The [internal] technology organization does not have the ability to walk away in the same way.

Unlike some of the other sources of managerial evaluations, I did not find clear examples where the ability to commit the business to a course of action led project managers to outsource projects that

they would otherwise have carried out internally. Instead, it was cited as a benefit of outsourcing, suggesting that it was one of a number of factors that managers considered in evaluating outsourcing. I also found, as I describe below, that the opportunity to use external contracts to commit other groups within the organization shaped how those contracts were written.

**Conflict Resolution as a Determinant of Outsourcing**

Because managers' evaluations of the costs and benefits of outsourcing frequently reflected their own group interests, cross-group conflicts over outsourcing often occurred. How those conflicts were resolved then shaped what got outsourced and how contracts were written. Table 3 summarizes the main effects of those conflicts. In particular, I found that make or buy decisions were often shaped by the resources that different groups could deploy to advance their interests. Contract terms were also shaped by attempts to resolve internal conflicts.

***Resources as a determinant of outsourcing.*** As I described above, conflicts often occurred when senior and staff managers promoted offshore outsourcing over the resistance of project managers and business users. Managers drew on those conflicts to explain which projects were outsourced, arguing that decisions often reflected the willingness and ability of different groups to deploy resources to influence decisions, regardless of the characteristics of the transaction.

For example, one technology manager explained how business users that brought in more money could prevent projects being outsourced:

> "There are some groups that are politically powerful and don't want to use [offshore vendors]. For example, there is one desk that made 9 figures for the firm last year and have their own developers that have worked for them for years, and been brought along with them. If they don't want to use [offshore vendors], they can't be made to. Conversations usually end with 'How much money did you make for the Bank last year?' At that point, the CTO will say, 'Good point' and that's the end of it."

Others noted how project managers could influence decisions because of their roles in managing the ongoing projects: as one staff manager told me: "some people may not want the [offshore vendors] to work, and if they want the project to fail, it will." Most frequently, variation in which projects were outsourced was explained by the willingness of senior managers to enforce more offshoring. For example,

a sourcing manager explained the factors that a project manager might consider in deciding whether to outsource an application as follows:

> "Cost pressure would be the first one. Impact on competitive advantage. They also look at their people. If you're going to outsource something, the people that you're losing are not necessarily high performers or high potential. Ease of transitioning it. Whether they are being mandated by their boss to do it is probably a huge one."

Senior managers could use their hierarchical authority to promote outsourcing in a number of ways. In some cases, they simply required project managers to outsource. Often, senior management would limit the number of internal resources available, forcing managers to outsource work regardless of the project suitability (effectively, such behavior forced project manager to engage in rules arbitrage. Unlike the rules arbitrage described with systems integrators, though, this behavior actually promoted the goals of the senior managers). Hence, one project manager in the Institutional group explained the outsourcing of a specific project to me by saying:

> "That was really a program pushed from the highest levels of technology management here… [It's a] matter of how aggressively individual managers pursued it. Some managers did it to get more bodies in the door. [It was not about] what projects are more suitable."

The extent to which senior management required the use of offshore outsourcing was not based on the suitability of different pieces of work for outsourcing. Rather than tailoring mandates to different applications, senior managers imposed blanket rules that took no account of transaction characteristics. A technology manager explained to me how the targets for outsourcing were developed:

> "They are not [calculated] - they are basically made up at the top of the organization. [The CTO] has set the overall target, and at each level the target is then raised so that the managers feel comfortable that they will meet the target - they don't want to miss it with [the CTO]."

Project managers did have some scope within these targets to shift outsourcing towards the most appropriate transactions among those that they managed. Yet because each project manager was responsible for a specific set of applications, much of the important variation in transactions was across managers; one manager told me that: "I have target levels for how much I need to outsource - but in my portfolio, everything comes up with 'not a good candidate to outsource.'" The blanket nature of the mandates therefore made it difficult to match outsourcing decisions with transaction characteristics.

The importance of these dynamics in shaping outsourcing decisions was highlighted by my survey of project managers. I asked the managers of each of the projects that was outsourced offshore why that project had been outsourced. Their responses are tabulated in Table 4. The managers referred to a variety of factors in describing their decisions, including such transaction cost factors as the ability to define requirements and minimize interdependence. The most common set of reasons, however, referred to pressure from senior manager and restrictions on internal resources.

Although these targets for how much to outsource played an important role in shaping outsourcing behavior, groups varied widely in how much senior managers were prepared to push their project managers to meet those targets. This variation in whether groups met their targets was invoked by informants to explain variation in the extent of outsourcing across different groups. According to a sourcing manager:

> "Some of the [business unit heads] took these targets more seriously than others, so offshore adoption rates vary widely across businesses. If everyone had met their targets, then they would have around 12-13% of headcount being offshore. As it is, one group is only around half of this."

As indicated above, Institutional was one of the groups where senior management pushed outsourcing the hardest. Consumer was one of the groups where outsourcing was going more slowly. One manager even complained that:

> "This resistance [by project managers] causes problems for [the IT head of Consumer] as well, because ultimately the ability to make this happen rests with him. Will he really push to get it done? [His] approach so far is to try to hold people to the dollars in the hope that they will start to go offshore because they need to in order to get everything done. His predecessor would mandate how things should be done."

These cross unit differences in the willingness of senior managers to deploy authority in mandating outsourcing did not appear to reflect differences in the nature of project characteristics across groups. All projects required very specific skills, and both Specialist and Institutional dealt with highly sensitive information, and used critical applications. A more likely explanation is that the relative balance of resources varied across groups. For example, mandates to increase outsourcing seemed to be more rigorously enforced in smaller IT groups, in which information asymmetries between senior managers and project managers were lower: senior managers who were responsible for fewer people and systems likely

understood the details of the work better, making it more difficult for frontline managers to argue that their applications were unsuitable for outsourcing. Conversely, one of the senior managers who was most reluctant to impose outsourcing on his subordinates was relatively recently arrived at the Bank, and was therefore at an even greater information disadvantage relative to the project managers.

In many cases, the struggles over outsourcing appeared to encourage integration of projects that may have been more suitable for outsourcing. As outlined above, powerful business partners could thwart outsourcing of otherwise suitable projects. Consumer was also criticized for doing too little to encourage outsourcing of suitable projects. I also encountered examples of the opposite kind of case, where projects were outsourced when integration might have been more suitable. In particular, I surveyed the manager of one project in Specialist that dealt with implementing critical new regulations. Implementing the project on time was necessary for the firm to remain in business. There was tremendous need for *ex post* adaptation as regulations were still being interpreted while the project was underway. Most of the work involved modifying existing systems, requiring high levels of firm specific skills. And the time pressure was intense. Of all of the projects that I studied, this seemed like one of the strongest candidates for internalization. Yet most of the work on this project was done by offshore vendors, and this at a time when only 15% of the Bank's overall IT work was outsourced. So why was this project outsourced rather than others? Because the senior managers in the group had moved most aggressively towards moving all projects offshore, limiting the project manager's ability to draw on internal resources for the project. This example therefore illustrates the way in which the exercise of resources helped to weaken the link between transaction characteristics and outsourcing decisions, both by introducing the new consideration of group resources into the outsourcing decision, and by encouraging senior management's use of blanket mandates, which did not discriminate amongst project types in promoting outsourcing.

***Contracting for internal audiences.*** As well as influencing what got outsourced, conflicts between groups also affected how contracts with vendors were written. My interviews indicated that contracts were often designed to meet the concerns of groups that might object to outsourcing or were written to limit the behavior of other groups within the Bank that might raise the costs of outsourcing.

I discussed contract terms with many managers at the Bank. Table 5 summarizes those managers' rationales for the terms that were included in contracts, and includes a count of the number of managers referencing each factor. Consistent with transaction cost economics, many managers referred to the need to provide effective incentives for vendors and the problems of writing detailed specifications in contracts. Yet almost as many managers explained how internal conflicts shaped contract terms.

In some cases, contracts were designed to overcome objections to outsourcing from other groups in the Bank. For example, managers described to me how detailed security provisions in contracts with offshore vendors were often written to overcome internal objections to outsourcing rather than because of real concerns about confidentiality. I was also told how detailed penalty provisions could be used to reassure either project managers or business partners who were concerned about their loss of authority over the work. According to one manager in Institutional:

> "I find that the traders like this structure as they can understand it - they are money motivated and think it is the right way to guarantee delivery."

Often, external contracts were also used to commit internal actors to a course of action. I described above how project managers could use contracts to prevent business partners from changing requirements during projects. Sometimes it was also necessary for project managers to use contracts to commit themselves to a course of action in order to overcome objections to outsourcing. For example, an important issue in engaging systems integrators was defining how much the project would cost. Given the high costs of systems integrators, staff managers were particularly concerned about entering into open-ended projects with them. Allaying concerns about those projects was therefore important for project managers if they were to be able to engage systems integrators. In describing their contract terms, managers repeatedly referred to the ability to tell the finance department exactly how much a project would cost. For example, one manager explained his decision to use fixed price contracting as follows:

> "It is desirable from a lot of perspectives. As a project manager, it is tougher to sell, but it helps to validate the sell. Finance understands exactly what the cost is."

Similarly, in explaining his decision to use a contract that combined elements of cost plus pricing and a fixed cap, one project manager specified that the goal was not to discipline the vendor, but rather to

reassure staff managers that he would not allow the scope to creep. Even though the lack of requirements prevented a true fixed price contract, the cap constrained the project:

> "The cynical part is to pacify my strategic vendor sourcing group because they were doing their job - they wanted to make sure that we were not on a slippery slope where costs spiral. Everyone hates variable cost. They want a fixed price. They came up with the idea of a cap so they still know there is an amount that we will not spend beyond... At the time, the nature of the project given that we don't have crisp requirements at the time – things were too fluid to manage fixed price… This way everyone gets what they want. Strategic sourcing and tech sourcing and finance get the cap. We get to manage the vendors tightly to within the cost and still develop our design and specification on a just in time basis. Everyone's happy."

Another project manager similarly explained that: "Fixed Price (contracting) is about disciplining the Bank, not the vendor."

Contracts could also be used to shape how managers worked with the vendors. A particular concern among the sourcing managers was that project managers would misuse offshore vendors. Rather than defining entire projects to hand off to those vendors, the project managers would use offshore personnel as extensions of their own group. One mid-level technology manager found that he could use the structure of contracts to overcome these problems, committing his subordinates to a more hands-off approach. He explained his use of external Service Level Agreements as follows:

> "A lot of this is about shaping how the managers use [outsource vendors]. It forces managers to focus on the vendor as a service provider, rather than the specific consultants as individuals… The penalties are really there to raise awareness among the managers about managing the [outsource vendors]… Using these measures forces managers to evaluate vendors' performance…In doing this, we are trying to remove some of the cultural bias in how offshore vendors are managed. Instead, we want to focus on: these are the deliverables. Are they acceptable, on time and on price? Ultimately, you can't control the other issues, and that's supposed to be one of the advantages of outsourcing – you shouldn't be worrying about who they hire. It is important to understand that the Service Level Agreements are as much a tool for educating the Bank's managers as they are a tool for managing the vendors."

Transaction cost economics argues that contracts are structured to provide optimal incentives for vendors, based on the characteristics of the transaction. The presence of different intra-organizational interests introduces new motivations for specific contract terms. Rather than attempting to influence the behavior of vendors, contracts were often used to influence the behavior of other groups within the client organization, both by addressing arguments that those groups could use to forestall outsourcing, and by committing project managers to behave in ways that met the goals of those other groups.

## DISCUSSION

This study shows how managers' pursuit of their own intra-organizational interests can affect the way that firms manage their boundaries. Where transaction cost economics traditionally suggests that outsourcing decisions should be aligned with transaction characteristics, I found only limited correlations between transaction characteristics and outsourcing decisions. My informants' descriptions of how decisions were made offered an explanation for this weak correlation between transaction characteristics and outsourcing: they suggested that groups' evaluations of outsourcing were often shaped by their pursuit of their own interests, that variation in what got outsourced was often shaped by variation in the resources that different groups had to influence decisions, and that decisions often reflected the use of blanket mandates that did not discriminate among transactions. Outsourcing decisions often therefore reflected many considerations beyond the goal of achieving efficient alignment.

My analysis also points to how structural accounts of organizational politics can be integrated into existing theories of firm boundaries. The effects of outsourcing described by managers at the Bank were similar to those assumed by transaction cost and capabilities-based theories of the firm – a loss of authority, weaker administrative controls, stronger incentives, and access to different capabilities. But the way that those effects were experienced and acted on was often shaped by the narrow, intra-organizational interests that the different groups pursued. My analysis demonstrates in particular how four different aspects of organizational structure shaped the nature and exercise of those interests. Differentiation of goals and responsibilities across groups, the organizational rules that structured interactions, and the pattern of interdependences across groups determined the costs and benefits to different groups of outsourcing. In some cases those structural influences introduced new considerations into decision-making; in other cases, those influences appeared to determine outsourcing decisions. The allocation of authority, information, and other resources then shaped how conflicts were resolved. By emphasizing the multiple ways that intra-organizational interest differences could shape both how outsourcing was evaluated and decisions made, the study highlights how these structural constructs might profitably be introduced into our models of when and how work is outsourced.

**An Organization-Level Perspective on Firm Boundaries**

By demonstrating the various ways in which managers' interests can shape outsourcing decisions, this study suggests that firm boundary decisions can be understood as an endogenous outcome of the system of incentives, information and authority that organizational structure creates, acting through that structure's effects on the interests and resources of different groups.

Considering make or buy decisions as a consequence of organizational structure suggests a different perspective on the efficiency of those decisions. I have presented evidence that outsourcing decisions were shaped by such structural considerations as the allocation of goals and authority and the structure of work and controls. Efficiency should therefore ultimately be evaluated at the higher-level of that organizational structure: has the organization been structured in ways that lead to the best possible outcomes? Agency theory suggests that even an optimal structural design will not lead to efficiently aligned make or buy decisions. Whenever managers' actions can be hidden or information is asymmetric, managers will not make "first best" decisions which maximize the interests of the overall organization (Holmstrom 1979; Milgrom and Roberts 1988). The best that can be expected is a "second best" outcome, where the incentives and task assignments are the best possible given the information asymmetries within the organization. Actual outsourcing decisions in real organizations are therefore unlikely to achieve perfect alignment. The best that organizations can achieve is to create the optimal structure in which those decisions will be made.

Of course, the efficiency of that organization's structure will not just depend on whether it leads to more or less aligned outsourcing decisions, but rather on the multitude of different decisions that it influences. Prior work has emphasized that organizational structures are inherently imperfect, being forced to make tradeoffs across such goals as responsiveness and standardization (Dessein et al. 2010), initiative and cooperation (Roberts 2004), and access to information versus incentive alignment (Aghion and Tirole 1997). Managing the firm's boundaries is just one of the outcomes that structure will be designed to influence and may not, therefore, be done very well.

This study illustrates how seemingly efficient decisions about how to allocate goals and influence can nonetheless result in misaligned make or buy decisions. I found no evidence that the Bank was substantially worse run and organized than its competitors. The Bank was well-known and respected within its industry, and was seen as a prestigious employer that was able to hire very good people. Examination of financial data also indicates that the Bank was more profitable than the industry average during the years immediately before and after the study.

Similarly, the allocation of resources to influence decisions at the Bank seemed to make sense: authority should accrue to those nearer the top of the organization, who are more likely to have a clearer understanding of the organization and more direct incentive alignment with its overall goals; those with more information by dint of their proximity to a decision should also have influence over how it is taken; it may also make sense for those who contribute more valuable resources to the organization to have extra influence over decisions if they will use that influence to increase their effectiveness, or if it helps the firm to retain their services. Yet the fact that the decision system made sense within the constraints imposed by information asymmetry and incentive misalignment does not mean that the decision outcomes were themselves efficient. Senior managers may have been aligned with the interests of the organization, but they lacked the information to make efficient decisions. While there are good reasons to give influence to project managers and their business clients, their interests often diverge from those of the organization, so that their decisions do not necessarily benefit the organization.

How much these structural influences lead to inefficient firm boundary decisions may depend on how important those boundary decisions are to organizational performance. At the Bank, for example, the scale of the projects that I studied was very small in comparison to the kinds of financial risks that the firm would take on in the course of its day-to-day work. The ability to make aligned outsourcing decisions may not have loomed large in the design of the organizational structure; nor would failures to achieve alignment have substantially increased the risk of organizational failure. Where make or buy decisions have much greater impact on organization viability, we might expect selection pressures to push organizations towards more aligned outsourcing decisions (Argyres and Bigelow 2007; Nickerson and

Silverman 2003), and the ability to make aligned outsourcing decisions would likely figure more prominently in decisions about the allocation of goals and authority.

**Structural Variables for Understanding Firm Boundaries**

Beyond highlighting the role of organizational structure in shaping firm boundaries, the study also advances a specific understanding of how that structure affects decisions, based around how structure shapes and constrains managers' goal pursuit. In particular, the paper demonstrates how four attributes of organizational structure can affect decisions about what and how to outsource.

First, how managers evaluated outsourcing decisions was strongly influenced by the differentiation of goals and responsibilities across groups. Prior work has argued that intra-organizational groups can impose externalities on others within the organization that are hard to account for in transfer pricing schemes, and that managers' decisions therefore fail to account for the full organizational costs of their actions (Argyres and Silverman 2004; Dessein et al. 2010; Radner 1986). Such dynamics affected how managers evaluated vendor capabilities. Consistent with prior theory, those capabilities were important influences on outsourcing decisions at the Bank (Argyres 1996; Jacobides and Hitt 2005). Yet different managers had different responses to those capabilities. Because vendors had worse capabilities than in-house providers along some dimensions, but better capabilities along others, managers' evaluations depended on how those capabilities aligned with those managers' specific goals, and the specific costs that they would incur from outsourcing projects. Whether actors preferred to outsource therefore depended critically on how the capabilities of vendors aligned with their specific goals and responsibilities. Understanding which actors within an organization are responsible for making outsourcing decisions, the kinds of incentives that they are subject to and the activities that they perform, can therefore help us to explain differences in how ostensibly similar transactions are outsourced.

Second, outsourcing decisions were influenced by the nature of the organizational rules within the organization. Williamson (1988, 1991) notes that organizations usually impose stronger controls on internal transactions than external. I found that those differences in controls could allow managers to benefit from the arbitrage opportunities that outsourcing created: where internal controls made it difficult

to get the work done, outsourcing became more attractive. In these cases, it was not transaction characteristics that promoted outsourcing, as transaction cost economics would suggest: instead it was the problems created by internal rules. The nature of administrative controls may therefore be another variable that shapes outsourcing decisions. In particular, organizations or activities that are more closely governed by administrative controls may be more likely to outsource transactions.

Third, the study demonstrates how the pattern of internal interdependences may affect managers' incentives to outsource. Although structural differentiation assigns particular tasks and goals to each group, workflows across the groups create demands to integrate those activities (Thompson 1967). The resulting demands for mutual adjustment can create problems by increasing the uncertainty that groups face (Gresov and Stephens 1993). I found that an advantage of outsourcing for project managers was the way that it helped them to minimize such interference from business users: because outsourcing entailed greater formalization and a consequent loss of project managers' authority, it was harder for business partners to demand changes. Such restrictions on managers' flexibility are often seen as a limitation of outsourcing (Novak and Stern 2008; Williamson 1991); yet where the main source of uncertainty was other internal constituents, outsourcing could benefit project managers by making it easier for them to resist attempts by other groups to change project requirements.

Previous discussions of the limits of internal organization have noted that the absence of clear contracts prevents owners from committing to a course of action internally in the same way that they can in the market (Baker et al. 2002; Williamson 1985). This study suggests that the difficulties of making commitments within firms do not just affect vertical authority relationships, but also horizontal interdependences within the organization. Furthermore, I show how contracts with an external actor can provide a means of solving these internal problems. Because those contracts commit the entire organization, they can be used by one group to bind the actions of others within their firm.

Based on this analysis, we would expect the uncertainty that managers face from other internal groups to be another structural variable affecting outsourcing decisions. How that uncertainty interacts with the resources groups possess may be complex: groups with many resources may be able to resist

demands for mutual adjustment without resorting to external contracts; groups with few resources may not be able to set the terms of contracts. It is therefore likely that the use of contracts to commit other actors is most widespread among groups that have strong influence over the terms of contracts, perhaps because they play the lead role in writing them, but less influence over other aspects of their work.

The study also alerts us to the way that inter-group relationships within firms can affect contract terms. Much work has explored how contracts are designed to fit the needs of transactions and manage the threat of supplier opportunism (Corts and Singh 2004; Crocker and Reynolds 1993; Joskow 1985; Masten and Crocker 1985). This study offers a different perspective on contracting, by suggesting that managers also use contracts to constrain the behavior of other groups within their own organization. In particular, contract terms often reflected groups' attempts to overcome internal objections to outsourcing or prevent other groups from raising the costs of outsourcing.

Fourth, the study shows how outsourcing decisions are affected by the way that organizational structure determines the allocation of authority, information and other resources across groups. Generally, prior work has not explored how variation in the resources of affected parties might shape outsourcing decisions (but see Goodstein et al (1996) for an application to the conflicts between professional and managerial norms). An important implication of my study is that variation in resources may explain outsourcing decisions when groups conflict over whether to outsource. Among the variables that could be used to measure such resources are the hierarchical position of a group, its position in the network structure (Burt 1992), the importance of the resources that it contributes to the organization (Pfeffer and Salancik 1978), and its formal authority to make a decision (March 1994). Transaction cost accounts of firm boundaries have thus far paid little attention to resource dependence theory, yet the assumptions of opportunism and self-interested behavior on which transaction cost economics relies suggests that conflicts will occur in organizations, and that access to resources should help to explain which groups prevail in those conflicts. Tighter integration of transaction cost and resource dependence ideas may therefore benefit both theories.

**Limitations and Future Research**

The use of a single case study for this paper requires caution in generalizing its findings. There is some evidence that similar dynamics occur in other organizations: although not the focus of their various studies or an object of theory development, Kalnins and Mayer (2004:210) noted that fixed price contracts were sometimes a response to internal pressures and Vaast and Levina (2006) provided an example of customers outsourcing IT work because of the weaker administrative controls that applied to external projects. Lacity and Hirschheim (1993) also discussed how the power of IT departments helps to explain the outcomes of outsourcing decisions. It is therefore likely that the importance of intra-organizational interests were not confined to the Bank. In this paper, I extend those observations to develop a more detailed account of why and when intra-organizational interests affect make or buy decisions.

It is also likely that a number of my findings were shaped by specific characteristics of the Bank's structure – indeed, a central implication of my arguments is that different organizational structures are likely to lead to different outsourcing decisions. For example, the decision of the Bank to organize IT departments as cost centers rather than profit centers increased constraints on the way that managers could contract internally; reduced constraints would likely have lowered project managers' incentives to outsource. Increased formalization of internal development or rules that prevented the business from changing requirements might also have reduced the attractiveness of outsourcing. It is also possible that project managers' formal authority to take sourcing decisions increased their influence at the Bank, although their detailed information about the projects would likely have proved a powerful resource in any case. Where the business was able to completely bypass the IT department by outsourcing work (as could happen on occasion, but was outside the scope of this study), the specific constellation of interests and resources would also have been different.

The use of qualitative methods to understand decision making also has limitations. Examining descriptions of decision making can provide unique insight into the mechanisms behind organizational decisions; yet such descriptions can be heavily influenced by self-serving biases. The lack of legitimacy of political processes (Pfeffer 1981) may limit such concerns in this case, by leading managers to

understate the influence of intra-organizational conflicts. The qualitative data that I draw on is also unsuited to hypothesis testing. Quantitative validation of the paper's arguments is a critical next step in advancing this research agenda; such research would be particularly valuable for its ability to establish the relative role of intra-organizational interests versus organizational interests in shaping decisions.

A particularly interesting topic for future research is to understand how outsourcing affects politics within organizations. Although this study has largely examined how intra-organizational interests shape outsourcing decisions, its findings also suggest that outsourcing affects the scope and nature of conflicts within the organization. Much political conflict is driven by interdependence and the pressures to coordinate within organizations (Gresov and Stephens 1993). One of the insights of this paper is that outsourcing provides a means for organizational units to alleviate these pressures, both because external contracts can be used to commit other internal actors to a course of action, and because outsourcing provides a means of evading internal administrative controls. If firm boundaries act as a useful resource in managing internal conflicts, then organizations with highly permeable boundaries may prove better able to manage their internal conflicts than organizations that operate as closed systems. Indeed, while much research has explored the effects of external sourcing on transaction performance, the literature is largely silent on how opening up the boundaries of the firm affects the internal management challenges that organizations face (but see Jacobides and Billinger 2006 and Bradach 1997). This study suggests that while extensive penetration of the firm by external suppliers increases the complexity of the organization, it also provides managers with a greater range of tools to manage their internal relationships.

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**TABLE 1: COMPARISON OF OUTSOURCED AND INTERNAL PROJECT CHARACTERISTICS**

| | Outsourced | | | Internal | |
|---|---|---|---|---|---|
| | Mean | Std. Dev | | Mean | Std. Dev |
| **Need for Firm Specific Knowledge** | | | | | |
| Percent time modifying existing systems | 65.5* | 43.0 | | 85.3 | 26.7 |
| Project involves implementing third party application (1-0) | 0.3 | 0.21 | | 0.2 | 0.16 |
| Extent of expected future enhancements to project (1-7) | 3.6 | 1.8 | | 3.3 | 1.9 |
| Percent time spent on business issues | 19.5 | 13.2 | | 24.6 | 18.1 |
| **Project Importance** | | | | | |
| System business criticality (1-7) | 4.6 | 2.1 | | 4.3 | 2.1 |
| Project importance to senior management (1-7) | 5.9 | 1.6 | | 5.2 | 1.6 |
| Project time pressure (1-7) | 5.7* | 1.3 | | 4.6 | 1.4 |
| **Ability to Write Complete Contracts** | | | | | |
| Stability of business processes (1-7) | 4.8 | 2.0 | | 4.7 | 1.5 |
| Dependence on other teams (1-7) | 3.3 | 1.7 | | 3.5 | 2.1 |
| Need for expertise (1-7) | 4.9 | 1.2 | | 5.1 | 1.2 |
| Need for innovation (1-7) | 4.5 | 1.5 | | 4.8 | 1.5 |
| Percent change in requirements | 15.0 | 14.3 | | 16.2 | 16.4 |
| **Project Size** | | | | | |
| Number of people[a] | 7.1 | 3.5 | | 6.2 | 3.1 |
| Duration (months) | 7 | 4.5 | | 8.2 | 3.5 |
| | | | | | |
| Number of projects | 10 | | | 46 | |

[a] excluding project manager. For outsourced projects, total includes Bank personnel involved with the project

* difference from internal projects is significant at the 5% level

All data comes from surveys of project managers. The project managers were asked about the percent of project time that was spent on various activities. They were also asked to rate the project against a number of criteria on a scale of 1-7, where 1 would be the lowest possible project at the Bank, 4 would be the average project, and 7 would be the highest project

**TABLE 2: EFFECTS OF INTRA-ORGANIZATIONAL INTERESTS ON THE EVALUATION OF OUTSOURCING**

| | **Differentiated interests and the evaluation of firm boundaries** | **Rules arbitrage** | **Contracting Externally to Reduce Internal Uncertainty** |
|---|---|---|---|
| **Effect of Firm Boundary** | Access to different capabilities provided by vendors<br>*"Ultimately it comes down to dollars. If all else were equal, then I would prefer to do things with employees. However, all else is not equal, and the difference is dollars." (Technology Manager)*<br>*"I think that domain expertise is essential for these projects to work well... We get a lot of complaints about this issue from our teams, who find that [the vendors] don't have the necessary domain specific knowledge." (Sourcing Manager)* | Weaker administrative controls applied to internal transactions than external transactions<br>*"From a corporate bureaucracy role, it is easiest to bring in an [outsource vendor, including a systems integrator], next easiest to bring on [an independent contractor], then an employee. And [independent contractor] and employee are closer together than they are to an outside vendor." (Project Manager)* | External projects governed by more formalized, binding agreements<br>*"When you are working across companies, it forces much more accountability. Hand-offs must be much cleaner. [Offshore vendor] are accountable for everything that they do. This does not tend to be the case when you are working with internal people." (Line Manager)* |
| **Source of Intra-Organizational Interests** | Differentiated structure gives groups different goals and responsibilities<br>*"It is because of the way that the system is set up - they are rewarded for delivering things on time and on budget. As a result they push to get the biggest budgets and the longest timelines that they can." (Line Manager)* | Administrative controls can interfere with groups' ability to meet their goals<br>"*If you have a new project you need resources, and don't have enough employees, and can't hire because of hiring freezes" (Project manager)* | Demands for changes by internal clients disrupt project managers' work<br>*"I was absolutely rigid about documenting the requirements to a really low level. I got burned in my previous project and wanted to make sure that it wouldn't happen again. The business are really not very good at documenting their questions… I worked very hard to get them to articulate the project requirements." (Project Manager)* |
| **Effects on Evaluation of Outsourcing** | Evaluation of outsourcing depends on whether vendor capabilities align with specific interests of group involved<br>*"Working with [offshore vendors] has proved to be difficult though. They are in different time zones, there is less communication, they need to get to understand the legacy systems and there is a need to get the business to really think deeply about what they want up front. As a result, they [project managers] have ended up with a lot of people going around saying "[offshore vendors] suck". (Sourcing Manager)* | Groups prefer outsourcing when internal controls prevent them from meeting their goals<br>*"I almost think the firm purposely puts very intentional road blocks to bringing on permanent staff, because at the most senior levels of the firm they want to rigidly control headcount and spend, but it causes this other thing [the use of systems integrators] to go up." (Project Manager)* | Outsourcing can benefit project managers by reducing business changes to requirements during projects<br>*"I insisted no changes would be made unless they were severity 1 as I realized that in order to have a successful project we had to freeze things as they left shore and went off. We held the line - more strict than usual - we operate that way as a rule when things go offshore. It's a benefit of what we do [going offshore] - a way of enforcing [with the business]- "This is what you are going to get, so you'd better get it right the first time." (Project Manager)* |
| **Summary of Evidence** | • Conflicts observed between project managers and staff over offshore vendors, based on cost versus expertise<br>• Conflicts observed between project managers and staff over use of systems integrators, based on cost versus expertise | • Managers describe outsourcing projects because systems integrators are easier to hire than internal resources<br>• Managers discuss preference for outsourcing because of ability to hold vendors to fixed price | • Managers describe ability to commit business clients to requirements and reduce business interference in ongoing projects as an advantage of outsourcing |

**TABLE 3: EFFECTS OF CONFLICT ON OUTSOURCING DECISIONS**

| | Resources as a determinant of outcomes | Contracting for External Audiences |
|---|---|---|
| **Group interests** | • Secure make or buy decision that meets group goals<br>*"I want to capture data that will incentivize the [project managers] to use [offshore vendors]. A lot of them do not want to use them, possibly because of the implications for their development teams." (Sourcing manager)* | • Overcome resistance to outsourcing<br>• Minimize costs of outsourcing<br>*"[Doing a project Fixed Price] is desirable from a lot of perspectives. As a project manager it is tougher to sell, but it helps to validate the sell. Finance understands exactly what the cost is." (Sourcing Manager)* |
| **Sources of Influence** | • Hierarchical authority<br>• Access to information<br>• Contribution of resources | • Involvement in writing contracts |
| **Effects** | Variation in make or buy decisions reflects variation in resources available to groups to influence decisions<br>*"It took a long time to get people working with [offshore vendors]. It was basically achieved by getting lots of high level management support to encourage / shame people into signing up for targets and then achieving them." (Staff Manager)* | Contract terms reflect need to persuade internal actors of benefits of outsourcing and prevent internal actors from engaging in costly behavior<br>*"[Are the contract terms about disciplining you or the vendors?] Probably disciplining us. The vendor will do what we ask them to do. If we ask them to go in a different direction, they will. [is it disciplining you or your stakeholders?] Both - the engagement managers on the Bank side as well as the stakeholders - our clients and customers. (Project Manager)"* |
| **Evidence** | • Project managers' descriptions of reasons for outsourcing specific projects (Table 4)<br>• Staff managers' descriptions of reasons for cross-group differences in outsourcing | • Project and staff managers' descriptions of contracting process (Table 5) |

**TABLE 4: RATIONALES FOR OUTSOURCING PROJECTS**

| Category | Count | Example Quotes |
|---|---|---|
| **Senior management pressure / mandates** | 4 | "The offshore vendors – it was the direction the overall tech group was going in at the Bank." |
| **Restricted availability of internal resources** | 3 | "We knew we had increased demand – we had a lot of work and no manpower to do it in a timely fashion." |
| **Cost** | 4 | "They had available technology knowledge and were cost effective" |
| **Stability of requirements** | 3 | "Once the specs are very well defined and the analysis has been done – go and code it – that can be done offshore." |
| **Well defined project** | 3 | "It was also that we don't have to deal with the communication problem of defining requirements – it had a well defined boundary: we want something that functions exactly like this." |
| **Project was not critical** | 3 | "If it's not a highly critical app" |
| **Project was simple** | 1 | "The level of difficulty of the project. The requirements were not as difficult as they might have been – in fact this project was less difficult across the whole project lifecycle, including the requirements." |
| **Outsourcers already have knowledge of system** | 2 | "They had become the domain experts on this system." |

Based on coding of 10 outsourced projects. Categories describe reasons given for outsourcing the project. Counts represent counts of projects for which this reason was mentioned. Counts are not exclusive.

**TABLE 5: RATIONALES FOR CONTRACT TERMS**

| Reasons | Counts: Staff/ senior | Counts: Proj mgrs | Counts: Total | Examples |
|---|---|---|---|---|
| **Effects of Internal Conflicts** | | | | |
| **Using terms to convince others** | 3 | 3 | 6 | |
| Penalties sell inside | 1 | 1 | 2 | [Penalties] "are only there to make the people in tech sourcing feel warm and fuzzy. This is only for the people who haven't engaged in these projects." |
| Certainty helps convince Finance | 1 | 2 | 3 | "Why FP? That is a Bank preference… There is bidirectional intent. It assists the vendor - we want to try to avoid scope creep and price creep - the vendor is incented to stop the client from increasing the scope. It also helps finance to stick a number around something, when there is a relative degree of uncertainty" |
| Security terms sell to other parties | 1 | 0 | 1 | " The reason for this [the use of strong controls] is that there are always a lot of naysayers and these tend to be the first objections that they come up with. With these strong controls they are able to say "we have these controls - do you have these here? Do you have these sort of provisions with your consultants?" |
| **External terms as internal discipline** | 0 | 4 | 4 | |
| Disciplining scope creep | 0 | 3 | 3 | [Is a price cap about disciplining you or disciplining the vendor?] Probably disciplining us. The vendor will do what we ask them to do. If we ask them to go in a different direction, they will. |
| Directing how managers interact with vendors | 0 | 1 | 1 | "The penalties are really there to raise awareness among the managers about managing the [offshore vendors]. Managers have entered into the relationship as if they were still working with [independent contractors]. It is very much "you are now attached to my team and will now do what I say."… Using these measures forces managers to evaluate vendors' performance." |
| **Management of Vendors** | | | | |
| **Ability to set incentives** | 3 | 3 | 6 | "Fixed Price relieves the burden of having to manage the work carefully. The [vendors] really focus on getting it on line" |
| **Ability to define work** | 3 | 5 | 8 | "With a fixed cap project, you have these milestones and also deliverables to agree against. With Fixed Price projects, you need that box nailed down. |
| **Not needing to manage work** | 2 | 1 | 3 | "With a Fixed Price project, you manage to the SLAs. With a Time and Materials project, you generally end up managing to individuals, even though there is an SLA." |
| **Ability to name individuals taking part** | 2 | 0 | 2 | "Under Time and Materials you have this ability to specify which individuals will work on a project" |
| **Other** | | | | |
| **Knowing budget** | 2 | 3 | 5 | "Everyone hates variable cost. They want a fixed price." |
| **Vendor takes on risk** | 1 | 1 | 2 | "When someone does a project on a T&M basis there is more risk for the vendor to charge you more than expected. When they do it on a Fixed Price basis, they take on the risk of managing it to that dollar." |
| **Learning** | 2 | 0 | 2 | "[Increased use of detailed performance standards] is just a sign of the process maturing. Managers are realizing more that [detailed contracts] are important. They're being told by their managers, by the audit group and by the classes that these are important. Also, a lot of them are likely to be learning from earlier mistakes." |

Counts based on numbers of managers reporting theme. Based on interviews with 16 managers who discussed contract terms

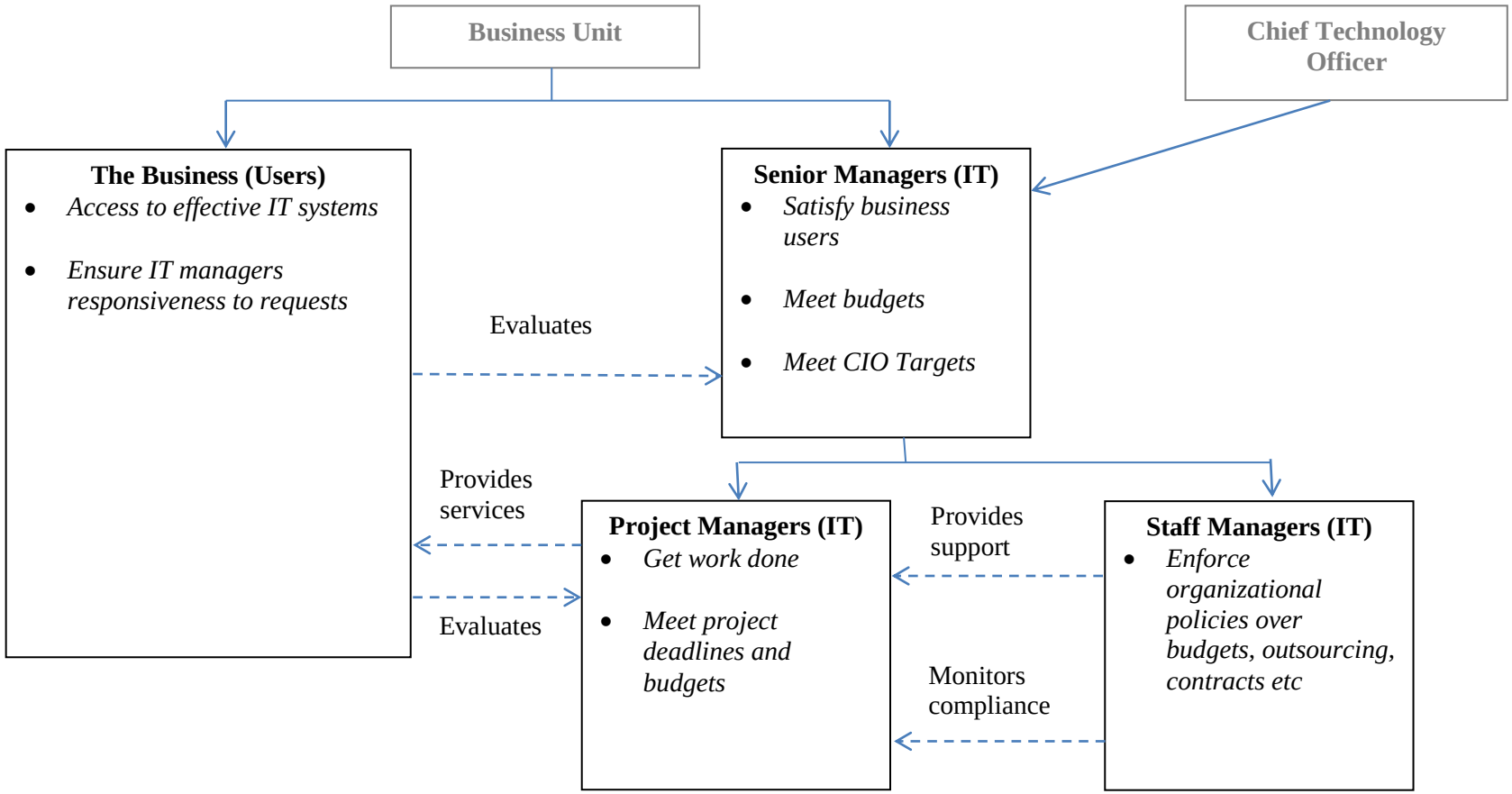
## APPENDIX: SURVEY ADMINISTRATION

In order to collect detailed data on how projects were governed in practice, I surveyed the project managers of completed projects using a structured questionnaire. For two of the outsourced projects, I was not able to interview the manager directly, but instead interviewed the liaison between the client's group and the outsourced vendor. In these cases, however, the individual had been closely enough involved in the project to provide a detailed description of the project and its governance. The questionnaire contained a mixture of quantitative and qualitative questions about project characteristics and governance, and was developed following interviews with several managers. The surveys were administered face-to-face or over the telephone, and took between one and two hours to complete.

In order to generate a sample of in-house projects to survey, I constructed a list of the largest in-house new development projects that had been carried out in the Consumer division during the previous year. Out of the 190 projects identified, I was able to identify 63 project managers who had managed 124 of these projects. I surveyed 44 of these project managers, which represented a response rate of 70%. Because outsourced and insourced development projects were much fewer in number at the time of the survey, I was not able to use a similar sampling strategy for them. Instead I used a convenience sample of managers that I was put in touch with through the outsourcing relationship managers. All of the insourced projects were inside the "Consumer" division. However, seven of the ten outsourced projects surveyed were in other Business Units, as Consumer was a late adopter of outsourcing. Although this sampling strategy is far from ideal, it did contain managers who had had both positive and negative experiences with outsourcing.

I surveyed 2 insourced projects and 10 outsourced projects, representing response rates of 66% and 91% respectively. The projects surveyed represent a very small proportion of the work carried out by the Bank over the course of the year (of the order of 1% of total man hours). They also represent an over-sampling of outsourced and insourced projects, relative to the total hours worked in each of these modes.

**Figure 1: Summary of Key Actors at the Bank and their Goals and Relationships**




Note: Solid arrows indicate reporting relationships
Dotted lines indicate flows of services and reporting relationships
Items in italics indicate actors' goals
Actors in gray are not directly discussed in analysis

**Figure 2: Summary of Theoretical Model**