

GLOBALLY DISTRIBUTED WORK AND THE VALUE OF AGENCY THEORY IN UNDERSTANDING OUTSOURCING

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Agency theory has emerged as a dominant paradigm in the social sciences. The theory addresses basic behavioral issues that arise when two parties work toward shared economic objectives, a topic that is central to several social science disciplines. Consequently, the logic and language of agency have been adopted in an extraordinarily wide range of theoretical and empirical research settings, including the study of globally distributed work.

The purpose of this paper is to examine the value of the agency paradigm as a conceptual basis for understanding and researching distributed work, in specific, the study of outsourcing relationships. We describe the basic logic of the agency model and identify its underlying behavioral assumptions. Borrowing from legal research, we examine several contracting strategies that principals (clients) use to manage and control the work of their outsource vendors (agents). Finally, we conclude that, despite its popularity and ubiquity as a lens through which to view all forms of economic interdependence, in the case of outsourcing, the agency model provides little in the way of a firm theoretical basis for either research or management of the outsourcing phenomenon.

Keywords:

agency theory, outsourcing, monitoring, contracts

(Agency theory has) "...had a significant impact on the intellectual agenda of the academy, spawning a massive empirical literature in management and organizational behavior."

"Agency theory has become a cottage industry that explores every permutation and combination of agency experience in the corporate form."

(Shapiro, 2005)

As globalization expands access to new resources and markets, it exerts pressure for new configurations of strategy, organization design, and managerial capability. One such important managerial capability to emerge from the globalization of business is the ability to coordinate and control globally distributed work (GDW). While managers have wrestled with the practical challenges of managing distributed work arrangements, theorists and researchers have searched for ways to study and understand these new and complex organizational relationships.

Agency theory has come to play a central role in this effort. As in so many other social sciences that focus on cooperative human interaction, management and organization theorists have enthusiastically adopted the language and logic of agency as a lens through which to view the dynamics, motives and incentives operating as people organize to accomplish shared objectives. Scholars of globally distributed work have been equally enthusiastic in their embrace of the agency model as a conceptual basis for their research.

But the very popularity and ubiquity of the agency paradigm in social science research begs the question of its utility across the myriad conditions and disciplines in which it is applied. The purpose of this paper is to address the question of utility in a specific context. We examine the application of agency theory to the specific setting of outsourced work relationships. Our objective is straightforward. We want to ascertain whether or not the model helps us to understand, research, and, ultimately, to manage these relationships. Our concern is that the agency model has been misapplied so often and so widely that it has lost its explanatory or predictive power in many of these situations.

We begin with a brief description of the basic logic and structure of the agency model, including its underlying behavioral assumptions. We next attempt to apply the model to a hypothetical outsource situation, followed by a description of various contracting strategies that have been used to devise incentive contracts for outsourcing

vendors. We conclude with an evaluation of agency theory as a conceptual basis for understanding and managing outsource relationships.

1. A BRIEF DESCRIPTION OF THE PRINCIPAL-AGENT MODEL

Agency theory is concerned with the problems that arise when one party, the principal, delegates work to another party, the agent. Agency problems arise from the information asymmetry that results from this division of labor and from the conflicting goals and risk preferences of the two parties (Jensen & Meckling, 1976). Because the agent may not share the principal's goals, and because the agent is more familiar with the details of the task, he may have both motive and opportunity to behave in ways that maximize his own utility at the expense of the principal's. To safeguard his own interests, the principal can either reduce the information asymmetry by investing in monitoring systems (e.g., hierarchy, audits), thereby constraining the agent's opportunity to "shirk" (Fama, 1980; Fama & Jensen, 1983), or he can structure agent incentives such that the two parties' interests are aligned (Jensen & Meckling, 1976). Agency theory focuses on the relative costs of these two solutions to the problem of agent control.

Agency costs consist of a) the investments in monitoring systems needed to reduce the principal's information deficit; and b) the costs of transferring risk to the agent in the form of outcome-based incentives. Agency theory posits that the more efficient (i.e., less costly) of these two means of control will form the basis of the contract between principal and agent. Where the cost of monitoring agent behaviors is high, the more efficient contract is outcome-based. However, because the agent is compensated solely on the basis of performance outcomes (which may be influenced by factors other than the agent's effort), the agent will demand a premium for bearing compensation risk. Thus, an outcome-based contract is efficient only if the cost of transferring risk (the risk premium) is less than the cost of monitoring. Where agent behaviors can be monitored at reasonable cost, a behavior-based contract is more efficient since it avoids the need to pay the agent a risk premium.

Theorists have applied the agency perspective to a wide range of organizational settings in which control is exercised under conditions of goal divergence and incomplete information. Studies utilizing the agency model have focused on corporate governance (Jensen & Meckling, 1976; Kosnik, 1987; Oviatt, 1988), executive compensation (Kerr & Kren, 1992), retail sales (Eisenhardt, 1988), budgeting systems (Demsky & Feltham, 1978), acquisitions (Amihud & Lev, 1981), and, in general, the condition in which interdependent actors may engage in self-interested behavior (Walsh & Seward, 1990). The value of the theory lies in its specification of how risk is allocated among contracting parties, the tradeoff between the costs of information and the costs of risk bearing, and the incentives operating in contractual relationships (Eisenhardt, 1989).

2. THE CASE OF OUTSOURCING

Outsource relationships seem to embody the principal-agent model and therefore seem to meet Eisenhardt's (1989) requirements for a useful application of the theory. The two parties to an outsourcing arrangement, client and contractor, are interdependent and cooperative, yet rationally may pursue different, even contradictory, goals. Agency theory incorporates behavioral assumptions that are relevant to the outsource relationship, such as the presence of bounded rationality, and the likelihood, or at least the possibility, of opportunism and goal conflict (Gencturk & Aulakh, 1993). Furthermore, agency theory focuses on the economic motives operating within a relationship (i.e., risks and incentives), regardless of whether the relationship is regulated through a corporate hierarchy (in-house) or an external market mechanism (outsourced) (Eisenhardt, 1989).

In theory, a firm has available a range of possible relationships through which to organize a productive activity, with each relationship imposing its own particular trade-off in terms of control and resource commitment (Anderson & Gatignon, 1986). High control arrangements tend to require high investment (e.g., vertically integrated, owned subsidiaries) while low investment tends to result in low control (e.g., outsourced production). A wholly-owned subsidiary provides high control but requires a significant commitment of tangible and intangible resources. For example, it may require the firm to make investments in a foreign country, thereby exposing it to unfamiliar risks and uncertainties. Furthermore, by fully integrating the activity, the firm loses the flexibility to switch quickly and at low cost to another production arrangement. Thus, contracting firms make trade-offs between the amount of control they need and the level of resource commitment and risk they are willing to bear.

Shapiro (2005) (following Mitnick, 1984) discusses four types of agency relationship. "Practical" agency is motivated by the relatively simple need for help with a task that is too big for the principal to accomplish alone (i.e., agency in

is often motivated by positive impulses. These include the desire to experience feelings of achievement, closure, competence, belonging, and the respect and gratitude of others. While agency theory ignores the cooperative aspect of social exchange and social relations, stewardship theory (Donaldson, 1990), in fact, postulates that agents are frequently other-oriented and even view their roles in altruistic terms.

Assumption 4: An active, powerful, controlling principal. As noted above, the classic agency perspective is ‘principal-centric’, i.e., it focuses on the principal’s need to control (through monitoring) and manipulate (through incentives) the agent into meeting his contractual obligations. As part of this perspective, the principal is assumed to be active and ‘in charge’—specifying preferences, creating incentives, designing contracts—while the agent is assumed to be passively reactive to the terms and conditions of the principal’s offer. In reality, of course, these exchange relationships are negotiated business agreements—agreements that are often iterative and mutually designed. They depend (as do most such agreements) on the usual conditions of supply and demand, and they must satisfy at least partially the needs of both parties.

Despite the theoretical bias of the agency model, in the case of outsourcing contractors (agents) are often in a strong bargaining position and actively influence the terms of exchange. (This is especially true in “contentful” or “bridging” agency relationships as opposed to simple cost-based or capacity-based agreements.) The agency model *appears* to account for the bargaining position of the agent in its consideration of the risk premium needed to engage the agent in an incentive-based contract. But, this consideration merely serves to highlight the limits of the model. The notion of “compensation risk” hardly captures the complexity of the agent’s decision to commit to a contract. The contractor must factor in the uncertainty of the task, the costs of production, the availability of resources, the long-term economic potential of the client relationship, the opportunities for organizational learning and growth, and myriad other strategic and operational variables that would go into such a decision.

Assumption 5: A single-cycle contractual relationship. In its basic formulation, agency theory all but ignores the fact that business relationships tend to evolve and deepen over time. Because of repeated exchanges, individuals come to trust each other, accrue favors and obligations, earn reputations, and, based on satisfying and honest past dealings, develop relationships that transcend a particular transaction. In effect, trust develops over successive exchanges as contracting parties gather detailed information about each other’s performance and trustworthiness.

Whereas the agency model assumes a need for control based either on monitoring or manipulation of agent behavior, it fails to consider a third, quite powerful form of control based on norms and expectations developed over time [cf., Ouchi’s (1982) notion of cultural or “clan” control]. In the case of trusted long-term suppliers or outsource contractors, each party to the relationship comes to rely on the competence, dependability, and good faith of the other, and to value the positive regard in which he is held by the other. Given enough history, in fact, it would not be surprising for norms to develop (just as they do between buying and supplying in-house departments) that regulate how technical staff communicate, how responsibility for discrepancies and errors is assigned, how delays and adjustments are made, and how unanticipated costs are to be born.

Since both the agent and the principal in an outsourcing relationship are likely to be organizations, not just individuals, it is reasonable to assume that a competitive strategy also drives the agent’s organization. Moreover, given their symbiotic relationship, that strategy is likely to go beyond that of a passive agent. That is, the agent’s role may include the expectation of initiating design and other changes to the contractually specified results. Not only may this expectation be explicitly specified in the contractual relationship (as is often the case with electronic manufacture suppliers, for example), but, on the assumption that the agent seeks repeat business, the agent’s strategy may include seemingly altruistic behaviors that are part of the agent’s value-added strategy vis-à-vis the principal. Thus, the agent’s optimization of its resources and its value-added contribution to the principal reinforces the need for a more iterative process and suggest a more complimentary, equal, and interdependent relationship than assumed in agency theory.

Assumption 6: A clear, unambiguous, outcome-based compensation contract. In the agency model, an incentive compensation contract based on performance outcomes is positioned as the ‘second-best’ alternative to the ‘first-best’ but messy process of actually monitoring agent performance. In situations in which it is difficult to observe the agent’s work or difficult to evaluate what is observable, an outcome-based compensation contract alleviates the need to interpret agent behaviors and make difficult judgments about performance and appropriate rewards. Performance is defined in terms of clearly measurable outcomes which determine, in an equally objective manner, specific types and levels of compensation.

3.4. Organizational distance

Organizational distance varies from low to high. ‘Same organization, same division’ represents low organizational distance; ‘same organization, different division’ represents moderate distance; different organizations in a stable relationship (e.g., vendor-client) represent high distance, while a consortium (multiple “peer” organizations in a temporary relationship) represents very high organizational distance. Obviously, in the low distance condition, different groups from the same division of a corporation are not very highly distributed. Groups from different divisions of the same corporation are considered to be reasonably close organizationally; however, a high degree of managerial autonomy and product/market diversity within the corporation may result in significant distance between groups despite common ownership. In fact, as noted earlier, organizations engaged in long-term, stable vendor-client relationships, although legally independent, may exhibit lower organizational distance than highly autonomous “sister” divisions within the same company.

3.5. Task structure

The risk factors discussed so far have been based on some form of communication/coordination barrier, whether spatial, cultural, or organizational. Task structure, however, refers to the clarity of the division of labor and “deliverables” for which each party is responsible. In distributed work situations in which tasks or outcome measures are poorly specified, the probability of a less-than satisfactory experience for both parties is greatly increased. Evaristo et al. (2004) identify three factors that affect task structure: the clarity of overall project objectives; the clarity of distributed responsibilities; and the clarity of specific hand-offs between work groups.

3.6. Task uncertainty

Of course, outsourced tasks cannot always be completely specified in advance. In some cases, neither the final product nor the work process can be predicted with certainty and both (or all) parties need to engage in a learn-as-you-go relationship characterized by mutual, frequent adjustments. Such processes, difficult enough to manage in-house, put even greater strain on communication and coordination systems when managed across organizational boundaries. Obviously, in a distributed work (outsource) setting, the risk of sub-optimal performance for such a project is considerable.

Clearly, managing distributed work is often not an easy responsibility. Based on the previous discussion, in fact, we can identify a worst-case outsourcing scenario. This would be a situation in which contractor and client: a) are spatially distant from each other; b) are from cultures that are very different in terms of language, professional norms, values, etc.; c) utilize different technology platforms and organizational arrangements in their work; d) are from distinct organizations with little or no history of working together. In addition, the task: e) is not well defined in terms of overall objectives or specific responsibilities; and f) requires significant real-time learning and frequent mutual adjustment on the part of both parties.

How might the agency model be applied in this scenario? In order to most effectively manage the contractor (the agent), the client firm (the principal) would need to devise a control method that depends either on directly monitoring the contractor’s work or on performance-based incentives that motivate the contractor to work in the client’s interest. According to the theory, the client’s choice will depend on the relative costs (and, we can assume, the expected effectiveness) of these two methods of control.

A consideration of the six risk factors provides some insight into how the client’s decision process might work. First, spatial and cultural distance argue for an incentive-based control method since distance complicates the client’s ability to directly monitor the vendor’s work. Spatial distance inhibits face-to-face communication and tends to result in asynchronous rather than real-time information exchanges, while cultural differences tend to contribute to misunderstanding. The same argument can be made for work methods and organizational distance. Since the client’s methods, organization, and work culture are different from the vendor’s, there is less chance that direct monitoring (if indeed it were possible) would be interpretable by the client-principal.

The risk factors discussed so far point clearly and neatly to control based on performance incentives, a solution that would be favored by the client since it reduces the need to monitor by transferring compensation risk to the vendor. The two remaining variables, however, are problematic because they clearly do *not* support an outcome-based control solution. In fact, they render it impossible. Incentive-based control is efficient only when a) direct monitoring is impractical or overly costly, and b) objective, measurable performance outcomes are available. By definition, an

equity position in the vendor firm, presumably to obtain even greater operating control and influence than it would have through contractual relationships alone.

4.5 Exit Rights

The last strategy discussed by Geis for limiting agency costs consists of contract provisions that specify the circumstances under which the client firm can unilaterally terminate the outsource relationship. While clearly a powerful threat against ‘shirking’, such provisions leave the vendor with considerable risk, especially if the nature of the work requires the vendor to make relationship-specific investments. Consequently, to protect the vendor against arbitrary or unjustified termination, the contract typically specifies the particular performance failures under which the termination clause is triggered. Once again, in other words, the actual control process requires that the client carefully monitor vendor performance, this time in such detail that failures can be measured and documented reliably enough to withstand legal scrutiny.

While academic discussions of agency theory typically gloss over the particular elements of (what is glibly called) an outcome-based contract, the five contracting strategies described above suggest just how complex the contracting process is and how much more sophisticated are those firms and managers faced with the difficult task of actually managing outsource relationships. It is worth noting that in all five cases, (even in the third, incentive-based contracts), the contract itself is virtually meaningless as a control or deterrent to vendor opportunism *in the absence of client monitoring*. In fact, each contracting strategy depends on the ability of the client to enforce the terms of the contract through direct monitoring of vendor performance. While the agency model assumes (and requires) a clear trade-off between two broadly drawn and opposing modes of control (i.e., behavioral versus outcome-based), in fact, in the real circumstances of outsourcing at least, no such contrast seems to exist.

5. HOW USEFUL IS AGENCY THEORY IN UNDERSTANDING GDW?

“There is nothing so practical as a good theory.” (Lewin, 1951)

As noted earlier, agency theory has been applied by researchers in an impressively wide variety of settings and disciplines. In fact, its dominance as a paradigm for studying economic exchange between interdependent parties has become so total that at this point it may be worth asking: Has the ubiquity of the agency model desensitized us to the possibility that there are situations and circumstances in which it provides little explanatory or predictive power? After all, a theory is useful only in so far as it is helpful in understanding, predicting, or managing a phenomenon. We have tried to show in this paper that, in the context of outsourcing, the agency model appears to add little to these objectives beyond a highly stylized vocabulary and well-polished rhetorical structure.

At root, the basic problem seems to be the absence of a viable alternative to direct monitoring as a method of control. While the logic of agency theory posits a trade-off between two distinct modes of control, on closer examination it appears that (in the distributed work context) outcome control (based on alignment of vendor incentives) invariably defaults to behavioral control (based on direct monitoring by the client). Obviously, if the second hypothesized mode of control is not a realistic possibility, then the logical structure of the theory quickly unravels. Absent the logic of an efficiency-based tradeoff, we are left with not so much an insightful theory of why control in contractual relationships takes the forms that it does, but merely a vague description of a hypothetical control process.

5.1 Implications, practical and theoretical

With only one alternative available, predicting the principal’s preferred method of control becomes something of a moot issue. More importantly, perhaps, the value of agency theory as a lens through which researchers can usefully examine the phenomenon of control in globally distributed work is greatly reduced. Instead of a theoretical framework that helps to delineate cause and effect, at most agency theory provides an elegant vocabulary and hermetically sealed logic, neither of which maps accurately to actual negotiated exchange relationships between vendor and client.

Prescriptively, of course, the model would have little to say to practicing managers about how to structure outsourcing arrangements with contractors. If, as Geis’ (2006) analysis suggests, outcome-based incentive contracts cannot be structured in sufficient detail and clarity to substitute for direct monitoring, it is unlikely that managers would be surprised to hear that they need to carefully monitor their outsource relationships.