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OUTSOURCING SUCCESS:
PSYCHOLOGICAL CONTRACT PERSPECTIVE

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Abstract

One of the major issues in IT outsourcing is the management of the client-vendor relationship. Researchers have suggested the use of both formal processes such as contract negotiations and bidding and to informal processes such as relationship management to reduce vendor opportunistic behaviors. This paper explores psychological beliefs about mutual obligations in outsourcing relationships through the prism of psychological contract theory. Rooted in the expectation confirmation theory, we develop a theoretical model of the salient factors that contribute to psychological contract violation and how such violation may influence the continuance of IT outsourcing relationships. The potential of this model and its implications are also discussed.

Keywords: Psychological contract, Psychological contract violation, Outsourcing success

Introduction

In recent years, many firms have adopted outsourcing as a means to manage their information technology (IT) operations. IT outsourcing creates strategic advantages for firms in terms of availability of highly skilled labor at low cost and potential market opportunities (Chen et al. 2002) and is considered as one of the managerial options to mitigate risks (Benaroch 2002).

Despite the widespread diffusion and wide range of benefits, outsourcing is a risky venture in itself mainly due to the management aspects of outsourcing. Researchers have discussed outsourcing risks as they can result in undesirable outcomes such as unexpected escalated costs, disputes and litigations, lock-ins, and loss of organizational competencies (Auburt et al. 1999; Bahli et al. 2003). One of the key risks in outsourcing is the management of the relationship. Research in managing the outsourcing relationships has considered formal processes in earlier phases such as contract negotiations and bidding to reduce opportunistic behaviors (Aron et al. 2005), and to informal processes such as relationship management (Kern et al. 2002b; Shi et al. 2005) in the later phases. However, the quest for the most effective way to manage client-vendor relationship is sill active and calls for additional research in this area have been made (Kern et al. 2002b; Lacity et al. 2000; Lee et al. 1999).

Contracts have long been essential in outsourcing relationships. Academics have paid great attention to economic and legal contracts analyzing and guiding the types of contracts for different scenarios. Researchers, however, have recognized the importance of informal processes (Kern et al. 2002b; Shi et al. 2005) in light of the successes of long term relationships in outsourcing (Lee et al. 2004). It has been suggested that "outsourcing should be considered more as a management of relationship with a vendor rather than a simple subcontract for IS commodities"(Kishore et al. 2003).

Motivated by the need to further examine the informal processes in outsourcing contracts, this paper explores psychological beliefs about mutual obligations in outsourcing relationships through the prism of psychological contract theory. There has been little attention paid to addressing the nature and role of psychological contracts (PC), and particularly how the violation of psychological contracts influences client-vendor relationship. The present paper is an attempt to fill this research gap. Following the literature on psychological contract violation (PCV) that has shown the key role of PCV and its potentially destructive role in organizational relationships[1], this proposal argues that PCV is also central in client-vendor relationships. The paper in particular explores the role of PCV in outsourcing success. We develop a theoretical framework for continuance of IT outsourcing based on PCV using expectation confirmation theory as its theoretical foundation. The paper is organized as follows. First we discuss relational governance and its importance in outsourcing. Next we describe the psychological contract violation in the context of outsourcing. We then develop a general theoretical framework explaining outsourcing success and continuation of outsourcing relationship based on PCV and expectation confirmation theory. We conclude the paper with a discussion of potential and implications of this framework.

Relational Governance in Outsourcing

Contract is a major governance instrument for outsourcing relationship management and risk mitigation. However, choosing an appropriate contract is not an easy task. (Choudhury et al. 2003) suggest an evaluation of portfolio of controls for vendor governance. These mechanisms include control of outcomes (project plan, project timelines, regular delivery of software), behavior control (project plan, weekly/monthly reports, meetings, calls, visits) etc. However, many of these practices may not be possible in outsourcing arrangements. Choice of contract duration of a contract may pose pros and cons that need to be considered. For example, longer duration contracts provide stable and more revenue and are considered for better development of relationship with the vendor. On the other hand, they may create lock-in situations and can be more risky. Short term contracts earn lower revenue due to learning curve effects. However, they are less risky than longer term contracts. (Lee et al. 2004) find that longer term relationships are more successful than short term relationships. The authors argue that this may be because time is a critical dimension in the development of relationships; while time introduces an element of risk in relationships, it also facilitates cooperation among the parties.

(Balaji et al. 2005) suggest vendor management, project management and process management as key aspects for success in outsourcing. According to Clark et.al (1998) ".. *the truly critical success factors associated with successful outsourcing are those associated with vendor governance*" (p.72). Vendor management is one of the dimensions that can lead to outsourcing success . Managing client-vendor relationship is a combination of both formal processes in earlier phases such as contract negotiations/bidding and informal processes such as relationship management (Kern et al. 2002b; Shi et al. 2005). Examining

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[1] refer to Pavlou, P.A., and Gefen, D. "Psychological Contract Violation in Online Marketplaces: Antecedents, Consequences, and Moderating Role," *Information Systems Research* (16:4) 2005, p 372. for review of literature in this area

the dynamic nature of client vendor relationship and its implications for the success of outsourcing is an important research issue that has received attention in the literature. .

Relational governance can be studied through various theoretical perspectives. Social exchange theory which predicts that social relationships are formed on the basis of partner's motivational investment and anticipated social benefits suggests that when these benefits are not fulfilled for the participants in outsourcing, it can potentially lead to a strain in the relationship and conflict may arise. Opportunism and threats of switching by a party can deter other party's potential gains from making relationship specific investments (such as dedicated staffing and specialized equipment/software) and can be seen as deterrent factors to involvement in outsourcing. Relationship marketing emphasizes relationship building in buyer-seller interactions. The theory suggests that if conflicts are not resolved, they can lead to relationship termination. If, however, conflicts are resolved, they may increase productivity. This holistic view of conflict centers on the presence of commitment and trust in building a successful relationship.

The interaction approach draws upon inter-organizational theory, the marketing and purchasing literature, and on transaction cost theory to substantiate its different constructs and dimensions (Kern et al. 2002b). It focuses both on short-term episodes and general long-term relationships in dyadic buyer–supplier ventures. In outsourcing relationships the approach recognizes that participants are commonly confronted with a complex pattern of interactions between and within organizations, and that the interactions become institutionalized into a set of roles that each organization's stakeholders expects the others to perform. Thus, this process may involve differing degrees of both conflict and co-operation. The interaction approach offers a more complex, realistic positioning of the role of *trust* amongst other influential factors, and shows that trust needs to be earned over time, through experiences, and cannot be assumed to be in place at any time, let alone on day one (Kern et al. 2002b).

One key similarity in all these approaches is that they emphasize the mutual relationship between client and vendor. Conflicts in mutual relationships in outsourcing can occur as a result of differences of interpretations as well as difference in interests in client and vendors. One of the major risks in IS outsourcing is contractual conflicts, which arise because of: *differences in objectives of the client and vendor*; incomplete and/or poorly designed contracts, not covering all future contingencies; *different interpretations of the contract*; change in the business needs and requirements of the client; or technological changes (Parolia et al. 2005). Presence of conflict among the vendors affects the client-vendor relationship. If conflicts are not resolved amicably, the hostility and bitterness resulting from them can lead to negative consequences including relationship termination (Morgan et al. 1994).

As outsourcing relationships evolve from arm's length, transaction-based relationships to strategic relationships, understanding why conflicts occur and resolving them has become particularly important. In outsourcing research there has been some consideration of relationship between client and vendor (Grover et al. 1996; Kern et al. 2002b; Shi et al. 2005) but very few studies have examined conflicts in IS outsourcing. In this regard several issues can be examined such as (1) why do conflicts occur — what are the antecedents of conflict?, and (2) what is the impact of conflict on the client-vendor relationship and continuation of outsourcing?.

Psychological Contract (Violation) and its relevance to outsourcing

Psychological contract theory focuses on people's mental beliefs and expectations about their mutual obligations in a contractual relation (Rousseau 1995). Outsourcing involves *mutual obligations* which are beyond mutual expectations and based upon perceived promises of a reciprocal exchange. Failure to meet obligations is likely to lead to erosion of the trust and relationship between the client and vendor, and likely to impact vendor's satisfaction. As the outsourcing relationships move from simple arm's length to more strategic alliances and partnerships involving more and more informal processes and understandings between the two parties rather than reliance only on the formal and legal contracts, PCs become important in outsourcing context.

Psychological contract theory is based on three principles: (1) mutual (rather than one sided) obligations between contractual parties, (2) psychological (as distinct from legal) obligations and (3) individual (rather than interorganizations) level of analysis. As suggested by (Koh et al. 2004) these three principles play an important role in outsourcing including offshore outsourcing.

Mutuality and PCV

The first principle of mutuality is anchored in the reciprocal relationship between two parties. The concept of mutuality makes it important to look at perceived obligations from the perspectives of both parties, rather than only one party. Mutuality essentially means that the parties involved do in fact hold the same belief (Koh et al. 2004; Rousseau 1995). When either party in an outsourcing relationship, client or vendor, perceives that other party has failed to adequately fulfill the obligations of psychological contract, a PCV occurs (Pavlou et al. 2005). It can have potentially destructive role in organizational relationships (refer to (Pavlou et al. 2005) for review of literature in this area).

Extant amount of literature in organizational science has shown that psychological contract violation is "not the exception but a norm" (Koh et al. 2004; Robinson et al. 1994). Outsourcing is no exception to this finding. In outsourcing, although they were studying the outsourcing success through psychological contracts, Koh et al. (2004) found that majority of the respondents reported violations of their psychological contracts. Conflicts in outsourcing can arise from various reasons. Although, prior research has studied the PC and PCV in employer-employee, buyer-seller context (Pavlou et al. 2005) and PC in outsourcing context (Koh et al. 2004), the concept PCV can and should be applied in offshore outsourcing context as well.

Psychological nature of contract and PCV

As posited by (Koh et al. 2004) IT outsourcing relies heavily on psychological contract between the client and the vendor. Early theories on contracts posit that interorganizational relationships are governed by more than legal exchanges. Written obligations incorporated in legal contracts can never be complete and parties must be supplemented by unwritten promised and spirit of the contract. As Sabherwal (1999) notes most interorganizational relationships involve psychological as well as formal, written contracts. Given the complexities of outsourcing arrangements due to rapidly changing environment and technologies, reliance on the legal contracts alone is not sufficient. This has led researchers to recommend managing outsourcing ventures as strategic partnerships (Willcocks et al. 1995).

Psychological contract is distinct from the legal contracts representing implied contract subject to interpretation by the other party. It therefore encompasses perceptions and beliefs of both the explicit written terms found in the legal contract as well as implicit unwritten terms. And in reality, all contracts whether written or unwritten are fundamentally psychological, existing in the eye of the beholder (Rousseau 1995). Unlike written contracts which are generally understood, expectations of what each party gives and receives in the relationship that make up the psychological contract are often only barely understood by the involved parties. In outsourcing, the differences in interpretations of the obligations by both parties for various reasons can lead to PCV.

Individual Level of analysis and PCV

The psychological contract is an individual level construct. It can be applied to outsourcing with project managers as the focal stakeholders (Koh et al. 2004) or it can be applied to individuals involved in the project. Kern and Willcocks (2002a) suggests that at least two individuals, one from each organization will form the key interface point in the relationship; however, more usually many individuals at different levels in the hierarchy and across the organization will be involved. In general it can be expected that individuals from both sides of outsourcing relationship will interact in their task achievement. Their interaction with each other will engender the feelings of cooperation, understanding, compatibility or conflict. Thus PCV can be applied to manager level to represent the group or organization level analysis or can be applied to each person in the team which is likely to influence overall group perceptions.

An Expectation –Confirmation Model of Psychological Contract Violation and Outsourcing Success

Relational governance literature has recognized the importance of covering the perspectives of both parties (Kern et al. 2002a), (Koh et al. 2004). Kern and Willcocks (2002a) mention the importance of qualitative research method of multiple respondents covering the perspective of both parties would be appropriate for exploring relationship practice in outsourcing. From Koh study (2004) it is clearly evident that both vendors and clients have expectation from each other. Based on a qualitative study of nine client organizations and six supplier organizations they provide a valuable taxonomy of obligations

for both sides. Due to the mutuality of psychological contract, psychological contract violation and its effects can be evaluated from both the client and supplier (vendor) perspectives.

Psychological contract consists of unwritten and largely unspoken sets of congruent expectations held by transacting parties. These expectations of what each party gives and receives from the relationship vary in their explicitness and parties are often unaware of the nature of expectations. Conflicts arising from non fulfillment of expectations can be viewed from theoretical perspectives presented earlier (interaction approach, relationship marketing, social exchange framework) as well as through the lens of Expectation-Confirmation Theory. Expectations-Confirmation theory (ECT) (Oliver 1980) posits that expectations, coupled with perceived performance, lead to satisfaction. As explained by the expectation (dis)confirmation theory, satisfaction is determined by the intensity and direction of the gap between expectation and perceived performance. Customers are more likely to be satisfied if service performance meets (confirmation) or exceeds (positive disconfirmation) their expectations. Conversely, consumers are more likely to be dissatisfied if service performance falls below their expectations (negative disconfirmation).

Motivational factors are likely to play a role in outsourcing success. Both client and vendors intrinsic motivations were found to be important factors in knowledge transfer (Ko et al. 2005). In general, literature focusing on employee perceptions and behavior has explored the role of intrinsic and extrinsic motivations that play a role in employee behavior in completing the desired tasks.

On the other hand, motivational factors to capitalize can lead to the differences in interpretations of the obligations in PC by both parties and lead to PCV. IT outsourcing research has recognized the importance of knowledge sharing between the parties as a success factor for outsourcing (Lee 2001). Knowledge sharing is also an integral component of PC (Koh et al. 2004). Outsourcing has been considered as a part of the way that firms assemble knowledge from suppliers (Shi et al. 2005). In similar lines, it is recognized vendors specializing in IT outsourcing can develop their expertise through building knowledge from experiences and holding the knowledge for competitive advantage. However, from the client perspective, academics have expressed concerns regarding the potential loss of internal know-how through IT outsourcing as well as potential loss of intellectual property . Similarly, vendors can develop their expertise through building knowledge from experiences and holding the knowledge for competitive advantage.

Relational governance literature has identified trust as main factors in outsourcing success. Trust can be defined as trustor's belief that the other party (trustee) in the exchange relationship will behave in accordance with the trustor's confident expectations (Pavlou et al. 2003). If the obligations are met according to expectation or if performance exceeds the expectations, it is likely to create feeling of reliability and dependability in the partner. There is significant evidence in the literature to suggest a strong association between trust and continuity. On the other spectrum, risk is defined as "a consumer's perceptions of the uncertainty and adverse consequences of engaging in an activity" (Dowling and Staelin, 1994). If the performance falls short of the expectation the outsourcing partner is likely to have feeling of uncertainty in the outcome.

Based on the literature review and above discussion we present a general model of psychological contract (violation) in outsourcing as presented in Figure 1 below.
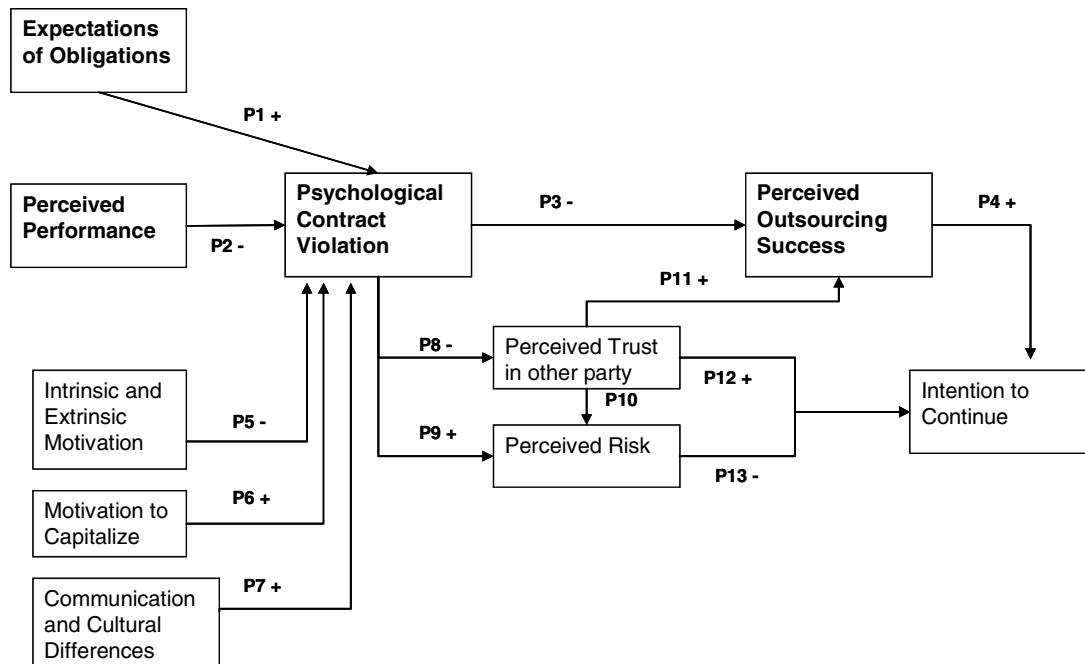
Figure 1: *PCV and Outsourcing Success*

According to ECT, when the performance falls short of expectations, there is negative disconfirmation. In similar view, we can argue that in offshore outsourcing when the involved parties perceive not getting what they expect and the performance of other party falls short of their expectation, a violation of psychological contract could emerge. Higher expectation and /or lower performance can lead to a violation of psychological contract. This leads to our first propositions,

Proposition 1: Higher expectations regarding the obligations will have higher chance of PCV.
Proposition 2: Higher level of perceived performance will have lesser chance of PCV.

ECT suggests consumer's satisfaction about a service is a result of a cognitive appraisal of the expectation-performance confirmation. Individuals are more likely to be dissatisfied if service performance falls below their expectations (negative disconfirmation). In an outsourcing if the perceived performance on the obligations falls short of the expectation (i.e. there is PCV), it is less likely to lead to perception of success. On the other hand, in line with the ECT, if the performance meets the expectations, we can expect that lower level of PCV is likely to result in higher extent of outsourcing success. Thus we can anticipate,

Proposition 3: Psychological Contract Violation will be negatively related to perceived outsourcing success.

ECT also theorizes that consumer's intention to repurchase a product or continue service use is determined primarily by satisfaction with prior use if the product or service (Bhattacherjee 2001; Oliver 1980). Increased satisfaction with a service enhances customers' repurchasing intention toward product or service (Anderson et al. 1993; Cronin et al. 1992). In similar view, in outsourcing study Koh et al.(2004)found that continuation of outsourcing contracts were related to the fulfillment of obligations. Thus it can be hypothesized,

Proposition 4: Perceived outsourcing success will lead to intention to continue outsourcing relationship.

Large extent of literature evaluating employee behaviors has discussed the role of extrinsic and intrinsic motivations leading to employee behaviors related to completing desired tasks. When employee satisfaction lies in doing the activity itself, intrinsic motivation is at play. Intrinsic motivation occurs when an activity "is valued for its own sake and appears to be self sustained" (Ko et al. 2005). Both client and vendors intrinsic motivations were found to be important factors in knowledge transfer (Ko et al. 2005). Intrinsic motivation has found to be important in transferring best practices.

In contrast to intrinsic motivation, employees are extrinsically motivated when satisfaction does not lie in the content of the activity itself; rather compensation schemes and other rewards structures play a role. Great deal of economics literature has focused on the extrinsic rewards in order to reinforce and reward behaviors for completion of desired tasks. In IS, the results of Bock and Kim's (2002) field survey indicate that extrinsic rewards are a trigger for knowledge sharing suggesting extrinsically motivated consultants and clients facilitate knowledge transfer.

Proposition 5: Intrinsic and extrinsic motivational factors to succeed will negatively affect the PCV.

Outsourcing has been considered as a part of the way that firms assemble knowledge from suppliers (Shi et al. 2005). Thus, IS outsourcing can be seen as a mechanism to integrate IS knowledge from IS vendors. In similar lines, it is recognized vendors specializing in IT outsourcing can develop their expertise through building knowledge from experiences and holding the knowledge for competitive advantage. However, from the client perspective, academics have expressed concerns regarding the potential loss of internal know-how through IT outsourcing (Willcocks et al. 2004) as well as potential loss of intellectual property (Chen et al. 2002; Evaristo et al. 2005). In order to hold a prominent place in the outsourcing market, vendors are likely to be motivated to protect their knowledge. (Szulanski 1996) identifies lack of incentives, lack of confidence, turf protection, and the "not invented here" syndrome as motivational factors potentially influencing knowledge transfer. Thus PCV is likely to occur for multiple reasons including client and vendors have competing objectives. While vendor expects the knowledge transfer from client related to business know-how, necessary information and knowledge, client expects vendor to transfer knowledge as well as share best industry practices and know-how of products and services. However, to retain the competitive edge or to retain intellectual property, both vendor and client may be reluctant to share knowledge they have completely. This is likely to lead to conflicts.

Proposition 6: Motivational factors to capitalize will be positively associated with the PCV.

PCV can occur because of mere lack of competence or opportunism as well as due to different understanding about contract obligations. The IS literature has consistently identified communication difficulties between stakeholders as major impediments to the successful deployment of systems and has identified communication as one of the critical success factors (Ko et al. 2005). Outsourcing studies have found that cultural similarity as well as fulfilling the obligation of knowledge sharing has positive relationship with partnership quality which in turn was also found to be outsourcing success factor (Lee et al. 1999; Lee 2001). If the participants do not have similar communication patterns or similar cultural values which may be due to differences in organizational cultures or differences in national cultures, it is likely to induce conflict. Hence we can anticipate

Proposition 7: Cultural and communication differences will be positively associated with the PCV.

Role of Trust and Risk in Outsourcing Success

Trust is an implicit set of beliefs that the other party will refrain from opportunistic behavior and will not take advantage of the situation (Gefen et al. 2003). If the obligations are met according to expectation or if performance exceeds the expectations, it is likely to create feeling of reliability and dependability in the partner. Reliability and dependability are usually needed for trust relationships to develop can be ascertained over time (Ridingsa et al. 2002).

Risk which is perception of the uncertainty and adverse consequences can also be described as the possibility of a negative outcome coupled with a positive outcome and aggregate level of risk can be different than if only the possibility of the negative outcome exist (Gefen et al. 2003). If the performance falls short of the expectation the outsourcing partner is likely to have feeling of uncertainty in the outcome. Thus we can anticipate

Proposition 8: PCV will be positively associated with perceived risk.
Proposition 9: PCV will be negatively associated with perceived trust in vendor.

Trust and risk have often been linked in the literature, but their relationship is far from clear. (Das et al. 2004) contend that subjective (perception) trust and perceived risk are mirror images, while (Pavlou et al. 2004) showed a causal relationship between trust and perceived risk. The discussion of the causal relationship between trust and perceived risk can be found in (Gefen 2002). Prior research has contended that trust reduces expectations of opportunistic behavior (Gefen et al. 2003) and shown that trust diminishes risk perceptions(Pavlou et al. 2004). Hence we can propose

Proposition 10: Trust in vendor will reduce the perception of risk in venture.

Interorganizational trust is key in maintaining continuity and satisfaction in buyer-supplier relations (Anderson et al. 1989). According to (Geyskens et al. 1998) satisfaction is a trust outcome. Trustworthiness was found to be one of the factors in partnership quality which led to outsourcing success (Lee et al. 1999; Lee 2001). Although the outsourcing success was not measured, in a survey based study of personnel from outsourcing and client companies (Jennex et al. 2003) found that trust in

client vendor relationship is a critical factor in outsourcing success. In similar Vain, Zaheer and Venkatraman (1995) found that higher level of trust occurring from the exchange was associated with interorganizational ties.

Proposition 11: Trust in vendor is positively associated with perceived outsourcing success.

E-commerce literature has shown that trusting beliefs are correlated with transaction intentions with same vendors (Gefen 2002; Pavlou 2003; Pavlou et al. 2004). There is significant evidence in the literature to suggest a strong association between trust and continuity. In interorganizational context, Morgan and Hunt (1994) show that trust leads to a willingness to continue an interorganizational relationship. Anderson and Weitz (1989) also find that interorganizational trust is key in maintaining continuity and satisfaction in buyer-supplier relations. On the opposite spectrum, perceived risk was found to have strong negative influence on on-line subscribing and purchasing behavior (Drennan et al. 2006). If it is perceived to be a risky venture, the managers (partners) are likely to be reluctant to continue the relationship. Hence it can be proposed,

Proposition 12: A higher level of trust in vendor is likely to induce intention to continue the partnership.
Proposition 13: A higher level of risk in the venture is likely to reduce intention to continue the partnership.

Control Variables

Earlier work in outsourcing has recognized that contract characteristics as well as team and organizational characteristics influence the outsourcing success. Contract length (Lee et al. 2004), contract characteristics, project size and project complexity (Ko et al. 2005), as well as team size and team structure are considered by earlier empirical work in this area. Since they are not the main focus of this model we consider them as control variables in this paper.

Conclusion

Outsourcing failures call for research in identifying the causes and impacts of failures, especially failures of offshore outsourcing relationships. Although, there has been some research examining the components of outsourcing relationships success, the research is lacking in evaluating the flip side of it, specifically what are the causes of failures and impact of such failures. This proposal tries to bridge this gap by suggesting a research agenda in one such issue, namely trying to understand the outsourcing relationship success/failure through the spectrum of psychological contract violation and its impact on outsourcing relationship. The general theoretical framework proposed in this paper provides a basis for developing empirically testable models to understand antecedents and consequence of psychological contract violation from both the client and vendor perspectives.

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