

Chapter 4

INFORMATION SYSTEMS OUTSOURCING CONTRACTS: THEORY AND EVIDENCE

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Abstract: The information systems outsourcing market has seen rapid growth. Companies are increasingly choosing to outsource many of their information systems activities to services firms rather than sourcing them internally. This trend is inconsistent with the predictions of some of the published literature which point to the high costs of using an outside market. These articles, based on transaction cost economics, point out the difficulty of writing efficient contracts in the face of high transaction costs which result from the considerable technological and business uncertainty in a typical outsourcing arrangement. Yet, the growth in the outsourcing market clearly indicates that the economics of external provision are dominating these contractual concerns. Given that companies are outsourcing information systems services through multi-year contracts, economic theory suggests that outsourcing contracts will seek to minimize the associated transaction costs. I propose a framework for the analysis of information systems outsourcing contracts based on transaction cost theory and the economics of production of information systems services. Based on this framework I develop propositions related to the contractual elements likely to be observed in outsourcing contracts. I test the predictions of the model by studying ten outsourcing contracts in detail. The results indicate that contracts are designed to mitigate transaction costs, and that transaction cost economics is a useful lens with which to analyze an IT services sourcing arrangement.