The role of trust in outsourcing

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Management Summary

Since trust is a binding force in most supply chain relationships, this research investigates the influence trust has on outsourcing. In this thesis the concepts of trust and outsourcing are used and their relationship is defined.

To begin with, outsourcing "represents the fundamental decision to reject the internalization of an activity" and involves a long-term relationship. Moreover, the main costs of outsourcing are production, bargaining and opportunism costs. In addition, the firm strategy has impact on the type of outsourcing. On the one hand, peripheral outsourcing was found to be effective for companies applying a cost-leadership strategy since those can possibly benefit from outsourcing core activities because being cost-efficient is their primary goal, which can be supported by outsourcing. On the other hand, differentiators should always refrain from outsourcing core-activities and will benefit less from outsourcing peripheral activities. Furthermore, governance forms in supply chains have traditionally been the battlefield of transaction cost theory. However, transaction cost theory focuses too much on processual issues, and ignores other factors, like trust.

Trust is present if parties "will behave in a mutually acceptable way" and if neither party will aim to exploit the other party's vulnerabilities. In addition, in partnerships, more trust is required while moving up the scale to vertical integration, away from spot-market exchanges. Moreover, trust is important in creating governance structures; it can be used as a substitute for a hierarchy and the other way around. Outsourcing lies somewhere between the two extremes arm's length and vertical integration, distinguishing itself from spot-market transactions by means of long-term relationships. Furthermore, trust can be a self reinforcing power; when partners get used to each other this is likely to increase trust over time. Since outsourcing relationships are long-term, it can be said that these relationships in general foster the creation of trust.

In sum, there is a strong relationship between outsourcing and trust. There are clear linkages between the two investigated concepts. Companies can take advantage of this knowledge in several ways. In order to foster trustful relationships, outsourcing relationships should be long-term and characterized by two-way information exchange. Next to that, support can be given to partners. Moreover, hostages can be used to restore the power balance and to align the incentives between parties.

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Preface

Writing this thesis was a good way of extending my knowledge with regard to supply chain management and more specifically to the role of trust in outsourcing decisions. This bachelor thesis was the first thesis I ever wrote; before writing it I was only involved in academic writing superfluously. It was a great challenge to come up with an interesting subject and to find a real problem to investigate. I was inspired by the topic 'trust' because it is hard to define but at the other hand has a large impact on people and organizations world-wide. Moreover, the topic offered the possibility to use knowledge from a variety of different fields of study within operations management, strategic management and behavioral sciences, which proved to be an interesting journey. Furthermore, the group-meetings involved in the process of writing this thesis were very interesting, as often other perspectives in your own thesis were brought to the light and you also had the opportunity to have a critical look at other theses. Especially in the difficult start-up phase, the meetings proved to be very useful. I learned a lot from writing this thesis and it truly improved my academic skills.

Chapter 1: introduction

1.1 Introduction

This document is a bachelor thesis in the field of “Organization and Strategy”, written at Tilburg University. The thesis investigates the role of trust in outsourcing for international operating companies, and will define the concepts and their relations. First of all, a problem indication will be given, which defines the building blocks of this thesis by defining a precise problem area. Subsequently, the thereby belonging problem statement and research questions will be presented. Furthermore, this section will outline the research design, data collection and concludes with the structure of the thesis.

1.2 Problem Indication

Because of continuing internationalization, businesses more and more face issues on the field of globalization and global (out) sourcing. Questions such as ‘in what country can we best produce our products?’ and ‘how can we best serve the global market?’ have to be answered by almost every multinational organization. Multinationals have parts of their business spread over numerous countries around the globe. In the past decades a development of outsourcing towards countries like Brazil, Russia, India and China (the so-called BRIC-countries) is shown. Consequently, outsourcing is a very complex process and involves numerous risks and conditions, especially in international environments (Bahli & Rivard 2005).

According to Adler (2003), the six key factors that companies should take into account when making important outsourcing decisions are: 1. dependency risks, this occurs when a supplier adapts its operation to the buyer, it will then find itself in a dependent position, 2. spillover risks, which involves the leaking of critical information, 3. trust, which supports spillover and dependency risks, 4. relative proficiency, when companies can take advantage of economies of scale 5. strategic capabilities, incorporates that companies should think twice about outsourcing any core activities or critical supporting activities, and 6. commitment versus flexibility, irreversible commitments can be a signal towards competition, but also a restrictor for flexibility. According to Adler (2003) these six factors help to explain why differences in outsourcing policies, e.g. between small and medium-sized companies, exist.

For example, a small company is likely to outsource payroll activities because it lacks the economies of scale. While a large company at the other hand might be more inclined to outsource benefits processing, as they offer a wider range of benefits which would reduce economies of scale for handling the activity in-house (Adler 2003).

Adler concludes that dependency risks and spillover risks are highly dependent on trust. If trust does not exist, these both types of risks dominate the relationship between two parties, because they will then act solely in their own self-interest (opportunism) by leaking information and exploiting the dependency advantage. In short, trust appeases both spillover and dependency risks.

Furthermore, Adler (2003) states that parties cannot rely on contracts solely because these are very costly to negotiate and often the enforcement of the contracts is highly uncertain. When one party does not fulfill its contractual duties a lawsuit can be started, but this is very costly and time-consuming. Also in the process of setting up a contract, a lot of costs have to be made to draw up and negotiate the exact specifications for which often expert support is called in.

In addition, Vining & Globerman (1999) agree that outsourcing involves significant risks of opportunism that must be handled with care and stresses that an outsourcing firm is placing part of its destiny in the hands of another firm, which is trying to maximize its *own* profits. However, trust does not go without saying in relationships; different interests make trust conditional in nature. If no basis of trust exists, parties are more likely to act opportunistic.
Trust is especially critical when uncertainty and asymmetric product information are present in the transactions in a supply chain (Agarwal 2003). Both uncertainty and asymmetric product information make one party vulnerable to the opportunistic behaviour of another party. A high level of trust can appease this opportunistic behaviour.

Also Williamson (1991) already acknowledged that his transaction costs theory had to be extended with 'relational contracting', meaning that not only a contract can support transactions between two parties, but also close relationships and trust are of importance.
Furthermore, Slack (2004), recognized trust as an important challenge in managing supply chain relationships. He states that "trust is widely held to be both the key issue in successful partnerships, but also, by far the most difficult element to develop and maintain".

Since trust is a binding force in most supply chain relationships (Adler 2003), this research investigates the influence trust has on outsourcing.

1.3 Problem statement

Based on the problem indication provided above, the following problem statement is defined:

"What is the relationship between trust and outsourcing relationships in international operating companies?"

1.4 Research Questions

To answer the problem statement described above, several research questions have been formulated:

1) What is outsourcing?

2) What is trust and how does it influence inter-organizational relationships?

3) How could international operating companies deal with trust in their outsourcing?

1.5 Research Design

The main concepts to be researched in this study are *outsourcing* and *trust*. This thesis will elaborate on both these concepts and will find out, with the help of existing literature, what the relationship between the two variables is and next to that what other factors are relevant.

A literature review will be conducted in order to provide the reader with a detailed overview of the published work from secondary resources within the area of interest. The literature review will make sure that all important variables are taken into account and that the problem statement can be formulated with precision. By means of the literature review the researcher can make sure that the research is perceived to be relevant and significant (Sekaran 2003).

Hence the collected literature will be critically reviewed and the managerial implications will be drawn up. The purpose of the study is descriptive in nature, because the focus will be on describing the characteristics of variables of interest. According to Sekaran (2003) a descriptive study is carried out to describe and ascertain the variables involved in the study.

1.6 Data Collection

This thesis is based on secondary data. According to Sekaran (2003) secondary sources can be described as "information gathered by someone other than the researcher conducting the current study". The research is cross-sectional, since data will be only collected once and not at several points in time. Mainly journals will be used, which will be consulted via ABI/Inform. Keywords used are, amongst others: 1) trust 2) outsourcing 3) trust AND outsourcing 4) outsourcing decisions 5) transaction costs.

Next to that, several textbooks will provide additional information. The main drawback of this type of research, as opposed to primary data, is the risk that information might be obsolete (Sekaran 2003). To solve this, recent articles will be used whenever possible. To ensure reliability, the journals used will mostly be top-journals from the field of Logistics and Operations Management and Strategy. If necessary, additional information might be found in less well-established journals. Content and bibliographic analysis will be used in the research process, by means of using the right keywords. Next to that, the snowball method, which implies searching the references for new articles, will be used to further explore supporting theories.

1.7 Structure of the thesis

The remainder of the thesis will be organized as follows. This Introduction chapter has as goal to make the reader familiar with the topic of investigation; the problem and context in which the investigation will take place is highlighted. The next sections, Chapter Two and Chapter Three are a literature study and try to give a clear overview of the different theoretical research conducted on the concepts; trust and outsourcing. Chapter Four will elaborate on how companies should deal with the findings of the research done in the previous chapters. The last chapter will be a conclusion and finishes with recommendations for further research and discusses the limitations of this study.

Chapter 2: What is outsourcing?

This section provides the reader with a review of the most important definitions within existing literature of the term outsourcing. Besides that, this section reexamines the most important advantages and disadvantages of outsourcing. Subsequently the process of outsourcing decisions will be dealt with.

2.1 The definition of outsourcing

Venkatraman & Loh (1992) come up with a definition of outsourcing, in a study on Information Technology outsourcing. They called IT-outsourcing "*the significant contribution by external vendors in the physical and/or human resources associated with the entire or specific components of the IT infrastructure in the user organization*". Later on Lei & Hitt (1995) described outsourcing as *"the reliance on external sources for manufacturing components and other value-adding activities"*. According to them, outsourcing implicates relying on external know-how and capabilities, as the product or service is produced by an external vendor and not directly under control of the focal firm. Firms might rely on external know-how if they 1) do not have the required technology in-house or 2) are unable to make use of economies of scale in-house. However, Lei & Hitt (1995) also point out that outsourcing can damage the firm's chances for organizational development and ability to gain knowledge on new technologies. This is especially dangerous if it involves those skills necessary for the development of new business opportunities and core capabilities.

It is argued by Gilley (2000), that the large variety of existing definitions of outsourcing differ to some extent and that therefore outsourcing can be described very broadly. According to Gilley (2000), outsourcing includes almost all services and products obtained from outside firms. However, every single firm obtains certain resources from outside the focal firm. This definition makes the term outsourcing an empty shell since almost all transactions with other firms are labeled outsourcing. To solve this Gilley proposes that outsourcing *"represents the fundamental decision to reject the internalization of an activity"*. According to Gilley (2000) outsourcing can arise as a *substitution*, meaning that the outsourcing concerns vertical disintegration and acquisition of external activities for the focal firm. The other form of outsourcing being distinguished by Gilley (2000) is a*bstention* and also involves the purchasing of goods and services which were never produced internally. But, Gilley proposes only to speak of outsourcing if the product obtained from an external party "*was within the acquiring firm's managerial and/or financial capabilities"*.

So, if the product in question can not be produced by the focal firm internally (e.g. because of a lack of technological abilities), then the external production will not be called outsourcing. Spee (1995) states that firms widely outsource in areas once strictly considered internal domains, and adds the duration of the relationship as a relevant factor describing outsourcing as a "*long-term contractual relationship for business services from an external provider*". In addition, Outsourcing is first of all a process of change. What is most distinguishing about outsourcing is the introduction of dramatic changes at various stages, e.g. in the nature of work, and organizational design (Bettis, Bradley, Hamel 1992). Next to that, it can be said that outsourcing means replacement, since products or services which were formerly produced internally are now produced by an outside vendor. The units that used to produce internally are eliminated and this makes the organizational implications greater than simple contracting (Lever 1997).

In conclusion, outsourcing involves the acquisition of certain products from an external firm. Furthermore, it can be said that in outsourcing the capabilities of the focal firm are of interest, in other words: is a company able to produce certain products or services better internally compared to externally? And, outsourcing relationships can be said to be long-term, in order to distinguish them from transactions on the spot-market and emphasize the closer cooperation required. In this research the definition of Gilley will be used since it is all-embracing and decides only to speak of outsourcing in case the focal firm would have been able to produce the product itself, making it a strategic choice.

2.2 Outsourcing decisions

Outsourcing of goods and services is not a new phenomenon. During the 1980s and 1990s the wages of low-skilled workers have fallen relative to those of high-skilled workers, which led to an increase of outsourcing activities towards economies with primarily low-skilled cheap labour (Feenstra & Hansen 1999). McFarlan and Nolan (1995) state that it is commonly believed that an outside trader can provide the same level of service at a lower price than the internal department. The logic is that the outside trader has better abilities to exploit economies of scale, closer control of fringe benefits, better access to low-cost labour and focused expertise (McFarlan & Nolan 1995). To indicate the diversity in outsourcing; in 1998 the WTO reported that of the typical production of an 'American' car 30% of the value goes to Korea for Assembly, 17,5% to Japan for components and advanced technology and 7,5% to Germany for design (Grossman & Helpman 2005).

Next to cost reduction and cash needs, focusing on core competencies and getting access to important technological expertise are among the primary non-financial reasons for outsourcing (Smith, Mitra, Narasimhan 1998). For example, specialized firms can more easily contract highly educated and skilled professionals and technical specialists that are in undersized supply. Other sources of cost reductions are the elimination of large fixed costs during recessions and the transfer of adjustment costs to the outsourcer when a new technology is adopted. In the next section we will elaborate on the most important reasons for outsourcing.

2.3 Why do firms decide to outsource?

According to Lever (1997) *cost savings* are a powerful motivator for outsourcing. Outside vendors can optimally benefit from economies of scale because of specialization. Since they have the possibility to focus on one particular type of product and have been able to construct methods, which suit this particular product, in order to save time and money. In addition, they benefit from learning curve efficiencies as the company can often combine orders of many clients.

Another reason for outsourcing is *disciplining internal production*. Internal production units can act like monopolists, since the units they produce are not benchmarked in comparison to external vendors and the internal costs are often drawn up by unit managers aiming for a maximum turnover for their own unit, which leads to suboptimal prices because of artificially high production costs (Lever 1997). This in turn leads to deteriorating profits because the products are overpriced. Outsourcing forces internally produced items to be benchmarked against those being externally produced (Vining & Globerman 2000). So, outsourcing can improve the efficiency in internal production since it forces internal production units to remain competitive and strive for good quality and competitive pricing.

Moreover, outsourcing can also *reduce risks*, since costs are made variable when products are obtained from an external party. Firms can then refrain from investing in capital-intensive goods and personnel. Outsourcing *insures* companies against troublesome performance linked to a changing external environment with changes in the legal environment and in demand (Arrow 1965). Moreover, Deavers (1997) stresses the impact of rapid technological change, requiring greater flexibility, as one of the main drivers for outsourcing. An external, specialized, firm will be better focused. Section 2.5 will elaborate on the risks involved in outsourcing practices.

A fourth reason for outsourcing is offered by Quinn and Hilmer (1994), who state that organizations could strategically outsource to be able to *build core competencies*. In this view, outsourcing presents the firm the ability to focus solely on its core business. In section 2.4 this reason will be elaborated on.

2.4 Creating an outsourcing relationship and the relevant costs

Quinn and Hilmer (1994) distuingish four stages when creating an outsourcing relationship. First, internal performances are benchmarked, future requirements are listed and a short-list of qualified vendors is created. This stage is aimed at getting a better understanding of a firm's capabilities, and can also lead to reengineering rather than outsourcing. Second, the negotiation phase takes place, and a contract can be drawn up. The third phase is the transition phase, where, if necessary, employees and computer applications are transitioned. The final phase represents the assessment phase, when the vendor is already providing the product or service, the contract then is re-negotiated or ended.

In addition, according to Vining & Globerman (2000), there are three types of costs which are relevant to the outsourcing decision. The first is production costs, which represents the cost of internal production or the direct purchase price. Next to that, bargaining and opportunism costs play a crucial role. Bargaining costs arise from negotiating the contract, making chances in the contract when unforeseen circumstances arise, the costs of monitoring performance of the other party and the cost of disputes. Moreover, opportunism, is behaviour of a party to change the agreement in its favor, and happens if a party acts self-interested. However, it is very difficult to distinguish between opportunism costs and bargaining costs, since it is always in the interest of an opportunistic party to bring up an unexpected change in circumstances forward as the reason for their behaviour. Akerlof (1970) states that this inability to distuingish between the two types of costs itself raises outsourcing costs, since it takes up a lot of resources to investigate the differences. Three main types of costs determine these bargaining and opportunism costs: product complexity, contestability and asset specificity. Complex products are more often internalized. Becasuse a complex product is more uncertain since it is often not easily possible to asses the quality of the product right after the point of sale. Moreover, higher product complexity leads to a greater potential for information assymetry, which in turn leads to higher vulnerability to opportunism (Vining & Globerman 2000).

2.5 Peripheral outsourcing

This section will show that in outsourcing decisions the role of the generic firm strategy is also of importance (Gilley 2000), when distinguishing between peripheral and core activities. Peripheral outsourcing, the abstention of non-core, supporting, activities, is believed to be an effective strategy for companies striving for a *cost-leadership strategy*. Within this strategy, the focus is on low-cost efficient supply chains, focusing on operational efficiency at low costs. In addition, because of specialization by the outside firm, the quality of the products or services supplied can be greater (Dess, Rasheed, Mclaughin and Priem 1995). Next to that, outsourcing peripheral activities can enable the focal firm to focus on core competencies, making it possible to aim for focusing at the activities which form the key of their business. By ‘peeling of layers of peripheral tasks’, these companies can optimally benefit from economies of scale within the company to which the activities are outsourced. Gilley (2000) propose that a cost leadership strategy strengthens the positive effect (or reduces any negative effect) of peripheral outsourcing on firm performance, because of the favourable cost-position relative to industry rivals. On the other hand, companies focusing on a *differentiation strategy* are to gain less from outsourcing peripheral activities. The cost improvements are significantly less important to companies applying a differentiation strategy than to those who adopted a cost-leadership strategy, although these firms might also benefit from increased peripheral activity quality and focus on their core competencies.

2.6 Outsourcing of core activities

Harrigan (1984) stated that it is important for companies applying a differentiation strategy to determine ‘which activities drive their differentiation’ (also referred to as core activities), and keep them in-house. Differentiators who decide to outsource a lot of their core activities will find that their control over these activities is sacrificed. The core activities form the key to business success for companies applying a differentiation strategy. If these companies outsource their core activities they are very dependent on the outsourcing partner, since this partner delivers the most important parts of the activity or product (Barney 1997). In addition, the company is subject to spillover risks, since important information has to be shared with the outsourcing partner. Subsequently, this partner might use this confidential information for his own benefit (Adler 2003).

For cost-leaders the benefits of losing control over their core activities might be partially offset by their increased cost-performance. In other words, outsourcing here supports the main aspect of the business strategy, being cost-efficiency. So, the risks and disadvantages involved with outsourcing for cost-leaders can be appeased by the opportunities to reduced costs. Spillover risks are lower, since the shared information is less unique and therefore less vulnerable to leaking, instead the focus is on doing things efficient in order to minimize costs (Gilley 2000).

2.7 Risks and outsourcing

As already mentioned in the problem indication, outsourcing involves several risks which companies should take into account. Dependency risks and spillover risks were already discussed as being highly dependent upon trust. According to Aubert, Dussault, Patry and Rivard (1999), there are several risks involved in the transaction.

Risks in outsourcing
1. Asset specificity
2. Small number of suppliers
3. Uncertainty
4. Inflexibility
5. Measurement problems

Figure 1, risks in outsourcing. Aubert et al. (1999).

The first risk is *asset specificity*, referring to investments in assets which are specific to a relationship and which are difficult to redeploy. Asset specificity makes the investor vulnerable to exploitation. For example, when companies collaborate intensively IT-enabled systems, like EDI (Electronic Data Interchange), are often used to streamline information flows across the various layers in the supply chain. Evidently, EDI implementation exposes suppliers more than buyers to risk, given the high degree of asset specificity of the investment, which is linked to a bigger dependence and risk of opportunistic actions by buyers (Terpend, Krause, Tyler, Handfield 2008).

Second, a *small* number of suppliers create a risk because if the number of alternative suppliers is low, the dependency on the existing ones is great, making the client subject to opportunistic bargaining power. *Uncertainty* is the third source of risks in outsourcing relationships. Because of so-called bounded rationality, which incorporates that perfectly rational decisions are often not feasible because of the limited computational resources for making them (Williamson 1985), parties are unable to survey all possibilities creating an incomplete picture – leading to unclear situations and thus uncertainty. Fourth, relatedness of different parts of the business on each other can create *inflexibility,* and subsequently, unnecessary cost. Fifth, *measurement problems* provide a risk. When it is hard to measure individual performance or to measure the fair value of contributions, buyers have to engage in an expensive process of monitoring, or sellers have to engage in a costly process of signaling (Bahli& Rivard 2003).

2.8 Transaction cost theory

Outsourcing is often supported by contracts, however solely contracts do not suffice (Kern & Willcocks 2000). Most classical economists argue that trust results from the ability to create contracts, rewards and punishments in such a way that individuals behave in a prespecified way (Bhattacharya, Devinney & Pillutla 1998). However, the role of contracts is limited as enforcement and negotiation is often expensive and time consuming. Every party involved will strive to draw up a contract which is beneficial for its own situation. In addition, enforcement of contracts often has to be done in court, which takes up a lot of time and financial resources (Adler 2003). According to Willcocks and Choi (1995) governance forms in supply chains have traditionally been the battlefield of transaction cost theory, originally developed by Williamson. Transaction cost theory is based on two assumptions. First, the theory recognizes the limited ability of the human mind to evaluate fully all consequences related to a decision. The second assumption is opportunism. Human beings not only act out of self-interest but also act with guile (Bahli & Rivard 2005). However, transaction cost theory has two main limitations. First, it neglects the interdependent relationships between various actors in the supply chain, aimed at maximizing value as opposed to focusing on cost minimization solely. Second, “transaction cost theory has a strong focus on the structural features of the exchange act that neglects significant processual issues”, issues which prevail in outsourcing relationships (Dietrich 1994). In other words, it focuses more on the contractual issues and neglects other issues in the exchange.

2.9 Summary

This chapter answered the problem statement "What is outsourcing?". According to Gilley something should be called outsourcing if the product obtained from an external party "*was within the acquiring firm's managerial and/or financial capabilities*". Next to that outsourcing *"represents the fundamental decision to reject the internalization of an activity"* and involves a *long-term* relationship. In addition, the main reasons why companies decide to outsource are: potential cost savings, reduced risks, disciplining internal production and building core competencies. Moreover, the main costs of outsourcing were briefly discussed; these are production, bargaining and opportunism costs. The latter two costs are hard to seperate and the inability to distuingish between the two types of costs itself raises outsourcing costs, since it takes up a lot of resources to investigate the differences. In addition, companies applying a cost leadership strategy can have large benefits of outsourcing peripheral activities and could possibly benefit of outsourcing core activities. At the other hand, companies applying a differentiation strategy will benefit less from outsourcing peripheral activities and should refrain from outsourcing core activities. The relevant risks in outsourcing are 1. Asset specificity, 2. Small number of suppliers, 3. Uncertainty, 4. Inflexibility and 5. Measurement problems. Finally, transaction cost theory and its shortcomings were discussed, this theory focuses too much on processual issues. Next to that, drawing up and enforcing contracts requires a lot of time and financial resources.

Chapter 3: What is trust and how does it influence inter-organizational relationships?

In the preceding chapter, the concept of outsourcing was discussed and in the last section the role of Transaction Cost Theory and its limitations were treated. The chapter highlighted its narrow focus on contractual issues and indicated that Transaction Cost Theory neglects other issues in the exchange. In this chapter trust will be pointed out as one of these issues and linked to outsourcing. In order to indicate the role of trust in outsourcing relationships, at first the definitions of trust, found in existing literature will be given. Subsequently, the relationship between trust and outsourcing will be discussed.

3.1 The definition of "trust"

The variable trust cannot be measured easily, since it is of subjective nature. Therefore, a clear definition is necessary. Morgan and Hunt (1994) conceptualize trust as "*existing when one party has confidence in an exchange partner's reliability and integrity*". Later, Fukuyama (1995) summarized trust as "the expectation ... of regular, honest, and cooperative behavior, based on commonly shared norms." Social capital "arises from the prevalence of trust in a society," and cannot be acquired through decisions based on financial facts. The party who trusts is the trustor and the party who receives the trust is the trustee. In addition, Mayer, Davis and Schoorman (1995) describe trust as the readiness of a party to be vulnerable to another party, based on the confidence that the other party will carry out certain actions important to the trustor, without taking into account the opportunities to monitor the party. So, making oneself vulnerable involves taking risk. According to Mayer trust is not per definition taking risk, but rather the willingness to take risk; according to this definition trust is to some extent a choice for a party. In comparison to the definition of Morgan and Hunt, the definition of Mayer incorporates the ability to monitor the other party as a non-decisive factor. So, the structural type of relationship is less important here.

However, the above definitions are not specifically aimed at describing inter-firm trust, which is what this research tries to investigate, but describe trust on an inter-personal level. In addition, trust on an inter-firm level can be said to be the expectation that a trading partner "*will behave in a mutually acceptable way*" and that neither party will aim to exploit the other party's vulnerabilities (Sako & Helper 1998). This expectation reduces the uncertainty involved in the actions of the other party. Another way of describing trust is in the activities that are involved in relationships with high trust, such as communication, informal agreement, absence of monitoring, and no or limited task co-ordination (Currall & Judge 1995). The definition used in this research will be the definition of Sako & Helper, since it is most suitable to inter-organizational trust.

3.2 Levels and characteristics of trust

Mink, Owen & Bright (1993) describe three levels of trust:
(I) Contractual trust, as the "*confident expectation that people will do what they say they are going to do"*.
(II) Self-disclosure trust, meaning "*a willingness to engage in reciprocal sharing and openness, to share relevant information when it is needed"*.
(III) Physical trust, as the "*confidence that other people care about our physical and psychological well being, a certainty as to the safety of our environment*" (Mink et al., 1993).

Moreover, Agarwal (2003) defined trust in terms of three characteristics: reliability; predictability; and fairness. For making on-line transaction under an environment of uncertainty and vulnerability reliability, predictability and fairness in transaction help in building trust among traders in a supply chain. *Reliability* arises when an exchange partner is expected to be trustworthy such that his word or promise can be relied on, and the exchange partner will behave in ways that equitably protect the welfare of both parties. *Predictability* refers to the extent actions can be foreseen by logical sense. *Fairness* in relationship develops when exchange partners are dedicated for reciprocating the obligations and commitments between them under an environment of uncertainty and vulnerability (Agarwal 2003).

3.3 Collaboration and trust in supply chains

One of the most important performance outcomes expected from improved inter-organizational relationships is cycle time reduction in the supply chain. Customers can then be served at competitive speed, at the right time and will therefore be satisfied (Handfield, Krause, Scannell & Monckza 1998). To be able to reduce cycle times, collaboration has to be established.

Collaboration is characterized by mutuality of benefit, rewards and risks and has a sharing of information as a foundation (Stank, Crum, Arango 1999; Barratt & Oliveira 2001). According to Harrison and Van Hoek (2005) collaboration takes place at different levels, from 'arm's length' to vertical integration (see Figure 2 beneath). In case of an 'arm's length' relationship, trust needed is minimal as the relationship involves only transactions on the marketplace based on price. In the other extreme case, 'vertical integration', where the relationship is characterized by common ownership, trust is an important element in the relationship. Here, the risks of outsourcing, like spillover and dependency risks, are higher and therefore high levels of trust are essential.

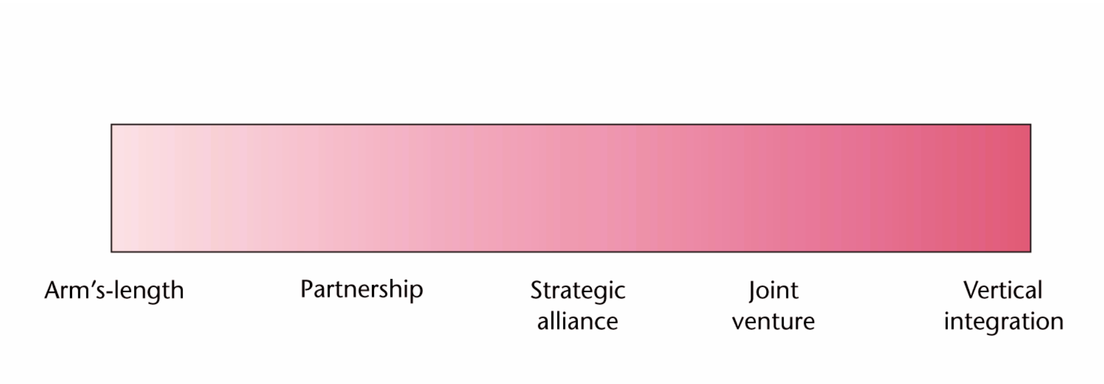

Figure 2. Relationship styles continuum (Harrison and Van Hoek 2005)

In addition, joint ownership is a major feature of vertical integration, and vertical integration represents the opposite of outsourcing as it deals with bringing several tiers into one focal company instead of bringing certain business processes outside the focal company (Harrison and Van Hoek 2005). In Chapter Two it was discussed that outsourcing involves *long-term relationships*, which distinguishes outsourcing from spot-market exchanges which are solely based on simple market exchanges based on price (Adler 2001). So, it can be argued that outsourcing lies somewhere in between of the two extremes, 'arm's length' and 'vertical integration' on the relationship continuum.

Also Willcocks et al. (1995) define strategic alliances as collaborative relationships between organizations accompanied by voluntary effort and meaningful resources of two or more organizations to maximize joint value. Furthermore, they discuss the role trust plays in forming these alliances. According to them a common contrast is made between short-term 'contractual' versus long-term 'trust/relationship' approaches to partnering, as in line with Harrison and Van Hoek mentioned above.

3.4 The role of trust in governance structures

As the firm moves a relationship away from a traditional contractual basis (as in arm's length relationships), it should find out new ways of managing it that support the degree of alliance it wants to create with the other party (Ring & Van de Ven 1992). The firm may substitute or at least increasingly rely on trust instead of the formal controls used to manage more traditional relationships, which are contractual in nature (Bradach & Eccles 1989).

Trust or opportunism can be said to be important for determining governance structures. For example, trust can be a social norm which reduces the necessity to use hierarchy in order to appease opportunism. Thus, the higher the general level of trust, the less need there is for vertical integration (Williamson 1985). In vertical integration control is established by acquisitions of companies from other layers in the supply chain (Harrison & Van Hoek 2005), if trust is abundant there is no need to use this type of control system. In addition, the other way around, it can also be stated that when there is control because of integration (which facilitates better monitoring), there is no need to rely on trust as a coordination mechanism.

Next to that, trust enables a network of firms to be more flexible and therefore adapt more quickly to a rapidly changing environment. In other words, if companies trust each other they will more quickly rely on the other party's suggested actions, since they have confidence in the intentions of this party, and as a result transaction costs are reduced (Jarillo, 1988).

3.5 Self-reinforcing trust

Positive past experiences with a partner create trust (Anderson & Weitz 1989). Partners get used to each other as they continue their relationships over time, this is called habituation and describes repeated interaction leading to the creation of habits and subsequently institutionalization of behaviour. Moreover, any repeated human activity is subject to habituation, which removes the necessity to make decisions (De Jong & Nooteboom 2000). Akkermans, Bogerd and Van Doremalen (2004) have found that trust is one of the main drivers of interorganizational collaboration dynamics. Akkermans et al. (2004) modeled the factor trust in supply chain relationships and also incorporated habituation (described as a 'history of successful collaboration'). System dynamics were used to indicate the relationship between various variables (see figure 3).

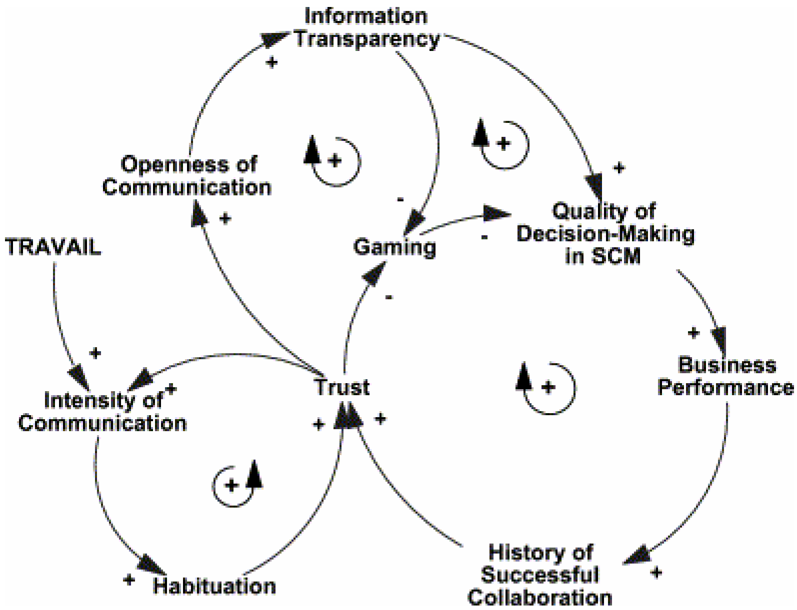

Figure 3: Trust building in SCM. Akkermans et al. (2004)

According to this figure, supply chain transparency is the result of interactions between 'shared hard working' (*travail*), 'believe in the honesty, integrity, reliability, justice of the partners' (the definition of *trust* used in this research), and 'open sharing of all relevant information' (*transparency*). In this model, transparency determines the level of success of the collaboration in a supply chain (Akkermans et al. 2004). It is important to note the 'positive feedback loop nature' of this model, which implies that a high level of trust involves a virtuous cycle (Sterman 2000). Trust is self-reinforcing as it leads to more trust in the future. More specifically: Increases in trust lead to higher transparency, which enhances decision-making quality, which leads to increased supply chain performance. As a result, this then leads to habituation, which, in turn, increases trust further, making it a virtuous (self reinforcing) cycle. In sum, since outsourcing deals with long-term relationships, it can reasonably be assumed that an outsourcing relationship could have a positive effect on the amount of trust and therefore foster ever better business performance.

3.6 Summary

This chapter provides the answer to the research question: "What is trust and how does it influence inter-organizational relationships?". Sako & Helper state that trust is present if parties "*will behave in a mutually acceptable way*" and if neither party will aim to exploit the other party's vulnerabilities. In addition, different *levels* of trust were discussed in this chapter. An outline of three *levels* of trust, from contractual to self-disclosure and physical trust was presented. Next to that, three main *characteristics* of trust were distinguished; reliability; predictability; and fairness. To bridge the gap between supply chain management and trust the importance of trust in various types of collaboration was discussed. The framework of Harrison and Van Hoek for partnerships was treated, ranging from arm's length to vertical integration, showing that more trust is required while moving up the scale to vertical integration. Trust is important in creating governance structures; trust can be used as a substitute for a hierarchy and the other way around. Outsourcing lies somewhere between the two extremes arm's length and vertical integration, distinguishing itself from spot-market transactions by means of long-term relationships. The final section highlights that trust can be a self reinforcing power; when partners get used to each other this is likely to increase trust over time. In addition, in the proposed causal loop model, transparency determines the level of success of the collaboration in a supply chain. The model shows that a high level of trust can lead to a virtuous cycle adding to the success of supply chain collaboration and increased chain-performance. As outsourcing is concerned with long-term and sometimes vulnerable relationships, it can be said that trust can thus be an important element in these transactions.

4. How could international operating companies deal with trust in their outsourcing?

In this chapter it will be reviewed how companies can actively anticipate on the factor trust in their outsourcing practices. This chapter will elaborate on the implications trust has for companies involved in outsourcing and more specifically what actions the companies can take.

4.1 Building relationships

As we discussed in Chapter Two, trust is more important when the relationship between parties is closer, as close collaboration leads to making oneself more vulnerable to another party, e.g. by means of spillover risks. According to Anderson & Weitz (1989) there are a few important factors in relationships which are influenced by trust. Trust is enhanced by *two-way communication* between parties, since this decreases role ambiguity as parties are better aware of what is happening at the other side of the line. In addition, good communication improves trust by solving problems by aligning visions and expectations (Etgar 1979), mostly in an informal way, which in turn enhances trust and coordinative behaviour even more (Pruitt 1981). Moreover, as extensively mentioned in the previous chapter, relationships tend to get stronger and more based on trust when they get *older*. Next to that, more trustful relationships occur with parties who *provide support* to their partners on for example research and development. Moreover, mutual trust is influenced by an unequal *power balance* in a negative way. If one party is dominant over the other party, the weaker party gets mistrustful and anxious about the stronger party's intentions since this party has the ability to exploit the dependence of their weaker partners.

4.2 Hostages

In the latter section the negative impact of an unequal power balance was treated. However, it is argued that the establishment of credible commitments, also called 'hostages', can bind parties to trustworthy behavior in case of power imbalance (Sako & Helper 1998). These hostages come in the form of investments, which reduce the incentive of parties to behave opportunistically, since they invested in the relationship. Put it in another way, the 'mutual hostage' situation aligns the incentives of the parties by shared equity (Gulati 1995).

So, incentives to cooperate can be aligned by means of investments which bind the parties together. In seeking for outsourcing relationships companies can make use of hostages. Good examples from hostage situations can be found in the automotive industries. Large customer-specific investments are asked from companies delivering to the large automotive producers, which in turn reduces their incentives to breach the contract. However, on the downside of this is the increased temptation for the automakers to behave opportunistically. This can be solved by a mutual hostage situation, where the customer has partial equity shares in the supplier, mitigation the power inequity and balancing the incentives of both parties, since the automakers have financial incentives to make the supplier a healthy company (Ahmadjian 2005).

4.3 Control systems

When a company perceives greater risks in a partnership, and lower levels of trust, a control system might appease the risk to support trust. So, the company tries to moderate the relationship by creating more transparent systems to control the other party which in effect reduces the risks. For example, when companies in a partnership have very transparent systems, like open book management, monitoring tools or tight budget processes, higher levels of trust will be found (Mayer et al. 1995). Also Das and Teng 2001 agree that appropriate governance structures, including management control systems and the development of trust, may work to reduce risk and decrease failure. Smith and Smith (2003) consider management control systems in outsourcing decisions, stating that formal control systems could reduce flexibility and adaptation. However, they stress that in some outsourcing relationships a formal control mechanism could enable more control and transparency. As mentioned in section 3.4 transparency can greatly enhance the levels of trust between parties. The provision of information is a crucial component of management control systems, and even more when it concerns outsourcing relationships. Moreover, very strong control systems will hinder the development of trust. The responses by the company will then by merely initiated by the control system rather than by the actions or believes of the trustee (Mayer et al. 1995). So, control mechanisms can create a type of artificial trust. In sum, there is no widespread agreement to whether or not control systems support trust in inter-organizational relationships especially because of the artificial trust which can be created by these systems.

4.4 Summary

This chapter proposed several methods to build trustful relationships. Companies should focus on building long lasting partnerships which are characterized by two way communication. In addition, support should be provided to the other party were needed. In order to build trustful partnerships there should be an equal balance of power, which reduces mutual incentives for opportunistic behavior. If one party is dominant over the other party, the weaker party gets mistrustful about the stronger party's intentions since this party has the ability to exploit the weaker party. In case of an unequal balance of power hostages can be a way to restore this balance and in turn increase trust between parties. However, a mutual hostage situation is required in order to appease opportunism. In addition, some scholars have argued that management control systems could establish trust, because these systems improve transparency. However, others believe that management control systems will anaesthetize trust, because organizations will then solely act on the control system itself rather than having 'real' trust.

Conclusions & Recommendations

The aim of this thesis is to answer the problem statement: *"What is the relationship between trust and outsourcing relationships in international operating companies?"* By first discussing outsourcing and the role of trust in inter-organizational relationships, the relationship between the two concepts could subsequently be defined. Finally, the actions which individual companies can take to deal with trust were discussed. In this chapter the main findings of the research will be presented and the answer to the problem statement will be revealed.

5.1 Conclusions

To begin with, a transaction can be called outsourcing if the product obtained from an external party "*was within the acquiring firm's managerial and/or financial capabilities*". Next to that, outsourcing *"represents the fundamental decision to reject the internalization of an activity"* and involves a *long-term* relationship. Moreover, the increase in outsourcing by companies in the past decades was initiated by the falling wages of low-skilled workers relative to those of high-skilled workers. Naturally, in outsourcing certain risks are involved, since a firm puts part of its destiny in the hands of another firm. Dependency risks and spillover risks are among the most prevalent risks involved in outsourcing. In addition, a clear link was found between the firm strategy and the type of outsourcing which should preferably be used. At the one hand, peripheral outsourcing was found to be effective for companies applying a cost-leadership strategy since those can possibly benefit from outsourcing core activities because being cost-efficient is their primary goal, which can be supported by outsourcing. On the other hand, differentiators should always refrain from outsourcing core-activities and will benefit less from outsourcing peripheral activities. Governance forms and levels in supply chains have traditionally been the battlefield of transaction cost theory. However, the applicability of transaction cost theory is limited, since it focuses more on the contractual issues and neglects other issues in the exchange, like trust. Trust is said to be present if parties "*will behave in a mutually acceptable way*" and if neither party will aim to exploit the other party's vulnerabilities. In the research it was shown that more trust is required while moving up the scale from arm's length to vertical integration, since the parties are then more vulnerable to for example spillover risks. Trust is important in creating governance structures; trust can also be used as a *substitute* for a hierarchy and the other way around. This research showed that outsourcing lies somewhere between the two extremes arm's length and vertical integration on the relationship style continuum, distinguishing itself from spot-market transactions by means of long-term relationships.

Trust can be a self reinforcing power; when partners get used to each other this is likely to increase trust over time. In sum, since outsourcing relationships are long-term, it can be said that these relationships in general foster the creation of trust. So, the conclusion of this study is that there is a strong relationship between outsourcing and trust. The study reveals clear linkages between the two investigated concepts. Companies can take advantage of this knowledge in several ways. In order to foster trustful relationships, outsourcing relationships should be long-term and characterized by two-way information exchange. Next to that, support can be given to partners. Moreover, hostages can be used to restore the power balance and to align the incentives between parties. In addition, the effect of management control systems is subject of discussion and from existing literature it cannot be convincingly proven that these systems will enhance partnerships in the supply chain in general, and outsourcing relationships in particular since they can create artificial trust.

5.2 Limitations of this study and recommendations for further research

In this thesis a limitation is that trust is mainly described as a one-sided issue, while it in fact always incorporates two or more players. In a relationship A can trust B, but B may not automatically trust A. In addition, the objective measurability of trust is difficult, therefore it is more difficult to measure trust as absolute input or output in relationships.

Next to that, in the literature there exists a gap between literature on outsourcing and literature on trust. Only limited research has been carried out at the combination of trust and outsourcing, a direct link between the two variables is only rarely made. Additional research is recommended to test the revealed propositions and to discover new relations. At the other hand, the role of different kinds of partnerships and the trust involved in these inter-organizational relationships can be linked to trust. Further studies could focus on the direct link between outsourcing and trust.

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