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A Transaction Cost Economics View of DoD Outsourcing

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A TRANSACTIONS COST ECONOMICS VIEW OF DOD COMPETITIVE SOURCING

Raymond E. Franck & Francois Melese
Second Annual Research Symposium,
18-19 May 2005

OUTLINE

- INTRODUCTION: The Promise of Outsourcing
- TRANSACTIONS COST ECONOMICS (TCE): The Perils of Outsourcing
- IMPLICATIONS FOR DoD COMPETITIVE SOURCING
- CONCLUSIONS
 - FOR PROGRAM MANAGERS
 - FOR POLICY MAKERS

BASIC RULE FOR MAKE-OR-BUY DECISION

- BUY (OUTSOURCE) IF
INTERNAL COSTS > OUTSOURCED COSTS
- INTERNAL COSTS = PRODUCTION COSTS + “AGENCY” COSTS
- OUTSOURCED COSTS = PRODUCTION COSTS + “TRANSACTIONS” COSTS

STARTING POINTS

- AGENCY THEORY (including the Principal-Agent Problem)
- TRANSACTIONS COST ECONOMICS (TCE)
 - “VERTICAL” BOUNDARIES OF THE FIRM:
what to produce *within firm boundaries*.
- COMPETITIVE SOURCING, e.g., A-76

THE PROMISE OF OUTSOURCING

- LOWER PRODUCTION COSTS IN THE GENERAL MARKETPLACE
 - COMPETITIVE FIRMS ARE HIGHLY EFFICIENT
 - ... AND PASS THOSE RESULTS ON TO THEIR CUSTOMERS ($P = MC$)
- LESSENING “AGENCY” COSTS
 - REMINDER OF CONTESTABILITY

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TRANSACTIONS COST ECONOMICS (TCE): Some Basics

- STUDY OF “VERTICAL” FIRM BOUNDARIES
- KEY PARTS OF WORLD VIEW
 - MARKETPLACE IS NOT A FRICTIONLESS, COSTLESS MEDIUM
 - ENTERPRISES ARE A NETWORK OF CONTRACTUAL RELATIONSHIPS (TRANSACTIONS)
 - THE NATURE OF THE RELEVANT TRANSACTIONS DETERMINES THE VERTICAL BOUNDARIES ... OR INDICATES WHETHER TO MAKE OR BUY
- A WELL-DEVELOPED FIELD OF STUDY ... AND A STANDARD SUBJECT FOR TEXTBOOKS

TCE AND THE PERILS OF OURSOURCING

- TRANSACTIONS COSTS ARISE FROM VARIOUS SOURCES
 - COORDINATING ACTIVITIES
 - SAFEGUARDING SENSITIVE INFORMATION
 - MOTIVATING EFFORTS FOR MUTUAL INTEREST
 - *ASSET SPECIFICITY*: site, physical capital, human capital, ...
- RISKS TO BOTH PARTIES OF THE RELATIONSHIP

THE FUNDAMENTAL TRANSFORMATION

- SOME OUTSOURCING RELATIONSHIPS TAKE US OUTSIDE THE COMPETITIVE MARKETPLACE
- IN PARTICULAR, RELATION-SPECIFIC INVESTMENTS REMOVE ALTERNATIVE TRADING PARTNERS
- *EX ANTE* COMPETITIVE BIDDING ENDS UP AS *EX POST* BILATERAL MONOPOLY

Vulnerabilities with the Transformation: Opportunistic Behavior

- OPPORTUNISTIC BEHAVIOR: “Self-interest seeking with guile ...” (Williamson)
- Also defined as unproductive bargaining or “rent-seeking” activities
- Bilateral bargaining can dissipate or even eliminate any gains from a transaction.

... AND “HOLD UP” (Two Perspectives)

- “A firm holds up its partner by attempting to renegotiate ... A firm can profit ... when contracts are incomplete and when ...” the target (victim) has no place else to go. Frequently made possible by relationship-specific investments conferring significant “quasi-rents.” (Besanko)
- Any party with specific assets may be “held up” or forced to accept worse terms through renegotiation with a partner who threatens to terminate the relationship. (Melese)

ADDRESSING THE HOLDUP PROBLEM

- WELL-CRAFTED CONTRACTS
 - INCENTIVES
 - ENFORCEMENT
 - “GOVERNANCE”
- “TAPERED” INTEGRATION
 - STANDBY CAPACITY
 - “GOCO” PHYSICAL ASSETS
- COSTLY ACTIONS WHICH DISSIPATE GAINS, BUT STILL LEAVE SOME (ALBEIT LESSENED) RISKS

Assessing Outsourcing Candidates' Transactions Costs

CERTAIN KEY CHARACTERISTICS PREDICT TRANSACTIONS COSTS:

- ASSET SPECIFICITY
- COMPLEXITY
- FREQUENCY
- UNCERTAINTY
- LENGTH OF RELATIONSHIP
- TIME SENSITIVITY
- IMPORTANCE
- ...

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ASSESSING COMPETITIVE SOURCING CANDIDATES

“STOPLIGHT METHOD”

- ASSET SPECIFICITY
 - RED: ONE QUALIFIED SUPPLIER
 - GREEN: MANY QUALIFIED SUPPLIERS
- COMPLEXITY
 - RED: LARGE SCALE, SPECIALIZED SKILLS
 - GREEN: ROUTINE TASK OR STANDARD PRODUCT

ASSESSING OUTSOURCING CANDIDATES II

- LENGTH OF RELATIONSHIP
 - **RED**: LONG-TERM, HARD TO FORESEE PROBLEMS
 - **GREEN**: SERIES OF SEPARATE TRANSACTIONS
- FREQUENCY
 - **RED**: SPECIALIZED TASK WITH SIGNIFICANT LEARNING BY DOING
 - **GREEN**: ROUTINE, STANDARD TASK. WIDESPREAD LEARNING BY DOING

ASSESSING OUTSOURCING CANDIDATES III

- TIME SENSITIVITY
 - **RED:** TIMELY, SHORT-FUSED PERFORMANCE HIGHLY IMPORTANT
 - **GREEN:** NON-TIMELY PERFORMANCE CAUSES INCONVENIENCE
- OPERATIONAL SIGNIFICANCE
 - **RED:** UNSATISFACTORY PERFORMANCE DEGRADES READINESS OR SAFETY
 - **GREEN:** UNSATISFACTORY PERFORMANCE CAUSES INCONVENIENCE

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FOR MANAGERS: WHAT IF THE CHART ISN'T GREEN?

- RECONSIDER COMPETITIVE SOURCING
- RESTRUCTURE THE COMPETITION
 - Rebundle the goods and services
 - Consider “tapered integration”
- COMMIT *MANAGEMENT ATTENTION* TO
 - Defining the Performance-Work Statement (PWS)
 - Structuring the contract
 - Right form (incompletely explored territory, we think)
 - Appropriate incentives (ditto)
 - “Governance” of the relationship
- SOME CONTRACTS ARE TOO IMPORTANT TO BE LEFT ENTIRELY TO THE CONTRACTING STAFF

FOR POLICY MAKERS ...

- ONE SIZE CLEARLY DOESN'T FIT ALL
 - TRANSACTIONS COSTS ARE AN IMPORTANT PART OF THE MAKE-OR-BUY DECISION
 - ... AND VARY WITH THE NATURE OF THE “TRANSACTION,” OR RELATIONSHIP INVOLVED
 - THEREFORE, THE A-76 TEN-PERCENT RULE IS LIKE A STOPPED CLOCK.
- LET'S TRUST THE MANAGERS ON THE SCENE. (ALSO VERIFY.)