Outsourcing Type of Network Organizations: Key Determinants for Innovation and Insider Information

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***Abstract*—This paper focuses mainly on the inter-organizational type of network relations. Three models based on this aspect of network organizations are proposed, with the aspects of insider information concerns and the innovation behavior. It is suggested that, as a type of networking organization, outsourcing companies engage in innovation behavior from a different perspective, in that they are assumed to share the innovation with their contractors. On the other hand, as for all organizations, insider information builds up an important concern for outsourcing companies, as their business consists intense relations with third parties.**

***Index Terms*—network organizations, outsourcing, innovation, insider information**

I. Introduction

The literature on the network organizations is divided into two subcategories: one field concerns with the intra-network relations within single organizations, while the other is about inter-organizational relations. For the purpose of this paper, main approach will be the inter-organizational type of network relations. "Interfirm networks, which are sometimes referred to as (constellations of) strategic or collaborative alliances, have been analyzed from the perspective of very different economic, organization and network theories (cf. Davis and Powell 1992, Grandori and Soda 1995, Osbom and Hagedoom 1997, for recent reviews)" [1]. Three models based on this aspect of network organizations will be proposed, with the aspects of insider information concerns and the innovation behavior.

II. Explanations on Concepts

A. Definition of Network Organizations

In general, network theories define the frameworks for the network organizations. "Social network analysis concerns how actors (e.g., individuals, groups, organizations, etc.) are tied by some sort of social relationship (e.g., advice giving, resource sharing, alliance partnership, etc.; Borgatti, Mehra, Brass, & Labianca, 2009)" [2]. "In social network theory, network structure has been defined as "the arrangement of the differentiated elements that can be recognized as the patterned flows of information in a communication network" (Rogers and Kincaid 1981, p. 82)" [3].

As stated above, within the scope of this paper, inter-organizational relations are the major focus. "An inter-firm network is a mode of regulating interdependence between firms which is different from the aggregation of these units within a single firm and from coordination through market signals (prices, strategic moves, tacit collusion, etc.) and which is based on a *cooperative game with partner-specific communication."* [4]. Sydow provides three typical characterizations for inter-firm network, as: "(1) a special kind of (network) relationship, (2) a certain degree of reflexivity, and (3) a logic of exchange that operates differently from that of markets and hierarchies" [1]. Examples for inter-organizational network arrangements are suggested as "a wide array of joint ventures, strategic alliances, business groups, franchises, research consortia, relational contracts, and outsourcing agreements" [5].

B. Outsourcing

In general terms, outsourcing refers to the companies delegating some of their operations/services to other contractor companies, by establishing defined relations to the advantage of all parties involved. "Faced with increasingly dynamic, hypercompetitive, complex environments, more and more organizations are being advised to concentrate on their "core competencies" (Prahalad and Hamel 1990). To implement such a strategic orientation, organizations prefer an intelligent "downscoping" (Hoskisson and Hitt 1994) to a straight-forward downsizing or demassing of their activities. Thereby most of them do not simply become islands of smaller firms but interfirm networks" [1]. The definition is explained as: "there is a central firm, the main contractor, who negotiates the entire job with a client (e.g. a construction, a plant) and assigns parts of the job to specialized sub-contractors. This arrangement is very common in the construction industry (Eccles 1981; Dioguardi 1987), as well as in other mature industries such as the automobile industry (Sabel et al. 1987; Cainarca and Colombo 1990)" [4]. Grandori details this interorganizational relation with regard to the resulting interdependency. "Inter-firm reciprocal interdependences

Manuscript received October 13, 2013; revised January 19, 2014.

doi: 10.12720/joams.2.3.211-215

are constituted, for example, by those transactions in which the output of A is specific, ‘tailored for’, realized after the ‘indications’ of B for which it is an input. A can act only if, in turn, B either provides an input, or transfers elements of know-how, even if these are merely adequate materials and tools. Many sub-contracting relationships are good instances of this type of interdependence” [6]

The important point in outsourcing is that this relationship benefits all parties in the way determined at the beginning of the relation. Usually, these relations have complementary natures, as the parties contribute to the finalization processes of each other, which might not be have been easily realized otherwise, due to lack of competence or high costs incurred. “As organizations open themselves to stakeholders and communities, they tend to specialize and develop relationships with other organizations that complement and extend their core expertise. These relationships are the lynchpin in efficiently and effectively providing a complete solution for their customers. One can think of the organization today as a collection of components which are brought together because of their individual capabilities and assembled for a specific purpose” [7]. In this way, outsourcing organizations become more capable to specialize certain competences.

While contributing to each other’s advantage, the parties involved also increase mutual interdependencies, by complementing competencies, defined by Grandori [6] as “joint application of complementary resource to a common activity in an integrated way”. “A key idea is that business relationships between suppliers and customers imply that the two exchange partners coordinate a number of exchange and production activities in a way that increases their interdependence, thereby raising their joint productivity and creating relationship value. By relationship value creation, we mean the effect of the relationship on the joint economic performance of the partner firms (Barney, 1996).” [8]. These interdependencies add to the developing relations between parties, so that more and more unitary patterns are observed on these outsourcing relations. As Daboub stated, “We have seen increased use of outsourcing, the practice of letting other organizations perform important functions. Outsourcing is not limited simply to buyig parts, but can include basic functions such as manufacturing. The trend is to remove barriers among people, organizational units, and organizations. In the process, organizations have become leaner, flatter, and more focused on their contribution to the value chain. They are becoming like nodes in a network of complex relationships” [9].

On the other hand, outsourcing relations also create new areas for the parties involved to care and concern for. Their strategic decisions affect and are affected by each other leading to key dimensions to consider. “Outsourcing key functions of a business can readily create difficulties for the core company. Indeed, when interdependent functions are administered by managers in different companies in different locations, misunderstandings and breakdowns in communication and performance can easily occur (see Davis and Darling, 1995). Thus, key aspects of this dimension are to ensure that integration processes between the companies support mutually agreed outcomes, that there is clear communication and understanding between the firms, and that interactions between the companies are perceived as aboveboard, fair and ethica” [10]. Accordingly, in this paper, the innovation patterns of outsourcing companies and also the insider information concerns will be focused on.

C. Innovation

Designing new products, services or technologies are key to today’s businesses due to the rapid changing industries. With regard to the outsourcing organizations, innovation activities are shared with the contracting parties, as the production or service decisions are taken together. The complementarity aspect was mentioned before and this aspect helps the parties to involve in innovation practices together. “It must be noted that the complementarity (and hence diversity) of the resources controlled by different firms is considered a predictor of network formation, especially for purposes of innovation (Teece 1986, Richardson 1971, Camagni 1991)” [4].

Much of the literature defends the view that network organizations help the single organizations to engage in innovation activities. According to Bovasso, “the network organization may more efficiently and appropriately respond to contingencies created by changing markets, technology, and other facets of a chaotic business environment” [11]. “Baker (1992) claims ‘The network form is designed to handle tasks and environments that demand flexibility and adaptability’” [3]. Shuman refers to the dynamic nature of collaborative networks, claiming that these provide basis for innovation. “The collaborative network is a dynamic, fit-for-purpose structure that has the agility to iterate its components and how they relate to one another legally and operationally as the purpose and context of the network evolves. It is a way of organizing that is best positioned to leverage existing resources and create new value. It is a way of working that harnesses the strengths of all who contribute and thus benefits and connects them in new, innovative ways” [7].

However, specific to outsourcing type of network organization, innovation may not result in improvements, as the outsourcing organization may have a tendency to expect the innovative behavior from the contracting party. The single organizations may hesitate to apply innovative methods, due to the possible failure of the contracting parties to adapt to the changes and meet the new expectations. “Their aggregate cognitive endowment can become a net liability, with organizational innovation and performance suffering (Hambrick *et al*, 1996)” [12].

D. Insider Information Sharing

“Dyer and Singh (1998) and Gulati (1999) proposed that valuable resources, such as information, may be inherent in the networks within which firms are situated that, in turn, provide strategic advantage" [12]. Outsourcing organizations inevitably engage in information sharing activities, due to the communication reasons with the contracting parties. "According to Thompson (1967: 35), cooperative strategies rest on 'the exchange of commitments.' One of the parties takes the initiative to enter into a cooperation with the other by committing resources to the relation. To the extent that the other party responds, the exchange can evolve sequentially in a series of episodes, with more or less incremental commitments being made by the parties involved in developing the cooperation with each other" [8]. "Networks of inter-firm relationships provide channels for sharing valuable information and resources. A firm can use its net work channels to search for advice and gain access to key resources needed to deal with its competitive challenges" [13] These exchanges provide basis for sharing information, as the organizations need to communicate their needs and expectations to other parties. However, while doing these, they may need to disclose some insider information as well, willingly or unwillingly, in order to clarify better. These information sharing are actually to the benefit of both parties; "… the network perspective offers a useful way to more deeply understand coordination, an activity that is fundamentally about connections among interdependent actors who must transfer information and other resources to achieve outcomes" [14]. However, the nature of the insider information may add more disadvantages to the sharing organization that the advantages.

One the one hand, organizations may hesitate when being in need of sharing these types of information. On the other hand, however, due to the necessary trust and loyalty relations between the parties, it should not be a concern for the outsourcing organizations, as the other parties are not expected to misuse the acquired information within the idea of 'goodwill'. "A number of scholars have argued that network forms of organization can be characterized by a distinct ethic or value-orientation on the part of exchange partners. In his analysis of long-term buyer-supplier relations among Japanese firms, Ronald Dore (1983) points to what he calls the "spirit of goodwill" underlying these relationships. The central elements of this spirit of goodwill are a commitment to use "voice" rather than "exit" (cf. Hirschman 1970) to resolve disputes and a high level of trust between the parties. The buyer tries to work with the seller to address any deficiencies in the seller's performance rather than simply moving to another seller. Buyer and seller are both willing to make relationship-specific investments without contractual guarantees protecting those investments because each party expects that the other will not use the relationship-specific investments to its own advantage. Similarly, Powell (1990) argues that a norm of reciprocity is a guiding principle underlying net-work forms of organization. Each member of the network feels a sense of obligation to the other party or parties rather than a desire to take advantage of any trust that may have been established" [5].

III. The Suggested Models

The three models in Fig. 1, Fig. 2 and Fig. 3 emerged as a result of relevant literature review are suggested in this part. Networking organizations create interdependencies among themselves. This interdependency leads to more concerns for insider information, as they necessarily share some internal data. The first model is related to this aspect. Similarly, the second model suggests a different dimension to the insider information issue.

The Company

Mode of Production	Outsourcing	Integrated System
Innovative	More concern for insider information to the contractor	More concern for insider information to the competitors
Routine	Less concern for insider information for the contractor	Less concern for insider information to the competitors

Figure 1. Model 1: Outsourcing–insider information model

The first model presented in Fig. 1 suggests that companies having innovative modes of production tend to have more concerns for insider information, considering their relations with their contractor companies. While Buono [10] states the communication difficulties as the most significant problems outsourcing companies face, this paper places insider information concerns as superior. The reason derives from the fact that outsourcing companies need to share much information and knowledge about the company, including insider information. They mostly hesitate inbetween keeping these information by themselves and disclosing it to the contractor company in order for their business relations to continue better and produce desired outcomes. With regard to this aspect, Podolny [5] points to several scholarly works, arguing that trust and reciprocity are major issues between exchange partners in business. This might be the case for financial issues and manufacturing facilities (operational aspect), however, when the issues comes to the insider information, for which all companies are very sensitive, the idea of trust can turn into suspicion. This is especially true, according to the model, for innovative companies having research and development activities usually kept secret. They would not prefer to share their ideas of new products/servies with their contractor companies, unless necessary. And in situations where it deems to be necessary, they do not feel comfortable. Compared to innovative mode of production companies, the routine ones would feel such concerns less, as they have less research and development issues.

On the other hand, this concern for insider information is not unique to the outsourcing companies. The ones having integrated systems, which means allocating all facilities and functions by themselves, would feel the same problems with regard to their competitors. It is because those integrated companies would have a more ‘closed’ nature, deriving from their ‘closed’ production/service facilities. For this reason, they would fear more from situations where their competitors would have a chance to learn about their insider information, compared to the outsourcing companies. In this case, again the innovative nature would play a crucial role for the integrated companies this time, adding to their insider information concerns with regard to competitors.

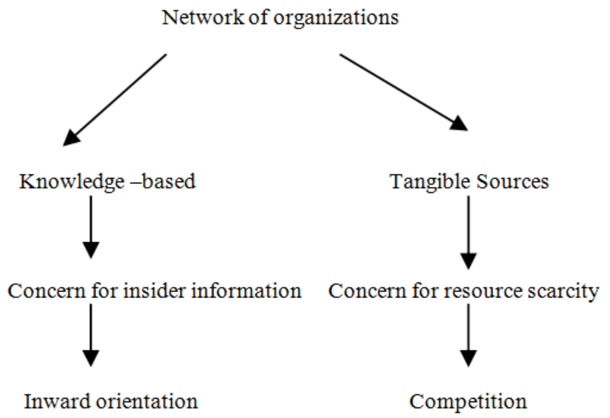

Figure 2. Model 2: Network of organizations

This second model showed in Fig. 2 proposes a differentiation between knowledge-based (or services) outsourcing relations and tangible resources (or production) outsourcing. It distinguishes between their concerns, related to the Fig. 1’s major subject of insider information. Accordingly, as the knowledge-based outsourcing relations apparently include more informational relations, the companies involved face more concerns of disclosure of insider information with regard to the contractors. However, when involved in production-intense relations including tangible resources aspect by the contractors, the contracting company would fear more from any possibility of resource scarcity with regard to the contractor company, as their production is dependent on that contractor’s output. These two situations result in different types of patterns for companies. The knowledge-based relations leading to concerrns for insider information result in inward orientation for the concerning companies. They tend to not share these information and thus their contractual relations may even deteriorate. On the other hand, the concerns for resource scarcity by the production-based outsourcing companies would lead to more competitive behavior over resources. They would concern more both for the contractor’s competitors and their own competitors, when any signal for resource scarcity is observed.

This final model in Fig. 3 is about the innovation patterns of outsourcing companies and their inward-outward orientations. It suggests that outsourcing companies having well developed relations with their contractors do not necessarily engage in innovative behavior, as much of the innovation is assumed to be easily and effectively communicated to the contractor. The development level of the network strength is measurable based on the shared trust between the parties. This results in outward orientation by the outsourcing companies, based on their trustful communications with the contractors. As stated by Grandori “the least-cost coordination mechanisms necessary for achieving a coordinated result in a pooled interdependence situation are supposed to be communications, rules and procedures that prescribe some types of actions and forbid others, and some common staff supporting these activities” [6].

The Company

		Outsourcing	Integrated System
Network Strength	High	Outward orientation	High innovation
	Low	Low innovation	Inward orientation

Figure 3. Model 3: Outsourcing – Innovation Model

On the other hand, less developed relations lead to certain levels of innovation, as the company feels more responsible about its ‘dependent’ production/services. However, for companies with integrated system, the situation is quite different. When having developed relations with their environment, they would have more chance to keep updated and this contributes to their innovation. Being more ‘closed’ systems, they would ‘observe’ the developments and apply to their own facilities by themselves. In contrast, when having weak relations with the environment, those ‘integrated’ companies cannot go further than being only inward-oriented.

IV. Conclusion

In this paper, it was mainly presented that as a type of networking organization, outsourcing companies engage in innovation behavior from a different perspective, in that they are assumed to share the innovation with their contractors. On the other hand, as for all organizations, insider information builds up an important concern for outsourcing companies, as their business consists intense relations with third parties. The models in this paper suggest that innovative outsourcing companies and also the ones engaging in knowledge-based contractual relations face more concern of insider information compared to others.

Acknowledgment

The author wishes to thank Department of Management, Bogazici University. This work was supported by a grant from the Faculty.

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