

Outsourcing: Theoretical foundations and incentive theory

Soukaina DRIOUICH, (PhD Student)

*Research Laboratory in Organizational Management Sciences
National School of Business and Management
Ibn Tofail University of Kenitra, Morocco*

Mustapha ACHIBANE, (PhD, Full Professor)

*National School of Business and Management
Ibn Tofail University of Kenitra, Morocco*

Mounir EL BAKKOUCHI, (PhD, Full Professor)

*Faculty of Economics and Management Kenitra
Ibn Tofail University of Kenitra, Morocco*

Correspondence address :	ENCG Kenitra, B.P 1420 +212 5373-29421
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Abstract:

In an environment where outsourcing is experiencing increasing expansion, this phenomenon draws the interest of numerous researchers. Consequently, a paradox exists in the literature on outsourcing due to differences in the theories applied by various studies. This phenomenon is rooted in numerous scientific theories, creating significant confusion in the literature. However, it is observed that during the evolution of outsourcing, the expectations of organizations and the factors driving outsourcing also change, consequently, the theoretical foundations change in parallel. This narrative review aims to present an in-depth review of the literature on outsourcing to better understand the phenomenon and comprehend it through the lens of certain pertinent, innovative, and complementary theories. Here, we will discuss the theory of incentives according to Jean-Jacques Laffont and Jean Tirole (1993), a theory newly applied in the field of outsourcing. This theory views outsourcing as a contract that best manages the interests of stakeholders by involving the most appropriate incentives such as cost, quality, and price.

Key words: Outsourcing, the theoretical foundations, the incentive theory, regulation.

JEL classification: H830

Paper type: Theoretical Research

Introduction:

Kakabadse and Kakabadse (2002) observed that American and European organizations consider outsourcing as a fundamental element of their organizational strategy. Indeed, certain elements suggest that well-defined outsourcing strategies can enhance the overall strategy of the organization (McIvor, 2005; Feeny et al., 2005). Outsourcing is regarded as a powerful means to reduce costs and enhance performance.

Consequently, the strategic practice of outsourcing is receiving increasing attention from the scientific community as its practical implementation continues to proliferate. However, outsourcing possesses a highly complex structure, comprising a variety of activities and functions that give rise to a series of administrative and management dilemmas. Several theories have been employed to assist scientists in interpreting, analyzing, and studying this phenomenon.

It is commonly acknowledged that any phenomenon can be described through a series of theoretical frameworks based on the most appropriate approaches. Naturally, outsourcing has been approached by applying a series of different theories, which can often lead to confusion among researchers (Busi & McIvor, 2008). In order to adequately address the vast diversity of research on outsourcing, we present the theoretical foundations of published articles on the subject. To bring order to this diversity, we try to identify the theoretical foundations, i.e., the reference theories applied to the subject of outsourcing, and demonstrate how the different streams of research are articulated, leading to a number of implications for further research.

Upon examining the literature on outsourcing, it became evident that there isn't a singular method or theory adopted by all researchers. Even a single study relies on several different theories depending on the set research objectives.

Well, it seems there is a consensus on the general lack of theory reported in the scientific literature on outsourcing (Hartman et al., 2008; McIvor, 2000). This article seeks to address this need by exploring and synthesizing the academic literature on outsourcing. It provides an in-depth presentation of the most important and diverse theoretical approaches provided by the international literature, aiming to interpret and explore the phenomenon of outsourcing, and to offer relevant suggestions to researchers who share an interest in making this field a full-fledged scientific discipline.

"This work aims to review the theoretical elements and empirical findings from various literatures in order to propose an original model for our issue, which is 'How to assess the performance of outsourcing in the public sector?' To achieve this, this article provides a comprehensive theoretical framework that offers an expanded view of outsourcing in the public sector by considering conflicts of interest among stakeholders and issues related to managing incentives at the contractual level.

More specifically, we break down this general issue into two research sub-questions: How to assess the performance of outsourcing in the public sector? How to enhance the performance of outsourcing in the public sector? How does outsourcing influence the performance of public organizations?"

Prior to developing this article, the work is structured into four points and framed by an introduction and a conclusion. Firstly, we lay out the theoretical foundations of outsourcing to grasp the phenomenon from various perspectives and existing theories in the literature. Next, we present empirical studies proposing models based on specific theories. Then, we synthesize the main theories grounded in the literature, and finally, we choose to shed light on the incentive theory by J. Tirole and J.J. Laffont (1993) by presenting incentive systems for cost reduction, quality incentives, both simultaneously, as well as pricing in an incentive system.

1. The theoretical foundations of outsourcing:

It is universally accepted that any phenomenon can be explained by different theories based on relevant methods (Busi, McIvor, 2008). In this regard, the phenomenon of outsourcing is rooted in numerous scientific theories, creating significant confusion in the literature. Some of these theories are complementary, while others are contradictory (Perunovic, Pedersen, 2007). The main objective of this article is to explore the theoretical foundations of evaluating the performance of outsourcing.

Due to the changes and development in outsourcing, the literature employs various scientific theories aimed at explaining the outsourcing phenomenon. However, during research, it is noted that as outsourcing evolves, the expectations of businesses and the factors driving outsourcing also change. Initially, outsourcing was considered a means of cost reduction (a tactical objective). Over the years, organizations (both manufacturing and service-oriented) increasingly expand their outsourced activities, and outsourcing becomes strategic and then transformative. Consequently, the theoretical bases change in parallel.

Marshall and al. (2007) state that a paradox exists in the outsourcing literature due to differences in the underlying theories applied by different studies. However, some researchers note that multiple theories have been developed in various fields over the years and choose to summarize those that are consistently referenced in outsourcing-related research. Summaries of the dominant theories on outsourcing are presented below:

Busi and McIvor (2008) established an international review named "Strategic Outsourcing, an International Journal" (SOIJ) as the first journal exclusively dedicated to publishing research on outsourcing. One of its key objectives is to foster and lead the international debate on outsourcing by presenting the largest collection of the latest interdisciplinary research published on outsourcing. In this regard, the authors published an article in its third issue proposing a research agenda for outsourcing studies, aiming to identify a limited number of key and urgent research areas requiring scientifically valid knowledge.

Busi and McIvor (2008) rely on their experience and personal knowledge to identify key landmark studies in the field, observe gaps in current knowledge, and provide suggestions for future research. They particularly focus on the section where they suggest the top 10 theories underpinning current outsourcing research.

Busi and McIvor (2008) state that one of the most frequently referenced theories in outsourcing is the Transaction Cost Theory (Coase, 1937; Williamson, 1975, 1985). They note that several theories have been developed in various disciplines over the years, which are frequently, if not constantly, referenced, summarized, and discussed in published outsourcing research. However, they chose to provide a "top 10" list of the ten most common theories (with references to related foundational works), which can be beneficial to both practitioners and researchers interested in delving into the theoretical pillars of current outsourcing knowledge: 1. Transaction Cost Theory (Coase, 1937; Williamson, 1975, 1985); 2. Resource-Based Theory (Penrose, 1959; Richardson, 1972); 3. Principal-Agent Theory (Ross, 1973; Jensen and Meckling, 1976); 4. Vertical Integration Theory (Bain, 1968; Grossman and Hart, 1986); 5. Strategic Management (Quinn and Hillmer, 1994); 6. Evolutionary Economics (Nelson and Winter, 1982; Mahnke, 2001); 7. Market/View Relationship (Berry, 1983; Sommer, 2003); 8. Industrial Economics (Porter, 1980); 9. Strategic Alignment Theory (Henderson and Venkatraman, 1990); 10. Core Competence Theory (Prahalad and Hamel, 1990).

Vaxevanoua A. and Konstantopoulos N. (2015) presented an in-depth review of the outsourcing literature, leading to the identification of ten different outsourcing theories and associated models. The authors focus on models published in the last 25 years as they contain solid knowledge from previous researchers and ensure the minimum required relevance. Indeed, in their presentation, they analyze the advantages and disadvantages of each model to draw useful conclusions for organizations considering implementing such theories. The theories selected by

the authors are: 1. Transaction Cost Economics Theory, 2. Core Competence Theory, 3. Relational Theory, 4. Resource-Based Theory, 5. Evolutionary Economics Theory, 6. Knowledge-Based View Theory, 7. Agency Theory, 8. Neoclassical Economic Theory, 9. Social Exchange Theory, 10. Information Economics Theory.

Bendi A. and Nemmiche K. (2015) propose a theoretical re-examination of the outsourcing issue, emphasizing the three main theories generally recognized in outsourcing literature that have been able to address the question of resorting to outsourcing: Transaction Cost Theory (TCT), Agency Theory (TA), and Resource-Based Theory (TR) (Teng et al., 1995; Ngwenyama et Bryson, 1999; Aubert et al., 2004). The first two theories (Transaction Cost Theory and Agency Theory) adopt an economic approach to outsourcing, while the last one (Resource-Based Theory) reflects its strategic dimension.

From an economic standpoint, transaction cost and agency theories suggest that outsourcing occurs when a company delegates activities to specialized service providers to reduce costs. If transaction costs and agency costs are relatively low, both theories favor outsourcing. From a strategic perspective, resource-based theory views outsourcing as a tool to fill a deficit of resources needed to carry out an activity, provided that the acquired resources are not strategic (Teng and al., 1995). This orientation reflects the outsourcing company's desire to focus its strategic resources on its core activities (Quinn and Hilmer, 1995).

In a study on information systems outsourcing conducted by Dibbern, Goles, Hirschheim, and Jayatilaka (2004), they identified the reference theories adopted in the outsourcing literature and observed considerable diversity. To simplify this diversity, they adapted the structuring approach of Lee and Kim (1999) (who in turn adopted the approach of Cheon, Grover, and Teng (1995)) by combining alternative reference theories into three categories: strategic, economic, and social/organizational.

Strategic theories focus on how companies develop and implement strategies to achieve specific performance objectives. Reference theories of this kind include game theory, resource-based theory, resource dependency theory, and theories of strategic management. Economic theories center on the coordination and governance of economic agents in their transactions with each other. Reference theories of this kind include agency theory and transaction cost theory. Social/organizational theories take a wholly different orientation. Avoiding strictly rational views of organizations, these theories concentrate on the relationships among individuals, groups, and organizations. Reference theories of this kind include social exchange theory, innovation theories, theories of power politics, and relationship theories.

Kroes and Ghosh (2010) classified four theories used to analyze outsourcing: transaction cost economics (TCE) theory, resource-based view (RBV) theory, knowledge-based view (KBV) theory, and agency theory. From a more pragmatic perspective, theoretical bases such as TCE, RBV, and KBV are considered insufficient to evaluate outsourcing performance and yield tangible results since the intentions of organizations change.

2. Empirical Studies Based on the Theoretical Foundations of Outsourcing:

In the literature, there is a multitude of empirical studies proposing models based on specific theories according to the context and objectives set. It is worth noting that few researchers have used a single theoretical basis to explain outsourcing and its outcomes (Ellram et al., 2008; Espino-Rodríguez & Padron-Robaina, 2006; Logan, 2000), while several others suggest that outsourcing decisions should be explained using multiple theories (Bahli & Rivard, 2003; Gerbl et al., 2015; Holcomb & Hitt, 2007; McIvor, 2009; Verwaal, Commandeur, & Verbeke, 2009). In this article, we first present studies that use a single theoretical basis in analysis, followed by those that combine multiple theories.

Ulset (1996), who explored the role of research and development in the outsourcing process based on the TCE theory, focused on the necessity for organizations to protect the intellectual

property of their patents. Their model analyzed preparation, supplier selection, and relationship management.

Brandes, Lilliecreutz, and Brege (1997) analyzed the factors determining the success of an outsourcing effort, basing their model on TCE theory. The researchers concluded that when the decision to outsource is based on TCE theory, the outcome is better, as is the case when the supplier manages to develop a strong manufacturing base.

Prahalad and Hamel (1990) propose that the core competence theory evolved from the resource-based view theory. They suggest that shared management of knowledge and the externalizing organization's competencies are key factors determining the success of the outsourcing contract. Yahnghong (2011) described an outsourcing model based on relational theory aimed at interpreting the phases of preparation, supplier selection, and relationship maintenance. The research concluded that the benefits of the outsourcing process are determined by the quality of the relationship at its establishment and by the care taken by the contracting parties in developing the relationship.

The knowledge-based view underlies the model proposed by (Lee, 2001), which attempts to explain the management of the relationship between the two contracting parties in the outsourcing process. The model, which also incorporates the core competence theory, concludes that knowledge sharing is one of the key success factors in an outsourcing process. Similarly, Sakas & Kutsikos (2013), Kutsikos & Mentzas (2012) support this conclusion by demonstrating that knowledge sharing during the relationship management phase of the outsourcing process is positively linked to the success of the outsourcing agreement.

Spence (1973) and Stigler (1961) presented a model based on information economics theory, seeking to determine the scope and reliability of available information and how this information affects decision-making in an organization.

Cox (2001) introduces the theory of critical assets in outsourcing. This approach helps identify supply chain resources that are or could be critical and important for businesses. A critical asset is a source or combination of sources within the supply chain that holds such significance in the value control process that its ownership grants the owner or controller the power to determine and distribute value throughout the supply chain.

A series of research conducted by the scholar McIvor over the years on outsourcing addresses the phenomenon from various perspectives:

McIvor (2005) conducted a study to verify if outsourcing allows for the development of collaborative buyer-supplier relationships to mitigate risks associated with outsourcing. This case study identifies factors that influenced outsourcing in the telecommunications sector, focusing specifically on activities with the supplier, including assembly, manufacturing, logistics, and design.

Similarly, McIvor (2005) proposed a conceptual model for evaluating outsourcing decisions. The overarching framework of the model relies on three main criteria: core competencies, capabilities (within the organization versus outside the organization), and expenditures (within the organization versus outside the organization). The practical framework of the model is presented in certain phases such as core activities, value chain activities, cost analysis, and assessment.

In another research effort, Marshall, McIvor and Lamming (2007) present the findings of an analysis of the experiences of three telecommunications companies that heavily engaged in outsourcing in the United Kingdom—'EquipCom,' 'PhoneCom,' and 'MobiTell'. Transaction cost economics (TCE) and resource-based view (RBV) were used to derive a theoretical framework to determine the primary influences on outsourcing and outsourcing outcomes in the three case companies. TCE and RBV played an extremely influential role in the outsourcing study. TCE primarily focuses on the role of effective governance—through transaction analysis—in determining the boundaries of the firm (Bahli & Rivard, 2005; Kern et al., 2002;

Barthelemy, 2001), while RBV concentrates on seeking competitive advantage—analyzing organizational capabilities (Barney, 1991).

The results revealed the importance of collaborative relationships in the context of outsourcing in the telecommunications industry. Specifically, the findings demonstrated that companies that developed collaborative relationships based on establishing mutually beneficial relationships with their suppliers achieved higher levels of outsourcing success. The results challenged certain transaction cost economics prescriptions regarding inter-organizational collaboration in outsourcing, indicating that successful outsourcing programs more closely followed the logic of RBV than that of TCE. Indeed, outsourcing should be used to cultivate and maintain relationships beyond internal and external boundaries to support the organization's competitive position instead of a short-term perspective primarily motivated by seeking short-term cost reductions. The results also questioned the value of the essential/non-essential logic as the basis for outsourcing, illustrating how two companies succeeded in outsourcing areas considered essential. Furthermore, the research identified the influence of political motivations on outsourcing as an important area for further investigation.

In a study by Taponen S. and Kauppi K. (2020), they compare service outsourcing decisions between public and private organizations, aiming to understand sector differences and provide a more suitable outsourcing framework specifically tailored to the public sector. The authors opt for a multiple case study approach, examining phenomena across various situations. This study, based on Finnish data, also applies to public sector organizations within the EU following the same operational guidelines. The findings indicate that public sector organizations lag behind their private sector counterparts in the decision-making and funding processes. Consequently, they propose changes to the outsourcing framework as suggested by McIvor (2000). The most significant evolution of McIvor's framework resulting from these findings is the revised order of McIvor's process stages: McIvor's Stage 2 has become Stage 4. The authors find this revision particularly relevant in the context of the public sector.

The newly developed framework, grounded in empirical evidence, includes the following phases: regular assessment of service functions as the starting point for service outsourcing decision-making, market analysis to precede cost analysis and comparative analysis, as the availability of more qualified suppliers than internal processes defines the make-or-buy decision, and evaluation of relevant service activities. Implementing this framework enhances the efficient delivery of outsourced public services and brings public sector outsourcing closer to the professionalism currently present in the private sector.

An example of an empirical study combining transaction cost economics and the resource-based view is Gottschalk and Solli-Sæther's research (2008). They investigated the validation of a maturity model for outsourcing relationships in the information technology field, linking maturity stages to associated reference variables. They chose transaction cost economics and the resource-based view as foundational theories to ensure outsourcing success, and they demonstrated that neoclassical economic theory can explain critical success factors in the outsourcing process during the reconsideration phase (2006, 2008). Their research employed a survey approach targeting 657 major Norwegian companies, all with a turnover exceeding 500 MNOK (approximately 80 million dollars) in 2005.

Drawing from organizational theories and outsourcing practices, Gottschalk and Solli-Sæther (2006) identified cost stage, resource stage, and partnership stage as maturity processes in outsourcing relationships. The cost stage involves high economic benefits, low transaction costs, effective contracts, principal-agent cooperation, and efficient division of labor concerning company boundaries. The resource stage focuses on supplier resource access, resources for innovation, strategic resources, and the development of core competencies within the client organization in terms of skills and capabilities. The third and final partnership stage

pertains to alliance work, economic exchanges, mutual relational standards, social exchanges, and balancing stakeholders' interests.

Additionally, three reference variables were validated in this empirical study. First, in terms of economic benefits, cost minimization and operational efficiency belonged to stage 1, while business productivity and technological innovation belonged to stage 2, and business advantages and mutual objectives belonged to stage 3. Second, supplier behavior control was statistically significant across stages: the cost stage associated with service level agreement and cost, the resource stage linked with project performance and service quality, and the partnership stage correlated with strategy implementation. Finally, leveraging supplier resources is characterized by excellent operations at the cost stage, technological initiatives at the resource stage, and complementary capacities, skills, competencies, and methods at the partnership stage.

A study by Alvarez-Suescun (2010) proposes a model that combines resource-based theory with TCE theory to interpret the implementation of outsourcing processes concerning IT operations. The model primarily focuses on the transition phase, suggesting that the resource-based theory is the most appropriate approach for its interpretation.

Aubert, Rivard, and Patry (1996) also proposed a model combining TCE theory with Incomplete Contracts theory to formulate a model explaining the Preparation and Relationship Management phases. Eight years later, the same researchers (Aubert et al., 2004) returned with a new model that once again combines both theories, this time exclusively interpreting the outsourcing preparation phase.

Focusing solely on the relational management of outsourcing, an example is provided by the study conducted by Kern and Willcocks (2000) on IT outsourcing. They particularly delve into post-contract management of outsourcing and the resulting development. This work integrates theoretical concepts from organizational theory, social exchange theory, and social contract theory to develop a conceptual model for understanding the properties of outsourcing relationships. It highlights not only the contractual, social, and economic characteristics of outsourcing relationships but also numerous additional elements deemed relevant in practice. After a preliminary exploratory study on relational practices within twelve organizations involved in outsourcing, the results obtained provide valuable insights that advance thinking on outsourcing relationships.

In this quest, they specified context, contract, structure, behavior, and interactions (Kern, 1997; Willcocks & Kern, 1998) as key dimensions covering the overall IT outsourcing relationship. Drawing on the lineage of Dwyer and al. (1987), the authors observe that: 1. exchanges or interactions represent the central event of the relationship, 2. outsourcing can thus be characterized as a contractual exchange relationship, 3. exchanges define an important framework for understanding the inter-organizational structure of relationships between individuals and organizations participating in the development and execution of the relationship, 4. the exchange allows for examining behavioral dimensions evolving among individuals as relationships extend over time.

3. Summary of the main theories related to outsourcing:

Since its inception, outsourcing has been explored through different theories, leading to confusion among researchers regarding this phenomenon. Several authors have compiled a significant number of theories aimed at explaining outsourcing. To detail these theories, we summarize the main theories in the table below based on a documentary study of research articles dedicated to this subject.

Table 1: Summary of the theoretical bases of outsourcing in the literature

Theoretical foundations	The fundamental idea	Basic hypothesis	Key variable	Authors
Transaction cost theory	This theory argues that using the market is costly and that economic efficiency can be achieved through a comparative analysis of production costs and transaction costs.	The theory is based on two fundamental behavioral assumptions: Limited rationality, where it is only possible to establish incomplete contracts (Simon, 1957) unless both parties are trustworthy. Opportunistic behavior, where parties seek their own self-interest cunningly at the expense of others.	Transaction costs, production costs, opportunism.	Coase (1937), Williamson, 1975, 1981, 1985).
Agency theory	This theory focused on the relationship between the management of an organization and all other stakeholders (agents). However, the conceptualization of the firm as a nexus of contracts between principals or stakeholders and agents.	The basic assumption of agency theory is the existence of asymmetric information and differing risk perceptions between the principal and the agent, as well as uncertainty. Continuous monitoring and strengthening the ties between the two organizations can resolve any problems that may arise.	Agent costs, optimal contractual relationships, information asymmetry, continuous monitoring	Jensen & Meckling (1976), Arrow, (1985), Barney & Hesterly, (1996)
Resource theory	There are essentially two types of resource theories: Resource-based theory focuses on the internal resources and capabilities of a company, whereas resource dependency theory focuses on resources from the external environment. Both emphasize the central role of a company's resources as the foundation of its strategy.	A company is a collection of resources, and a competitive advantage can only arise when the company's resources are heterogeneous and immobile. Both internal and external resources represent the foundation of its strategy.	Internal resources, external resources.	Barney (1991); Penrose (1959); Pfeffer & Salancik, (1978); Thompson, (1967)
The knowledge-based view	Managing the relationship between the two contracting parties in the outsourcing process.	Knowledge sharing is one of the key success factors in an outsourcing process.	Knowledge sharing, the relationship between contractors.	Lee (2001), Kutsikos & Mentzas, (2012), Sakas & Kutsikos (2014).
Game theory	Explaining the strategic behavior of players or actors (such as companies) in specific game situations.	All actors work under the same conditions, making rational and intelligent decisions to maximize their profits. The newer game theory, known as dynamic game theory, as opposed to traditional mathematical game theory, incorporates the assumption of incomplete information into its analytical models.	Players' strategic behavior, game situations, and incomplete information.	Kreps et al. (1982); Nash (1953) ; Spence (1976); Fudenberg & Tirole (1990)

Competency-based theory	Core competencies are seen as the collective knowledge within an organization, particularly in terms of how to combine different productive skills and methods for integrating various technologies.	Supplier capability analysis is the primary factor determining the success of an agreement.	Supplier capabilities, and productive skills.	Prahalad & Hamel (1990)
Social exchange theory	Dyadic exchange relationships are seen as voluntary transactions involving the transfer of resources between two or more individuals for mutual benefit. It's simply an ongoing reciprocal process where the actions of individuals or organizations depend on the enriching responses they receive from others.	Participation in exchange occurs with the assumption of providing rewards in return for the benefits received.	Rewards, mutual benefit.	Thibaut & Kelley (1959), Homans (1961), Blau (1964), Emerson (1972) & Cook (1977), Gottschalk & Solli-Sæther (2005)
Relational theory	Relational theory provides explanations on how companies can acquire and retain a competitive advantage in their relationships with other organizations.	Proper planning can transform the outsourcing process from a mere partnership into a strategic alliance.	Strategic relationships, strategic alliance, competitive advantage.	Willcocks & Choi (1995) ; McIvor (2005)
Evolutionary economic theory	Changes have an unpredictable outcomes; they are irreversible.	A set of six basic assumptions: The first assumption is that individuals and organizations can never be fully informed. The second assumption is that the decision-making process is subject to rules, norms, and institutions. The third assumption is that individuals and organizations can, to some extent, imitate behaviors and rules followed by their peers to create innovation. The fourth assumption concerns the fact that processes of imitation and innovation may be interrupted by occasional disruptions due to exceptional circumstances. The fifth assumption emphasizes that the success of interaction between individuals and organizations is conditioned by external factors and their methods. Finally, the processes of change occur within a framework determined by the aforementioned five assumptions.	Process of change, process of imitation, interaction between individuals and organizations.	Andersen (1994) ; Mahnke (2001)

Source : the authors

4. Incentive theory in the research framework of J. Tirole and J.J. Laffont:

Existing literature on outsourcing indicates that previous studies are based on different theories depending on the objectives set for outsourcing. Here, we choose to discuss incentive theory, a newly applied theory in the field of outsourcing. This theory views outsourcing as a contract that best manages the interests of stakeholders by involving the most appropriate incentives such as cost, quality, and price. Therefore, we present the incentive theory by Jean-Jacques Laffont and Jean Tirole (1993), which will be highly useful for incorporating incentives into an outsourcing contract to maximize the positive outcomes of the phenomenon.

We begin with an analysis of the conditions under which the dimensions 'cost reduction and quality' impact the effectiveness of incentive systems. In the case of outsourcing, what method can be followed to achieve conflicting objectives of offering quality and cost reduction? A strong inclination toward cost reduction leads to powerful incentive systems, while a strong inclination toward quality leads to weak incentive systems. We then delve into both cases and explore the balance between the aforementioned objectives. Next, an analysis is presented on pricing within an incentive system and the advantages of each type of pricing.

4.1. Incentive for cost reduction:

Consider the simple case of a public project with a value S for consumers, executed by a single company. Its cost function is:

$$C = \beta - e,$$

Where β is an efficiency parameter, and e is the effort exerted by the company to reduce the (monetary) cost of the project and bear a disutility of $\psi(e)$ (monetary). The disutility increases with effort ($\psi' > 0$ for $e > 0$), at an increasing rate ($\psi'' > 0$), and satisfies $\lim_{e \rightarrow \beta} \psi(e) = +\infty$.

Consider the cost C is observable by the regulatory authority¹ (and by convention). The cost is reimbursed by this authority in the form of a net transfer t to the company. Let U designate the level of utility for the company:

$$U = t - \psi(e).$$

The participation constraint (PC) of the company is:

$$t - \psi(e) \geq 0.$$

Let λ represent the fictitious cost of public funds. This fictitious cost, which can be interpreted as the Lagrange multiplier of the state's budget constraint, measures the social cost of the state's economic intervention. For λ close to 0, the government maximizes consumer net surplus; for large λ , the government places more weight on the social cost of transfers. The fictitious cost of public funds is positive because transfers to regulated firms either decrease the production of public goods or increase taxation, leading to distortions. Every euro transferred to the regulated firm costs society $(1 + \lambda)$ euros². This means that taxes introduce distortions that inflict a disutility of $(1 + \lambda)$ euros on taxpayers when they are levied 1 euro by the state. The net surplus of consumers/taxpayers is:

$$S - (1 + \lambda)(t + \beta - e)$$

Social welfare is the difference between consumer surplus and the sum of the total cost $C + \psi(e)$ as perceived by taxpayers and the product of rent and the fictitious cost of public

¹ Regulation is discussed when a company offers a good to consumers of the state.

² In developed countries, λ is primarily equal to the deadweight loss due to imperfect income taxation. It is estimated at around 0.3 (Snower and Warren, 1996). In developing countries, low income levels and challenges in implementing effective tax programs pose significant constraints on the state budget, resulting in higher values of λ . Particularly, the value is very high in countries close to financial failure. To illustrate, the World Bank (1998) suggests a fictitious cost of 0.9.

funds. The crucial aspect of the social welfare function is that the regulatory authority does not favor leaving rent with the company. For a utilitarian regulatory authority, the ex-post social welfare is:

$$S - (1 + \lambda)(t + \beta - e) + t - \psi(e) = S - (1 + \lambda)[\beta - e + \psi(e)] - \lambda U$$

In the case of complete information, when β is known and e is observed, the regulatory authority must maximize social welfare:

$$\begin{aligned} & \max_{(U, e)} \{ S - (1 + \lambda)[C + \psi(e)] - \lambda U \} \\ & \max_{(U, e)} \{ S - (1 + \lambda)[\beta - e + \psi(e)] - \lambda U \} \end{aligned}$$

Under the constraint $U \geq 0$, the solution to this program is:

The marginal disutility of effort $\psi'(e)$ equals the marginal cost savings as follows:

$$\psi'(e) = 1 \text{ and } e \equiv e^*$$

The existence of a fictitious cost implies that the company does not receive rent as follows:

$$U = 0 \text{ and } t = \psi(e^*)$$

Many contracts between the company and the regulatory authority involve an optimal level defined by these last two equations. The regulatory authority can provide transfer $t = \psi(e^*)$ for an effort e^* by setting a cost target $C = \beta - e^*$. In the event the company exerts less effort e^* than stipulated in the contract, it will incur a substantial penalty. Another option for the regulatory authority is to offer the company a fixed-price contract:

$$t(C) = a - (C - C^*)$$

Where $a \equiv \psi(e^*)$ and $C^* \equiv \beta - e^*$. The company ultimately benefits from its cost savings and selects e to maximize $a - (\beta - e - C^*) - \psi(e)$, equalizing e between e and e^* ($e = e^*$) and $U = 0$. Consequently, a fixed-price contract perfectly incentivizes the company to reduce its costs. The fixed part a can be defined in such a way as to fully capture the company's rent in the case of complete information. With this type of contract, the regulatory authority does not need to observe the effort; it can deduce it $e = \beta - C$ because β and C are known.

4.2. Quality incentives:

An unregulated company has two incentives for quality: to increase sales when consumers observe quality before purchase (a search good); and to safeguard reputation in case consumers only observe quality after purchase to ensure their future purchase and secure profits (an experience good).

We examine the quality incentives in a regulated environment. Therefore, it's necessary to distinguish between verifiable and observable qualities. Quality is generally observable before or after purchase by consumers. Quality is verifiable if its level is described ex-ante in a contract and established ex-post by a tribunal. If quality is verifiable, the regulatory authority can impose a quality target on the regulated company, and reward or penalize based on the level of quality. The regulatory authority must create quality incentives for the regulated company in the case of unverifiable quality. Several incentives are possible in this case: compensation based on sales, the possibility of non-renewal of the contract, seeking a new source of supply, etc.

From the above, we can discuss the link between quality and the strength of incentive systems. Considering that an incentive system has high strength if the company bears a high fraction of the costs it incurs (fixed-price contract); and an incentive system has low strength if the company bears a low fraction of the costs it incurs (cost-plus contract).

The link between quality and the strength of incentive systems has been the subject of numerous debates. The negative effect of the strength of incentive systems on quality arises because

companies focus their efforts on reducing the costs they bear and sacrifice quality in a high-powered incentive system.

In the case of an experience good, the incentives to offer quality and reduce costs are fundamentally conflicting, and the regulatory authority has only one means to balance the two incentives, which is the cost reimbursement rule. Indeed, high-powered incentive systems involve cost reduction for the company but increase its cost to provide quality, creating a trade-off between quality and the power of the incentive system.

For a search good, the regulatory authority has two instruments to address cost and quality issues: the cost reimbursement rule and sales incentives. The incentive to provide quality is achieved through compensation based on a quality index, which is the level of sales adjusted by the price charged by the company. The incentive to reduce costs is provided through cost reimbursement. We can say that the trade-off effect is latent but has no influence on the strength of the incentive system.

Consider a natural monopoly producing a single good in quantity q of observable and unverifiable quality. We put the verifiable cost function in the form, ruling out any cost reduction effort:

$$C = C(q)$$

On the demand side, we assume that the regulatory authority does not have a precise knowledge of the demand curve, which depends on the quality s . It would be capable of inferring from the price and production data the exact level of services provided by the company. We consider the following inverse demand function:

$$p = P(q, s, \theta),$$

Where θ is a demand parameter known only by the company, P is decreasing concerning q and θ , and increasing concerning s . The gross consumer surplus function is $S^g(q, s, \theta)$.

Quantity and quality are net complements if:

$$\frac{\partial^2(S^g - C)}{\partial s \partial q} = \frac{\partial(p - C_q)}{\partial s} > 0$$

While quantity and quality are net substitutes if:

$$\frac{\partial^2(S^g - C)}{\partial s \partial q} < 0 \quad \text{The quality is provided by the company, which has a non-monetary disutility of } \psi(s), \text{ with } \psi' > 0, \psi'' > 0, \psi''' \geq 0.$$

Under the accounting convention where the regulatory authority reimburses the cost C and receives the sales revenue, the level of utility for the company is:

$$U = t - \psi(s)$$

Social welfare W is concave with respect to (q, s) , and is represented as follows:

$$W = S^g(q, s, \theta) + \lambda P(q, s, \theta)q - (1 + \lambda)[\psi(s) + C(q)] - \lambda U.$$

From a methodological perspective, the model resembles the cost reduction formula by replacing θ with β , and s with e .

4.3. Incentives for quality and cost reduction:

The cost function depends on the quantity produced q , the level of quality s , the level of cost reduction effort e , and the private information parameter β . The model involves two dimensions of moral hazard (e and s) and adverse selection dimensions (β and θ). The cost function is presented in the form:

$$C = C(q, s, e, \beta),$$

Let's assume that the accounting cost is $C = (\beta - \tilde{e})q$, where $\tilde{e}$ is the cost reduction effort. Let's also assume that the company exerts a second type of effort s per unit to provide services to

consumers. The disutility of effort is $\psi(\tilde{e} + s)$, with $e \equiv \tilde{e} + s$, the disutility of effort becomes $\psi(e)$;

The accounting cost takes the form: $C = (\beta + s - e)q$.

The company's rent is: $U = t - \psi(e)$

The gross consumer surplus is: $S^g(q, s, \theta) = (A + ks - h\theta)q - \frac{B}{2}q^2 - \frac{(ks - h\theta)^2}{2}$

Where A, B, h, and k are positive constants and where $\theta \in [\underline{\theta}, \bar{\theta}]$ is a demand parameter. The inverse demand curve is:

$$p = \frac{\partial S^g}{\partial q} = A + ks - h\theta - Bq$$

Quantity and quality are net complements if $k > 1$ and net substitutes if $k < 1$. The net consumer surplus is:

$$S^n = (A + ks - h\theta)q - \frac{B}{2}q^2 - \frac{(ks - h\theta)^2}{2} - pq - (1 + \lambda)(C - pq - t)$$

Thus, $S^n = (A + ks - h\theta)q - \frac{B}{2}q^2 - \frac{(ks - h\theta)^2}{2} + \lambda(A + ks - h\theta - Bq)q - (1 + \lambda)(C + t)$

Under complete information, a utilitarian regulatory authority maximizes the sum of consumer and producer surplus subject to the constraint that the company is willing to participate in:

$$\max_{(q, s, e)} \left\{ W = (1 + \lambda)(A + ks - h\theta)q - B\left(\frac{1}{2} + \lambda\right)q^2 - \frac{(ks - h\theta)^2}{2} - (1 + \lambda)[(\beta + s - e)q + t] + t - \psi(e) \right\}$$

So that, $t - \psi(e) \geq 0$

When B is sufficiently large, the last two formulas are concave, and their maximum is achievable under four conditions according to the following formulas:

The first condition makes the marginal social utility of the good (composed of the marginal utility of the good for consumers S_q^g and the marginal financial gain $\frac{d(\lambda pq)}{dq}$) equal to its

marginal social cost $(1 + \lambda)C_q$. It is presented as follows:

$$(1 + \lambda)p - \lambda Bq = (1 + \lambda)(\beta + s - e),$$

The second condition makes the marginal social utility of service quality equal to its marginal social cost, presented as follows:

$$(1 + \lambda)kq - k(ks - h\theta) = (1 + \lambda)q,$$

The third condition makes the marginal disutility of effort $\psi'(e)$ equal to its marginal utility q , in the following form:

$$\psi'(e) = q,$$

The fourth condition indicates that no rent is left to the company in the following form:

$$t = \psi(e).$$

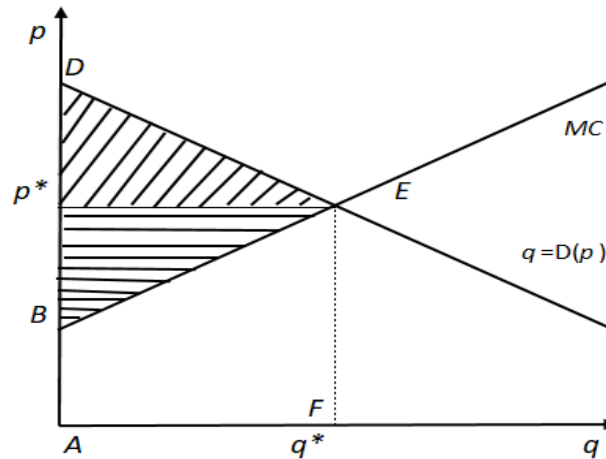
4.4. Pricing in an incentive system:

Laffont J.J. and Tirole J. (1993) discuss traditional theories of regulation and the stakes involved in the new theory of incentives. These authors approach pricing from various angles, such as marginal cost pricing, and peak-period pricing, they present a critical analysis of both marginal cost and average cost pricing, and they outline the Ramsey-Boiteux balanced-budget model (1927), suggesting that the regulatory authority should produce in a way that maximizes social welfare while involving prices covering the cost.

The first contribution concerns marginal cost pricing developed by Dupuit (1844). As shown in the following figure, the price p^* must be equal to the marginal cost q^* . In the figure, area

ADEF represents consumer gross surplus (for consumption q^*), area CDE represents consumer net surplus, area ACEF represents gross surplus minus expended income, and area BCE represents the profit of the firm between price and marginal cost.

Figure 1: Marginal cost pricing developed by Dupuit (1844)

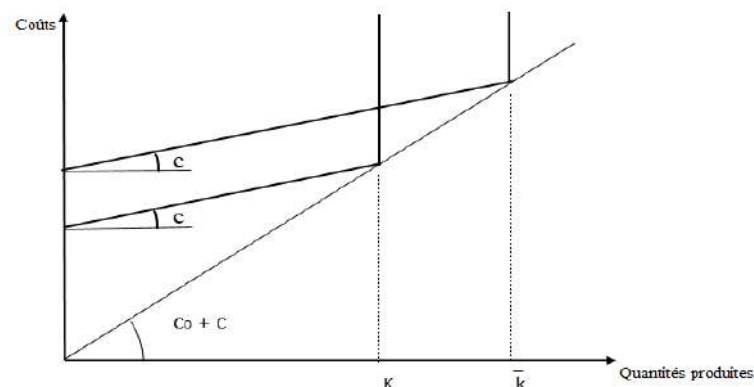


Source: Laffont J.J and Tirole J. (1993), "A theory of incentives in procurement and regulation"

For peak-period pricing, Boiteux (1949) drew implications from the Dupuit-Hotelling analysis regarding the 'common capacity problem.' The simplest model for peak pricing is as follows: the company selects a capacity K for n periods, where the investment cost is c_0K . At time $t \in \{1, \dots, n\}$, the company produces $q_t \leq K$ with a variable cost cq_t . The short-term marginal cost is then c when $q_t < K$ and $+\infty$ when $q_t \geq K$. The long-term marginal cost is $[c_0 + c]$.

The figure shows the well-known tangency of short-term cost curves with the long-term cost curve.

Figure 2: the short-term and long-term cost curve according to Laffont and Tirole (1993)



Source: Laffont J.J and Tirole J. (1993), "A theory of incentives in procurement and regulation"

The above figure illustrates a demand curve at each moment t , with time H representing the peak. Marginal cost pricing requires $p_t = c$ for $t \neq H$ and $p_H = c_0 + c$.

In the case of inelastic demand, pricing is irrelevant, but constant returns to scale and marginal cost pricing ensure budget equilibrium when capacity equals peak demand ($q_H = K$). The revenue is:

$$c(\sum_{t \neq H} q_t) + (c + c_0) q_H;$$

Where c is the variable cost at time t , q_H is the marginal cost at time H 'peak', and the sum of the investment cost and variable cost is:

$$c(\sum_t q_t) + c_0K$$

where c_0K is the investment cost.

Elastic, deterministic, and independent demands: It is considered that the demand curve depends solely on the price at a date τ , thus $q\tau = D\tau(p\tau)$. In the first scenario, when the demand during peak periods is so strong compared to other periods that the marginal cost pricing at DH $(c_0+c) > D\tau(c)$ for all $\tau \neq H$, assuming inelastic demands, doesn't shift the peak. In this case, the previous rule of marginal cost pricing applies.

The second scenario occurs when the investment cost is high, and the peak shifts. Then, marginal cost pricing is used to shift and reduce peak periods. The capacity K and prices $p\tau$ must be determined simultaneously by solving the following system of equations.

With : $T1 \equiv \{\tau | D\tau(c) \leq K\}$ et $T2 \equiv \{\tau | D\tau(c) > K\}$.

For marginal cost pricing: $p\tau = c$ for $\tau \in T1$ (1)

$D\tau(p\tau) = K$ for $\tau \in T2$ (2)

To balance the budget: $\sum_{\tau \in T2} (p\tau - c) = c_0$ (3)

Marginal cost pricing requires that prices be at least equal to the variable cost c . If $D\tau(c) \leq K$, any price $p\tau$ higher than c results in excess capacity in τ , which implies a marginal cost of c and consequently a price above the marginal cost. There are often multiple peak periods (periods in $T2$). During these periods, the price is a priori undetermined between c and c_0+c . It is chosen to equalize the supply K and the demand $D\tau(p\tau)$. Thus, condition (2) is fulfilled. Condition (3) amounts to budget equilibrium. It is achieved when:

$$\sum_{\tau} (p\tau - c) D\tau(p\tau) - c_0K = [\sum_{\tau \in T2} (p\tau - c) - c_0]K = 0$$

A more natural way to consider condition (3) is to adopt the perspective of optimal investment: an additional unit of capacity costs c_0 and allows satisfying an additional unit of consumption valued at $p\tau$ at time τ , during all periods where the capacity constraint is saturated.

Stochastic Demands: All companies face stochastic demand or stochastic supply. Therefore, prices must be periodically adjusted based on demand to reflect marginal costs contingent on states of nature. Prices are usually rigid and do not react to shocks affecting supply or demand. Demand fluctuations are met either by resorting to high marginal cost technologies or by consumer rationing (in cases where capacity is fixed).

5. Conclusion:

This article leads to an assessment of the theoretical foundations of outsourcing and sets the stage for further development of the topic. It aims to theoretically frame the research topic in a general manner to pave the way for empirical analysis, which involves the points already addressed in this article. Indeed, the various aforementioned theoretical bases of outsourcing provide a coherent understanding of the research topic, along with the presentation of several empirical studies proposing models based on different theoretical foundations to empirically demonstrate the determinants of outsourcing success. We position this research within the framework of incentive theory (Laffont and Tirole, 1993).

Incentive theory suggests that establishing a comprehensive and effective contract requires the presence of appropriate incentives for performance (typically either cost reduction, quality improvement, or both), and considerations of costs and quality can align the interests of the parties involved, which are the subject of contract economics. Striking a balance between costs and quality and introducing a relevant incentive system are key to the success of an outsourcing contract in the public sector.

From the above, it is concluded that incentives related to "cost, quality, and price" are considered foundational principles for the success of outsourcing in the public sector.

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