



Contents lists available at ScienceDirect

## Industrial Marketing Management



## Using performance-based contracts to foster innovation in outsourced service delivery

Regien Sumo<sup>a,\*</sup>, Wendy van der Valk<sup>b</sup>, Geert Duysters<sup>b</sup>, Arjan van Weele<sup>c</sup><sup>a</sup> School of Industrial Engineering & Innovation Sciences, Eindhoven University of Technology, P.O. Box 513, CNT0.16, 5600 MB Eindhoven, The Netherlands<sup>b</sup> Tilburg School of Economics and Management, Tilburg University, The Netherlands<sup>c</sup> School of Industrial Engineering & Innovation Sciences, Eindhoven University of Technology, The Netherlands

## ARTICLE INFO

## Article history:

Received 16 May 2016

Accepted 27 May 2016

Available online xxxx

## Keywords:

Performance-based contract

Innovation

Case study

Inter-organizational relationship

Outsourcing

## ABSTRACT

While many scholars claim that Performance-based Contracts (PBCs) foster supplier-led innovation, empirical research into their actual use and effects remains limited. We therefore explore two cases of IT outsourcing through such contracts to see whether, and if so how, PBCs foster innovation. Our findings suggest that in both cases, the low degree of term specificity in PBCs (i.e., their openness regarding how to render the contracted services) provides suppliers with autonomy in their daily service operations, which in theory allows them to innovate. However, only one of the suppliers exhibited high innovative performance. Other relevant factors aside, our findings further suggest that a lack of *granted* autonomy during contract execution is an important factor in explaining the level of supplier-led innovation. Our findings imply that outsourcers that remain too closely involved with the outsourced service delivery and do not allow their suppliers to act autonomously during contract execution limit their suppliers' innovation potential.

© 2016 Elsevier Inc. All rights reserved.

## 1. Introduction

Inter-organizational relationships (IORs), such as buyer–supplier relationships, have become important for organizations that wish to complement their internal innovation strategies with innovative solutions, ideas, and technologies from external partners (Chesbrough, 2003; Chesbrough, Vanhaverbeke, & West, 2006; Kuhne, Gellynck, & Weaver, 2013; Smets, Rijdsdijk, & Langerak, 2013; Soosay, Hyland, & Ferrer, 2008). Such IORs are usually governed by legal contracts (Williamson, 1985; Yu, Liao, & Lin, 2006), which are “legally bound, institutional frameworks in which each party's rights, duties, and responsibilities are codified and the goals, policies, and strategies underlying the anticipated IOR are specified” (Luo, 2002, p. 904). Whether and how these contracts affect innovation remain unclear: whereas some authors have acknowledged the positive effects of such contracts on innovation (Johnson & Medcof, 2007; Wang, Yeung, & Zhang, 2011), others have identified types that do not incentivize suppliers to innovate (Gopal & Koka, 2010).

Despite a lack of consensus and empirical evidence, researchers have generally suggested that performance-based contracts (PBCs), in particular, positively affect innovation (Kim, Cohen, & Netessine, 2007; Martin, 2002; Ng & Nudurupati, 2010). PBCs underline the *outcome* of the transaction, rather than prescribing how it is delivered or which

resources to use, and reward suppliers for the extent to which these outcomes are achieved (Kim et al., 2007). Outsourcers in both the public sector (e.g., infrastructure and healthcare) and private sector (e.g., logistics and maintenance) (Hypko, Tilebein, & Gleich, 2010; Martin, 2002) have increasingly adopted PBCs in search of continued and sustained service performance improvement: in these industries, supplier-led innovation in outsourced service processes are critical<sup>1</sup> for continued customer satisfaction.

Although the number of PBC studies is increasing (Guajardo, Cohen, Kim, & Netessine, 2012; Kleemann & Essig, 2013; Randall, Nowicki, & Hawkins, 2011), research into the *actual use* of PBCs and their effects remains limited (Hypko et al., 2010; Martin, 2002). Given the importance of supplier-led innovation in outsourced service delivery, appraising PBCs' potential to foster innovation, as well as understanding the conditions under which this potential can be fully exploited, is critical for buyers and suppliers. This resonates with calls for enhanced understanding of the nature and form of the new contract types being increasingly adopted by organizations (Mouzas & Blois, 2013; Roxenhall & Ghauri, 2004).

Our research objective is therefore to empirically investigate whether and how PBCs affect innovation. Our research question is twofold: 1) To what extent does supplier-led innovation take place when using

<sup>1</sup> We focus on innovation that occurs within the daily processes that make up the outsourced service activities. Suppliers will generally be confronted with multiple performance outcomes (e.g., delivery, quality), which may or may not require innovation to take place. We are thus not talking about innovation contracts (Beneito, 2006; Gilson, Sabel, & Scott, 2009), which have innovation as the sole contracted performance outcome.

\* Corresponding author.

E-mail addresses: R.A.F.Sumo@tue.nl (R. Sumo), w.vdrvalk@tilburguniversity.edu (W. van der Valk), gduysters@tilburguniversity.edu, duijsters@tilburguniversity.edu (G. Duysters), a.j.v.weele@tue.nl (A. van Weele).

PBCs in outsourced service delivery?; and 2) How can this effect be explained? We start by reviewing the (performance-based) contracting literature to identify two characteristics of PBCs. We then draw on transaction cost economics (TCE) and agency theory (AT) to argue how these characteristics affect innovation. Subsequently, we conduct an exploratory embedded case study involving two cases of IT outsourcing PBCs between a focal organization and two of its suppliers: one of these cases is characterized by high supplier-led innovation, while the other exhibits low innovation.

Our analysis is based on two-sided data collection through extensive interviews with representatives of the outsourcer and the suppliers, along with analyses of the actual content of the contracts and other relevant formal documents, comprising over 1500 pages of detail. Access to the actual content of the contracts, in addition to other data sources, is relatively unique in inter-organizational research (Faems, Janssens, Madhok, & Van Looy, 2008), since organizations are not usually willing to share such information. As a result, studies of IORs usually rely on interview information, which can be subjective. The opportunity here to look at actual contracts allowed us to verify interviewee statements and thereby obtain a more objective representation of reality. This greatly enhanced the quality of the analyses of an otherwise limited number of cases.

Our study contributes to the existing literature in several ways. First, it adds to the currently limited number of studies on the use and effects of PBCs (Hypko et al., 2010; Martin, 2002) and the performance implications of contracts (i.e., innovation) (Schepker, Oh, Martynov, & Poppo, 2014), which enables us to advance both the formal IOR governance and innovation literature. Moreover, our study is not limited to establishing the effects of contracts on innovation: our case-based research approach allows us to empirically study the mechanisms underlying those effects.

The remainder of this paper is organized as follows. First, we review the literature on contracting to understand how the characteristics of PBCs could affect innovation. After describing our research methodology, we present extensive within- and cross-case analyses. We conclude with a discussion of the study's scientific contributions and managerial implications, as well as its limitations, and suggest promising avenues for future research.

## 2. Theoretical background

### 2.1. Introduction to performance-based contracts

PBCs are increasingly being used for the effective, cost-efficient sourcing/outsourcing of business services and integrated product-service offerings (Datta & Rajkumar, 2011; Glas, Hofmann, & Essig, 2013; Randall et al., 2011; Stremersch, Wuyts, & Frambach, 2001). From a supplier's perspective, Kleemann and Essig (2013, p. 186) argue, PBCs are positioned as "a specific industrial marketing concept in the field of product-service systems (or 'solutions')." A well-known example is Rolls Royce's "Power by the Hour" business model, in which suppliers are compensated for the availability of the aircraft engines they maintain, rather than for the labor and spare-part costs associated with the maintenance activities (Cohen & Levinthal, 1989; Neely, 2008). Such performance-based pricing schemes are also emerging in other service sectors, such as government procurement (Behn & Kant, 1999), including as part of complex, performance-involving, public-private partnerships (Caldwell, Roehrich, & Davies, 2009; Lewis & Roehrich, 2009), and logistics (Essig & Glas, 2014; Glas et al., 2013; Randall et al., 2011), as well as in manufacturing industries (Hooper, 2008; Hypko et al., 2010; Kim, Cohen, Netessine, & Veeraraghavan, 2010), and require a complete rethink of the supplier's business model and capabilities for cooperating with the buyer (i.e., value co-creation) (Ng, Ding, & Yip, 2013).

Since PBC research generally covers a variety of sectors, individual studies tend to produce highly contextual findings (Hypko et al., 2010;

Kleemann & Essig, 2013; Martin, 2002). Selviaridis and Wynstra's (2015) literature review showed that the majority of PBC literature is empirically descriptive in nature, focusing on describing the practices and challenges related to PBC design and implementation, and one third of it is conceptual in nature. Apart from Kim et al.'s (2007) paper, which identifies the optimal combination of contractual levers (including PBCs) for achieving the best possible outcome for a buyer, studies oriented at demonstrating the empirical effects of PBCs are limited in number, especially in relation to innovation.

The wide variety of contexts in which PBCs are studied results in PBC research employing an equally wide variety of definitions and approaches, which are not interconnected and too often lack a sound theoretical basis (Selviaridis & Wynstra, 2015). According to Martin (2002), sector-specific definitions of PBCs do share two common elements: 1) the level of term specificity; and 2) the degree to which rewards are linked to performance. To be more precise, we argue that – compared to other contract types – PBCs are typically characterized by relatively low term specificity and a high degree of partner rewards being linked to performance (Hypko et al., 2010; Lamonthe, 2004; Martin, 2002; Ng & Nudurupati, 2010). This characterization closely resembles more general characterizations of contracts (e.g., level of contract specification and incentive schemes; De Vries, Schepers, Van Weele, & Van der Valk, 2014).

### 2.2. Theoretical background on the effects of performance-based contracts on innovation

Hereafter, we seek to explain the extent to which innovation occurs by looking specifically at these two characteristics. In line with existing research (Johnson & Medcof, 2007; Wang et al., 2011), we define innovation in the context of a buyer–supplier relationship as supplier-led, proactive undertakings – with or without the outsourcer's collaboration, but in any case on their behalf – that in the *outsourcer's perception* result in new or improved ways of delivering transactions. The key point of this definition of innovation is that outsourcers tap into the suppliers' innovative knowledge and ideas (Shimizu, 2012). In the context of outsourced service activities, suppliers may innovate as part of the daily operational activities they perform for the outsourcer, with the objective of achieving performance more efficiently and/or effectively. This pertains primarily to process innovations, that is, incremental changes that result in higher quality or faster service delivery. For example, less commonly, the supplier may make more radical changes, for instance to the underlying service concept, by introducing new services or tangible aspects of a service.

In terms of the first characteristic of PBCs, term specificity, what is being specified is a desired level of performance, results, or outcomes, rather than the processes and inputs needed to achieve those outcomes. This feature of low term specificity is one of the two main characteristics of incomplete contracts<sup>2</sup>: *not* specifying all the partner's observable obligations and actions (Bernheim & Whinston, 1998; Luo, 2002). Term specificity is thus defined as the extent to which processes and behaviors are specified in the contract, which relates to the degree of freedom that the supplier has in designing, managing, and executing the outsourced service processes; in other words, a high level of term specificity implies little freedom, whereas a low level implies a lot of freedom.

Term specificity does not refer to the extent to which outcomes are specified: PBCs may contain detailed descriptions of relevant performance indicators and how they are measured. That is to say that even

<sup>2</sup> Incomplete contracts are contracts that do not take into account all the relevant contractual terms (Saussier, 2000). The second characteristic of incomplete contracts is contingency adaptability, that is, the extent to which the contract allows for adaptation to unforeseen circumstances (Bernheim & Whinston, 1998). This flexibility, along with the freedom that follows from low term specificity, determines the level of contractual completeness. The higher the flexibility and freedom in the contract, the more incomplete a contract is. In the current study, we only focus on term specificity.

Download English Version:

<https://daneshyari.com/en/article/5111161>

Download Persian Version:

<https://daneshyari.com/article/5111161>

[Daneshyari.com](https://daneshyari.com)