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**HIERARCHIES, RELATIONAL CONTRACTS
AND NEW FORMS OF OUTSOURCING**

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HIERARCHIES, RELATIONAL CONTRACTS AND NEW FORMS OF OUTSOURCING

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Abstract

We observe that economic restructuring is significantly changing organizational governance. On the one hand, we witness an increase in mergers & acquisitions, which substitutes markets for hierarchies and, on the other hand, we see an increase in outsourcing and subcontracting activities, appearing to replace hierarchies by markets. However, there is evidence that an increasing part of outsourcing activities mix hierarchies with market forms of governance. The key argument of this paper is that firms have established governance structures based on markets, hierarchies *and* self-enforcing relational contracts so that they are able to keep a substantial amount of control despite of sourcing out labour. Furthermore, we argue that such hierarchical forms of outsourcing produce dependency. Using empirical evidence of the Austrian insurance industry, it is demonstrated that dependency is created, firstly, by the contractual restriction of alternative uses of resources, secondly, by support measures that bind the upstream party closely to the downstream party, thirdly, by relationship-specific investments made by the upstream party, and fourthly, by authority elements.

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Introduction

Recent economic and political developments such as the opening of markets through increasing economic and political integration, the accession of Central and East European countries to the European Union and WTO-agreements have strongly affected both public policy and the governing modes of economic exchange in Europe. On the one hand, we observe an increase in mergers and acquisitions, which substitutes markets for hierarchies, leading to further economic concentration. On the other hand, we see an increase in outsourcing and subcontracting activities, which appear to be replacing hierarchy by market forms of governance. However, there is empirical evidence that an increasing share of outsourcing activities are based on mixed governance structures, integrating hierarchical and market structures (OECD 2000; Burchell et al. 1999; Dietrich 1996; Semlinger 1993). This paper analyses such outsourcing activities, gives evidence of *how* firms mix governance structures and investigates the consequences for both the upstream (i.e. the outsourced work force) and the downstream (i.e. the firm that sources out) parties.

The motivation for this research lies in the observation that although the emergence of “hierarchical” forms of outsourcing (or self-employment) are widely discussed in national (e.g. Burchell et al. (1999) and Collins (1990) for the UK; Dietrich (1996) for Germany; Lyon-Caen (1990) for France), European (Sciarra 2004; Perulli 2003; Eiro 2002; Supiot 2001) and in international (ILO 2003; OECD 2000) political and legal forums, there is a surprising lack of both sociological and economic research to understand the emergence and the consequences of this development.

Hierarchical forms of outsourcing refer to business relationships where the upstream party is formally self-employed (or declares itself as self-employed) but the conditions of work are similar to those of employees. Although the upstream party works exclusively (or mainly) for a specific firm (downstream party), it is neither clearly separated from the firm they contract with nor clearly integrated.

This development has the effect that both organizational boundaries and the boundaries between employment and self-employment becomes blurred, resulting in a need to rethink labour and social security law (as most prominently argued in the Supiot report). Self-employed persons usually work for a large number of contractors

without placing themselves in hierarchical subordination to them. They bear the entrepreneurial risk but also gain the entrepreneurial possibilities implied by self-employment. However, if the self-employed person works only (or mainly) for one contractor in (partial) subordination, part of the entrepreneurial risk is transferred to the upstream party, while its entrepreneurial possibilities are restricted.

Thus, we argue that these business relationships create both economic and personal dependence. Economic dependence basically means that the upstream party takes (part of) the entrepreneurial risk. Since the upstream party has only one (main) contractor it generates its whole (or a substantial part of its) income from this very business relationship. Thus, they do not appear on the external market and are thus restricted in their alternatives. If we assume that the two parties do not usually agree on a constant quantity of orders but quite the contrary, namely that the quantity of business transactions depends on the economic situation of the downstream party, then the upstream party obviously takes the entrepreneurial risk. In the case of the service industry with third-party customers, the upstream party is dependent on the downstream party due to the fact that the upstream party only sells products or services from the downstream party and is dependent on the competitiveness of the downstream party. Additionally, in contrast to employees who are (mainly) remunerated with a fixed wage, the upstream party in hierarchical forms of outsourcing earns a variable income depending on production, which means that it bears demand fluctuations. Personal dependence – or subordination – means that the downstream party strongly determines over working methods as well as time, place and content of work.

However, (partly) transferring entrepreneurial risk is not the only motive for externalising parts of the production or sales process on a hierarchical basis. These contractual arrangements also transform fixed costs into variable ones and allow the downstream party to gain financial flexibility. Another pivotal rationale – especially in highly regulated labour markets – is to circumvent labour and social security laws. The downstream party faces less legal constraints of employment protection in terms of working time or security since most employment protection laws are not applicable in such business relationships. Moreover, it does not have to pay social security contributions and does not bear the financial risk when the worker (the upstream party) gets ill. The upstream party is, moreover, usually beyond the scope of collective

bargaining and trade union representation. Since these business relationships are based on commercial contracts rather than employment contracts, there are less regulations restricting the contractual arrangement, allowing contracts customised to the special needs of the downstream party (Muehlberger 2004). As a result, legal scientists argue that outsourcing activities with hierarchical structures undercut laws that are designed to protect workers (Sciarra 2004; Freedland 2003; Perulli 2003; Supiot 2001; Davies and Freedland 2000).

Hierarchical forms of outsourcing have also an effect on internal labour. It decreases the bargaining power of employed labour and circumvents institutionalised hierarchical structures (Rubery and Grimshaw 2003). Another rationale is to extend the control function of management across organizational boundaries. By mixing governance structures, firms are able to benefit from the advantages of outsourcing without losing control over labour and assets. Simultaneously, the downstream party increases the incentives for payment and asset maintenance. In other words, by creating close (hierarchical) ties, the downstream party improves the trade-off between incentives (typically linked to market transactions) and control (typically linked to hierarchy).

Examples of outsourcing relationships where the upstream party only works for one particular firm in the organizational studies literature usually refer to the trucking, construction and media industries. Analysing the US trucking industry, Baker and Hubbard (2004) find that changes in contractibility affect firm boundaries, arguing that increased contractibility (for instance, due to better monitoring technology) leads to less outsourcing. Arruñada et al. (2004) and Fernández et al. (2000) claim that hierarchical forms of outsourcing (or quasi-integration) is generally more efficient than vertical integration in the European trucking industry as it solves moral hazard problems, simultaneously allowing for economies of scale and density and (partly) solving hold-up problems. Looking at the Austrian trucking industry, Muehlberger and Zagler (2003) identify the reduction of fixed overheads and changes in the cost structure, volatile demand and the partial transferral of economic risk as the main drivers for hierarchical outsourcing.

Empirical research in the construction industry demonstrates that higher risks of hold-up reduce the probability of subcontracting because vertical integration is better

for solving the quasi-rents expropriation problem (González-Díaz et al. 2000; Eccles 1981). Bosch and Philips (2003) compare the consequences of deregulation in the construction industry in nine countries and find that outsourcing is a common response to the high financial risk faced in the industry. They argue that subcontracting to individual workers “is usually designed to evade regulations protecting wage workers rather than designed to extend specialization” (Bosch and Philips 2003: 10). Nisbet (1997) finds for the UK construction industry that labour market segmentation (in the sense of a primary and secondary labour force) is undermined by the existence of discrete advantages generally perceived to exist in both employment and outsourcing relationships.

Empirical studies in the British media industry have highlighted that deregulation in public sector services has dramatically changed work organization in this sector, strongly stimulating freelance contracts on a self-employed basis (Baumann 2002; Dex et al. 2000). The result was that the distribution of risk changed dramatically, leading to a shift of risk to the outsourced workforce.

Felstead (1993) analysed franchise contracts in the UK and in Germany, stressing that only few franchisees are found to have significant levels of autonomy. He finds that franchisees are often dependent workers, being highly vulnerable to changes of rules and policy as well as priority and goals of the franchisors.

Although these empirical papers shed some light on the reasons and consequences of outsourcing, they – with the exemption of Felstead’s analysis of franchising – lack the analysis of the hierarchical element in these business relationships. However, franchising is a special case in the analysis of hierarchical forms of outsourcing because the relationship between the franchisor and the franchisee is mostly based on explicit, written contracts that are often standardized as shown in Felstead (1993). Hierarchical forms of outsourcing, however, are mainly based on informal, relational contracts. Consequently, this paper aims at adding such a focus to the analysis of outsourcing, illuminating the mechanism of organizational governance of outsourcing activities that integrate hierarchical and market structures.

The rest of the paper proceeds as follows. The next section looks at conventional theories of organizational governance, arguing that the theoretical distinction between hierarchies, markets and networks (or relational markets) does not allow to explain

hierarchical forms of outsourcing. Instead it is hypothesised that such business relationships introduce elements of hierarchies into the market by using relational contracts that are additionally empowered by dependency (or the lack of alternative uses of resources) and hierarchical control elements. On the basis of case study research in the Austrian insurance industry, Section 3 tests the hypotheses posed in the previous section, illustrating how firms mix governance structures as well as the creation of economic and personal dependency and calculative trust. Finally, Section 4 concludes.

Mixing Governance Structures:

Hierarchies and Relational Contracts in Outsourcing

Research on organizational governance has been characterised by a sharp delineation of markets, hierarchies and networks. These different modes of governance have long been seen as alternative mechanisms for allocating resources. The Coase-Williamson transaction cost approach put forward the argument that high costs of market transactions (e.g. contracting costs, regulation constraints, marketing costs) can make it more efficient to coordinate production within firms (hierarchy) than through markets. In his early research, Williamson (1975) argues that hierarchies usually function better than markets in completing a related set of transactions because (1) bounded rationality problems can be better solved in hierarchies than within markets, (2) hierarchies are less vulnerable to the hazards of opportunism due to additional incentive and control structures, (3) hierarchies are better in solving information problems since the cost of collecting and transferring information is minimised through intra-firm information channels and (4) trust is more easily developed within firms than between firms. Williamson sees modes of organization as lying on a continuum between markets and hierarchies, suggesting that firms might do better than markets because they can rely on relational contracts. Although Williamson's analysis reflected the actual organizational trend of vertical integration during the 1960s and early 1970s, he nevertheless deployed a very narrow definition of the market, not analysing the functioning of the market itself.

In a later publication, Williamson (1985) looks more closely at market transactions, arguing that three dimensions are critical for the decision whether

transactions are carried out in-house or by another firm: asset specificity, uncertainty, and frequency. The higher the degree of these three dimensions, the higher the probability of establishing a non-market governance system (i.e. vertical integration in contrast to external business relations). Transactions with a high level of uncertainty (i.e. likelihood of opportunism) and a high degree of asset specificity (i.e. ex-ante investments) require complex contracts and have, moreover, a greater need for ex-post adjustments. Finally, high frequency of transactions reduces the fixed costs of a non-market governance system.

Although transaction cost economics explores the inefficiencies of markets in conducting transactions, it does not look closely at the inefficiencies of the firm in its internal organization and performance. The crucial point of the transaction cost argumentation is the assumption that a firm can reduce the likelihood of opportunism through firm-internal administrative fiat. Instead, we argue, firstly, that firms find other ways to deal with the problem of opportunism than vertical integration and, secondly, that administrative fiat is not necessarily restricted to employees.

The tendency to vertical disintegration in the late 1970s and 1980s and the combination of vertical integration and disintegration (through outsourcing activities) since the early 1990s has been followed by research on the functioning of the market, elaborating on business networks and relational contracts between firms. The aim of these newer approaches is to capture the organizational logic of business structures that rely on stable, long-term relationships between firms. Networks (e.g. Podolny and Page 1998; Uzzi 1996; Powell 1990), alliances (e.g. Gulati 1995), joint ventures (e.g. Kogut 1989), business groups (e.g. Granovetter 1995) or outsourcing (e.g. Helper et al. 2000; Dore 1983) are some examples where the market-versus-hierarchy approach fails, and new analytical tools like relational contract theory have been developed. In brief, research on long-term relationships between firms documents that informal mechanisms (e.g. reciprocity) strengthen formal contracts, leading to a variety of advantages like spreading risks, facilitating the management of resource dependencies, fostering learning, enhancing flexibility, gaining access to specific know-how, realising economies of scale and entering new markets.

This stream of research shows that long-term business relationships based on relational contracts help firms to circumvent difficulties in formal contracting (Baker et

al. 2002; Helper et al. 2000; Powell 1990). In this literature, relational contracts refer to informal agreements, unwritten codes, and understandings that forcefully affect the behaviour of firms when cooperating with other firms. In contrast to formal contracts, they leave room for adapting to new information which arises during the business relation. The non-specificity of relational contracts, however, means that they are non enforceable by a third party (such as a court). Consequently, they must be self-enforcing, implying that “the short-run value of renegeing must be less than the long-run value of the relationship” (Baker et al. 2002: 41).

Departing from Macaulay (1963), sociologists and economists have widely investigated the logic and consequences of relational contracts. Dore (1983: 459) identifies relational contracts in the Japanese textile industry in which “goodwill ‘give-and-take’ is expected to temper the pursuit of self-interest”, arguing that these supply relationships are based on the principle of mutuality and the stability of the relationship. Powell (1990) describes relational contracts in networks as being based on “reciprocal, preferential, mutually supportive actions” (p. 271) and stresses that Williamson’s continuum view of economic exchange is misleading because it “blinds us to the role played by reciprocity and collaboration as alternative governance mechanism” (p. 267).

We argue that the distinction between markets (both spot and relational) and hierarchies detracts from the fact that (relational) markets and hierarchies often occur in combination with one another. For instance, modern multidivisional firms often deploy mixed control mechanisms like profit centres or transfer-pricing. In such cases a price control mechanism is mixed with a hierarchical governance structure (Bradach and Eccles 1989). A similar mechanism is observable in hierarchical forms of outsourcing.

We put forward the argument that the organizational structure of firms that use hierarchical forms of outsourcing shows two important features. Firstly, these business relationships are characterised by both hierarchy and (relational) markets. They are based on relational contracts that are laced with elements of hierarchy. The authority mechanism is primarily enforced by relational contracts since legal regulations do usually not allow to refer to authority in formal contracts. The price mechanism comes into play through asset ownership, governance structure competition and performance-related payment. Asset ownership means that the upstream party owns the produced good or service, which has an implicit price and is, thus, tradable and marketable.

Competition through other organizational structures – i.e. hierarchy (employees) and spot markets (occasional independent contractors) – further enhances the price mechanism by reducing the bargaining power of the upstream party. Another component of the price mechanism is that the upstream party only earns income by producing or selling.

Secondly, many firms that source out part of their workforce also have employees or spot business relationships which essentially do the same job. Thus, firms simultaneously make, buy *and* cooperate rather than of the classical make *or* buy decision. This means that transactions are embedded in the context of other transactions: Transactions that are controlled by one mechanism have an impact on transactions controlled by another mechanism (Bradach and Eccles 1989). For instance, analysing fast-food chains that use both company stores and franchise stores, Lewin-Solomons (1998) shows that such systems produce a dynamic efficiency. On the one hand, company stores can use the innovative ideas (such as management or technical innovations that lead to more efficient operating procedures) generated by their franchisees for the benefit of the company stores. On the other hand, franchisers can use the information about production their company stores generate to control the franchisees and reduce the uncertainty of opportunistic bargaining. Thus, it may be an efficient solution to simultaneously run company and franchise stores even if company stores are less efficient than franchise stores. Moreover, using various control mechanisms simultaneously fosters competition between the two, creating additional incentives for both in-house managers and outside contractors.

Rubery and Grimshaw (2003) offer a similar argument, stressing that the simultaneous use of different governance structures displaces risk and consolidates power. They emphasise that this corporate strategy is deployed to restructure internal organization by using external threat to weaken the internal power of labour and circumvent internal constraints. For instance, if the institutionalisation of internal structures like labour costs are too difficult to change, externalisation may be employed to indirectly alter the system.

The aim of this paper is to go beyond a structural analysis of governance structures and to show *how* firms mix governance structures. It discusses the ways firms simultaneously use (relational) market and hierarchy mechanisms. Research on

hierarchical forms of outsourcing has to focus on both formal and, even more importantly, on informal organizational structures. Analysing only formal structures and relations would not reveal the actual organization of these business relationships since hierarchical forms of outsourcing are managed by both formal and informal, relational contracts.

While a formal contract regulates the basic framework of the relationship, often forbidding the upstream party to deal with other parties (exclusiveness), informal agreements, unwritten codes of conduct and understandings – in short, relational contracts – determine the social structure of the business relationship. We argue that hierarchical forms of outsourcing create dependency not only by formal, but also by informal means, resulting in the following hypothesis: *Hierarchical forms of outsourcing are managed by both formal and relational contracts, creating economic and personal dependency (Hypothesis 1).*

The essence of managerial control over the upstream party is to make sure that the latter works according to the rules and norms of the downstream party and to reduce the discrepancy between the upstream's and the downstream's goals, or in other words, to reduce the principal-agent problem. Research on managerial control in industries with third-party customers has emphasized that the triangular relationship between customer, employer and worker produces a tension between discretion to workers and hierarchical control over workers (Lloyd and Newell 2001; Frenkel et al. 1999). On the one hand, discretion and autonomy for workers is seen as important for the quality of the customer services since it allows workers to build up a relationship with customers. On the other hand, hierarchical control over workers and less autonomy may ensure better direct access to customers to increase customers' loyalty to the firm rather than to the worker and a higher productivity level (Lloyd and Newell 2001). Management literature defines hierarchical control as setting goals, monitoring and evaluating work, providing feedback, and imposing consequences on workers on the basis of their performance. Consequently, hierarchical control includes both the provision of information (i.e. goal setting, monitoring and feedback) and imposing performance-related consequences (i.e. rewards and punishments) (e.g. Anderson and Oliver 1987; Challagalla and Shervani 1996).

As discussed above, hierarchical forms of outsourcing use both the hierarchical and the price control mechanism to reduce opportunism. On the one hand, hierarchical control is executed using authority structures similar to those in employment relationships (i.e. goal setting, monitoring, feedback, rewards and punishments). On the other hand, as described above, the price mechanism through asset ownership, competition by other governance structures and solely performance-related payment further enhances control. However, these two control mechanisms are embedded in a third mechanism, i.e. the power of relational contracts. As long as relational contracts are self-enforcing – meaning that both parties have enough incentives not to renege – neither party will compromise the business relationship. Thus, we put forward the following hypothesis: *The control mechanism of hierarchical forms of outsourcing is based on authority, prices and the self-enforcing nature of relational contracts (Hypothesis 2).*

Literature on trust in interorganizational relations or networks shows that trust helps to overcome problems of opportunistic behaviour and incomplete contracting, and, hence, produces an economic value (Nooteboom 2002; Bachmann 2001; Lane and Bachmann 1998; Gambetta 1998). While one string of research views trust as based on calculation and rationality (e.g. Gibbons 2001; Hardin 1996), the other accentuates that trust is value- and norm-based (e.g. Lorenz 1999; Gambetta 1988). We do not intend to directly take part in this discussion, but rather concentrate on its relevance for the subject-matter of this paper. Referring to proponents of the value- and norm-based trust view such as Gambetta (1988) or Zucker (1986), Lane (1998: 6) states that “trust begins where rational prediction ends”. Some authors in this debate argue that trust based on calculation is not really trust at all. Although we agree that calculative trust is indeed a different kind of trust, we nevertheless use the same word (“trust”) because we argue that the outcome is the same although the reason or cognitive basis differs. Expressed differently, in calculative trust, parties behave “as if” they trusted the other party.

Rubery and Grimshaw (2003) and Nooteboom (2002) argue that existing theories of interorganizational contracting assume that organizations are treated as if they have the same status within networks. They suggest that power drives out trust

between unequal partners or, in other words, that trust and power are mutually exclusive in unequal business relationships.

So far we have argued that hierarchical forms of outsourcing refer to business relationships where the downstream party is extremely powerful in comparison to the upstream party. Does this mean that if the downstream party is too powerful to be trusted, it has no incentive *not* to renege on its commitments? Is the downstream party capable of making credible commitments to the upstream party and thus, of building up trust?

In accordance with Farrell (2004) and Bachmann (2001), we claim that it is important to consider forms of trust between unequal parties since the majority of interorganizational relations are based on *both power and trust*. Thus, we hypothesise that trust is also generated in business relationships with strong asymmetries of trust, as observed in hierarchical forms of outsourcing: *Despite dependency and asymmetries of power, hierarchical forms of outsourcing produce calculative trust (Hypothesis 3)*.

Hierarchical Forms of Outsourcing in the Austrian Insurance Industry

The following case study research in the Austrian insurance industry aims at testing the hypotheses described above, analysing how firms mix governance structures and discussing the consequences for both the upstream and the downstream party. The insurance industry makes an excellent case study because most insurance companies organize their distribution using different channels like direct sales agents, tied agents and independent agents. Although these different workers perform the same kind of work, namely selling insurance contracts to clients, they work on a different contractual basis. In contrast to tied and independent agents, direct sales agents are employees of the insurance companies. Both tied and independent agents are self-employed but have different contracts with insurance companies. Whilst a tied agent is only allowed to represent one particular insurance company, an independent agent is able to sell insurance contracts from different companies. Although tied agents are self-employed and work from their own premises, they nevertheless access the market under the logo and name of the insurance company they contract with.

The Austrian insurance industry has seen an intensive restructuring process - mainly a result of deregulation and increased competition following the accession to the European Union in 1995 - significantly altering the organisation of work. Austrian insurance companies have downscaled their employed sales force by sourcing out on a hierarchical basis. All major insurance companies in Austria – and all eight insurance companies covered by this case study – have started to work with tied agents since the mid-1990s.

While the direct sales force of an insurance company does not bear the entrepreneurial risk, the tied agents (partly) do for various reasons. First, whilst the direct sales force earns a basic salary plus commission for every insurance policy they sell, the tied agent receives only commission. Thus, in case of low demand of insurance products or a reduction in the competitiveness of the specific insurance company, employees are guaranteed a fixed income, while tied agents lose (part) of their income. Second, in contrast to the direct sales force, tied agents must finance their own assets (i.e. office, car, IT). Third, tied agents face economic risk when they are prevented from carrying out their work (e.g. illness, holidays). Finally, they invest in specific human capital since they sell insurance products from only one firm. For this and for other reasons (e.g. contractual clause), switching contract partner creates costs.

The following analysis is based on 32 semi-structured interviews in the Austrian insurance industry. It includes eight major insurance companies, representing a market share 64.7 per cent (using total gross premiums of 2001). We interviewed not only high-level managers from insurance companies, but also salespeople representing different forms of work relationships (i.e. employment, self-employment and hierarchical forms of outsourcing/self-employment): employees of the companies' direct sales force, tied agents, and independent financial advisers. In addition, officials from trade unions and professional associations were interviewed to discuss hierarchical forms of outsourcing and working relationships in the insurance industry.

Mixing Governance Structures and the Creation of Dependency (Hypothesis 1)

Above we have argued that hierarchical forms of outsourcing are based on both formal and relational contracts. The analysis of hierarchical forms of outsourcing in the Austrian insurance industry shows that formal contracts only regulate the basic

framework of the relationship, while the details are managed by relational contracts. Formal contracts determine the exclusiveness of the business relationship (i.e. that tied agents are only allowed to sell insurance products of their contract partner), the amount of the commission for products sold and, in some reported cases, also the details of the financial support, a minimum turnover or the treatment of the files of the customers (i.e. the client bank) after the termination of the contract. On the other side, formal contracts do not regulate issues such as the organization of administration, training, provision of business know-how and management skills, assistance in (or control of) accounting, IT, tax matters, organization of business meetings with company managers or pecuniary and non-pecuniary incentive schemes.

The rationales behind the simultaneous use of formal and relational contracts are the following. First, in order to avoid conflicts with legal regulations, insurance companies have to ensure not to include any authority or routine mechanisms in legal contracts that raise suspicion of an employment relation. Thus, insurance companies have a strong interest in using a formal contract for the basic set-up of the business relationship and a relational contract that allows them to have a certain amount of managerial control over their tied agents. Second, writing a complete contract would require to foresee and describe all the relevant contingencies. Moreover, the parties must be able to determine the actions to be taken for each possible contingency. Since it is not possible to write such contracts (and if possible, they would be too costly) due to bounded rationality problems, the parties have to restrict the formal contract to clearly definable issues as described above. Most issues of the actual organization of the business relationship are therefore governed by relational contracts.

We argue that the normative basis of hierarchical forms of outsourcing is the upstream's dependency upon the downstream party, expressed by formal and informal means. A tied agent's dependence on an insurance company is created by two different mechanisms. First, insurance companies grant their tied agents a wide range of support in order to solve the principal-agent problem. Insurance companies offer their tied agents low-interest loans to build up their business. However, if the tied agents cancel the contract, the interest rate of the loans sharply increase. In addition, insurance companies financially support the purchase of office and IT equipment or marketing material. The reason for this financial support measures is not only to tie the agent

closer to the insurance company, but also to ensure that it represents the insurance accordingly (i.e. to solve the principle-agent problem). Other support measures are the provision of business know-how and management skills. For instance, some insurance companies develop a business plan for their tied agents, while others offer their tied agents entrepreneurial knowledge for the preparation of a business plan. Furthermore, insurance companies offer support with accounting, IT, tax consultancy, business management. However, these supporting measures are also designed to bind the agent more tightly to the insurance company, imposing high costs for changing contract partner.

Second, insurance companies have developed various managerial control instruments, introducing elements of hierarchy into the business relationship which makes the actual work organization of tied agents similar to that of the employed direct sales force. For example, tied agents have regular meetings with company managers and supervisors, ensuring the insurance company to be constantly informed about business development and other issues. Furthermore, insurance companies control whether their tied agents comply with the insurance company's corporate culture in terms of marketing, advertising or corporate design. Some managers of insurance companies even reported that they mandate trustees to audit their tied agents and undertake customer surveys to check the quality of the interaction with customers. It is shown that the development of information technology plays a crucial role here since it strongly decreases controlling costs.

On the basis of the definition of dependency in the introductory section of this paper, we have empirically observed both forms of dependency, i.e. economic and personal dependency. Economic dependence is mainly created by the exclusiveness of the business relationship and financial support measures that tie the agent closely to the principal by increasing the costs of outsider options. Personal dependence is created by support measures that increase the managerial control over the agent, such as assistance for accounting, IT, tax issues, or business know-how.

The Control Mechanism (Hypothesis 2)

The case study has revealed that insurance companies not only use elements of markets and hierarchies, but also relational contracts to control their tied agents. First, control

through the price mechanism is exercised by asset ownership, distribution channel competition and a performance-related payment structure. The most important asset in the business relationships described in this paper is the client bank (i.e. the files of the customers). Theoretically, the client bank is owned by the insurance companies. However, it is the insurance agent who has direct access to customers and thus an influence on the decisions of customers. Consequently, managers from insurance companies stress that the tied agents de facto own the produced asset 'client bank'. This creates an implicit price for which the downstream party would have to buy the client bank after the termination of the business relationship. This price mechanism helps to motivate the tied agents to undertake activities that increase the value of their de-facto-asset, enhancing efficiency and mitigating the principal-agent problem. Competition by other distribution channels – i.e. the direct sales force and independent financial advisers – strengthens the price mechanism by reducing the bargaining power of tied agents. On the one hand, insurance managers stress that the motive for sourcing out labour is not only to dispose the “problem of labour law”, but also to reduce overhead costs by transforming fixed costs into variable costs. On the other hand, employees (direct sales force) report managerial threats to further source out labour. Consequently, insurance companies use the multi-channel distribution strategy to bring competition into the firm and, thus, to reduce the room for manoeuvre for each distribution channel. A final layer of the price control mechanism is that tied agents only earn when they sell since they have – in contrast to the employed direct sales force – no guaranteed income.

Second, as already argued above, the downstream party deploys authority (hierarchy) mainly by informal agreements in order not to get in conflict with legal regulations. Case study research has revealed that insurance companies have developed sophisticated mechanisms of controlling the work of tied agents. The main source of managerial control are regular meetings with company managers and supervisors as well as bureaucratic checks by compliance supervisors. Moreover, interviewees have reported that control is executed through trustees (such as chartered accountants), customer surveys, training obligations or internal regulations of market appearance. More subtler layers of control are specific pecuniary (e.g. commission structure) and non-pecuniary (e.g. contests) incentive schemes. Insurance managers further stress that monitoring increases when tied agents under-perform, resulting in the cancellation of

the contract if sales do not increase eventually. In sum, we found that insurance companies use all dimensions of hierarchical control – i.e. goal setting, monitoring, feedback, rewards and punishments. The authority mechanism is, additionally, facilitated by the fact that most insurance companies deploy individuals of their former direct sales force and can thus apply firm-specific routines.

Third, the relationships between insurance companies and their tied agents are controlled by relational contracts. Relational contracts have two major aims in these business relationships. On the one hand, they help to circumvent difficulties in formal contracting and to be compliant with legal rules as already discussed above. On the other hand, they provide incentives for both parties not to behave opportunistically due to the self-enforcing nature of relational contracts. Interviews have proven that the business relationship between insurance companies and their tied agents is organized in a way so that both parties profit in the longer term. For instance, tied agents get better conditions, higher commissions and have less hierarchical control the longer (and better) the business relationship goes. If tied agents sell long-term insurance products (e.g. private pension), they get a part of their commission after the insurance contract is signed and subsequent payments every year as long as the insurance contract continues. However, after termination of the business contract, the tied agent either loses the subsequent payments entirely or only receives a small part of them. Thus, tied agents would lose part of their income if they cancelled the contracts. Further, the conditions of the financial support improve over time, reducing the dependency due to credits. Of course, also insurance companies profit from a longer term perspective of the business relationship since the discounted (or present) value of training and recruiting costs as well as costs of supporting tied agents decrease over time.

In sum, an important characteristic of hierarchical forms of outsourcing is the interplay of different layers of control. The long-term incentive structure of self-enforcing relational contracts is fortified by hierarchies and the market mechanisms.

Dependency, Asymmetries of Power and Calculative Trust (Hypothesis 3)

Although, the climate between the upstream and the downstream parties is bureaucratic (due to the hierarchical governance mechanism), it is also characterised by mutual benefits produced by self-enforcing relational contracts. Bureaucracy and administrative

fiat plays a crucial role in these business relationship. As argued above, insurance companies have developed a large range of managerial control over their tied agents similar to employment relationships. This is additionally strengthened by the fact that many insurance companies supervise their tied agents through the same managers that control the direct sales force. Moreover, most tied agents were previously employed by the same insurance company, also reinforcing the bureaucratic climate.

Nevertheless, this study also shows that the nature of self-enforcing relational contracts creates mutual benefits in the long run and thus *trust*. On the one side, tied agents have an incentive to behave trustworthy because they are interested in a long-term relationship due to the high costs of alternative options in the short run. The insurance company, on the other side, *trusts* the tied agent because it takes the rationales of the tied agent into account. Thus, we found that the institutional framework of these business relationships produces incentives for both parties to behave trustworthy despite the asymmetries of power. The resulting trust is defined as calculative, rational trust, where parties behave “as if” they trusted the other party due to the institutional framework of the business relationship.

The amount of commitment the business parties generate is strongly determined by the underlying self-enforcing relational contracts and the resulting creation of calculative trust. The downstream party is interested in getting high-value work from the upstream party. Since it is difficult to write a contract which determines high-value work (despite the fact that it may be observable), the parties agree upon relational contracts that provide – as discussed above – the necessary incentives to carry out work with an observable but non-contractible high value due to the long-term value of the relationship. Hence, long-term relational contracts provide incentives to show a high level of commitment in order to profit from future payoffs. Additionally, the hierarchical control mechanism forces the upstream party to show a substantial amount of commitment in order to retain the business contract.

Conclusions

The re-emergence of outsourcing and the creation of hierarchical forms of outsourcing has resulted in an active legal and political debate on possible reforms on

the national and EU level. This paper has highlighted that the binary distinction between subordinate employment and self-employment no longer reflects the work organization of the postfordist firm. Not only has the technical and operational independence of employees risen (“work empowerment”), but also self-employed individuals working closely with a main principal are observed to show characteristics of dependence (Sciarra 2004; Perulli 2003; Supiot 2001; OECD 2000; Burchell et al. 1999).

Sciarra (2004) and Perulli (2003) point out that it is most difficult to assess dependent forms of self-employment due to its complexity and ambiguity. On the one hand, we observe different levels of dependency and autonomy, and on the other, very heterogeneous circumstances of industries and professions. The aim of this paper was to empirically demonstrate how dependency is created in hierarchical forms of outsourcing, focussing on the different layers of control. Although research in the British insurance industry, the Austrian trucking and business service industry (Muehlberger and Zagler 2003; Muehlberger 2004) and in the British and German franchising industry (Felstead 1993) has shown that industrial and national regulations play a crucial role in the emergence of hierarchical forms of outsourcing, the organizational logic of hierarchical forms of outsourcing – i.e. the introduction of hierarchical elements into the market by relational contracts that are additionally empowered by dependency – proves to be very similar over industries and countries.

We find that the work relationships resulting from hierarchical forms of outsourcing are close to that of employment. First, the downstream party strongly controls the work of the upstream party. The downstream party not only sets the goals of the upstream’s performance (e.g. through development of the business plan), but also closely monitors the upstream party by both information technology and regular meetings with supervisors. Like with employees, the downstream party cancels the contract if the upstream party under-performs for a certain period of time. We have seen that the control mechanism works not only through hierarchy, but also through prices (asset ownership, governance structure competition, performance-related payment).

The discretion-control-dilemma is (partly) solved by both the de facto transference of asset ownership to the upstream party and the performance-related payment. This way, the upstream party has a strong incentive to find a profitable balance between customer service quality and productivity. Nevertheless, managers

have also emphasized that access to customers is more difficult in comparison to employing agents. However, the downstream party tries to mitigate this effect by offering the upstream party to buy the client bank after termination of the contract.

Second, the upstream party is substantially integrated into the business of the downstream party. Although the upstream party works from its own premises, it nevertheless works under the logo and the name of the downstream party, making it difficult for customers to realize that they deal with a self-employed agent. We have seen that the upstream party successfully introduces hierarchical elements into the business relationship, placing the upstream party in partial subordination.

However, unlike employees, the upstream party in hierarchical forms of outsourcing bears part of the entrepreneurial risk. While employees have a fixed basic income, self-employed agents only earn when they produce or sell. Thus, demand fluctuations, the competitiveness of the downstream party and events that prevent the upstream party from working (e.g. illness) are risks the upstream party has to take. Nevertheless, we have also seen that although various support measures (e.g. business know-how, accounting, IT) aim at binding the upstream party closely to the downstream party, they also help to counterbalance the effects of the risk transfer.

In sum, we argue that firms use hierarchical forms of outsourcing to reduce the flexibility-control dilemma. On the one hand, sourcing out labour displaces part of the entrepreneurial risk and detaches the downstream party from employment and social security law, allowing to gain financial and organisational flexibility. On the other hand, the downstream party nevertheless keeps a substantial part of control over labour.

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