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New Forms of Organisational Governance

We observe that organisational restructuring is significantly changing the governing modes of economic exchange. On the one hand, we witness an increase in mergers & acquisitions, which substitutes market for hierarchy, leading to further economic concentration. On the other hand, we see an increase in outsourcing and subcontracting activities, appearing to replace hierarchy by market forms of governance. However, there is evidence that an increasing part of outsourcing activities is based on dependent business relationships. Dependent outsourcing refers to business relationships where subcontractors are formally self-employed (or declares herself as self-employed) but their conditions of work are similar to those of employees. They are economically - and in extreme cases even personally - dependent on their contractor. Dependent self-employed workers bear the entrepreneurial risk without having the entrepreneurial possibilities of independent self-employed persons because they do not appear on the external market since they have only one (major) contractor.

Organisational theorists have argued that employment (hierarchy) mitigates problems of hold-up and opportunism. This paper, however, argues that firms find other ways than hierarchy to reduce these problems. The key argument is that firms have established governance structures based on markets, hierarchies *and* relational contracts (i.e. unwritten codes and understandings or informal agreements) so that they are able to keep a substantial amount of control despite of sourcing out labour. In other words, by creating close (dependent) ties, the downstream party improves the trade-off between incentives (typically linked to market transactions) and control (typically linked to hierarchy).

It is argued that such dependent business relationships cannot be explained by the traditional market versus hierarchy approach. Instead, it is shown that dependent forms of outsourcing 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. While the basics of the business relationship are written down in formal contracts, the actual structure and organisation relies on unwritten, relational contracts. It is shown that relational contracts are not only used to deal with non-contractible issues as suggested by the organisational economics literature, but also to increase the power of the downstream party through control and dependency. Furthermore, the organisational economics literature argues that every transaction can be linked to a most efficient organisational arrangement. This paper, however, finds that it is misleading to investigate single transactions, as some are embedded in others.

Using empirical evidence of the British and Austrian insurance industry, it is demonstrated that dependency in dependent business relationships is created, firstly, by the contractual restriction of alternative uses of resources, secondly, by support measures that bind the upstream party to the downstream party, thirdly, by relationship-specific investments made by the upstream party, and fourthly, by authority elements of the business relationship. In sum, it is empirically demonstrated that dependent long-term business relationships are based on relational contracts that are laced with elements of an hierarchical control mechanism.