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What is the right outsourcing strategy for your process?

Ronan McIvor *

University of Ulster, Northern Ireland

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Summary Outsourcing has become a critical strategic decision that can allow organisations to develop and leverage the capabilities required to compete in today's global business environment. This paper provides a practical framework that managers can use to identify suitable outsourcing strategies for their processes. In particular, the framework provides a mechanism for understanding, which processes should be kept internal and which should be outsourced based on both organisational capability and opportunism considerations. The logic of the framework and the sourcing strategies is illustrated through providing real case examples from organisations that participated in the research.

Introduction

The trend towards outsourcing both locally and offshore has been increasing dramatically throughout the developed economies of the world. The drive for greater efficiencies and cost reductions has forced many organisations to increasingly specialise in a limited number of key areas. Outsourcing is increasingly being employed to achieve performance improvements across the entire business. Leading firms have been adopting more sophisticated outsourcing strategies and have been outsourcing core processes such as design, engineering, manufacturing, and marketing. These organisations have been benefiting greatly from accessing the specialist capabilities of suppliers in a range of business processes (Aron and Singh, 2005). Many specialist suppliers can develop a greater depth of knowledge, invest more in systems and processes, and achieve efficiencies through economies of scale and experience. Leveraging the capabilities of more capable suppliers allows organisations to outsource more critical business processes and enhance their own internal core capabilities that drive competitive advantage. However, many organisations are failing to capitalise on the opportunities offered by outsourcing. Many organisations continue to make outsourcing decisions on a piecemeal basis and fail to develop outsourcing strategies for their processes that allow them to compete in the global economy (Gottfredson *et al.*, 2005). In many cases, the choice of which parts of the business to outsource is based on ascertaining what will save most on overhead costs, rather than how the decision impacts upon the long-term capabilities of the organisation. In some instances, organisations are outsourcing processes that are critical to competitive advantage and over time are relinquishing important knowledge sets and capabilities.

* Tel.: +44 28 71375275; fax: +44 28 71375323.
E-mail address: r.mcivor@ulster.ac.uk

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Two influential theories in the study of outsourcing have been transaction cost economics (TCE) and the resource-based view (RBV) of the firm. Transaction cost economics specifies the conditions under which an organisation should manage an economic exchange internally within its boundaries i.e. hierarchies and the conditions suitable for managing an economic exchange externally i.e. markets (Williamson, 1975, 1985). Hierarchies involve performing processes inside the firm, using management authority to make and execute decisions. Markets involve relatively short-term, bargaining relationships between independent buyers and suppliers. The needs of the buyer are non-specific, which enables the supply market to achieve economies of scale. According to transaction cost economics, a company will make the outsourcing decision on the basis of reducing production and transaction costs. Production costs refer to the direct costs involved in creating the product or service and include labour and infrastructure costs. Transaction costs include the costs of selecting suppliers, negotiating prices, writing contracts, monitoring performance, as well as the potential for opportunism from suppliers. The potential for opportunism increases if investments have to be made which are specific to a particular relationship. TCE argues that organizations should employ hierarchical governance or employ a governance structure that uses less specialized investments in order to reduce the potential for opportunism.

Another prominent theory employed in the outsourcing decision is the resource-based view which views the firm as a bundle of assets and resources that if employed in distinctive ways can create competitive advantage (Peteraf, 1993; Barney, 1991). A major concern of the resource-based view is how an organization's capabilities develop and affect its competitive position and performance. Proponents of the resource-based view argue that heterogeneity in an organization's knowledge-based resources and capabilities explain differences in performance and the sustainability of a competitive advantage (Teece *et al.*, 1997). Therefore, the outsourcing decision is influenced by the ability of an organization to invest in developing a capability and sustaining a superior performance position in the capability relative to competitors. Processes in which the organization lacks the necessary resources or capabilities internally can be outsourced. Organizations can access complementary capabilities from external providers where they can gain no advantage from performing such processes internally.

Although the RBV and TCE are focusing on two different issues (1) the search for competitive advantage and (2) the most efficient governance structure, organisations have to deal with these two important issues when making outsourcing decisions. Practitioners have to assess their capabilities across a range of business areas as they are increasingly being confronted with constraints on resources. This means that they have to prioritise resource allocation in certain key business areas where they possess strengths and outsource less critical areas. Indeed, the trend towards specialisation in many product and service markets has opened up opportunities for further outsourcing as specialist suppliers chase demand through offering a wider range of capabilities in more critical business areas. Furthermore, organizations perceive outsourcing as a means of achieving performance improvements in many areas of the business. Specialist suppliers are expected to deliver costs efficiencies whilst at the same offer a higher level of value. However, the potential for performance improvement has to be balanced against the potential for opportunism in the supply market. Organisations have to consider factors that influence the potential for opportunism such as the level of specific investments with the supplier, performance measurement difficulties, and the inclusion of contractual safeguards to allow for uncertainty and changes in requirements. Possessing an understanding of these factors also allows an organisation to adopt a relationship strategy, which reduces the risks of outsourcing whilst at the same time leverage the specialist capabilities of suppliers.

Outsourcing frameworks in the literature

There are a number of frameworks in the literature offering guidelines and prescriptions on the outsourcing decision. Early approaches in this area tended to focus on outsourcing in a manufacturing context - the classic make-or-buy decision (Culliton, 1956; Higgins, 1955). These approaches were principally concerned with applying quantitative models to evaluate the decision. Transaction cost economics has been extremely influential on outsourcing frameworks proposed in the literature (Vining and Globerman, 1999; Ngwenyama and Bryson, 1999). Proponents of approaches influenced by the transaction cost perspective argue that the optimal sourcing option will be chosen on the basis of transaction cost minimisation. Vining and Globerman's (1999) framework focuses on how an organisation assesses *ex ante* the potential transaction costs that arise in outsourcing and how and in what circumstances transaction costs can be reduced. Vining and Globerman's (1999) framework focuses on how an organisation assesses *ex ante* the potential transaction costs that arise in outsourcing and how and in what circumstances transaction costs can be reduced.

Some have challenged the predominance of cost considerations in the outsourcing decision with scant attention being given to how the decision impacts the overall business strategy of the organisation (Baden-Fuller *et al.*, 2000). Consequently, a number of frameworks proposed in the literature have focused on the strategic implications of the outsourcing decision (Roy and Aubert, 2002; Insinga and Werle, 2000; Quinn, 1999; Venkatesan, 1992). Many of these outsourcing approaches have been influenced by the principles associated with the resource-based view. For example, Venkatesan (1992) describes the approach adopted at the US engine manufacturer - Cummins Engine, which introduces the ideas of integrating product differentiation, an analysis of component families and manufacturing capabilities into deciding whether processes should be outsourced. The core competence approach — which has evolved from the RBV - has been extremely influential in distinguishing between processes that should be kept in-house and outsourced. Quinn (1999) has argued that effective outsourcing for an organisation involves concentrating on a set of core competencies where it can achieve pre-eminence and outsourcing other processes which are neither critical nor the company has a distinctive capability.

Although many of the frameworks discussed have made a valuable contribution to the study of outsourcing, they tend to be derived from a single theoretical standpoint, which limits their predictive power. One approach in the literature that considers TCE and the RBV in outsourcing decision making is Cox's relational competence framework (Cox, 1996). However, this approach is largely conceptual and fails to sufficiently integrate each theoretical standpoint into explaining the complexities of outsourcing. Although the approach links capabilities and asset specificity into outsourcing, explicit recommendations are not provided on how the principles associated with the RBV can be integrated into the analysis. The main gap in the frameworks discussed is the lack of a structured approach to outsourcing, which is clearly underpinned by antecedents of both TCE and the RBV of the firm. This is an important limitation in the existing literature, as evidence suggests that outsourcing in practice is increasingly considering both capabilities and transaction costs (Holcomb and Hitt, 2007; McIvor, 2005). Indeed, some authors have found both capability considerations and factors such as asset specificity and the threat of opportunism are present in outsourcing practice (McNally and Griffin, 2004; McIvor, 2007).

Research approach

This paper presents a framework developed from integrating TCE and the RBV and through in-depth case study analysis of outsourcing strategies in real industry situations. The development of this framework evolved from a research project concerned with analysing both theoretical and practical influences on outsourcing in a range of organizations that have been involved in extensive outsourcing. The objective of this work has been to develop a practical methodology for application in a range of service and manufacturing settings. This work is based on a case study approach. The initial phase of the research involved analysing the literature on TCE and the RBV in the area of outsourcing decision-making. Exploratory research was then carried out, using interviews with practitioners and analyses of documentary evidence, in order to understand how organizations approached outsourcing. Furthermore, this phase of the research examined the presence of TCE and RBV variables in outsourcing decision making. This facilitated the development of an initial outsourcing methodology, which was based on both theory and practice. The initial methodology was then applied through conducting workshops with a number of organisations, which allowed further refinements to be made to the initial methodology. Finally, in-depth case study analysis was carried out with a number of organisations in order to further refine the outsourcing methodology. In adopting this approach the recommendations of Eisenhardt (1989) for in-depth case study research were followed.

The following section provides an overview of the outsourcing methodology. The next section then outlines the implications of each of the sourcing strategies. Throughout this section the implications of the sourcing strategies are illustrated by providing real case study experiences of companies that participated in the research. The case studies are illustrations of successful outsourcing strategies from the case companies and validate the outsourcing strategies proposed in the framework. These case studies were developed from interviews with personnel involved at each stage of the outsourcing process within the companies including directors, senior managers, and managers from a range of business functions. As well as illustrating the practical implications of the outsourcing framework, these case studies illustrate the presence of TCE and the RBV considerations in practice. These findings also emphasise the need to consider both theoretical perspectives in order to understand the outsourcing decision. In the final section, management implications are presented.

An overview of the outsourcing methodology

The principal proposition of this paper is that implementing a successful outsourcing strategy for a process must involve an analysis of a number of dimensions including relative capability in the process, contribution of the process to competitive advantage and the potential for opportunism from outsourcing the process. Analysing each of these dimensions will provide an organisation with a number of sourcing strategies. The relationship between each of these dimensions and these sourcing strategies is shown on the matrix in Figure 1. The importance of considering these dimensions in outsourcing decisions is now discussed.

Relative capability position in the process

A key issue in competitive strategy involves understanding why one firm differs in performance from another. Some firms gain advantage over others because they can conduct certain organisational processes in a superior manner relative to their competitors. Furthermore, the superior performance in the process is considered sustainable where it is extremely difficult for competitors to replicate within a realistic timeframe or cost (Barney, 1991). In evaluating the suitability of processes for outsourcing, determining whether the organisation performs certain processes relative to competitors, and indeed suppliers, is a key issue. Therefore, this analysis is concerned with identifying the disparity between the sourcing organisation and potential external providers of the processes under scrutiny. It allows an organisation to focus on whether it will be detrimental to its competitive position to outsource certain organisational processes. It is also important to determine whether the organisation can achieve a sustainable competitive advantage by performing a critical process internally on an ongoing basis. Clearly, if the organisation can perform such a process uniquely well, then this process should continue to be carried out internally. Part of this analysis involves understanding the sustainability of a superior performance position. In the case of critical processes, such an understanding will have a fundamental influence on the sourcing option chosen due to the implications for the competitive position of the organisation. Understanding the source of the advantage will provide a sound indication of the difficulties with attempting to replicate or surpass superior performance levels in the process.

Contribution of the process to competitive advantage

This stage is concerned with assessing the contribution of the process to competitive advantage. Determining the

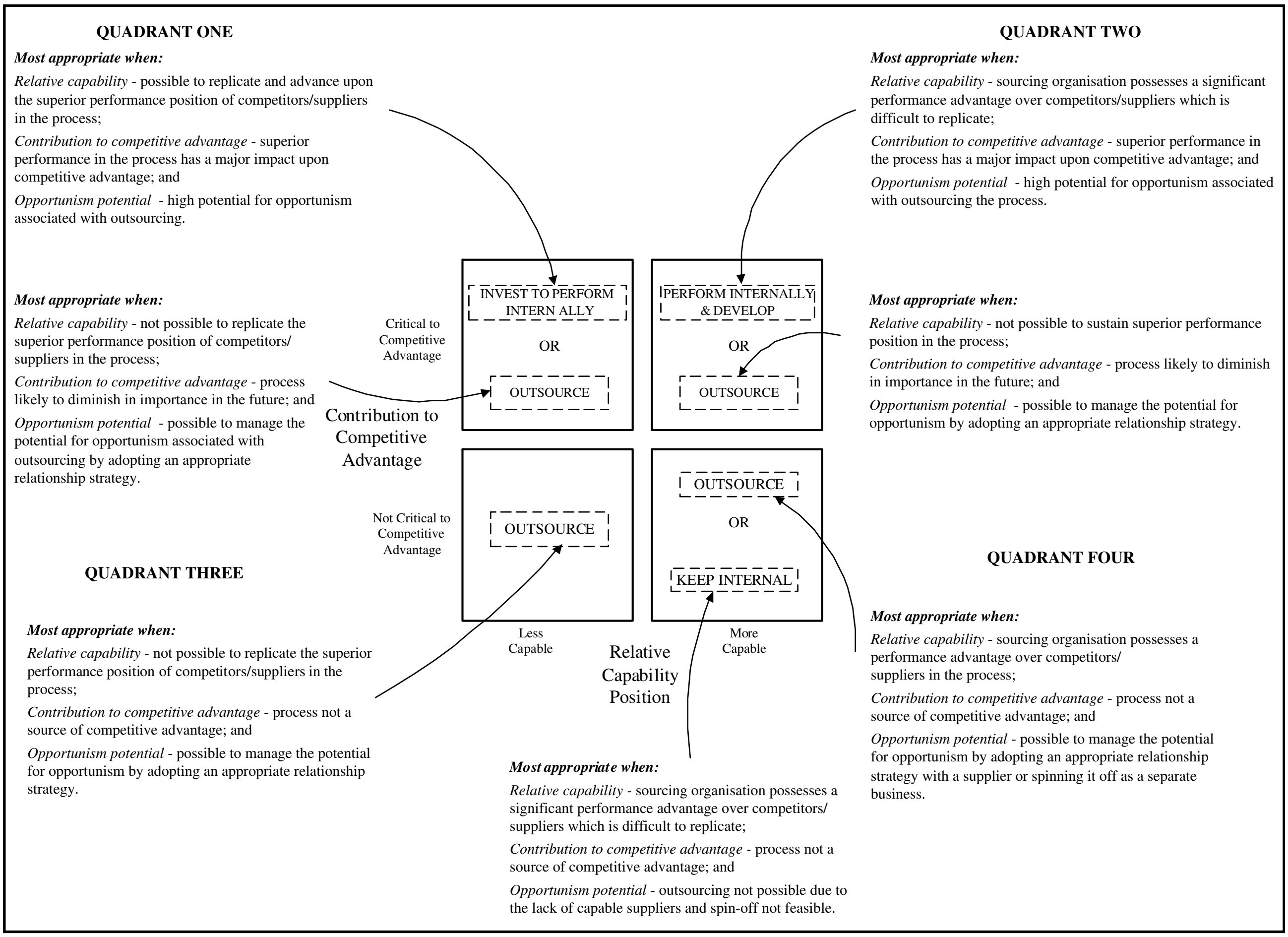

Figure 1 The Sourcing Strategies.

contribution of a process to competitive advantage is central to the outsourcing process. Processes that are critical to competitive advantage and in which the organisations possesses a distinctive capability should remain internal and receive a considerable level of strategic attention to maintain such a position. Processes that are critical to competitive advantage have a major impact upon the ability of an organisation to achieve competitive advantage either through the ability to achieve a lower cost position and/or create higher levels of differentiation than competitors. Therefore, superior performance in such a process allows an organisation to offer sustained price reductions and/or differentiate the product or service in the eyes of the customer. Processes that are not critical to competitive advantage have a limited impact upon the ability of an organisation to achieve competitive advantage. Although these processes have to be performed well, any performance improvements achieved in such processes are unlikely to be a source of competitive advantage as they are not key differentiators in the eyes of customers when purchasing the product or service.

Potential for opportunism

This stage involves assessing the potential for opportunism from outsourcing the business process. There are a number of indicators of opportunism potential in outsourcing situations. The presence of investments in physical or human assets dedicated to a particular relationship will create switching costs for the sourcing organisation. This problem is further exacerbated if there are a small number of capable suppliers in the supply market. Such conditions make the sourcing organisation prone to opportunism during the contract and at the time of contract renewal. Uncertainty both in the business environment and in the requirements of the sourcing organisation may mean that it is not possible to write complete contracts and renegotiation and frequent amendments are required as circumstances change. Complex interdependencies between business processes can also increase the potential for opportunism. High levels of interdependencies between processes — either internally or with other outsourced processes — increase the need for co-ordination, joint problem solving and mutual adjustment (Van der Vegt *et al.*, 1998). The degree to which the process can be codified will also influence the ease of transfer of the process to the supplier. Processes with a high proportion of explicit knowledge are more codifiable than those with high proportion of tacit knowledge and therefore can be transferred more readily to a supplier (Aron and Singh, 2005). Difficulties with measuring the contribution and performance of the supplier can also create problems in the relationship, as the sourcing organisation must expend additional resource on monitoring performance. Furthermore, differences in relation to the interpretation of performance can also create difficulties in the relationship. For example, where effective performance measures have not been developed for the outsourced process, it will be difficult to determine whether the supplier has executed the process better than when it was in-house.

There are a number of strategies that companies can adopt to deal with opportunism. Firstly, the high potential for opportunism may lead the sourcing organisation to retain the process internally. In certain circumstances, it may not be possible to draft a sufficiently robust contract to deal with the potential for opportunism. However, in many circumstances it is possible to deal with the potential for opportunism by adopting an appropriate contracting arrangement. In an outsourcing situation where there is low level of investment in specific assets and relative certainty in requirements, a short-term contractual arrangement can be adopted. Alternatively, where the requirements of the sourcing organisation are highly specific and there is uncertainty surrounding the transaction, a relational contracting arrangement is more appropriate. Relational contracting involves more than a formal contract and includes social mechanisms that promote flexibility, information exchange and joint problem solving. Finally, a potential sourcing strategy involves reducing the complexity of the process by re-designing it into a number of more non-specific processes that can be provided by more than one supplier. This in turn will reduce the level of uncertainty in the transaction. In addition, it is possible that these more standard outsourced processes share some of the transaction characteristics of a short-term market contract. Another potential strategy for reducing opportunism is transferring the process to a supplier that the sourcing organization already has a relational contracting arrangement with. In fact, the outsourcing of such a process may be part of a wider strategy of the sourcing organization further strengthening a relational contracting arrangement with one of its key suppliers.

The sourcing strategies

Quadrant one

This quadrant includes critical processes where competitors or suppliers are more capable than internally within the sourcing organization. In this case, the sourcing organization has to consider how performance in this process can be improved. There are a number of potential sourcing strategies for improving performance.

Invest to perform internally

This option involves investing the necessary resources in order to address the performance disparity in this process. The selection of this option will be influenced by the significance of the disparity in performance. Where the disparity is not significant, there is the potential to invest resources in order to perform the process internally. Furthermore, the sourcing organization may have to consider this option due to the high potential for opportunism as indicated by the lack of capable suppliers. However, the sourcing organization should ensure that it is in a position to replicate and advance upon a superior performance position held by one or more of its competitors. There are a number of situations when this option may be desirable:

- In a case where the technologies associated with the processes are in the early stages of development and offer potential for future growth, investing in this area may be the most appropriate option.
- Analysis of the process may reveal that the disparity in performance is in an area such as quality or productivity, which can be addressed through an improvement initiative. An effective benchmarking exercise may assist in determining what actions need to be taken in order to improve performance. The potential for opportunism associated with outsourcing such a process to a supplier may also force the sourcing organisation to improve the process and keep it internal. Exhibit 1 illustrates how a retail bank decided to improve rather than outsource a process due primarily to the potential for opportunism in the service provider market.

Exhibit 1. *This case focuses on a retail bank. The bank had been experiencing considerable growth in the area of mortgages, whilst internal systems could not cope with the increasing volume of transactions. The bank investigated the feasibility of outsourcing this area, which involved an analysis of both their existing systems in the area of mortgages and the capabilities of external service providers. The investigation revealed that the bank had under invested in suitable technology and was managing the increased workload through increasing staff numbers along with the introduction of excessive overtime. Analysis of the service provider market revealed a number of service providers that had a lower cost base and could provide higher levels of service than the bank could attain internally, primarily through achieving greater economies of scale and investing more resource in technology.*

An in-depth analysis and benchmarking study of one service provider revealed that it could bring new products to market within six weeks, which was considerably more quickly than the bank could achieve internally. Initially, this seemed an ideal service provider to select as an outsourcing provider. However, analysis of the bank's internal processes in mortgages had revealed that there were complex interdependencies in the form of unwieldy reporting structures and process duplications that would prevent the bank from transferring the relevant processes to this service provider. In particular, the current structures made it extremely difficult to establish clear requirements and linkages with other internal processes, which would have increased the potential for opportunism in an outsourcing relationship. The bank were also concerned that it did not have volume of business relative to other clients of this service provider, which may have impacted service levels. Therefore, senior management embarked upon a business improvement initiative. This involved radically redesigning the existing mortgage processing structure internally, which involved separating mortgages into two distinct processes — sales/sanctioning and processing. This involved re-defining current work roles and drawing up key performance indicators to include *productivity rates, quality of work, turnaround times and levels of cross sales achieved. Furthermore, re-designing the mortgages area into sales/sanctioning and processing would enable the bank to outsource the processing element in the future.*

Outsource

Where the capabilities of the organization lag considerably behind the capabilities of competitors, it may be difficult to justify a substantial investment of resources in order to match or advance upon external capabilities. This option is likely if it is both difficult and costly for the sourcing organization to replicate a superior performance position. For example, consider an automaker that has previously designed and manufactured the engines for all its models internally. The same automaker considered engine design and manufacture to be an important process and a source of competitive advantage. However, through an extensive analysis of its internal capabilities it determined that it no longer possessed the design and manufacturing skills and resources necessary to match the performance levels achieved by competing carmakers. Even though perceived as an important process and a source of competitive advantage, it had no other choice than to source engines for a number of its models from another automaker. The importance of the process in the future will also influence the choice of this option. Although a process has added value in the past or is currently adding value, changes in the business environment such as new technology or changes in customers' preferences may render the process less valuable in the future. Organizations often outsource such a process, which is likely to diminish in importance in order to focus resource and effort on processes that promise to be a source of competitive differentiation in the future. Of course, the potential for opportunism has to be manageable if the organization is considering outsourcing such a process. For example, the sourcing organisation may decide to partially outsource the process whilst maintaining internal capacity. Furthermore, partially outsourcing a process to a supplier can allow the sourcing organisation to assess its own internal performance in the process and stimulate internal performance improvement to improve as illustrated by the company in Exhibit 2.

Exhibit 2. *This case focuses on a power generating company and the refurbishment of its network. The upgrading of the network had become a major issue for the company due to its vulnerability to power cuts in times of adverse weather conditions. The ageing nature of the network had meant that customers, particularly in rural areas, experienced frequent power cuts. A critical process associated with the refurbishment programme was replacing and upgrading overhead lines. Although the company had an existing cohort of internal staff in this area, it did not have sufficient internal capacity to undertake the full refurbishment of the network and the company was concerned about internal productivity levels in this area. In order to address productivity problems, the company considered undertaking a benchmarking exercise in this area with other utilities. However, previous experiences with benchmarking in other areas had revealed inconsistent results due to comparison difficulties such as differences in overhead allocations.*

Therefore, the company decided that the only means of determining a true measure of productivity in this area was to partially outsource this area through seeking tenders from a number of independent contractors. It was not possible for the company to outsource the entire process as permanent staff were required for 24/7 emergency cover throughout the year. Partially outsourcing this process allowed the company to improve performance. When the company employed the external contractor in this area they obtained a better reflection of the productivity of internal staff, which was found to be 15—20% lower than contractor staff. The company was careful to mix both internal staff and contractor personnel in the same projects, which had the effect of stimulating internal improvement. The lack of internal capacity to refurbish the network meant that the company could bring external contractors with limited employee resistance. Furthermore, this strategy proved to be a flexible way of dealing with internal capacity constraints as the company established short-term contracts with the contractors and therefore reduced the potential for opportunism.

Quadrant two

Processes that are critical to competitive advantage in which the sourcing organization has a strong performance position are located in this quadrant. There are a number of potential sourcing strategies in this case.

Perform internally and develop

This sourcing strategy involves performing the process internally and further developing future capability. The significance of the disparity in performance in the process should be considered. For example, if the sourcing organisation has built up a significant performance advantage through experience over time, then it may be difficult for other companies to replicate such a capability. Such a capability may be difficult to copy because other companies cannot understand the relationship between the resources and capabilities controlled by the company that possesses the capability — referred to as causal ambiguity (Reed and DeFillippi, 1990). Furthermore, the superior performance position in the process may be based upon a long and complex learning process. When there is no shortcut or straightforward means of carrying out this process, it is referred to as path dependent (Arthur, 1989). For example, consider a company with a strong quality position in a particular process. Such a capability has been developed over a long period of time through the many interactions of people within the company that are either directly or indirectly responsible for the quality of the process. Therefore, it is extremely difficult for a competitor to quickly replicate such a strong position. Clearly, keeping the process internal is most appropriate when the sourcing organisation is in a strong position to sustain its performance advantage over time. In many instances with this scenario, it may not be possible to outsource such a process because of a lack of suppliers in the supply market that can meet the performance levels required in the process. However, even in the case of a number of suppliers having the potential to offer the process, the sourcing organisation may still decide to perform the process internally due to its impact upon its competitive position and the potential to exploit the capability in other areas, as illustrated by the company in Exhibit 3.

Exhibit 3. *This case relates to the sourcing strategy for a design process with an electronics company. Due to increasing customer demand and a high level of competition in the marketplace, the company had been under considerable pressure to achieve advances in the design of components that were important drivers in product functionality and cost. Senior management believed that a more focused approach should be taken to allocating design resource in areas that could deliver long-term value for the company. In one component portfolio under scrutiny, suppliers were becoming more competent in design and were actively encouraging their customers to allow them to design as well as manufacture these components. However, by divesting its capability in this area, the company believed it would lose an important source of competitive differentiation both currently and in the future. Analysis of its own capabilities in this area relative to its suppliers and competitors revealed that it was marginally more capable than many of its competitors and suppliers. However, the analysis had revealed that two of its direct competitors had been investing in this area over the last number of years.*

Consequently, the company had to make a decision on whether to rely more heavily on suppliers or invest in this area in order to build upon its current capabilities. In this instance, the company decided to retain this design process internally and allocate additional resource in order to build upon it current position. By divesting its capability in this area, the company believed it would potentially lose a source of competitive differentiation both currently and in the future. Although the company was aware of supplier capabilities it believed it would lose important knowledge in the design process, which had been built up over time through complex interactions with other business functions. Furthermore, the learning and knowledge accumulated in the design process could be exploited in the design of other components. The company believed that further investment would further strengthen its capability.

Outsource

Ideally, an organisation would wish to have superior performance in as many critical processes as possible. However, it is only possible to possess superior performance positions in a limited number of processes due to the resources required to maintain such a position. In certain instances, any superior performance position currently held by an organisation is not sustainable and can be quickly replicated by competitors. For example, many advantages attained from innovations in computer hardware are typically very short-lived since competitors can rapidly replicate or any advance upon any such innovations (Mata *et al.*, 1995). Also, it may be more prudent to focus on other processes in which the organisation possesses a stronger performance position and which are more critical to success in the future. Increasingly, many organisations are recognising that competitive advantage can be achieved in the activity of specifying and integrating external services and other purchases, rather than in assembly and production of the goods themselves. Companies such as Dell and Cisco Systems in high technology industries have been pursuing similar arrangements with their suppliers. These companies outsource much of the product design to specialist design companies. Also, the majority of manufacturing is outsourced whilst maintaining control over final assembly, test and customisation of the end product to customer requirements. For example, Dell believes that many of these processes create little value for the end customer and can be more readily sourced from the supply market (Dedrick and Kraemer, 2005). Instead, Dell has pursued a strategy of 'virtual integration' that has involved sourcing the relevant technologies from the supply market and developing strong collaborative relationships with their most important suppliers.

Quadrant three

In this quadrant, there are competitors that are more capable than the sourcing organization for a process not critical to competitive advantage. Where possible, such processes should be outsourced. This quadrant can include the many routine processes performed by the sourcing organization. Potential ways of divesting the process include selling it off to a specialist organization or outsourcing it to a supplier. Where the sourcing organisation decides to outsource the process, the potential for opportunism from the supplier will influence the nature of the relationship strategy. In the case of non-specific requirements associated with the outsourced process, the sourcing organisation can adopt a more market-based contract with the supplier. In the case of less routine or standardised processes, the sourcing organisation will adopt a more collaborative relationship with the supplier to reduce the potential for opportunism. However, another potential strategy may involve redesigning the process prior to outsourcing in order to reduce the level of specificity in requirements. Exhibit 4 illustrates how a manufacturing company redesigned a process prior to outsourcing to increase the number of available suppliers.

Exhibit 4. *This case focuses on the European manufacturing plant of a global manufacturer of lifting equipment and trucks. This plant was under pressure from corporate level to outsource a number of processes including the manufacture and assembly of chassis for its forklift product portfolio. Initial evaluation of a number of potential suppliers in the lower cost region of the Czech Republic had revealed that a number of suppliers could offer 30% labour cost savings. However, in-depth analysis of these suppliers had revealed that only two of the suppliers had the experience and the specialist machining and casting skills to carry out both the manufacture and assembly process at the required volumes. Therefore, prior to outsourcing the company re-designed the manufacturing and assembly process for chassis to reduce the level of specific requirements. This involved removing a number of manufacturing processes that required specialist machining and casting capabilities. This strategy allowed the company to increase the number of*

suppliers capable of carrying out the manufacturing and assembly process. This strategy involved reducing the number of specific manufactured components associated with the assembly process and also reducing the number of variants of the chassis for different forklift models to allow the supplier to achieve further cost reductions.

Once the re-design process was completed, a supplier in the Czech Republic was selected. As part of the outsourcing strategy, the plant disposed of some of the equipment previously used internally and invested in new equipment that would be transferred to the supplier. There were a number of reasons for this decision. Crucially, the plant established a supplier agreement with the offshore supplier, which would allow it to transfer the equipment associated with the process to another supplier or back internally in the event of supplier failure. Although the initial supplier agreement included a one-year contract renegotiated annually, the plant was considering giving additional business and committing to a longer contract if the supplier met both cost and performance targets. However, due to constant pressures for cost reductions the plant considered a short-term contract along with the inclusion of mechanisms to facilitate rapid transfer of supply to be the most appropriate strategy in the early phases of the relationship.

Quadrant four

In this quadrant, the sourcing organization is more competent than competitors and suppliers in a process that is not critical to competitive advantage. There are a number of potential sourcing strategies.

Outsource

Although the sourcing organization has a strong performance position, the process is not central to competitive advantage. Ideally, the organization should consider externalising such a process and focusing resources on building capabilities in processes that are more critical to the competitive position of the organization. However, conditions in the supply market will influence the type of sourcing configuration chosen. The presence of a supplier with similar capabilities in the process may allow the sourcing organisation to establish a supplier development initiative, through the transfer of employees and equipment to this supplier. However, externalising the process through such an arrangement may not be appropriate due to the high potential for opportunism. In this case, another potential outsourcing strategy option involves exploiting the capability in this area by creating a spin-off business, which specializes in this area of operation and creates additional revenue streams as illustrated in Exhibit 5.

Exhibit 5. *This case focuses on a privatised utility company. Post privatisation, the company was faced with a number of challenges including a reduction in permitted capital and operational expenditure, customers demanding greater reliability, and pressures from the industry regulator for unit price reductions. The company believed it could not meet these challenges without outsourcing a range of business processes. One such portfolio of processes was 'billing and revenue', which included information technology development, meter reading, bill production, customer query handling, accounts receipting and debt recovery. Although these processes were being performed well, the company believed that external service providers could perform these functions. Initial analysis of a number of potential service providers revealed that it was possible to attain the required year-on-year cost reductions. However, more In-depth analysis of a number of suppliers revealed that they were unable to deliver the full range of services required within the utility company's area of operation. At this stage the company considered spinning off billing and revenue as a separate business rather than outsourcing to a service provider. Analysis of the service provider market revealed that existing internal capabilities had the potential to compete in this market. Furthermore, benchmarking studies of other utilities had shown that it was achieving comparable performance levels in this area.*

Therefore, the company established a spin-off company, which would offer a number of services including information technology application development, call centre management, meter reading and billing, logistics management, training and customer account management. This strategy enabled the company to reduce the potential for opportunism associated with outsourcing whilst allowing the further development of a capability. The utility company retained an equity stake in the new business whilst contractually stipulating that the spin-off business provide the required service portfolio. The spin-off business had the potential to create new revenue streams for the company whilst not being accountable to the regulator. As well as receiving business from the company, the spin-off company could service other customers in order to further grow its business. Through further developing its business, it was anticipated that the spin-off company would realize greater cost reductions and performance improvements through apportioning its fixed costs over a large number of customers.

Keep internal

In certain circumstances it may not be possible for the sourcing organisation to outsource a process that is not critical to competitive advantage and in which it has a strong competitive position. Although spinning off the process into a separate business offers a viable sourcing strategy in the case of a lack of capable suppliers in the supply market, in some case this may not be appropriate. For example, the organisation may have to retain the process internally either because it does not possess the skills to develop the area into a separate business or there is not a viable product to attract a significant amount of external customers. Furthermore, as with many outsourcing decisions there may be internal constraints such as workforce resistance to moving the process outside the organisation.

The relationship strategy

In the case of processes deemed suitable for outsourcing, the sourcing organisation will adopt an appropriate relationship strategy, which will be influenced primarily by the potential for opportunism in the relationship. Influences on opportunism include issues such as complex process interdependencies, performance measurement difficulties, uncertainty in requirements and high supplier dependency. These issues will influence the nature of the outsourcing relationship as reflected in the following generic strategies available to the sourcing organisation.

Non-specific contracting

In this case, the process can be readily sourced from a number of suppliers in the supply market. The supply market for the process is extremely competitive with a high level of rivalry between suppliers aggressively competing for business from buyers who share similar sourcing requirements. This outsourcing arrangement is driven primarily by the contract. It is based on the classical market contracting arrangement associated with TCE, which includes relatively short-term, bargaining relationships between independent buyers and suppliers. The primary objective when outsourcing this type of process is to achieve cost reductions. Therefore, the needs of the sourcing organization are often non-specific, which enables the supply market to achieve economies of scale on production costs.

Recurrent contracting

In many cases, the needs of the sourcing organisation can be quite specific. In this case, recurrent contracting is an appropriate relationship strategy, which involves repeated exchanges of assets with moderate levels of asset transaction-specific investments (Williamson, 1985). The low potential for opportunism is indicated by the presence of a number of capable suppliers in the supply market. Contracts can be employed in which future contingencies are specified and the impacts of unforeseeable events are limited by incorporating provisions for third party arbitration to resolve disputes. Recurrent contracting can allow the sourcing organization to establish a contractual arrangement, which allows it to switch to other competing suppliers that have become more capable, for example, as a result of changes in technology. Although the customer may employ more asset-specific investments to co-ordinate complex and non-standard processes between the supplier, excessive dependence on a single supplier is avoided. The company in Exhibit 6 adopted a relationship strategy comparable with recurrent contracting. Although there were a number of non-standard processes involved in the outsourcing arrangement, the company incorporated a number of mechanisms that would allow it to switch to another supplier in the event of contract termination.

Exhibit 6. *This case focuses on a global software company that had outsourced a number of elements of revenue processing including order processing, customer care and rebates to three service providers. However, over time these service providers were unable to cope with the increasing demands of the software company. In particular, there were high employee turnover rates, which meant that important knowledge was being lost and customer queries were taking too long to resolve. As the outsourcing arrangement had grown incrementally there was a lack of formal process definitions and poor service level agreements (SLA). As a result of these difficulties, the software company terminated the contract and consolidated the processes order processing, customer care, and rebates processes to one service provider. The service provider had sufficient capacity and skills to deal with the increasing requirements of the software company and could offer a number of standardised processes. Furthermore, it had a well-developed human resource structure, which would provide better career opportunities and reduce employee turnover.*

Prior to moving this process to the service provider and during the relationship the software company embarked upon a number of initiatives, which would allow it to switch to another service provider. It recruited additional expertise in the area of Six Sigma process analysis and workflow mapping which allowed it to remove inefficiencies and idiosyncratic requirements from many of the processes involved prior to handing responsibility for the processes over to the service provider. The company also invested additional resource in codifying tasks and deriving performance levels associated with as many of the processes as possible. Undertaking this analysis allowed it to communicate its requirements more clearly to the service provider and created fewer problems in the early phases of the relationship. This approach continued throughout the outsourcing relationship. Although the software company could not completely eliminate the specific and changing nature of the requirements associated with many of the processes, it adopted a more formal approach to documenting and updating processes, which involved using Intranets to store process maps and repositories of important knowledge. Documenting and reducing the idiosyncratic requirements from many of the processes involved would limit the effects of employee turnover and also make it less difficult to move the processes to another service provider in the event of difficulties.

Relational contracting

This relationship strategy involves the adoption of a longer-term collaborative relationship. This approach is appropriate in the case of a process, which is critical to competitive advantage for which there is high potential for opportunism indicated by the small number of suppliers and the inability to fully specify or control all elements of the transaction. Adopting this approach allows the sourcing organization to establish and build a mutually advantageous relationship with the supplier. The presence of relation-specific investments in areas such as collaboration in new product development and the development of inter-organizational information systems can create a high level of mutual dependency between the sourcing organization and the supplier. In relational contracting, the enforcement of obligations, promises, and expectations occurs through social processes that promote norms of flexibility, solidarity, and information exchange (Poppo and Zenger, 2002). The focus in a relational contracting arrangement is moving beyond a transactional mindset and developing a trust-based and mutually beneficial relationship.

The experiences of the companies that participated in this research support the view in the literature that detailed contracts are an essential ingredient for success in outsourcing. Drafting a tight contract can also act as an important complement to building an ethos of collaboration and problem solving in the relationship. It is often assumed that partnering and collaboration alone can deal with any difficulties in the relationship. However, a carefully drafted contract can serve as an impetus for action and improvement. In particular, the contract allows the buyer and supplier to establish expectations and make commitments to short-term objectives. Furthermore, it is important to place the role of collaboration in outsourcing relationships. There is much rhetoric in the academic literature and practice in relation to collaboration and partnerships in outsourcing relationships. For example, some argue that partnerships can be readily developed with suppliers in order to leverage skills and resources that are unobtainable by competitors. However, rather than using collaboration to achieve competitive advantage the companies that participated in this research were using collaboration to build flexibility into the relationship and compensate for any gaps in the contract in order to react to changing circumstances. It was often necessary to reconfigure and change the relationship between outsourced processes and internal processes. In some cases, it was possible to deal with these changes through re-negotiating the contract. However, collaboration acted as another important mechanism for allowing changes to be made to processes without having to renegotiate the contract. Collaboration was also an important mechanism for dealing with difficulties in the early phases an outsourcing arrangement. This is particularly important in a case in which the supplier cannot meet the required service levels because the sourcing organisation has outsourced a poorly performing internal process without understanding the causes of poor performance prior to outsourcing. Resolving performance problems via collaboration can be a much more effective means of addressing weaknesses in the outsourcing decision rather than terminating the contract. Exhibit 7 illustrates how a company employed collaborative mechanisms to address a number of difficulties rather than terminate the outsourcing arrangement.

Exhibit 7. *This case involves an electronics manufacturer that outsourced PCB assembly. Prior to outsourcing, the company had been experiencing quality and product performance problems, which stemmed from inconsistencies in design. The company was constantly re-designing PCBs to integrate components with higher levels of functionality at a lower cost. However, some of these product redesign initiatives were insufficiently formalised. In order to improve performance the company outsourced this area to a specialist supplier. The company did not have sufficient resource internally to invest in improving and developing this area of the business. However, at a very early stage of production this outsourcing arrangement encountered severe difficulties. In the early stages of the contract the customer was experiencing rapidly growing demand for its end products whilst the supplier was unable to meet this demand.*

Some of the problems stemmed from the difficulties the company had with the process prior to outsourcing. In particular, the supplier could not deliver at the quality levels required in the contract, which was due primarily to customer design inconsistencies. Furthermore, there was a lack of formal procedures between the customer and supplier to integrate re-designed components into manufacturing. Throughout this phase of the relationship there was a blame culture on each side. At the end of the first year of the contract the customer considered terminating the contract. However, this was not a viable option, as it was thought similar problems would arise with another supplier. Rather than resorting to the contract the company decided to resolve the problems on a collaborative basis. Consequently, senior management in both the buyer and supplier agreed to change the nature of the relationship by recruiting additional staff and committing additional resource to addressing the problems. The customer committed additional resource to remove the causes of the design and quality problems. The supplier also committed additional resource to this area and shared its specialist expertise. The specialist expertise of the supplier enabled the manufacture of more complex components on PCBs — an area that the company had traditionally had problems with. As well as joint problem solving, a cross-functional team was set up to establish mechanisms for formalising procedures for re-designed components.

Management implications

The analysis provided in this paper presents a number of important lessons for managers developing and implementing outsourcing strategies for their business processes:

- *Look beyond the headline indicators of poor process performance*. Rather than perceiving outsourcing as the only vehicle to improve poor internal performance, it is important to understand the causes. Consider the following: Can the process be improved through an internal improvement initiative? How much resource is required to improve internal performance? Why can your organisation not achieve the performance levels attained by suppliers in this process? Is it possible to codify the process so that the associated tasks and performance levels can be communicated clearly to suppliers? If outsourcing is necessary, how long will it take the supplier to achieve the required performance levels in the process? Can partially outsourcing the process stimulate internal performance improvement?
- *Understand the processes and associated interdependencies*. Organisations often outsource processes without fully understanding the nature of the process and linkages with other parts of the business, which for example, can lead to poorly specified requirements in the contract. Consider the following: Are there complex interdependencies between the outsourced process and other internal processes? How can your organisation better understand and reduce the complexities of internal processes? If outsourcing is necessary, how can processes be better understood in order to derive clearer requirements specifications for suppliers? Is it possible to reduce the level of specificity by removing idiosyncratic requirements from the process?

- *Understand the potential for opportunism prior to outsourcing the process.* Many organisations often rush into outsourcing without fully understanding the consequences. Consider the following: How many capable suppliers are there available to perform this process? How difficult is it to establish performance measures for supplier performance in providing the process? Are future changes associated with the process difficult to assess? How readily can the process be transferred to another supplier in the event of supplier failure? Can information technology be deployed to document and store repositories of knowledge associated with the process?
- *Employ the contract and relationship strategy as complements.* Drafting a sufficiently tight contract in outsourcing arrangements has been emphasised as an important mechanism for dealing with opportunism. However, the management of the relationship with the supplier becomes an essential complement for dealing with gaps in the contract, particularly in the case of complex outsourced processes. Consider the following: What contractual safeguards can be employed to reduce the potential for opportunism? How can the contract be drafted to encourage supplier performance improvement in the process? What collaborative practices can be developed between the customer and supplier to deal with unforeseen process changes?

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Dr. Ronan McIvor is a Professor at the University of Ulster. He has carried out extensive research in the area of outsourcing and supply chain management. He is currently carrying out research in the area of outsourcing with a number of service and manufacturing organisations. His work has been published in a number of leading international journals. He has recently authored a book entitled, *The Outsourcing Process*, which has been published by Cambridge University Press. He has also taught on executive development programmes in Europe and the USA.