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1 Outsourcing

On February 14, 2005, the *New Yorker* published an article with the remarkable title "Outsourcing torture: the secret history of America's 'extraordinary rendition' program." In the article it was argued that the US government deliberately chose to leave the questioning of its terror suspects to other countries like Syria, in order to evade the limitations posed by US human rights laws. These other countries are believed to be less stringent regarding torture and hence, by outsourcing, the US government could obtain more information (a "better product" in a sense). Outsourcing, a word unheard of just twenty years ago, has clearly gained entry into the vocabulary of ordinary people. In the business world such pervasiveness is already taken for granted. A simple search of the Financial Times / Business.com website generated 10,506 published articles during the year 2005 alone. It is hard to find managers who do not have an opinion of outsourcing and even harder to find an individual who is completely unaware of it.

People all across the world are today feeling the impact of outsourcing. Consumers in the United States increasingly deal with suppliers of the firms who sell them products and services, rather than with the firms themselves, for instance when they call service centers. Managers in Germany are faced with tough decisions about whether to restructure their firms by outsourcing more manufacturing and services activities, often to low-wage countries. People who want to buy property in Bangalore, India, face steep local prices as a consequence of the business process outsourcing (BPO) boom. Some politicians are scrambling to find protective measures that raise the costs of outsourcing and help protect local employment, at least in the short run. Research institutions and consultants produce large numbers of reports that document the outsourcing trend and contain bold predictions concerning its future and often equally bold statements about its benefits for companies.

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Outsourcing has indeed become one of the key restructuring tools for companies, with a promise to improve the fate of fledgling firms or to increase further the performance of firms that are already leading their industries. Stock markets, for one, seem to appreciate outsourcing. For instance, Oxford Metrica, an independent advisor, recently presented a study of outsourcing by asset managers in Europe with a combined $2,325 billion of managed funds.[1] It involved outsourcing of all kinds of non-core investment activities, including risk management, product development, and information technology. The outsourcing firms' share prices responded with an average price increase of some 10 percent. The logic presented by these firms was one of "core competences," which may be defined as "the collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies" (Prahalad and Hamel, 1990: 82). By outsourcing these activities, they could free up managerial time and better "demonstrate an understanding of strategic issues." As ABN Amro's Chief Operating Officer commented in the report: "Outsourcing our fund administration and investment operations will enable us to support our business more effectively and to focus on the investment process. We have put in place a structure for future growth." The study noted that none of the benefits ascribed to outsourcing by the asset managers were realized benefits. Rather, they were intentions. It did not comment on the possible effects on industry competition either.

Important trends in management practice eventually get studied by academics, though not necessarily in a timely fashion, and outsourcing is no exception. Although there are some earlier studies, it is only in the last ten or so years that academics have produced a steadily increasing number of publications on the topic, in which a wide variety of outsourcing decisions in industries and countries across the globe have been examined. Whatever these studies may disagree on, they all concur in concluding that outsourcing is becoming an ever more pervasive and important phenomenon and that the nature of outsourcing is changing at some pace. It is within this context that this book attempts to contribute to our understanding of outsourcing, specifically how it impacts the performance of firms.

[1] http://www.bankofny.com/htmlpages/data/value_outsourcing.pdf (accessed on August 19, 2005).

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What is outsourcing?

All the agreement about increased outsourcing levels conceals real differences among practitioners and academics over what the term outsourcing actually entails (see Linder, 2004). Let us consider some of the following definitions and discussions of outsourcing. Loh and Venkatraman (1992: 9) believe IT outsourcing is "the significant contribution by external vendors in the physical and/or human resources associated with the entire or specific components of the IT infrastructure in the user organization." Lei and Hitt (1995: 836) think of outsourcing as simply "the reliance on external sources for the manufacturing of components and other value-adding activities." Gilley and Rasheed (2000: 765), though not providing any conclusive definition themselves, suggest outsourcing does not occur when organizations have no choice but to acquire a particular good or service from an external source. Linder (2004: 27) defines it as "purchasing ongoing services from an outside company that a company currently provides, or most organizations normally provide, for themselves." Accountants have looked at it as "the transfer of an internal service function to an outside vendor" (Friedberg and Yarberry, 1991: 53). In the fifth version of the *Shorter Oxford English Dictionary*, published in 2002, outsourcing does not feature at all, which serves as testimony to its relatively recent origins and possibly to the robustness of British institutions as well. The Wikipedia, in a rather shaky and inconsistent discussion of the topic, defines it as:

> the delegation of non-core operations or jobs from internal production to an external entity (such as a subcontractor) that specializes in that operation. Outsourcing is a business decision that can be made for quality or financial reasons. A subset of the term (offshoring) also implies transferring jobs to another country, either by hiring local subcontractors or building a facility in an area where labor is cheap. It became a popular buzzword in business and management in the 1990s.[2]

Clearly, if anything, there is agreement to disagree. This raises the question how we should define outsourcing. I see the variety of definitions in use as being subsidiary to one of these three descriptions:

1. Outsourcing refers to those activities that are undertaken by outside suppliers.

[2] http://en.wikipedia.org/wiki/Outsourcing (accessed on August 2, 2005).

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2. Outsourcing refers to the transfer of activities and possibly assets from a firm to an outside supplier.
3. Outsourcing refers to those activities that are undertaken by outside suppliers but could also be undertaken by the firm.

The third description is particularly problematic in my view. Gilley and Rasheed (2000), who are among its proponents, never clarify whether they imply the technical or the economic ability of firms to undertake an activity. If we take it that it refers to the firm being *technically* able to undertake an activity, this is clearly not very meaningful because any firm could hire the people and obtain the assets to undertake most activities, short of rocket science. Discussions of outsourcing thus would be restricted to the very small set of activities for which it is not possible to procure the people or assets to produce them, for instance because doing so is illegal or because they are extremely rare. But few firms are in need of rocket scientists. If, on the other hand, we interpret this description as referring to whether the firm is *economically* able to undertake the activity, we enter into circular reasoning, for outsourcing would then refer to those activities that are best, or rather most economically, outsourced. This leaves us with sparingly little room for further analysis of outsourcing as a phenomenon. Furthermore it reduces the costs and benefits of outsourcing to a binary variable – either costs outweigh benefits or vice versa – which takes away from the range of intermediate positions that exist from very beneficial through somewhat beneficial and from somewhat costly to very costly. So this third description either reduces outsourcing to a set of activities too narrow to be meaningful or defines it in a circular sense.

Clearly, the first and second descriptions are more useful, though they too present their own problems. The second definition, which is what practitioners often seem to understand by outsourcing, refers to a transfer. But at what stage does a transfer begin or end? Is an activity or asset that was "outsourced" ten years ago, i.e. transferred to an outside supplier, still outsourced today? If not, then when did it cease to become outsourced and start to become something else, perhaps "purchased"? Some twenty-five years ago many firms, like banks, produced their own database programs for a variety of applications. Now they no longer do so but instead rely on outside software producers like Microsoft or Oracle. In lay terms this would perhaps be seen as a form of procurement, not outsourcing, but this definition appears to suggest it is outsourcing. If it is not, some cut-off point must be

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introduced, which is likely context-specific and hence for which no universal definition can be provided. The first description, while being very broad in scope and objective, does not help to distinguish among any of the forms of using external suppliers. In other words, it treats as being equal the purchase of off-the-shelf components with that of a highly customized service such as legal advice. It also makes no reference to when an input was externalized, or indeed whether it was ever performed in-house.

Therefore neither of these two descriptions by itself helps us to understand the outsourcing phenomenon in its entirety. Combined, though, they provide a powerful piece of equipment for outsourcing research for they help us think about outsourcing as a state and outsourcing as a process. Outsourcing as a state, henceforth referred to simply as *outsourcing*, I define as *the procurement of goods and services from external suppliers* (following Kotabe and Mol, 2005). To say that something is outsourced therefore means it is at present being procured from external suppliers. The counterpart of outsourcing is *vertical integration*, which refers to goods and services that are produced internally or procured from other units within a corporate system. Also note that, unlike some authors, I do not believe outsourcing necessarily refers to services or to information technology activities alone, much as it never strictly referred solely to goods when services outsourcing was not much of a topic of discussion yet. Firms, in other words, can outsource or integrate any sort of activity, in the same way that the US government outsourced torture.

The second description leads to what I will refer to as the *outsourcing process*, defined as *a range of actions within a clearly identifiable time-frame that lead to the transfer to outside suppliers of activities, possibly involving the transfer of assets including people as well, that were previously performed in-house or procured from other units within a corporate system*.[3] In the context of the outsourcing process to say that something is being outsourced means that there is an ongoing transfer process. The counterpart of the outsourcing process is the

[3] The use of a legal entity, the corporate system, as a deciding criterion is arguable in some ways. For instance, some firms operate internal markets, in which case internal sourcing may not be too dissimilar to outsourcing. And other firms have quasi-integrated some of their external suppliers. Yet this demarcation is a necessary step for further analysis, if one wishes at all to generalize beyond individual cases.

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insourcing process, which thus occurs when previously externally procured goods and services are taken in-house. By defining these terms, there is now room for both a static and a dynamic analysis of the outsourcing phenomenon. The reader who is not yet convinced of the usefulness of this distinction is encouraged to at least read the next paragraph.

A further qualification

This definition arguably does not capture other important dimensions of the sourcing phenomenon, most notably the nature of the relation between the outsourcer and the supplier on the one hand and the geographic scope of this relationship on the other. Some would for instance argue (Nooteboom, 1998; 1999) that outsourcing only occurs when the relationship is not strictly arm's length and some form of specification or customization takes place. This argument starts to run into the ground when one considers that real arm's length relations barely seem to exist and, even more importantly, recognizes that there is no natural cut-off point to determine what is and what is not specification (Hennart, 1993). Almost by definition we find a mix of specification and non-specification. Even the global currency trading market has recently been shown to be a social constellation (Knorr-Cetina and Preda, 2005). Ordering a book via Amazon using the "express delivery" option entails a form of specification too. Therefore we find a wide range of degrees of specification, which makes it hard to determine a cut-off point.

This does not mean that the analysis of the nature of buyer–supplier relations in outsourcing therefore becomes irrelevant. I will discuss the issue of outsourcing relations, and also that of geographic scope (international outsourcing or global sourcing), at length at a later stage, most notably in chapters 5 and 6. At this point it suffices to say that I do believe both dimensions are related to outsourcing (as evidenced by Mol, 2001) and that while they do not help us determine whether something is (being) outsourced, they do reflect upon the great variety of forms of outsourcing, both in terms of a variety of relations and in terms of a variety of geographical settings. And like the decision whether to outsource or to integrate activities, the way outsourcing takes place and its physical location can potentially have implications for the performance of firms.

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Two forms, three forms, many activities

Further evidence that outsourcing is not a uniformly identified phenomenon comes from responses I have received from academics and practitioners on my proposed definition of outsourcing. They suggested my definition amounts to "externalization," "external sourcing" (a term preferred by Murray, Kotabe, and Wildt, 1995) or "vertical disintegration" (a term used by Jacobides, 2005), but not to outsourcing. In addition they said outsourcing is but one form of externalization, external sourcing, or vertical disintegration. Some said there are two forms, outsourcing and purchasing; other that there are three forms including outsourcing, purchasing, and subcontracting. Finally, people have commented that it is not very useful to treat the different outsourced activities, including IT, manufacturing, BPO, maintenance, repair, and operations, and R&D outsourcing as one and the same. All of these remarks warrant a response.

My definition of outsourcing explicitly incorporates all forms of outsourcing, and includes purchasing. Purchasing is generally seen as a straightforward process, where simple specifications lead to deliveries according to these specifications. The definition also includes subcontracting. Subcontracting is sometimes used in the context of projects of limited duration. It is also used in situations where buyers drive the supply process and mostly operational information is exchanged. And the definition includes what is perhaps best called strategic outsourcing, when buyer and supplier exchange higher-level information and objectives in order to create competitive advantage.

One way to conceptualize these three forms of outsourcing is through Thompson's (1967) classical categorization of interdependence mechanisms.[4] Purchasing comes closest to pooled interdependence, when "each part renders a discrete contribution to the whole and each is supported by the whole" (Thompson, 1967: 54). In purchasing, suppliers fulfill a discrete function and no communication is needed between ordering and delivery. Subcontracting looks like sequential interdependence, when parts "make contributions to and are sustained by the whole organization . . . But, in addition, direct interdependence can be pinpointed between them, and . . . the order of

[4] I am grateful to Peter Cook for suggesting this parallel.

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that interdependence can be specified" (Thompson, 1967: 54). In subcontracting, buyer and supplier depend on each other and need to continuously communicate about operational matters, but the buyer still takes a clear lead. And strategic outsourcing is reciprocal, when "the outputs of each become inputs for the others . . . each unit is penetrated by the other . . . with each unit posing contingency for the other" (Thompson, 1967: 55). Here buyer and supplier work together more closely, what one partner does has serious implications for the other partner, and joint objectives may arise at the relational level.

These two or three forms of outsourcing, depending on whether one sees subcontracting as a viable separate form, are managed differently and carry different performance implications. Analytically, purchasing is less interesting than subcontracting or strategic outsourcing. Yet all three form part of the wider picture discussed in this book. There are two key reasons for this choice. First, there are important overlaps between the three (or two) forms, such that it will empirically be very difficult to separate one form from the other. These forms are little more than ideal types. Second, it is only by contrasting the more complex forms with the less complex ones that we gain real insights. So while the reader may indeed prefer external sourcing or vertical disintegration as the overarching term for what is discussed in this book, it is important to keep considering all three forms.

A further point is whether the different activities that are outsourced can be analyzed together. Would it not be better to treat outsourcing of software as a different phenomenon from outsourcing of market research? The answer to this question is twofold. One part of the answer is that these are different outsourced activities, which score differently on important characteristics. But the other part of the answer reads that these different forms of outsourcing can be explained by similar concepts and variables as a host of research has shown. In other words, there are differences of degree and in operationalization among these outsourced activities, but eventually the considerations driving them are quite similar.[5] Therefore there is merit in discussing the different outsourced activities together.

[5] Note that the question whether outsourcing is best discussed at the activity or the firm level is another one. It is discussed at length in chapter 3.

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A very brief history of outsourcing

It would obviously be a mistake to believe that outsourcing is somehow a recent phenomenon simply because its frequency of use has ballooned, or even to believe that the word outsourcing does not have any forerunners. Clearly outsourcing is similar in meaning to words like subcontracting, contracting out, contracting (Domberger, 1998), external sourcing (Murray, Kotabe, and Wildt (1995), and farming out (Doig, Ritter, Speckhals, and Woolson, 2001). While there is no need to define each of these terms at length, they often seem to differ from outsourcing by their use in a particular context, such as manufacturing or construction, by their reference to a particular type of outsourcing, or by the background of the user of the term. But there is little denying that both the practice and the academic study of management suffer from some repackaging of old phenomena into new terminologies (Abrahamson, 1997; Barley and Kunda, 1992) and in that sense outsourcing is neither very different from the above terms nor guaranteed any eternal popularity of itself. Therefore some understanding of historical developments and inter-temporal changes in outsourcing is useful prior to proceeding with a discussion of contemporary outsourcing strategy.

Outsourcing is in fact as old as the hills, or at least about as old as organizations themselves are. The kinds of businesses Adam Smith (1976) described very much relied on an interorganizational division of labor and subcontracting of production activities. His classical views presented the economy as consisting of markets in which an endless number of firms contracted endless numbers of activities to each other without transactional frictions or prima-facie motives for firms to grow beyond a single employee. Wilson (2005) describes how subcontracting existed from the very beginning of industrialization in Britain and how subcontractors were responsible for a range of management tasks.

To better understand outsourcing *circa* 2007, however, it helps to zoom in on changes in outsourcing in the twentieth century in general, and on three specific waves of outsourcing that have occurred over the past twenty-five years in particular. Broadly speaking, there was a rather substantial level of outsourcing in the early twentieth century, which was followed by strong vertical integration strategies that persisted into the 1970s and perhaps even the 1980s, and which themselves were replaced again by substantial outsourcing. This

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outsourcing trend has now been going on for at least twenty-five years, although it perhaps did not move into top gear until the 1990s. In our input–output analysis for a set of sectors of the Dutch economy, for instance, we found substantial rises in inter-sectoral trading patterns dating back as far as 1977 for some sectors (De Wit, Mol, and van Drunen, 1998).

In the early twentieth century contracting out was already a rather common phenomenon. Nishiguchi (1994) discusses the rising levels of subcontracting in Japanese manufacturing during the 1920s. Chandler (1977), in his work on the "visible hand" of management, sketches how there was a system of local contracting out in the United States, in which familiarity, and indeed family membership, played a major role. Such familiarity provided interpersonal trust in business contracts, thus allowing risky transactions to take place (see Lamoreaux, Raff, and Temin, 2003).

As the century progressed, however, firms changed their strategies substantially, in part forced by altered geopolitical conditions. Levels of vertical integration increased over time. The classic example of vertical integration is the Ford Motor Company. Its model of production has been referred to as "Fordism" (Piore and Sabel, 1984) and consisted of integrating into the firm not just assembly activities and production of components but even the extraction of iron ore and car dealerships. The thinking behind this strategy was that Ford could increase its scale and market power by owning all the activities required to produce a car and hence produce at low cost while excluding competing firms from its own channels (Chandler, 1977). General Motors is said to have taken the Fordist model even further than Ford itself and for a long time Fordism was the dominant production model in the automotive industry (Piore and Sabel, 1984).

Firms outside the automobile industry followed similar strategies. Unilever, for instance, maintained all kinds of agricultural facilities, including rubber plantations. Vertical integration levels appear to have risen until well into the second half of the twentieth century. One report (Ruhnke, 1966) stated that vertical integration levels might well continue to rise for another fifteen years and associated various advantages with vertical integration, including availability of supplies, control over quality and distribution, greater uniformity towards customers, and more coordination between activities. Clearly the dominant logic (Prahalad and Bettis, 1986) of the 1960s and 1970s was not geared

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