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Review Article

Outsourcing – A Review for Research and Practical Applications

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Abstract: There is an increasing need for firms to have a sustainable competitive advantage and outsourcing is one of the most important strategic tools for firms to gain a competitive edge. On studying the literature, it is identified that there are varied theoretical perspectives of outsourcing, with cost savings not being the sole reason for firms to outsource production. Based on the rich body of available literature, the types of outsourcing, factors influencing outsourcing decisions, the pros and cons of outsourcing and the strategic choices to outsourcing problems have been presented in this paper.

Keywords: Outsourcing, Theoretical Views, Competitive Advantage

1. Introduction

With the advent of globalisation, outsourcing has become one of the key strategic initiatives of firms in order to have a competitive advantage. Increasing globalization has made companies focus more on their outsourcing decisions [1]. Moving beyond the tactical companies has begun to incorporate outsourcing as a strategic weapon in their armory'. Companies are thinking about outsourcing at a more general strategic level: 'more and more companies are formulating and disseminating corporate-wide strategies for guiding outsourcing and offshoring decisions' [2]. Furthermore, firms are 'integrating offshoring decisions into the overall corporate strategy' [3]. Although there are benefits associated with outsourcing, there have been a number of studies in the extant literature on the shortcomings of outsourcing. Also, different studies have indicated cost savings as the single most important factor for outsourcing. However there are varied theoretical perspectives on outsourcing. The objective of this paper is to present a comprehensive view of the published literature on different aspects of outsourcing.

2. Literature Review

2.1. Outsourcing Defined

There have been several definitions of outsourcing in the literature. "*Outsourcing as a term has only come into vogue in recent times, even though the phenomenon itself is much older*" [4]. It refers to the practice of "t*he operation of shifting a transaction previously governed internally to an external supplier through a long-term contract, and involving the transfer to the vendor*" [5]. The strategy of outsourcing is one of the solutions to cost reduction and strengthening core competences [6, 7].

Outsourcing is also defined as the act of transferring some of the company's recurring interval activities to outside providers through a contractual arrangement [8]. The term 'outside' refers to external to the boundaries of the company, i.e. outsourcing is opposed to vertically integrated production. 'O*utsourcing means more than just the purchases of raw materials and standardized intermediate goods' since a primary characteristic of outsourcing is that there usually exists a long-term relationship between the firm which* *contracts out production and contractor'* [9]. This is the reason why purchases of intermediate products are not considered as outsourcing [10].

There are several types of outsourcing and these include subcontracting, offshoring, etc., based on the collaboration between the firms involved. Subcontracting corresponds to a particular type of outsourcing, where the relationship between principal and third party company is characterized by a '*dominant/dominated*' nature [10]. Offshoring refers to the relocation of one or more processes or functions to a foreign location [11]. This relocation can be carried out either in-house, as a tied or captive form of operations via the firm's own subsidiary; or through the use of an independent external supplier in the foreign market, referred to as outsourcing [12]. Eventually, through offshore outsourcing, a firm's capability to tap into another firm's production facilities and/or service provision capacities in a foreign location is aided [1]. Hence, depending on the level of partnership between the firms and managerial power over the outsourced production, different types of outsourcing exist [13]. It is shown that offshore outsourcing can play a crucial developmental role in a company's penetration of foreign markets [12]. Offshore outsourcing is considered as one of the strategic initiatives of firms to deepen internationalization.

2.2. Theoretical Views on Outsourcing

There are different theoretical views pertaining to how outsourcing should be dealt during different periods of history [14]. Several authors argue that different theoretical perspectives on outsourcing are widely used, but researchers still have a preference for one particular perspective [15]. Academicians typically use (i) a transaction cost approach (ii) a resource-based approach or (iii) a strategic approach [16, 17]. Three related views have been identified in the literature: the neo-classical perspective, the resource perspective and the power and dependency perspective [18]. It is significant to amalgamate the two different theoretical perspectives into a more encompassing view [19]. Several other studies also agree that it is important to combine the theoretical perspectives so as to understand the benefits and problems of outsourcing [15]. Three different theoretical perspectives, stemming from different school of thoughts have been explored. The views include (i) the cost-based view based on the transaction cost economic theory, (ii) the competence-based view based on the resource-based theory and (iii) the relationship-based view based on the social exchange theory. Furthermore, it is proposed that all the theoretical perspectives should be regarded when deciding on a firm's sourcing strategy [15].

2.2.1. The Cost-Based View

In the context of the cost-based view, outsourcing is considered as a choice between markets and hierarchies [20]. The objective of a firm is to minimise production and transaction costs and if the manufacturing capabilities of a firm is not confident to match the costs of its competitors, outsourcing should be the best option [21]. The main challenge in the cost-based view seems to be the predominance of cost considerations, and thus "scant attention being given...upon the long-term capabilities of the organisation" [14]. As a result, there is regard for other perspectives, one of which is the competence-based view [15].

2.2.2. The Competence-Based View

The competence-based view is based on the premise that firms should retain their core competences, and give up tasks not involving their core competences to outside players [22]. The aim is to protect and build competences to maintain a competitive advantage in the long term [7]. A firm should see suppliers who are resourceful to provide specialised services that could intensify its competitive advantage. Yet, a primary challenge of considering this view could be the need to extend the focus of resources [14]. Further, to attain and keep up a competitive advantage does not necessarily mean to own and control resources within a firm. On the contrary, resources can be managed by developing relationships with external entities [23]. As a result, there is regard for the relationship-based view [15].

2.2.3. The Relationship-Based View

In the context of the relationship-based view, a firm is not considered a sole entity, but should be understood based on the network in which it is integrated [24]. The efficiency and innovation of a firm is greatly improved when it is integrated in a network and hence integration is a primary requirement for attaining a competitive advantage. Outsourcing enables strong links between the participating firms, and eventually results in higher productivity [25]. Yet a primary challenge in the relationship- based view is that no single entity is held accountable to organising the processes between firms.

These three perspectives provide the foundation for our understanding of outsourcing, and have influenced the ways in which we perceive the empirical reality [15]. The three views offer rival explanations of outsourcing. The cost-based view is based on economic reasoning where decisions are made in isolation by each firm. A firm should always opt for the solution with the lowest cost, and make such choices without being constraint by other considerations. On the other hand, the competence-based view chiefly deals with a single organisation's ability to protect and develop internal competences and resources, which will provide a competitive advantage. Hence, what might seem to be a good option for outsourcing from an economic perspective can be a catastrophe from a competence view, because the outsourced activities and the competences related to the completion of the activities are what make the firm unique and competitive. Further, the relationship-based view considers an organisation as being embedded with other organisations, which provides an advantage if the single organisation understands how to access key resources in a way that spans the boundaries of the firm. Possible solutions to outsourcing problems rely on which theoretical perspective researchers or practitioners choose [15].

2.3. Factors Influencing Outsourcing Decisions

Outsourcing persists to be an important strategic drive for firms [15]. According to the theoretical and empirical literature, firm, industry and market characteristics impact the likelihood of outsourcing. Firm level characteristics that influence outsourcing decision using firm level data have been identified in their study [15]. Firms with previous subcontracting experience, higher wages, frequent market changes, R&D activities, product differentiation, large size and exporter status are more likely to engage in outsourcing.

One of the theoretical models states that transaction costs can severely hinder the adoption of outsourcing strategy and their presence would imply persistence in the outsourcing decision [26]. Therefore, previous outsourcing behaviour has an impact on the present decision to outsource. In a study of Spanish manufacturing firms, it has been identified that about 45% of firms are involved in subcontracting [15]. Furthermore, based on firm size, outsourcing strategy is more prelevant in larger firms (more than 200 workers), where around 55% of them contracted out production. Nearly 40% (42.4) of medium firms (from 25 to 200 employees) engage in outsourcing, while smaller firms (less than 25 employees) are the least involved in outsourcing. There are other related studies that identified a positive relationship between firm size and the propensity to involve in subcontracting [27, 28]. This can be attributed to the fact that large firms have lower fixed entry cost for outsourcing.

At industry level, it is identified that the decision to subcontract largely varies across industries. Five different industries such as machinery and mechanical goods, electrical equipment and other transport material are largely involved in subcontracting ("*more than 60% of firms have contracted out production in the period 1991 to 2002*"). Manufacturing industries subcontracting over the average are also textiles and clothing, editing and printing, rubber and plastic, metallic products, office equipment, motor vehicles and other manufacturing. Moreover, the propensity of firms in natural resources intensive industries to engage in subcontracting is very less. Hence the proportion of firms that engage in subcontracting varies across firm size and industries. That is, firm-size and industry-specific factors such as the productive process and market-specific characteristics seem to determine the subcontracting decision. The outcomes also point that previous subcontracting experience, wages, product differentiation, industry and firm size, exporter status, product differentiation, market changes, R&D activities and product and process innovation clearly favour engaging in outsourcing.

Firms choose to outsource not only to reduce labour costs but also for strengthening their core competences. Nevertheless, there are troubles in being an outsourcer. Prior outsourcing experience, large size and exporting seem to be requirements for outsourcing activities because they allow reducing outsourcing entry costs linked with determining suitable providers [10]. Further, '*firms increasingly outsource new product development activities to external organizations…the popularity of outsourcing is due in part to firms' ability to reduce development costs, shorten time to market, improve flexibility, and gain access to the specialized resources of external suppliers*' [29].

2.4. Capabilities Required to Outsource

There are few studies on the ways to outsource a job, some of these suggest that it is vital to "*control vendor opportunism and to incorporate incentives and penalties in contracts, in addition to pricing and monitoring clauses*" [30]. It is pointed out that leadership capabilities are needed for outsourcing [31]. Further, the need for firms to have a focus on the long-term outcomes of outsourcing, which depends on "the organization culture, the management philosophy, and the long-term and enduring choice of resources (capital, work, knowledge)" is also studied [16].

2.5. Benefits of Outsourcing

Several studies have identified the advantages firms have on outsourcing. Some of the benefits include the opportunity for firms to focus their resources on core activities; scope for greater flexibility, cost reduction, conversion of fixed costs to variables, attain benefits from the investments and innovations of their suppliers and the possibility of improving time to market [32, 33]. A survey conducted by PWC found that many top global executives believe they gain major competitive advantages from outsourcing. The study also indicates the growing importance of collaboration of firms with suppliers and service providers as a means to reduce complexity, reduce transaction costs, and gain competitive advantages. A recent study by Delloite Consulting reveals that more than 70% of the respondents of the survey had got their ROI goals improved due to outsourcing and a majority of them were highly satisfied with their outsourcing arrangements. The study also points out that the complete benefits of outsourcing is still to be explored [11].

2.6. Problems Faced by Firms When Outsourcing

While outsourcing can take place without major problems, some firms experience problems. Unfulfilled expectations or new opportunities can make alterations to existing sourcing solutions necessary. Such reconsiderations may be due to internal or external changes [15]. The increased instability of the exchange rate environment in the last several years has also led to increased difficulties in managing globally scattered operations that were once fashionable in the 1980s-90s under the rubric of global strategy [34]. The authors identify possible disadvantages and negative effects of outsourcing strategy on a global scale. Owing to global competition, most products' life cycle has seen a drastic reduction and hence a polycentric, country-by-country approach to international business is no longer feasible. If companies that have developed a new product do follow a country-by-country approach to foreign market entry over time, a globally oriented competitor will likely overcome their initial competitive advantages by blanketing the world markets with similar products in a shorter period of time. Indeed, it is imperative for companies to continuously create and acquire capabilities that would help generate a sustainable competitive advantage over their rivals. Increasingly, how to source globally has become a critical strategic decision that is influenced by the capabilities needed to compete. The problems faced by firms when outsourcing has been categorised as – (i) it was wrong to outsource the activity; (ii) the process of outsourcing was not expedient; (iii) the right solution was not identified; (iv) problems between partners evolve over time; (v) Unexpected changes have occurred [15]. Further, supply chain asymmetries pose a challenge to firm's outsourcing decisions [35].

Some of the problems experienced by firms when outsourcing are termed as "Seven Deadly Sins of Outsourcing" [36]. These seven core problems were caused by (i) poor judgement of whether the activity should have been outsourced in the first place; (ii) selecting the wrong supplier; (iii) poor preparation of the agreement between the involved parties; (iv) a lack of discussion regarding personal matters; (v) the firm losing control of the overview of the outsourcing process; (vi) hidden costs of outsourcing which were overlooked; and (vii) the absence of consideration for how to terminate the agreement with the supplier (an exit strategy). A series of difficulties concerning firms that seem to not have "*a robust methodology that sensitizes them to the main risks of the practice*" have been identified [31]. The problems identified include loss of core activities; being leveraged by suppliers; the failure of strategic flexibility; disruptions to supply; obtaining a poor quality of supply; a tumble in employee morale.

Moreover, firms end up making the error of outsourcing processes that are critical to their core competences [19]. It has been stated that difficulties may be attributed to a lack of ability of firms to carry out the outsourcing process [37]. Problems also arise in the relationships between firms, some of which could be attributed to cultural differences, lack of sufficient project specification and/or difficulties in knowledge transfer and process calibration [38].

2.7. Strategic Choices to Outsourcing Problems

It is pointed out that firms tend to reconsider their outsourcing decisions a result of problems or due to new opportunities coming up internally or externally [39]. Internal opportunities may stem from reconsiderations of competences, critical success factors and/or strategic aims. Externally, opportunities may be attributed to changes in customer preferences, new markets evolving, technologies appearing, new relationships with business partners, a change in or introduction of public regulations, and/or other parameters.

Furthermore, based on case studies of four Danish companies; suggest various alternatives open to firms when faced with the challenges of outsourced activities that call for action and solutions [15]. These solutions are identified based on the three rival theoretical perspectives. The four generic solutions comprise: (i) maintain the original outsourcing partner; (ii) obtain a new outsourcing partner; (iii) backsource to own business; or (iv) establish a new organisation. It is shown that internal and external business changes can create opportunities for new outsourcing engagements [40]. The authors also identify that operational (i.e. cost reduction and better quality), strategic (i.e. greater revenue and better resource allocation) and learning outcomes (increased process know-how) may be achieved depending on motives and contingencies. Backsourcing is regarded as another strategic solution for outsourcing problems. The other strategic choices could be to switch vendor [41]. Backsourcing refers to the act of transferring a once outsourced activity back into the organisation, with an objective to rebuilding internal capabilities.

3. Conclusion

Research in outsourcing to date is primarily on outsourcing IT/services with little focus on outsourcing production. The major areas of emphasis include the different theoretical perspectives of outsourcing, the difficulties faced by firms when outsourcing and firm level factors influencing outsourcing decisions. However there is more research required on capabilities required of an outsourcer to effectively meet the objective of outsourcing and strategic alternatives to existing problems of outsourcing.

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