



# The impact of outsourcing on the transaction costs and boundaries of manufacturing

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## Abstract

This paper discusses the concept of outsourcing, along with an account of the economic benefits that are achieved by reconfiguring the organization and reducing the transaction costs of providing products and services. With the practice of outsourcing experiencing exceptional growth, this paper examines the corresponding change (decline) in UK manufacturing as an economic activity, and considers how the economic benefits of outsourcing alter the contribution that an organization makes to a sector's gross domestic product. To assess this issue, an input–output methodology for measuring economic restructuring in UK manufacturing is presented.

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## 1. Introduction

All businesses exist because they perform value-adding processes that consist of transformation functions. Service, transportation and retail organizations perform processes that focus on information, geographical distance and availability, respectively. Manufacturing organizations focus, by definition, on processing raw material, but since the industrial revolution they have evolved into businesses that also deal with significant amounts

of information processing (design, marketing, R&D, customer service, etc.) geography processing (distribution and logistics) and availability (retail outlets).

Pioneered in the 1930s by organizations such as the Ford Motor Company, which was fervent about control, rationalization and the elimination of uncertainty, many corporations since then have sought growth and power by conglomeration, and vertical and horizontal integration. The Ford Motor Company altered the boundary of its organization by acquiring and integrating businesses that were parts of its supply chain. These included mining companies, shipping companies, railway companies and rubber plantations. This strategy, not only provided ownership and

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enhanced control of the supply chain and market, but as reported by [Lonsdale and Cox \(2000\)](#) it offered organizations the potential for economies of scale and the opportunity to exercise greater market power.

Manufacturing organizations are complex systems that consciously evolve in response to market needs, competition and innovation. Directing this evolution is a key management responsibility that involves making decisions about the configuration and boundary of an organization, to ensure competitiveness relative to market demands and stability. This concept is central to the transaction cost perspective (see Section 2.2), which asserts that organizations seek to reduce costs (direct costs and associated support costs) by forming alliances or selecting structures and practices that lead to efficiency improvements. This cost minimization hypothesis has underpinned the purchasing function and is a key issue in both defining an organization's boundary and understanding the benefits of outsourcing. For instance, in the early 1990s, many manufacturing organizations had evolved into businesses that were no longer just concerned with material processing and assembly. They had extended their boundaries and remit to focus on converting an idea or need into a marketable product, along with the provision of appropriate product support and service. The conglomeration and vertical integration activities of the previous 60 years had helped manufacturing organizations achieve this change in focus, but at the expense of burdening the organization with excess and inefficient processes and services, and uncompetitive transaction costs.

With this development in organizational focus, the need and trend for outsourcing emerged. It was based on the assumption that a competitive advantage would be gained if external suppliers were contracted to carry out non-core processes more efficiently and effectively. To achieve more proficient and profitable functions in areas such as accounting, logistics, catering, design, production, IT support and customer service, manufacturing organizations began to utilize the core-competencies of other manufacturing, service and transportation organizations. Today, manufacturing is the industry sector most likely

to outsource, with durable goods manufacturers accounting for 39% of all activity and non-durable goods manufacturers accounting for 25% ([Zhu et al., 2001](#)). In addition, with a global outsourcing market estimated at £188 billion in 1998, and with annual growth rates of 15% ([Coombs & Battaglia, 1998](#)), the distinction between economic activities in different sectors has become blurred.

With the practice of outsourcing experiencing exceptional growth, this paper examines a possible corresponding and related change, a decline in manufacturing as an economic activity, and considers how outsourcing alters the perceived contribution that an organization makes to a country's GDP. The conclusion is that the boundaries of manufacturing activity have altered, changing the ownership of certain aspects of the economic activity. Thus, to properly understand and measure the economic value of manufacturing requires an approach that recognizes the highly integrated and codependent set of activities that constitute the modern economic system of manufacturing.

To review and assess this notion, this paper will proceed as follows. Section 2 reviews the economic benefits and drivers that motivate manufacturing organizations to outsource. Section 3 provides an introductory account of the macro-economic decline that has occurred in UK manufacturing and asserts that the decline has been influenced by the practice of outsourcing, which has shifted activities and employment from manufacturing to services. Section 4 examines this claim by using an input–output methodology and more specifically the decomposition approach ([Dietrich, 1999](#)) to investigate the impact that outsourcing has had on the boundaries and outputs of the manufacturing sector. This method can be used to analyze the flow of goods and services from every sector to every other sector in the UK economy at a specific point of time. Thus, flows of goods and services can be traced between sectors and their relative contributions to economic output, value added or productivity can be estimated. The methodology is demonstrated using a range of UK input–output data. Section 5 provides a conclusion.

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