European Management Journal (2009) 27, 402–417

journal homepage: www.elsevier.com/locate/emj

Power and dependence perspectives on outsourcing decisions

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KEYWORDS
Outsourcing;
Power and dependence;
Core competences;
Asset specificity

Summary Since the 1980s outsourcing has been a major topic in both economic and management literature. Economic literature tends to focus on the transaction cost perspective. In management literature the core competence approach prevails. An emerging alternative view on outsourcing is the power and dependence perspective. Aspects of power and dependence become visible in four case studies involving the maintenance of capital assets. In each instance both the buyer and supplier sides of the dyad are examined. The paper concludes with managerial implications and research opportunities.

Introduction

Outsourcing has been widely practiced and studied since the 1980s (e.g. Ford et al., 1993; Barthélemy, 2003; Hussey and Jenster, 2003). Initially the emphasis was on outsourcing support and specialist activities in organizations, such as accounting, human resources, facilities and real estate management. In the 1990s a tendency towards the outsourcing of functions closer to the core of the organizations became apparent, including customer support and call centre functions, manufacturing and engineering (Ford et al., 1993).

Literature on make-or-buy decisions focuses mainly on the factors that influence the outcome of the make-or-buy decisions. The management literature on outsourcing is centred on the need for the firm to maximize return on investments by focusing on its ''core competences'' (Jenster and Pedersen, 2000). In contrast, the most common perspective in the economic literature concentrates on transaction cost economics and the implications of asset specificity for the outsourcing decision (Williamson, 1985). The outsourcing of activities that use assets or need investments being specific to the transaction might cause a firm to become locked-in to its supplier. If the firm tried to switch to another supplier, it would have to write off those asset specific investments. This lock-in situation for the outsourcing firm, i.e. the firm that is outsourcing activities to other firms, can lead to opportunistic behaviour by the supplier, exploiting his dominant position to renegotiate the terms

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0263-2373/$ - see front matter
doi:10.1016/j.emj.2009.01.001

of the contract, or insisting on different terms next time around (Lonsdale, 2001). Williamson (1985) argues that buyers and suppliers can and should use farsighted contracting to avoid such unbalanced asset specific investments. Hence, according to Williamson the concepts of power and dependence do not have anything to offer to analyse these situations. In contrast, Lonsdale (2001) shows that such farsighted contracting does not always take place and it does not take much for buyers to end up in a post-contractual dependence position in which they are locked-in and dominated by their suppliers. Lonsdale argued in this respect that ''it is this risk of outsourcing, rather than that of outsourcing core competencies, that appears to be at the root of a majority of the problems firms have experienced'' (2001, p. 22). In this view, the concepts of power and dependence are crucial in the analysis of outsourcing dynamics.

In this paper we endorse Lonsdale's view and present new case evidence showing that, in addition to asset specificity, power and dependence constructs strongly influence the outsourcing decision-making process. We claim that the economic logic of the transaction cost economics explanation of buyer-supplier relations needs to be complemented by a more sociological perspective which focuses on aspects of power and dependence. Thereby we attend to a weakness of the transaction cost economics view which, despite accepting the possibility of opportunism, still assumes that firms should try to pursue joint maximising outcomes in preference to trying to achieve and retain power over one another. Our aim in this study is to analyze the outsourcing decision and the outsourcing relationship with respect to issues about power and dependence. Particularly, we try to identify and describe the key variables that are considered to be important in the outsourcing relationship, and reveal why these variables are of the essence.

While a substantial body of literature has examined power and dependence in supplier-buyer relationships at the firm level (for an overview see Butler and Sohod, 1995; Gelderman, 2003), much less empirical studies on outsourcing have been carried out at the dyadic level (Jané et al., 2005; Zhao, 2007) and still fewer studies adopt a network level of analysis (Jané et al., 2005; Zhao, 2007). Our paper can be categorised as an empirical dyadic study. The specific novel contribution of this paper is the addition of new case material with a focus on the sociological perspective in outsourcing relations. By an examination of four cases, selected for the outsourcing of activities close to the core of the organization, we show how power and dependence constructs can be used to explain and better understand outsourcing decisions. Based on this exploratory work, we offer several research propositions for subsequent investigation.

In the next section, we introduce basic principles of studies about power and dependence in buyer-supplier relationships and review their relevance for the outsourcing decision. Subsequently, the methodology of this study is presented. The application of our insights from the power and dependence discussion to four dyadic case studies follows in the next section. In the final section we draw conclusions, give suggestions for further research by offering several research propositions and put forward managerial implications.

Literature review

Outsourcing is procuring a good or service from an external third party that was either originally sourced internally or could have been sourced internally notwithstanding the decision to go outside (Harland et al., 2005; Gilley and Rasheed, 2000). The difference between a regular buyer-supplier relationship and an outsourcing relationship lies in the fact that outsourcing is not simply a purchasing decision. Outsourcing represents the fundamental decision to reject the internalization of an activity, which makes it a highly strategic decision (Gilley and Rasheed, 2000, p. 764). Hence, an outsourcing relationship has the potential to have a bearing on the whole organization. This is why a first-rate buyer-supplier relationship with the firm to which activities are outsourced is of great value for an organization (e.g. Dyer and Ouchi, 1993; Quinn and Hilmer, 1994).

Over time, the scientific literature on outsourcing generated a variety of perspectives, each of which reveal factors that are relevant in the make-or-buy decision process. These views include (1) the neo-classical view, (2) transaction cost economics, and (3) the resource based view.

The neo-classical perspective centres on the production function of the firm. The outsourcing decision is based on production cost considerations. Outsourcing will lead to savings on overhead costs or it will induce short-term cost savings. Technological progress leads to specialization of small suppliers, which creates a possibility of cost-effective access to specialized functional capabilities offered by small suppliers (Englander, 1988).

In the view of transaction costs theory, the make-or-buy decision is influenced by the degree of asset specificity (Williamson, 1985; Coase, 1937). The outsourcing of activities that use assets being specific to the transaction may cause a firm to become locked-in to its supplier. A switch to another supplier would mean an unwanted write off of those asset specific investments. This lock-in situation might lead to opportunistic behaviour of the supplier, who could exploit his dominant position by renegotiating the terms of the contract or insisting on different terms next time around. This line of reasoning favours keeping activities in-house (Walker and Weber, 1984; Monteverde and Teece, 1982).

In the 1990s the resource based view emerged as a major school in strategic thinking about outsourcing (Wernerfelt, 1984). While competences express what a firm is able to do well (Prahalad and Hamel, 1990), core competencies encompass what the firm is able to do better than others (Lawson and Lorenz, 1999). As such they are the basis for a firm's unique competitive advantage. The ability to adapt core competencies quickly to changing opportunities is what ultimately drives competitiveness over time (Prahalad and Hamel, 1990). It has become conventional wisdom that core activities should stay in-house, while non-core activities should be outsourced (for an excellent overview of the resource based view of the firm, see Espino-Rodriguez and Padron-Robaina, 2006). Non-core activities that are often outsourced are for example catering services and logistics services. Kakabadse and Kakabadse (2001) show that 36 to 46% of private and public service enterprises in the USA and Europe outsource non-core activities in order to focus