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Outsourcing, competitive capabilities and performance: an empirical study in service firms

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ABSTRACT

In analyzing the relationship between outsourcing and firm performance, different authors have studied the effects that outsourcing can have on the firm. Even if we establish an initial link between outsourcing and representative measurements of the results achieved through cost savings or the creation of greater market value, no author seems to have established a precise relationship between outsourcing and the most representative measures of company performance (organizational and business performance). After reviewing the literature on this issue, we believe that research has undervalued the impact that outsourcing decisions have on our competitive capabilities. After making an empirical study of service firms, this article finds that there is a relationship between outsourcing decisions and company performance which is articulated via the impact of outsourcing decisions on the firm's competitive capabilities.

1. Introduction

In the study of the repercussions of strategic decisions on organizations, some research areas have been neglected. Various authors advocate the need for more research in this field, especially into the decisions that affect the structure of firms (Lonsdale and Cox, 2000) and suggest that this should be done in association with the performance analysis of the outsourcing strategy (Lee and Sung, 2008). In the process of monitoring the success of organizations, performance and the measurement of performance are the most commonly used tools for assessing whether or not organizations have made the right decisions (Dixon et al., 1990; Neely, 2002, 2005).

Within the degree of fit to the market environment, which has a direct effect on the results obtained, the need arises to study why firms adopt their particular structures. The main explanatory factor is the gap between the cost of accessing markets and the problem of diseconomies of scale that originate in the excessive size of certain firms (Coase, 1937). At this point the need arises to identify the boundaries of the firm correctly, defining which activities should be performed internally and which should be outsourced.

Outsourcing is a useful method for adjusting the boundaries of the firm in response to external economic pressures. It enables the firm to consolidate its strategy by restructuring its activities in order to stimulate growth of its core business. This involves a fundamental change in strategy (Prahalad and Hamel, 1990). In order to ensure that outsourcing is successful, firms should balance the strategies of vertical integration and externalization (Rothaermel et al., 2006) and analyze in detail the impact of these decisions on their results, by studying all the variables involved in this process. With this in mind, we have presented a model to study the relationship between the impact of outsourcing decisions on the firm's competitive capabilities, taking into account that this impact leads to improved company performance.

Although some authors studying the relationship between outsourcing and performance have analyzed the effect of externalization activities on the firm, we have found, as Jiang and Qureshi (2006) also indicated, few studies of the financial impact of outsourcing on firm performance (Jones, 1993; Gilley and Rasheed, 2000; Barrar et al., 2002). Many issues have yet to be analyzed in the outsourcing–performance relationship, particularly with respect to the impact of outsourcing decisions on the firm's competitive capabilities.

Having determined the need to find a relationship between outsourcing decisions and their impact on the firm's competitive capabilities, our ultimate goal will be to analyze the role of this impact, identified as the key mediating variable in the connection between outsourcing and firm performance. To this end, we have performed a study of this relationship in service firms, and we propose a model of explanatory variables to be studied through structural equations analysis.

2. Related literature

2.1. Outsourcing

Outsourcing can be defined as a predetermined means of externally obtaining goods or services previously provided by the

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organization itself (Kakabadse and Kakabadse, 2000). Almost all of the authors on this subject come to the conclusion that the firm should focus on activities in which it possesses a sustainable competitive advantage, and externalize those in which competing companies have a specific competitive advantage (Venkatesan, 1992). Prahalad and Hamel (1990) found that companies consolidate their corporate strategies through a restructuring of the firms' activities in order to stimulate the development of their main capabilities. It is necessary to develop the capacity to identify, develop and exploit the core competencies by implementing the strategy necessary to preserve them over time. Externalization of non-essential tasks to firms that specialize in performing them enables organizations to focus on the activities that generate greater added value, thus maximizing the implicit potential of these activities (Jiang and Qureshi, 2006). To achieve this, it is necessary to redefine the size and the boundaries of the organization, by deciding which activities the company will perform in-house and which activities it will outsource. In this way the company attempts to strike a balance between the different strategies of vertical integration and externalization of activities (Rothaermel et al., 2006).

Outsourcing has recently become an important component of organizational strategy, due on the one hand to pressures from management aimed at establishing the boundaries of the firm (Antelo and Bru, 2010), and on the other hand to a growing recognition of the possible advantages that can be gained from closer collaboration between the firm and the supplier of the service (Miles and Snow, 2001). Other possible advantages found in the literature on this subject include:

- Enabling companies to reduce and monitor operating costs. Economies of scale enable companies to reduce costs and distribute the cost among customers, making the achievement of economies of scale an organizational reason for practicing outsourcing (Kimura, 2002).
- Enabling organizations to focus on their core activities and competencies (Quinn and Hilmer, 1994; Sislian and Satir, 2000): By limiting the number of firm functions for which they are responsible, managers can apply their knowledge and experience to core competencies, externalizing those activities in which they are less competent, thereby benefitting from the experience of the service supplier. Within the range of decisions taken by managers, outsourcing shifts from being a mere cost saving exercise to a strategic decision that increases the firm's main capabilities (Mullin, 1996; Harris et al., 1998; Lankford and Parsa, 1999; Elmuti and Kathawala, 2000).
- Enabling the firm to respond to changes in demand when demand is variable and fragmented. The limited resources of small companies can be a conditioning factor when sudden changes in demand occur. Reductions in demand can lead to the company having to dismiss personnel in whom it has made large investments in terms of education and training (Lankford and Parsa, 1999; Pinnington and Woolcock, 1995; Kakabadse and Kakabadse, 2005).
- To sum up, outsourcing traditionally offers the firm the following advantages: To convert fixed costs into variable costs, to balance the number of employees, to reduce the needs for capital investment, to reduce costs via economies of scale, to accelerate the development of new products, to obtain access to the innovation and latest technologies offered by the supplier of the outsourced service, to focus our resources on those activities with high added value.

On the basis of these studies gathered from the literature, we propose a series of items that can be used in the scale for measuring the benefits of outsourcing decisions.

2.2. Theoretical perspectives on outsourcing

In order to compensate for the loss of internal technological capabilities, firms gradually increase their trust in external partners who can be effective substitutes for their internal capacity to generate knowledge and innovation (Quinn, 1992). Some of the main arguments in favour of outsourcing have attempted to design contingent models that seek to justify this practice from different perspectives. The literature yields a wide range of different theories that deal with this issue (Gottschalk and Solli-Sæther, 2005).

According to the transaction cost approach, companies will outsource those activities for which the benefit obtained, including both the increase in income and the reduction of costs, which is greater than the transaction costs incurred. This theory predicts that outsourcing will occur when specificity of assets is low and when we find ourselves in a state of low uncertainty and reduced frequency of transactions in these assets (McCarthy and Anagnostou, 2004). The firm cannot continue growing indefinitely; there comes a time when the costs of coordinating the activities within the firm exceed the transaction costs of the market. Thus, the firm will opt for the market or for one of the firm's own structures based on market opportunities and the efficiency to be found in these relationships. From this perspective, the theory of transaction costs defines the boundaries of the firm, as has become the theory of reference in studies of the divisional structure of the firm, vertical integration, and the establishment of strategic alliances (Hoskisson et al., 1999). Resources-based view (RBV) analyzes the firm as a set of unique strategic resources capable of generating a sustainable competitive advantage (Barney, 2001). In essence, this theory not only seeks to determine the competitive advantages obtained from the opportunities in the market, but also considers these advantages to be determined by the resources and capabilities that the firm is capable of identifying, developing and protecting (Penrose, 1959; Wernerfelt, 1984). The complexity of the outsourcing phenomenon requires a theoretical lens based on the integration of diverse theories (Ellram et al., 2008). Transaction Costs Economics (TCE) and RBV explain certain aspects of outsourcing. However it is necessary to incorporate more specific perspectives like Core Competences or Dynamic Capabilities, rather than a general perspective (McIvor, 2009). Hence, from the Competences-based perspective, core competences are the basis for developing sustainable competitive advantages (Prahalad and Hamel, 1990; Rumelt, 1994). Core competences are essential for internal as well as external firm processes (Hafeez et al., 2009).

In addition, the Dynamic Capabilities Approach considers process leveraging as source of competitive advantage through strategic positioning. Under this scope, the firm competitiveness is based on dynamic capabilities which allow firms to obtain competitive advantages within specific environments (Teece et al., 1997; Binder and Clegg, 2007).

The TCE approach, argues that the properties of the transaction determine the most efficient governance structure—market, hierarchy or alliance (Williamson, 1975). There is no clear consensus about the role of uncertainty as whether it reduces or increases the level of hierarchical governance (Walker and Weber, 1987). Complementarily, TCE focuses on the study of whether the firm should insource or outsource determined activities by balancing the potential for improvements in performance against specific conditions in the supply market (Stratman, 2008). In today's context of growing competitive pressure, firms focus on their core competencies and dynamic capabilities as source of their competitive advantage, and resort to outsourcing for those activities in which they do not have such an advantage (Prahalad and Hamel, 1990). By externalizing activities that are not of a