



## The dark side of logistics outsourcing – Unraveling the potential risks leading to failed relationships

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### ABSTRACT

We identify and empirically examine the potential risk factors and their structural relationships that can cause a logistics outsourcing relationship to fail. Specifically, we investigate how the relationship risk as perceived by apparel wholesalers as user firms influence their evaluation on the asset and competence entrusted with their logistics service providers, which are logistics outsourcing risk factors considered important by the former in determining continued relationships with the latter. The results highlight the need for relationship management by user firms to mitigate the risks in asset and competence specifically invested in logistics service providers for their outsourced activities.

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### 1. Introduction

Over the past decade, the concept of value has received substantial attention in the literature and in practice, as organizations shift to compete on providing superior value as a strategic imperative. Value has emerged as a fundamental element of relationship building (Ravald and Grönroos, 1996), with collaboration between firms in the supply chain regarded as a means of value creation. Given its importance to organizational performance, there has been growing interest in uncovering the determinants of value (Menon et al., 2005). Value is most commonly considered in terms of the trade-off between the perceived benefits and sacrifices of a supplier's offering (Zeithaml, 1988). Extant research focuses extensively on the benefits of a buyer–supplier relationship (BSR) (Lai et al., 2005; Yang et al., 2008), whereas sacrifices are mainly considered in the context of purchase price only (Menon et al., 2005). Although adding benefits is a means of enhancing value, an equally important way of creating value is through the reduction of perceived sacrifice via minimizing relationship costs (Ravald and Grönroos, 1996). A key sacrifice in BSR is risk, empirically demonstrated to exert a more powerful effect on perceived value than price (Sweeney et al., 1999). Despite this recognition, there remain considerable opportunities for further explorations specifically in the area of managing risk in BSRs, and in particular the consequences of failed relationships. Currently, most research on managing risk in BSRs examines its influence on firm performance and governance structures as a focal point (Lai, 2009); conversely little is known about the potential impact posed by failed relationships on the involved parties.

Vertical supply relationships such as logistics outsourcing are an increasingly popular alternative to traditional services such as transportation, warehousing, inventory, and value-added services (Hong et al., 2004). Some key benefits for organizations to outsource logistics activities include cost reduction and customer service improvement (Knemeyer and Murphy,

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2004). However, there is debate on whether the benefits from logistics outsourcing outweigh the risk of relationship failure (Kremic et al., 2006). It is argued that outsourcing does not always lead to service advantages and cost savings (Gerwig, 1999; Watjatrakul, 2005). Unsuccessful experiences that accrue undesirable consequences for client firms have been reported (Bahli and Rivard, 2003) and most of the research undertaken on outsourcing has revealed that the majority of managers are dissatisfied with the logistics outsourcing outcomes (Lonsdale, 1999). There is also a call for evaluation of logistics outsourcing risk by decision makers from organizations (Kremic et al., 2006), yet there remains a serious lack of studies on this important topic in business logistics (Wilding and Juriado, 2004; Lun et al., 2011).

This study contributes by shedding light on the noteworthy aspect of sacrifice in terms of different types of risks in managing BSR in the logistics outsourcing context. By understanding the potential risks in logistics outsourcing decisions, our efforts highlight the prospective elements that could compromise trust and value in managing the BSR. Grounded on the theories of transaction cost theory (TCT) and the resource based view (RBV) of firms, we conduct an empirical investigation of how relationship risk influence asset risk and competence risk on the logistics outsourcing decision of apparel wholesalers. The validated model provides a useful reference to compare and verify outsourcing theories in the logistics management context. Furthermore, the empirical results provide managerial insights on outsourcing risk issues in logistics management, such as risk mitigation, transfer, and sharing.

In the next section, we develop a theoretical framework on the interrelationships between the different risk types in logistics outsourcing decision. We then describe our methodology employed to test the framework based on survey data collected from Taiwanese apparel wholesalers. In the last section, we discuss the implications of our research, acknowledge the limitations of this study, and identify directions for this neglected but timely and important topic in logistics research.

## 2. Outsourcing risk

Outsourcing represents a fundamental decision to reject the internalization of an activity (Gilley and Rasheed, 2000). It is a means to gain access to resources where the firm suffers a shortfall in terms of resources and capabilities (Verwaal et al., 2009). Outsourcing creates value by different means and extends the firm's value creation opportunities by supplementing internal resources that are more costly to develop internally (Barney, 1991). Internal resources are enhanced by external resources (Verwaal et al., 2009) and these new resource combinations create more value (Dyer and Singh, 1998).

A production cost-based decision advocates that companies pursue more outsourcing, but increased governance costs for activities such as specification and monitoring of agreements may mean greater cost efficiency if activities were performed in-house (Kraut et al., 1999). This quandary is particularly relevant for those companies that tend to face great resource constraints (Arbaugh, 2003). Empirical evidence points to resource access opportunities as a principle driver of outsourcing decisions even though the outsourcing firm needs to use governance structures that are less efficient (Verwaal et al., 2009).

Successful and long-term oriented outsourcing arrangements depend largely on the BSR (Webb and Laborde, 2005). Firms are increasingly shifting to a relationship-based approach to meet challenges posed by the rapidly changing competitive environment (Lai et al., 2008), and growing product/service complexity (Harland et al., 2003). Despite the proliferation of collaborative BSRs, they are challenging and present an interesting dilemma; while they facilitate reduction of risk, they also generate considerable risk because there is the possibility of opportunistic exploitation arising from dependence (Lai, 2009). Examination of the potential dark side of inter-organizational relationships, such as relationship risk, is seldom investigated (Liu et al., 2008).

Risk is defined as possible events whose unfavorable consequences are difficult to accept or are even unacceptable (Das and Teng, 1996). In BSRs, there are two types of risk, namely relationship risk and performance risk (Das and Teng, 1996). Relationship risk occurs due to the possibility of relationship failure (Das and Teng, 1996; Fiet, 1995; Parkhe, 1993). It arises from failure sources including possible defection by a partner, perception of opportunistic behaviors, lack of understanding between partners, conflict risk, non-learning of competence, loss of core proprietary capabilities and encroachment risk (Delerue, 2004). On the other hand, performance risk arises due to factors which impact alliance performance such as intensified rivalry, changing government regulations, demand fluctuations, and lack of competence of partner firms (Das and Teng, 1996).

A recent study (Tsai et al., 2008) unveils three types of risk in logistics outsourcing, namely relationship, asset, and competence risk. These risks are derived using transaction cost theory (TCT) and the resource based view (RBV) of firms (Tsai et al., 2008). The TCT sheds light on the role of efficient exchange governance through analyzing the functions of firms in organizing economic activities. Nevertheless, the TCT perspective lacks consideration of relationship-based risk factors in an economic transaction (Bahli and Rivard, 2003) emphasizing the cost impact without due regard to the effect of inter-organizational collaboration (Zajac and Olsen, 1993). Recognizing that opportunism is a basic assumption of TCT, relational management on human actions can be an important part to determine economic actions and outcomes. In managing BSR, repeated collaborations need relational mechanisms to foster the continuance of the exchange and entrust parties with mutually agreeable outcomes. Simply put, organizations that outsource, or are intending to outsource their logistics activities should consider the relationship risk involved in the decision (Ngwenyama and Bryson, 1999). From a social exchange perspective, relational mechanisms such as trust and commitment are needed to reinforce partner relationships and mitigate the risks arising from unforeseen changes in the logistics chain. Considering that outsourcing can be a strategic choice, the resource-based view (RBV) of a firm has been used as a theoretical lens to examine outsourcing decisions (Arnold, 2000;

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