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Toward a model of strategic outsourcing

Tim R. Holcomb *, Michael A. Hitt [1]

Texas A&M University, Mays Business School, Department of Management, College Station, TX 77843-4221, United States

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Abstract

Acknowledging efficiency motives, firms have increasingly turned to outsourcing in an effort to capture cost savings. Transaction cost theory (TCT) has been the dominant means of explaining outsourcing as an economizing approach whereby cost efficiencies are achieved by assigning transactions to different governance mechanisms. Recent research has used the resource-based view (RBV) to examine the role of specialized capabilities as a potential source of value creation in relationships between firms. Although research in supply chain management has expanded substantially, only limited applications of TCT and the RBV are available, especially in the field of operations management. We extend both perspectives to explain conditions leading to strategic outsourcing.

Keywords: Strategic outsourcing; Operations strategy; Resource-based view; Transaction cost theory; Resource management; Value creation; Operations management; Supply chain management; Capabilities; Vertical disintegration; Intermediate markets

1. Introduction

Understanding how firms establish firm scope has interested management scholars for some time, and a body of research has explored the boundary conditions firms consider when choosing to source activity from the marketplace (e.g. Fine and Whitney, 1999; Gilley and Rasheed, 2000; Quinn, 1999). In particular, this research highlights the complex choices firms make when deciding whether to internalize or outsource production. On the one hand, internalization requires firms to commit resources to a course of action, which may limit strategic flexibility and be difficult to reverse (Leiblein et al., 2002). On the other hand, internalization may be required by firms to more effectively carry out production. The complexity of these boundary decisions has intensified in recent years stimulated by increased competitive pressures, the rapidity of technological change, and the dispersion of knowledge across different organizations and geographic markets (Hoetker, 2005; Teece, 1992). Accordingly, a variety of outsourcing arrangements has emerged. We rely on both transaction-based and resource-based logics to explain the emergence of one such arrangement *strategic outsourcing* in which firms rely on intermediate markets to provide specialized capabilities that supplement existing capabilities used in production.

What determines firm scope? A well-developed approach for boundary decisions associated with firm scope is transaction cost theory (TCT). According to this perspective, firms integrate production to minimize costs from opportunism and bounded rationality of

* Corresponding author. Tel.: +1 979 845 4852; fax: +1 979 845 9641.
E-mail addresses: tholcomb@mays.tamu.edu (T.R. Holcomb), mhitt@mays.tamu.edu (M.A. Hitt).
[1] Tel.: +1 979 458 3393; fax: +1 979 845 9641.

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firms and their suppliers, the uncertainty and frequency of market exchange, and asset specificity that arises from supplier-firm or firm-customer relationships (Coase, 1937; Williamson, 1985). This theory holds that certain types of governance mechanisms manage exchanges with particular characteristics more efficiently than others; cost economizing therefore reflects a firm's efforts to minimize costs arising from the governance of market exchanges.[2] Accordingly, the decision to outsource often rests on economizing motives related to the fit between firms' governance choices and specific attributes about an economic exchange (Grover and Malhotra, 2003; Silverman et al., 1997).

Recently, however, scholars have presented resource-based perspectives of integration that augment transaction-based views and sharpen the focus on firms' relative advantages (Combs and Ketchen, 1999; Leiblein and Miller, 2003; Poppo and Zenger, 1998). This growing body of work, which is based on the original work of Penrose (1959) and uses Barney's (1991) more recent translation of the resource-based view (RBV) of the firm, emphasizes the importance of resources in guiding firm activity and the management of a firm's portfolio of capabilities as central to competitive advantage.[3] More specifically, this research contends that the reasons for internalization extend beyond the cost of transacting through the market to the conditions that enable firms to establish, maintain, and use capabilities more efficiently than markets can do (Conner, 1991; Ghoshal and Moran, 1996; Teece et al., 1997).

The resulting convergence between these two theories has stimulated a number of empirical studies, which has created a more effective understanding of what drives strategic outsourcing. For example, in recent years, transaction cost scholars have accepted that transaction-based and resource-based perspectives "deal with partly overlapping phenomena, often in complementary ways" and that capability endowments matter to boundary decisions (Williamson, 1999, p. 1098). Combs and Ketchen (1999) found evidence that firms often place resource-based concerns ahead of exchange economies when deciding on potential interfirm cooperation. Complementary to this view, Madhok (2002) pursued the question of how firms should organize production given certain resource-based conditions (e.g. pre-existing strengths and weaknesses). He suggested that boundary decisions depend not only on the conditions surrounding the transaction, but also on capability attributes, and the governance context that it creates. Thus, substantial empirical support exists for the proposition that capability considerations trade-off with economizing constraints in the decision to outsource (e.g. Hoetker, 2005; Jacobides and Winter, 2005; Poppo and Zenger, 1998).

Our work contributes to this stream by extending earlier conceptualizations of outsourcing based on economizing conditions, such as asset specificity, small numbers bargaining, and technological uncertainty, to include factors that influence the selection and integration of capabilities from intermediate markets (Argyres and Liebeskind, 1999; Jacobides and Winter, 2005). In particular, we consider the complementarity of capabilities, strategic relatedness, relational capability-building mechanisms, and cooperative experience as four important conditions that establish a resource-based context for strategic outsourcing. According to this perspective, in the decision regarding the strategic outsourcing of production, firms evaluate internally accessed capabilities and those capabilities available externally from intermediate markets, and consider how they might best be integrated to produce the greatest value.

Therefore, this work goes beyond the question of governance mechanisms to enrich our understanding of capability selection and use, providing a more meaningful understanding of strategic outsourcing. Whereas transaction-based perspectives typically confine outsourcing to more specialized, repetitive activities such as manufacturing, logistics, and facilities management, resource-based theory provides a context to explain strategic outsourcing arrangements for more visible and

[2] There are multiple sources and aspects of transaction costs. Coase (1937), for example, emphasized the 'frictional' costs, such as those costs that arise from negotiating, drafting, and monitoring contracts. Williamson (1975, 1985) expanded this perspective by focusing attention on the costs of transactional hazards (e.g. difficulties) and governance mechanisms to limit such hazards. Whereas Williamson focuses on the tendency of transaction difficulties to emerge as a function of the exchange, Coase's frictional costs are a feature of economic conditions that occur independent of deliberate calculation or motives (see also Jacobides and Winter, 2005).

[3] Resources, broadly defined, have often been used in the literature in a generic sense to include capabilities (e.g. Barney, 1991). Other scholars have claimed that capabilities represent how firms *manage* resources (e.g. Dutta et al., 2005; Helfat and Peteraf, 2003) or that capabilities represent a unique combination of resources that enable firms to pursue specific actions that create value (Sirmon et al. in press). For purposes of this paper, we use 'resources' to represent tangible or intangible assets owned or controlled by firms (Barney, 1991; Grant, 1996) and 'capabilities' to represent organizational routines that allow firms to effectively integrate and use resources to implement their strategies (Lavie, 2006; Winter, 2003).