



## How the transaction cost and resource-based theories of the firm inform outsourcing evaluation

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### ABSTRACT

Transaction cost economics (TCE) and the resource-based view (RBV) of the firm have been extremely influential in the study of outsourcing both in theory and practice. This paper argues that neither transaction cost economics nor the resource-based view alone can fully explain the complexities of outsourcing. A review and critique of these theories as a means of understanding the complexities of outsourcing is presented. A prescriptive framework for outsourcing evaluation is presented, which was developed from integrating TCE and the RBV, and carrying out in-depth case study research in a number of organizations. The research findings emphasize the utility of integrating TCE and the RBV, and highlight the importance of operations management concepts such as performance management, operations strategy, business improvement and process redesign to the study of outsourcing. However, the findings have shown that these theories should be applied with caution due to contradictory prescriptions in some instances.

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### 1. Introduction

The drive for greater efficiencies and cost reductions has forced many organizations to specialize in a limited number of key areas. This has led organizations to outsource activities and services traditionally carried out in-house. Although the term outsourcing has been in vogue in the last number of years, organizations have always made decisions on determining the boundary of the organization. However, rapidly developing product and service markets – both locally and offshore – and developments in information and communications technologies (ICTs) have accelerated the growth in outsourcing to encompass almost every organizational activity (Aron and Singh, 2005). Outsourcing has moved on from focusing on peripheral activities such as cleaning, catering and security, to encompass more critical business activities such as design, manufacture, marketing, human resource

management and logistics. Many organizations are increasingly considering outsourcing as a critical element of their organizational strategy (Holcomb and Hitt, 2007). Outsourcing is regarded as a powerful vehicle to reduce costs and improve performance. For example, specialists in supply markets can develop greater knowledge depth, invest more in software and training systems, be more efficient, and therefore offer higher salaries and attract more highly trained people than many integrated companies (Quinn, 1999). Outsourcing can also be employed to cope with demand uncertainty and to obtain the benefits of supplier scale economies in a range of business areas.

The study of outsourcing has become a rich tapestry of theoretical and conceptual foundations, drawing on theories from a range of disciplines such as economics, business strategy, organization theory and general management. Two influential theories in the study of outsourcing have been transaction cost economics (TCE) and the resource-based view (RBV) of the firm. Both these theories make a valuable contribution to understanding outsourcing. TCE specifies the conditions under which an organization should manage an economic exchange

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internally within its boundaries, and the conditions suitable for managing an economic exchange externally, i.e. outsourcing (Williamson, 1975, 1985). TCE argues that organizations should consider the level of transaction-specific investment in the economic exchange as the principal determinant of whether an economic exchange should be managed internally within the organization. An alternative theory to understanding the outsourcing decision is the RBV, which views the firm as a bundle of assets and resources that, if employed in distinctive ways, can create competitive advantage (Peteraf, 1993; Barney, 1991). The RBV is important to the study of outsourcing, as superior performance achieved in organizational activities relative to competitors, would explain why such activities are internalized within the organization. The core competence concept developed by Hamel and Prahalad (1994) – which has evolved from the RBV – has been extremely influential in outsourcing practice, with the distinction between core and non-core business firmly established in the lexicon of many practitioners.

The research presented in this paper has evolved from a research project concerned with analyzing both the theoretical and practical influences on outsourcing in a range of organizations. The paper presents a prescriptive outsourcing framework, which is derived from integrating variables from TCE and the RBV, and undertaking in-depth case study analysis of three organizations that have been involved in extensive outsourcing. The findings show that neither TCE nor the RBV alone adequately explain the complexities of outsourcing. The research makes a number of important contributions. Firstly, it enriches our understanding of the influence of TCE and the RBV in outsourcing decisions. The variables associated with each of these theories were present in the outsourcing decisions of each company studied. Indeed, the findings in a number of the companies studied have shown that appreciation of these theories is both necessary and complementary for making outsourcing decisions. These theories also highlight the importance of operations management concepts such as performance management, operations strategy, business improvement and process re-engineering to outsourcing. However, the findings have revealed that organizations can make outsourcing decisions, which are based solely on variables associated with a single theoretical standpoint. This is an important area for further research, as in some outsourcing decision-making contexts the predictions of each theory can be contradictory.

Secondly, the research makes a contribution to an area that has received limited attention from operations management scholars (Holcomb and Hitt, 2007). A number of scholars in the operations field have argued that more research should be carried out examining the influence of theories from economics and strategic management (Grover and Malhotra, 2003). Although a number of authors have employed TCE and the RBV in an operations management context (Vivek et al., 2008; Holcomb and Hitt, 2007; Jiang et al., 2007; Hayes et al., 2005; Grover and Malhotra, 2003; Williams et al., 2002; Coates and McDermott, 2002; Vastag, 2000), none of these studies use both these theories to develop a

prescriptive outsourcing framework. Traditionally, operations management has focused on the make-or-buy decision in a manufacturing context (Powell Mantell et al., 2006). However, in an era of large-scale manufacturing and services outsourcing, both locally and offshore, there is an increasing recognition that operations management scholars should employ multiple theories from disciplines such as strategy, economics and organizational behavior to study outsourcing (Ellram et al., 2008; Youngdahl and Ramaswamy, 2008). The research presented in this paper further enhances our understanding of outsourcing in the context of operations management research using TCE and the RBV. Both of these theories are focusing on important concerns for operations management scholars, including the development and leveraging of capabilities for competitive advantage, and understanding where it is appropriate to pursue efficiencies, and where it is appropriate to pursue collaborative relations with suppliers.

Thirdly, the research in this paper has addressed an important area for practitioners. As organizations increasingly outsource more critical business areas such as design and customer relationship management, they are seeking to leverage a greater level of value from outsourcing. Although cost concerns are still important motivations for outsourcing in many contexts, the implications for the long-term capabilities of the company have to be considered. The outsourcing framework developed in this paper provides a valuable basis for practical prescription, which recognizes both capability and opportunism considerations. In particular, it provides a mechanism for understanding which activities should be internalized or outsourced, based on organizational capability considerations rather than on opportunism concerns alone. It also highlights the different outsourcing relationship configurations available, based on the need to either reduce cost or create value.

This paper considers outsourcing from a strategic perspective, which involves employing outsourcing not only to reduce costs, but also to allow an organization to develop a range of capabilities and leverage the specialist capabilities of suppliers (Holcomb and Hitt, 2007). The research focuses on the evaluation phase of the outsourcing process, which involves assessing whether outsourcing an activity is appropriate for an organization. This involves considering issues such as the capability of the organization in the activity relative to competitors, the impact of the activity on competitive advantage, the capability of suppliers to provide the activity, supply market conditions, and selecting the most appropriate relationship strategy. The paper is structured as follows. In the review of the literature, the characteristics and limitations of TCE and the RBV as a means of understanding outsourcing are outlined. An overview of the case organizations and outsourcing decisions studied is presented. This is followed by an overview of the measures and the outsourcing framework developed from TCE and the RBV, and the analysis of the case study organizations. In the next section, the theoretical implications of the research are explored, and areas for future research are proposed.

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