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The dilemma of outsourced customer service and care: Research propositions from a transaction cost perspective ☆

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ABSTRACT

This article aims to understand why customer service outsourcing and offshoring may lead to backlashes, as increasingly evidenced in the managerial literature. After identifying the motives behind outsourcing, and examining the extent to which customer service and care might or should be considered a core competence, transaction cost analysis (TCA) is proposed as a framework to better understand the contractual atmosphere that arises between a principal (i.e. a firm or customer) and the agent (i.e. an outsourcing service vendor or subcontractor), the result of which can affect service delivery. The main concepts of TCA, related to human behavioral factors as well as the market environment, are used to develop six research propositions that provide insight into the repercussions associated with the outsourcing of customer service and care, while also presenting guidance to those firms that might undertake such outsourcing strategies.

1. Introduction

Outsourcing has become an increasingly routine component of business strategy in the global economy. Defined as the “strategic use of outside resources to perform activities traditionally handled by internal staff and resources” (Quinn & Hilmer, 1994), outsourcing involves an organization relinquishing the management and optimization of a business function to a third party that conducts the activity based on a set of predetermined performance metrics. As noted by Kakabadse and Kakabadse (2005), the concept and practice of outsourcing is not new, dating back to the Roman government's bidding out of the tax collection function for defined regions within the empire to wealthy individuals who would in turn hire district managers and local individuals to do the actual collecting. In essence, outsourcing is “the fundamental decision to reject the internalization of an activity” (Gilley & Rasheed, 2000), involving a “make versus buy” or “provide versus contract out” choice that spans any number of activities within the firm, including manufacturing, information technology, legal, payroll, benefits, shipping, accounts receivable, training, procurement, logistics, call centers, and customer service, among others.

Originally instituted as a cost-cutting exercise during the recession of the 1980s, the rapid emergence of corporate reengineering and de-integration strategies added to the increasingly global nature of business operations fueled further interest in outsourcing initiatives throughout the 1990s and into the 21st century. While global estimates of the business process outsourcing market range from $150 billion to over $400 billion annually, experts agree that the practice has expanded tremendously over the last decade (e.g., Deloitte Consulting, 2005; Gartner, 2005; Gilley & Rasheed, 2000; Kakabadse & Kakabadse, 2005). Indeed, in today's business environment, some argue that the decision is not so much *whether* to outsource but *what* to outsource (Tompkins, 2005). Overseas outsourcing has been a particularly attractive, although sometimes politically controversial, arena as companies seek both access to new markets and reduced operating costs. “Offshoring”, a related practice wherein a company moves an internal business function from a domestic location to a foreign country, has also increasingly gained favor. Foreign locations like India, Pakistan, Malaysia, Mauritius, the Philippines, North Africa, Egypt, Latin America, and Eastern Europe have played a significant role in the growth of outsourcing and offshoring among U.S. and European firms due to their relatively inexpensive labor, often attractively combined with well educated workforces.

The rationale behind a company's decision to outsource can largely be divided into three categories: anticipated cost savings, attempt to improve quality or expand services through contracted expertise, and a desire to focus internal resources on core competencies. Other related perceived benefits include achieving economies of scale, increased flexibility and reaction speed, better documentation of internal processes, and spreading risk to vendors (Gilley & Rasheed, 2000). While empirical support has been limited, researchers have suggested that outsourcing firms achieve cost advantages versus those that choose to vertically integrate (e.g., Bettis, Bradley, & Hamel, 1992; D'Aveni & Ilinitch, 1992), and irrespective of actual results, there is

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little question that expected cost reduction is a major, if not primary, driver of the outsourcing decision (Deloitte Consulting, 2005; Prahalad, 2005; Quinn & Hilmer, 1994).

Economic theories are prone to advise firms to look for cost reduction whenever it is possible to better rationalize business process efficiencies. The question of whether to internalize or externalize activities has been widely studied by Williamson (1971, 1975, 1979, 1985), leading to an important research stream on transaction cost analysis (TCA) (Rindfleisch & Heide, 1997). TCA defines the boundaries of a firm by asking whether a particular function or activity is better performed within the firm (vertical integration) or by entities outside the firm (outsourcing). Further, TCA is concerned with interfirm issues, specifically the governance structure or relationships between the company and its external partners, the result of which can affect the delivery of the service or activity being contracted out. However pertinent Williamson's theoretical foundations may be in understanding how a company should envision its outsourcing decisions, to our best knowledge, the literature does not provide yet a comprehensive theoretical framework explicating the potential downsides of such a business undertaking as it relates to customer service. A close look at Williamson's (1975) concept of the contract atmosphere between principal (company) and agent (contract service provider) may be instructive as to potential consequences for customers, and as such, warn firms on the implicit risks associated with customer service outsourcing and offshoring.

Despite the concerns of managerial reports underlining the potential failures of outsourcing strategies (Deloitte Consulting, 2005), and recent well-publicized failures among several large American companies that resulted in scaling back or bringing back outsourced entities, such business process reorganization is still in fashion. Hence, this article addresses two specific questions: 1) Could backlashes associated with customer service outsourcing be predicted? 2) How can theory be useful in guiding and warning companies confronted with a decision of outsourcing customer service operations? Thus, the main objective of this research is to develop and justify a theoretical framework ultimately rooted in the TCA literature that leads to research propositions about customer service outsourcing decisions. We first question the concept of core competency in the context of outsourcing; we then examine to what extent customer service and care might or should be considered a core competency; in a third part, we identify some cautionary considerations for outsourcing that may arise from the TCA literature; and we finally conclude with a TCA-based set of research propositions that should be considered when outsourcing is at stake.

2. Outsourcing and core competencies

In a business climate marked by increased prioritization of cost containment measures as a means of hitting financial targets, particularly among underperforming or less than competitive business units, cost reduction initiatives are often seen as a more palatable and less risky course of action than attempting to increase revenues through additional expenditures or investment. This ongoing attempt to “do more with less,” indicative of a business climate marked by continued downsizings and restructurings, results in a management focus that naturally turns to cost efficiency and to initiatives that achieve a higher return on assets through less capital commitment, reduced overhead, increased flexibility to respond to change, and leveraging of subcontractor economies of scale (Insinga & Werle, 2000).

Perhaps the more compelling and strategically proactive motive to outsource, however, is the desire to increase focus on the firm's core competencies. The assumption here is that by shedding certain less critical activities, the firm is better able to concentrate internal resources on those activities supporting its core competencies while simultaneously leveraging the specialized capabilities of an outsourcing company. Clearly there are many firms who have had great success with this strategy. Popular examples include Nike, which outsources all of its shoe production while focusing on R&D and marketing, and Apple, which outsources numerous functions while concentrating its own resources on its operating system. A much earlier example is Coca-Cola, which in the late 19th century made the decision to focus on the production of syrup, its fountain business, and marketing, while outsourcing its bottling operations to independent bottlers (although several decades later the company would seek to regain control and financial benefit through a vertically integrated equity position in its bottler network). Other companies, however, have stumbled in such core competence related outsourcing decisions. For example, IBM has been criticized for contracting out the design of its personal computing operating system rather than developing that capability in-house, spawning the behemoth Microsoft. More recently, firms like Dell, Conseco, and Capital to name but a few, have struggled with customer relationship issues arising from the outsourcing of customer service and customer care activities.

A major issue is that conceptualizations of “core competence” differ among both researchers and practitioners. In their seminal article on the topic, Prahalad and Hamel (1990) define core competencies as “collective learning in the organization, especially how to coordinate diverse production skills and multiple streams of technology,” that provides a source of competitive advantage. They in turn suggest three tests for identifying a core competence — (1) provides access to a wide variety of markets, (2) makes a significant contribution to the perceived customer benefits of the end product, and (3) is difficult to imitate. In subsequent explorations of the topic, researchers have offered various alternative definitions of core competence, some broader in scope, some more restrictive (e.g., Coyne, Hall, & Clifford, 1997; Goddard, 1997; Hafeez, Zhang, & Malak, 2002; Hamel, 1994; Lahti, 1999; Quinn, 1999; Srivistava, 2005), and related terms like meta-competencies, critical competencies, and distinctive capabilities have been introduced.

While clearly there is little agreement on exactly what constitutes a core competence, precision with respect to one's conceptualization of core competencies is crucial when used as a basis for the outsourcing decision. Many of the definitions imply that among other things core competencies are a very limited number of intangible capabilities that likely span multiple activities and functions and that can be leveraged to provide competitive advantage in meeting customer needs. It is important to note that in the context of an outsourcing decision, in most cases what really is being discussed is not the outsourcing of a competence per se, but rather the outsourcing of an activity, function, or process. The logical question that follows is whether the particular activity, function, or process is an integral part of, or is critical to, the cultivation and deployment of one or more core competencies. Some may in fact be considered “commodity” or “peripheral” capabilities that are non-core, non-strategic, and non-differentiating (Deloitte Consulting, 2005) and as such advantageous to outsource. This, however, prompts the related question as to whether there are distinctive capabilities or even critical activities apart from core competencies that simply should not be outsourced. Is there such a thing as a core incompetence, that is, the lacking of a capability so fundamental to the firm's viability that its existence could be extremely harmful if not ultimately fatal to the firm? Is it in fact possible that the outsourcing of an activity, even one that appears on the surface to be peripheral, could contribute to the development of such a core incompetence? If so, one could argue that an “in-source what is core and outsource what is not” approach is, while straightforward and seemingly logical, somewhat simplistic and fraught with danger.

3. Outsourcing, core competencies and customer service and care

One certainly can make the case that a decision to outsource anything that might significantly impact customer satisfaction should,