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Offshore outsourcing of professional services: A transaction cost economics perspective

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Abstract

This research utilizes the framework of transaction cost economics (TCE) to develop an understanding of how firms manage the costs and risks of offshore outsourcing of professional services. This research examines the perspectives of eight organizations through interviews with 10 high-ranking supply management executives. The paper first explores the rationale for offshore outsourcing among the organizations studied. Using the tenants of TCE, this paper postulates that fixed costs of establishing the relationship dominate the variable costs of day-to-day transactions, and that organizations will not offshore outsource areas where there is high perceived degree of unmanageable risk. The paper expands on themes provided by TCE and offers some lessons learned, and guidelines for managing and controlling offshore outsourced services relationships.

Keywords: Business process outsourcing; Professional services; Transaction costs; Case studies; Service purchasing; Offshoring

1. Background/introduction

Outsourcing provides a potential path to price reductions and increased flexibility, allowing firms to convert fixed costs into variable expenses, and increase their economies of scope. Studies indicate that short-term price savings continues to be a predominant reason for both offshore and domestic outsourcing (Corbett, 2005; Doig et al., 2001). Yet the ramifications of outsourcing go well beyond immediate price reduction. Outsourcing has implications for day-to-day management and performance, as well as strategic implications. Outsourcing decisions clearly affect a firm's cost structures, but may also affect the long-term competitive situation and alter the nature of risks that the firm must manage.

Offshore outsourcing presents many opportunities that are not available domestically. For example, due to low Indian labor rates, an airline was able to offshore outsource its accounts payable auditing and recover $75 million in delinquent accounts that would not have been cost-beneficial to pursue domestically (Farrell, 2004). Outsourcing can also help a company get better, more state of the art services than it could afford internally. This is a commonly stated reason for outsourcing information technology (McDougall, 2004).

Clearly, there is much more to outsourcing than simply saving money. Offshore outsourcing creates both new opportunities and often unrecognized hazards, which may limit a firm's prospects. The long-term costs

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of these unanticipated consequences can greatly overshadow the potential cost savings. As such, careful consideration should be given to outsourcing decisions including all of the potential long-term consequences. It is no wonder that there has been a call for more research on offshore outsourcing of services (Roth and Menor, 2003).

The purpose of this paper is twofold. First, it explores why firms state that they choose to offshore outsource professional services. The second issue, and primary focus of the paper, is to use the framework of transaction cost economics to develop an understanding of how firms are managing the costs and the risks of offshore outsourcing professional services. Professional services offshore outsourcing is the focus because of its rapid growth and the expectation that this trend will continue (Apte et al., 1995; Bardhan and Kroll, 2003, 2006; Roth and Menor, 2003). Professional services require unique skills and independent work effort to satisfy the organization's temporary or ongoing needs. Included are areas such as information technology, advertising, customer service, accounting and payroll. Using transaction cost economics (TCE) as the framework, it is postulated that organizations will choose the business alternative that yields the lowest total cost of running their operations. TCE provides a rich framework beyond cost, also hypothesizing that organizations will not offshore outsource areas where there is high potential risk of supplier opportunism. TCE proposes that supplier opportunism is highest when the buying firm cannot specify or does not know what it wants, and when the buying firm cannot accurately assess whether the supplier is actually keeping its commitments.

The perspectives of eight organizations were explored through interviews with 10 high-ranking supply management executives who were intimately involved in the selection, relationship execution and ongoing management of offshored and outsourced professional services suppliers. The themes provided by TCE are expanded upon and some lessons learned are presented, along with guidelines for effectively managing and controlling offshore outsourced services relationships.

2. Review of recent literature

Outsourcing is not a new topic. Often called the ''make-or-buy'' decision, organizations have been grappling with what to perform internally versus what to ''buy'' in the marketplace as long as business has existed. Outsourcing is often seen as way for organizations to reduce costs and investment, while focusing on what they do well (Doig et al., 2001). For two decades, organizations have been warned to tread carefully into the outsourcing arena, not to outsource items that are strategic, or part of their core competency (Arnold, 2000; Prahalad and Hamel, 1990; Venkatesan, 1992; Quinn and Hilmer, 1994), and to manage outsourced relationships judiciously (Williamson, 1985). More recently, authors have emphasized the need to provide better controls and monitoring of outsourced relationships (Amaral et al., 2004). Managers have also been cautioned to understand the true, long-term cost structure of what they are outsourcing; realizing that a comparison to their internal cost structure may not be valid (Doig et al., 2001). Despite the increasing number of cautions, the pull to outsource remains strong, and growing.

For purposes of this research, offshoring is defined from a U.S.-Centric perspective to include sending work to countries outside of North America. Nearshoring includes sending work from the U.S. to Canada or Mexico. Outsourcing is distinguished from retaining work in-house in that work is performed by independent parties who are not part of the firm's employee base. Here, offshore outsourcing refers specifically to using an independent supplier outside of North America. Within the realm of outsourcing, there is a range of degrees of outsourcing, as will be further detailed in Table 4.

Much of the previous literature and studies have focused on manufacturing outsourcing (e.g. McCarthy and Anagnostou, 2004; Takeishi, 2001; Ulrich and Ellison, 2005; Wu et al., 2005). Manufacturing outsourcing has been more prevalent historically, and received a great deal of attention in the late 1980s and early 1990s when there was fear that industrialized nations were compromising their long-term competitiveness by ''hollowing out'' their manufacturing through outsourcing. Today, the attention has shifted towards the new move to outsource services, most notably to outsource professional services to offshore locations. Offshore services outsourcing is now possible due to the advent of relatively cheap and reliable information and telecommunication technologies. Most of the discussion around professional services offshore outsourcing has been around the impact on jobs and the economy (Bardhan and Kroll, 2003; Garner, 2004; Farrell and Agrawal, 2003). However, the operating implications of professional services outsourcing may be more subtle and insidious than manufacturing outsourcing. This includes the loss of understanding of the outsourced process that allows the firm to fairly evaluate the price and performance of a supplier over time (Amaral et al., 2006; Takeishi, 2001). On a more