



Outsourcing decision making: Can we make it more considered?

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Introduction

There is a constant drip drip of stories in the press announcing the march of outsourcing. The suggestion is that if you are not doing it then you are old fashioned, off the ball. One reason for the publicity is the stream of consultants' reports that describe either new outsourcing deals done or surveys of future intentions. Words, however, do not always live up to deeds. Or at least that is what we always thought. But now, especially in the public sector and in the age of recession, there may be substance to the prognostications of outsourcing growth.

What may not have changed is that organisations frequently do not make decisions in a systematic manner; they are driven by fads, the earning of organisational 'brownie points', a headline reduction in headcount and/or to rid the organisation of the business equivalent of 'the turbulent priest'. Judgements are tactical rather than strategic, with little relationship to a business or resourcing overview. The emphasis is often on immediate cost savings. There is little attempt to consider the longer term implications: a reflex response 'to get the business through a crisis or to secure a transition' (Hunter et al, 1993) and fail to 'accept that outsourcing is not about giving up management but managing in a different way' (Lacity et al, 2010).

Or the decisions are ideological. Free market liberals believe that tasks performed internally are by definition going to be more expensive than those delivered externally because they are not exposed to the rigours of the market. Moreover, these internally-managed tasks divert management attention from more important business issues. These ideologues believe in-house arrangements generate more work, result in over staffing and lead to greater inflexibility. Some have taken this further by arguing the need to create what have variously been described as the *virtual*, *modular* or *minimalist* organisation. Size is restricted as much as possible and the organisation works through a series of loose and temporary networks assembled to perform specific tasks as required.

So here outsourcing might be chosen not just to reduce expenditure, but also to change the organisational culture, to alter the attitudes to work of the remaining employees, making them more commercial and customer oriented.

There are of course organisations that do choose outsourcing in a more considered case-by-case way. Some organisations are attracted to the shift from fixed to variable costs and the resourcing flexibility implicit in a well-constructed outsourcing deal. Others want access to technology or skills that is obtainable at an acceptable cost only through an external supplier. Their principal aim is to improve service quality rather than save money.

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We offer below some mechanisms for making better quality and informed decisions that go beyond the lazy or political motivated choices, incorporating a range of factors, not only cost, and help those that pragmatically want to make the right choices.

Theories and models of outsourcing

We look at a number of conceptual models of decision making with respect to outsourcing. The theories propose distinct methods by which organisations might make strategic outsourcing decisions. They do not seek to provide a prescriptive methodology, or be universally applicable to this type of choice. Indeed, elements of one, or both, theories may be more/less applicable to different organisations.

Core versus peripheral activities

Atkinson and Meager (1986) proposed in the flexible firm model that the decision to outsource will depend on the organisation differentiating between those activities that are considered core to the business operation, and those which are more peripheral in nature. The critical question that then arises is on what basis is the decision made on what constitutes the core and what the periphery.

Some organisations have merely identified those activities that are core and those which are not based on implicit criteria. Other organisations may make a more explicit judgement distinguishing between those activities that are considered the source of its competitive advantage and those that are not. Hamel and Prahalad (1990) emphasised the importance of core competences with the understanding that activities related to other competencies should be outsourced. One argument in favour of such an approach is that it enables the management to focus on key organisational attributes. Yet this too requires further analysis, as it is by no means immediately apparent what provides competitive advantage or which competencies do.

A different method is to look at the processes, to determine what is critical to successful performance: the organisation's 'value chain'. Techniques such as activity analysis and business process redesign may help to identify the key elements, as can customer analysis. Thus it may be said that strategic or financial management are core processes, as are the management of external relations, including supply contracts, or design rather than production. Another approach is to decide which are the skills that the organisation above all else needs to control or nurture. The table below offers one view of how you might view the distinction.

Core versus peripheral activities

Core	Versus	Periphery
Skills specific to the firm	vs.	Generic skill requirements
Limited labour supply	vs.	Minimal supply restrictions
Hard to define tasks	vs.	Well defined or limited tasks
Activities which are well integrated	vs.	Jobs easily separated from other work
Easy to fund work	vs.	Resource intensive (especially in financial terms)
Stable work demands	vs.	Fluctuating work demands
Mature technologies	vs.	Those subject to rapid technological change

Source: IES, 2014

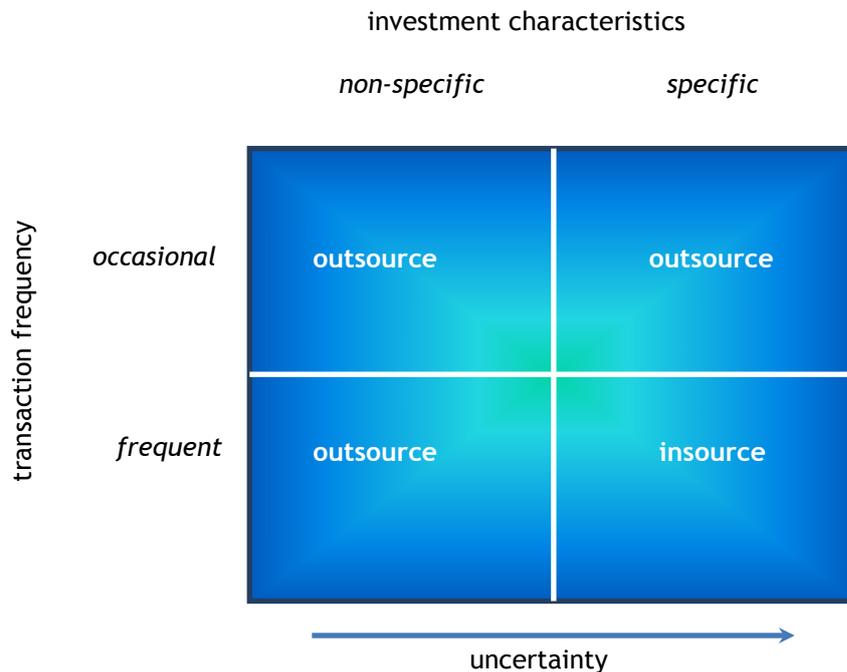
Transaction cost economics

Transaction cost economics provides a theoretical framework for assessing the option to keep an activity within the organisation, or to seek an externally provided alternative. Developed by Williamson, this perspective argues that the organisation will seek to choose 'the most economical governance structure' (Williamson, 1979). The theory argues that in transactions the 'make' versus 'buy' choice is composed of three key elements:

1. degree of uncertainty
2. frequency of transaction
3. specificity of activity/investment:
 - a. is the activity bound to a particular location(s)
 - b. how specific is the task (equipment/skills needed etc)
 - c. how specialised is the human knowledge needed?

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Williamson's transaction cost analysis (simplified)



Source: Reilly and Tamkin, IES, 1997

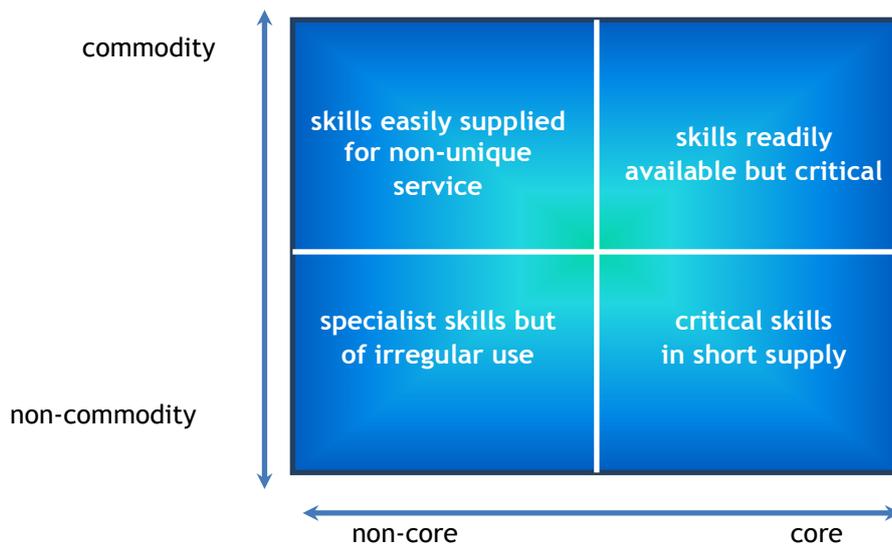
Supporters of this perspective argue that using transaction cost economics can assist an organisation in assessing the relative difference and competitive advantages between 'market costs' and 'production costs'. Outsourcing decisions based on transaction cost economics are likely to focus on the economies of scale and specialist skills available via vendors, although the effect of these benefits are likely to diminish as the level of service becomes more bespoke and frequently produced. Market arrangements, however, need to be closely monitored otherwise the supplier will seek to take advantage of the client because of 'opportunism' (Williamson, 1973). This involves a lack of honesty in behaviour or 'self-interest seeking guile' (Williamson, 1973). This sort of exploitation is particularly evident where there are a small number of vendors. Internal management does not have these governance costs because all those employed should be working for the common purpose of the firm's profit maximisation. There are also advantages in continuity, communication and control that should lead to better efficiency and performance.

Labour market-driven decision making

The following model builds on the core/periphery model and transaction cost economics, but emphasises the labour market context. So to the core/periphery distinction it examines whether skills are a 'commodity' ('a class of goods for which there is demand, but which is supplied without qualitative differentiation across a market' to quote Wikipedia) or not. Organisations thinking of outsourcing should be

mindful of whether the skills they need can in the first instance be traded and then whether they are, or will be, abundant or constrained in the market. The more they are of the latter type, the higher the cost and the greater the risk of outsourcing – suppliers holding vendors over a barrel or simply an inability of the supplier to provide the requisite (in terms of knowledge, skills and experience) people.

Skills based outsourcing assessment



Source: Reilly and Tamkin, IES (1997)

The other angle to consider by this model is the connection with the Resource Based View of the Firm (Barney 1991). This assesses whether the skills or capabilities in question (which can go well beyond people-related capabilities) are specific to the organisation and not easily imitated by competitors. If they are, they form a source of competitive advantage. In some versions of this approach (Argyres, 1996) it is simply necessary to outperform the competition in generic activities – this may be because of, for example, production or logistics execution capabilities rather than through say unique product design.

In comparing the resource-based view (RBV) of the firm with Transaction Cost Economic (TCE) theory, Espino-Rodríguez and Padrón-Robaina (2006) write that the latter ‘explains the negative consequences of outsourcing specific assets, while the RBV centres on the positive aspect of not outsourcing those activities comprising specific assets.’ This is because in the resource-based view of the firm, competitive advantage is rendered by continuing in-house with ‘specific assets’ whereas TCE worries about supplier exploitation and ignores core capabilities.

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Cost assessment

Since cost management is often a critical feature of the business case to outsource, it would be sensible to review the cost arguments more fully. This is done in the model by Benaroch et al (2010) which is set out below. This model suggests four possible cost-based decisions by examining fixed and variable costs (both insourced – in house – and outsourced). From a cost perspective, in two of the four scenarios the answer is clear. According to the authors, organisations should always outsource where internal costs (fixed and variable) are higher than would be the case externally. Conversely, where the external market would entail higher expenditure both for fixed and variable costs then you should retain services in house. The authors then point out that ‘the question of whether to outsource and when arises only when no sourcing mode offers an absolute cost advantage’.

Cost analysis in outsourcing decision making

Situation A	Situation B
Insource or outsource Internal Fixed costs > External Internal Variable Costs < External	Always Outsource Internal Fixed costs > External Internal Variable Costs > External
Situation C	Situation D
Always insource Internal Fixed costs < External Internal Variable Costs < External	Insource or outsource Internal Fixed Costs ≤ External Internal Variable Costs > External

Source: Benaroch et al (2010)

The key issue in this research is the capital-to-labour cost relationship and whether it is high or low. Situation A is indicative of a high capital-to-labour relationship, exemplified by the IT industry where there is relatively low labour costs compared with relatively high investment in capital infrastructure. So the choice for the vendor is whether to exchange these high internal capital expenditures for higher variable costs since the supplier will include capital costs in their contract price. Organisations that outsource to obtain technology are deciding this is a worthwhile trade-off: they avoid large investments in favour of costs spread over time (perhaps only a different form of amortisation except that initial financing comes from outside the organisation).

Situation D is the opposite: a low capital-to-labour relationship, typical of low-cost production activities or, as the authors observe, call centres. The organisation may have a low contractual charge, ‘but incurs higher fixed costs (relative to in-house processing) in the form of monitoring and quality assurance expenses’. This research suggests that organisations should not be seduced by apparently cheaper sourcing options without factoring the additional internal costs, especially where there is any element of supply

volatility. This has been the reason why some companies have resisted payroll outsourcing because the cost of change has been too great.

From theory to practice

The next question is, 'how can organisations apply these structured decision-making models?'

Espino-Rodríguez and Padrón-Robaina (2006) helpfully suggested that facets of the two theories they examined (TCE and RBV) can usefully be combined: 'outsourcing of services or business processes is going to depend on the strategic value of the resources constituting them. That strategic value is formed by the heterogeneity of the resources (valuable, specific), and the persistence of that heterogeneity (non-substitutable, inimitable and the appropriability of the rents)'. This approach can be extended further by looking at a broad range of factors.

One way is to use a decision tree as shown below. This still requires background work to be completed on the definition of core, awareness of internal processes, knowledge of the market, etc.

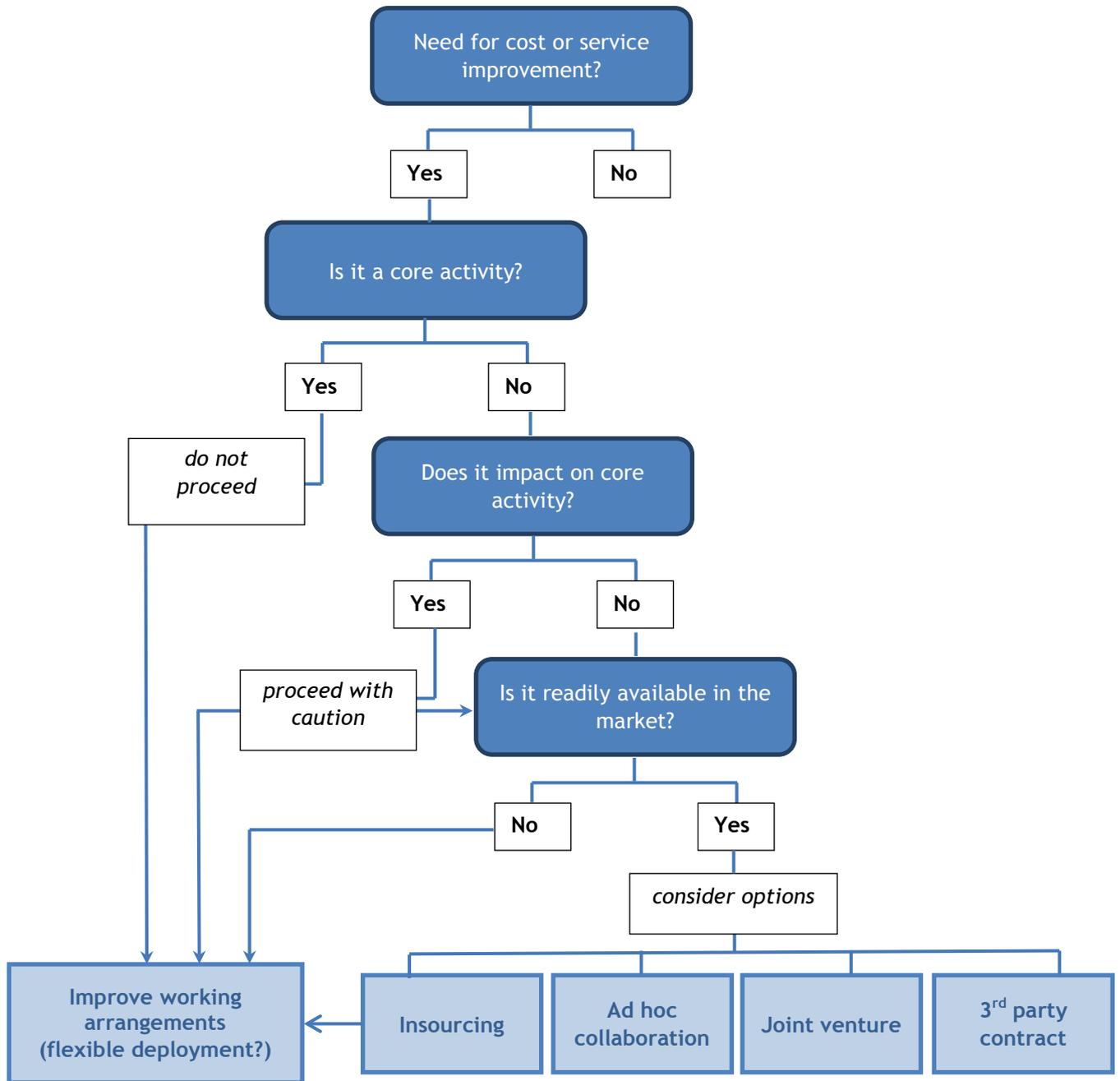
Even then if an activity is deemed to be a candidate for outsourcing a proper evaluation is still required which takes account of:

- Clear corporate objectives setting out the requirements of the exercise, be they cost reduction, service improvement, expertise acquisition etc.
- A risk assessment which considers the full range of business implications.
- A full estimation of the cost/benefits, including an assessment of the cost of retaining activities in house (eg human or physical resources) and the non-financial, eg skills' impact, cultural effect of outsourcing. This to be done on a long as well as short term basis.
- Consideration of tax, legal, procedural, security and confidentiality issues which may inhibit or alter the decision to outsource.
- The stability of the work demands: are they subject to significant fluctuation? Is the use of a service frequent or infrequent and does successful performance require any in-company knowledge?
- Developing a complete knowledge of the services under review: 'understanding process idiosyncrasies and internal interdependencies are important considerations when outsourcing complex processes' (McIvor, 2009).

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- Testing whether the organisation has the competencies to manage the supplier relationship, both technically and contractually.
- By the same token, judging whether suppliers have the necessary competence, systems and sufficient resources in account management. Do they also have the right attitude to customer service and commitment to joint success through both meeting both current and possible future needs? Are there 'strong complementary capabilities' for both parties necessary 'to make relationships successful' (Lacity et al, 2010)?
- Thinking through the need for change: the quality, customers view and cost of current service provision perhaps compared with peer organisations.
- Whether the same objectives could be met through an internal service provider, perhaps making more flexible use of own employees or agency staff.
- Whether the alternative external routes might be appropriate, such as via a partnership with other similar organisations (especially attractive in the public sector) or joint venture (again the public sector/private sector route has been used). Mudambi and Tallman (2010) argue that with knowledge process outsourcing (as opposed to business process outsourcing) it is indeed a 'make-ally-buy' decision because organisations want 'a governance structure that will both protect and leverage their strategic knowledge assets'. This emphasises the point that not all outsourcing should be treated in the same way, however much procurement departments might like a standard process.

Decision tree on who should execute HR activities



Source: Reilly and Tamkin (1997) adapted from Lentz (1996)

In summary, outsourcing works best for stable but frequently-used services in a commodity market that keeps costs down, or where the supplier has skills that are too expensive to retain in house. Each organisation has to make its own calculation of when outsourcing delivers real value and for what.

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