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Theoretical perspectives and motivational factors behind outsourcing

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Abstract: Outsourcing, in the face of globalisation, becomes one of the most important tools to deal with the competitive nature of the market. This is the reason that the outsourcing phenomenon has been increasingly receiving attention both from academic and business organisations. The term outsourcing is referred to the use of outside resources to perform in-house activities of the firm which were previously done by the firm itself. Behind this practice, there are some basic necessary propositions which are based on so some theoretical ground. Therefore, in this piece of paper it has been tried to focus on the theories which is related to the concept of outsourcing. Moreover, an attempt has been made to throw some light on the motives behind the outsourcing practices of the business organisations.

Key words: Outsourcings, transaction cost, make or buy, asset specificity, resource based,

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I. INTRODUCTION

The term outsourcing is referred to the use of outside resources to perform activities traditionally handled by the internal staff and resources of a firm. The idea of outsourcing has its roots in the '**competitive advantage theory**' propagated by Adam Smith in his book **'The Wealth of Nations',** which was published in the year 1776. Over the years, there is a change of opinion regarding the meaning of the term 'outsourcing'. During the Industrial Revolution outsourcing was started off as the shifting of manufacturing goods to countries providing cheap labour but now-a-days because of globalisation, organizations are becoming more competitive and hence give importance to their core activities and involve outsourcing practices to grab the benefits in the business. Outsourcing, therefore, today is an increasingly common way of doing business. For example, NIKE, Inc., focuses on pre and post production, and outsources 100% of its shoe manufacture (Quinn & Hilmer, 1995). According to Corbett & Associates (1999), there are sound financial reasons behind for not employing permanent staff when the firms can buy outside expertise which may be able to do the job better, cheaper and more quickly. This strategic importance of the practice of outsourcing by the business world has made the practice of outsourcing popular among the corporate.

II. OBJECTIVES OF THE STUDY

The present study would focus on two specific areas of outsourcing:

- The theoretical background of the outsourcing concept.
- The motivational factors behind the practices of outsourcing.

Today's global environment has placed increased pressure on firms to become more competitive and profitable. The firms, therefore, thought of some cost savings means to tackle the competitive nature of the market. All means to cut expenses are being considered and outsourcing appears to be a very viable solution to this demand. This is the reason that the outsourcing phenomenon has been increasingly receiving attention both from academic and business organisations. Therefore it is highly necessary to know the theories on which the concept of outsourcing is based. Further, it is also important to know the motives behind the outsourcing of the business organisations.

The present paper makes an attempt in this direction. The study is based on various sources drawn from

❖ Web based search or/and
❖ Few books and journals

Theoretical background of outsourcing:

The outsourcing process is a complex phenomenon. It is consisting of various activities and sub activities, carrying many managerial dilemmas. While studying different literatures on outsourcing it has been found that a plenty of reference theories have been adopted in the outsourcing literatures. It is also seen that each phenomenon can be described by several frameworks that are embedded in various theoretical approaches (Perunovic &Pedersen, 2007). This means that, the term outsourcing has been approach by different theories. On the whole these theories can be combined into four categories and they are **economic, strategic, social and systems sciences** (Lacity, 2012)**.** The following table shows the theories fall under the above mentioned four categories.

Outsourcing Theories

Discipline	Sample Theories	Overall Assumption
Economics	• Transaction Cost Economics • Agency theory • Various theories on contracting	Agents base outsourcing decisions and engage in contracts to minimize total costs and to mitigate risks, such as the risk that an agent or supplier will behave opportunistically
Strategic	• Resource-Based view • Resource Dependency theory • Game theory(auction theory) • Various theories of firm strategy	Agents build or acquire resources to execute strategies that lead to 'winning'
Social	• Social/Relational Exchange theory • Institutionalism • Social Capital theory • Power theories • Innovation Diffusion	Agents build relationships based on trust, power, feelings of mutual obligation and social norms
Systems sciences	• Modular Systems theory • General Systems theory	Firms exchange resources across organisational boundaries and learn through feedback

Source: Lacity, 2012

The above table spells out that there are multiple theoretic explanations regarding why firms terminate in-house operations in favour of outside services. **Economic theories** focus on the coordination and governance of economic agents regarding their transactions with each other. **Strategic theories** focus on how firms develop and implement strategies to achieve a chosen performance goal. **Social theories** focus on the organisations and on the relationships between individuals, groups and organisations (Lee et al., 2000). Theories under the discipline of **Systems sciences** focus on the behaviour of the organisations with their clients and also concentrate on the feedback learning (Lacity, 2012).

The theory which is most commonly used by the literatures in the outsourcing research is **transaction cost theory** (TCT). The transaction cost theory was the result of the pioneering efforts of the Nobel Laureates Ronald Coase and O.E.Williamson. According to Coase (1937) every firm has to incur some costs to buy products or services. These costs are price searching and provider searching (search cost), negotiation and contracting (contracting cost) and controlling and monitoring costs (coordination cost) and on the whole these are termed as transaction costs (Cheng et al., 2010, Neves et al., 2014, Singh & Zack, 2006). Coase was of the view that firms and markets are alternative forms of organisation to manage the same transactions. Based on an analysis of the magnitude of these costs, entrepreneurs decide where the transactions should occur, either within the firms or in the market (Neves et al., 2014). This is the familiar make vs. buy argument which proposes that firms buy services from other firms through the market if it is less costly than producing those services in-house through internal staff. That is to say, the scope of outsourcing is affected by the size of transaction costs (Singh& Zack, 2006, Cheng et al., 2010, Neves et al., 2014).

Later Oliver Williamson following Ronald Coase, pointed out that the choice between carrying out activities in-house or placing them under market governance depended on production, transaction and monitoring costs (L.Wang and De Vita, 2006). The underlying idea of transaction costs theory is that the make or buy decision is significantly influenced by the **degree of asset specificity**. Moreover, Williamson mentioned that **uncertainty and frequency of transaction,** other than the asset specificity, also affect the transaction costs (Singh& Zack, 2006, Xu, 2009).

Asset specificity refers to the investment that is put into a particular transaction and considered owning a high value for this transaction but would not be "redeployable" (Williamson, 1985) for another transaction or just show little value to another transaction. In order to have a more detailed description, Williamson divided the asset specificity into several types such as site specificity (e.g. a natural resource in the local environment, moveable with a high cost), physical asset specificity (e.g. special computer system design for a company), human asset specificity (e.g. learn a dialect from a rural area) and dedicated asset (Williamson, 1985). Three kinds of transactions can be linked to these specificities: 1. Non specific transactions, which have low asset specificity, are related to the acquisition of commodities; 2. idiosyncratic transactions, which correspond to highly specialised assets that are extremely rare and even unique; 3. Mixed transactions which pertain both of commodities and transactions (Ivanaj & Franzil, 2006). Asset specificity nature of the investments in transaction, according to some scholars, may cause a firm to become locked-in to its supplier. If the firm would try to switch to another supplier, it would have to write off those asset specific investments which would be undesirable. This lock-in situation for the outsourcing firm can lead to opportunistic behaviour by the supplier who could exploit his dominant position by renegotiating the terms of the contract or insisting on different terms next time around. This line of reasoning favours keeping the activities of the firms in-house. In spite of this, the transaction theory has received a lot of empirical support in explaining the outsourcing decision (Walker & Weber, 1984; Monteverde & Teece, 1982).

The second component which affects transaction cost is uncertainty. Uncertainty is of two types: general uncertainty and behavioural uncertainty. Due to lack of communication and the ever- changing nature of the market environment, one decision maker does not have the way to find the concurrent decisions and plans made by others and this leads to the instability for both sides in the transactions. Williamson has emphasized the risk induced by behavioural uncertainly, which arises when one decision maker intentionally covers up and distorts the information for some strategic purpose, from others. Such kind of behavioural uncertainty may lead to information asymmetries and opportunism. One party has the chance to take advantage of the other party's lack of information. Transaction with high degree of uncertainty will cause an increasing number of contingencies and more contingencies will cause more difficult and costly to construct and enforce the contracts (Xu, 2009).

The frequency of transaction refers to the number of times the transactions occur between buyer and seller. The transaction cost under such a situation is assumed as linear correlated with the scale economy issue (Williamson, 1985). According to Williamson transaction with specialised structures will be higher costs and as such will not be adopted unless the costs can be acceptable. It depends on the two sides: 1, specialized structures with a great deal investment in asset specificity could bring huge benefits; 2, the cost of specialized structures could be covered by its utilization in other transaction. Hence, for certain level of asset specificity, greater the volumes of trade, more likely the benefits of hierarchical governance exceed the costs and the hierarchical governance will be efficient only if the frequency of transaction occur at a high degree.

The agency theory and the transaction cost theory under the economic category of classification are based on the same assumptions that goods and services can be produced efficiently within a firm and this may achieve the economies of scale (Lacity and Hirschhein, 1993). These theories try to explain the characteristics of a structure such as governance or contract. According to agency theory, an agency relationship always exists between an organisation and the supplier. Since the essence of outsourcing is an exchange and an agency relationship is always one of the important factors in an exchange, so it can be said that outsourcing activities also rely mostly on the bases created by the agency theory (Lee et al., 2000, Cheng et al., 2010).

However, economic theories could not explain other important environment, structure and strategic factors which could also encourage an organisation to take decision to outsource. Economic theories throw light only on the cost efficiency of the firm. But the outsourcing decision of the firms is not only based on the cost saving factors but it is affected by some other strategic factors also

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The Resource-based and the Resource-dependency theories under the strategic discipline are the second most commonly used theories after the TCT by the scholars in the outsourcing literatures. In the 1990s the resourced based view (RBV) emerged as a major school in strategic thinking in outsourcing. The RBV was originated in the work of Thomson (1967) but did not become popular until the mid 1980s. Prahalad and Hamel (1990, 1994) popularised the approach using the concept of core competences. While competences express what a firm is able to do well, core competences encompass what the firm is able to do better than others (Lawson & Lorenz, 1999). As such they are the basis for a firm's unique competitive advantage at a given point in time. In the RBV, the allocation of resources to non- core activities leads to opportunity costs. It has become conventional wisdom that core activities should stay in- house, while non-core activities should be outsourced (Kakabadse & Kakabadse, 2000). In brief, the strategic management literature suggests that the dominant reason for outsourcing has changed over time from cost considerations to strategic choice about the firm's core activities (Caniels & Roeleveld, 2009). In this respect, based on RBV, Quin & Hilmer (1994) said that the firms should focus their resources on a set of core competencies in which they have definite advantage over their competitors and should outsource the other non-core activities.

Another theory is the **resource dependency theory (RDT)** according to which firms that lack resources must seek to establish relations with more powerful firms before they can obtain needed resources. From this perspective, a firm may alter its structure or strategy at a basic level in order to procure resources not generated internally (Jiang and Murphy, 2011). There are three core ideas of this theory and they are: 1. Social context matters; 2.Organisations has strategies to enhance their autonomy and pursue interests; and 3. Power is important for understanding internal and external actions of organisations.

The RBV and RDT theories are based on the strategic views of the firms. Both these theories view firm's resources as the foundation for firm's strategy. Resource dependency theory focuses on resources in external environment while resource based theory focuses on an internal resource and capability. The objective of both the theories is to get and sustain a competitive advantage by acquiring the scared and valued resources essential to organisational survival internally or externally. Therefore, this perspective interprets the relationship with other organisations as a dependency. However, this perspective does not consider how to manage the relationship between an organisation and its external environment. The reason is that the major target of strategic theories is to self maximise about internal resources without consideration about other organisations' situation. Today, the competitive power of an organisation is less important in inter dependent environment. Therefore, it is necessary to build inter-organisational linkages that help firms cope with resource scarcity while achieving goals for reducing vulnerability and uncertainty, and for maximising own autonomy and independence (Lee et al., 2000). However, resource dependency theory and the resource based theory could not properly explain why the firms entered into the closer relationship with their service provider.

Some researchers have suggested the social theories such as **Social exchange theory and Power theories** as appropriate tools for analysing the continuation of relationship. These theories are used to explain the reason why the organisations enter into closer relationship with their service providers. They tried to understand the relationship as dynamic processes through specific sequential interactions in which two participants carry out activities toward one another and exchange valuable resources.

Social exchange theory explains dyadic exchange relations as consisting of 'voluntary transactions involving transfers of resources between two or more individuals for mutual benefits'. Exchange actions are contingent on rewarding reactions from others. Exchange focuses directly on the social process of give and take, and aims to understand the behaviour of each actor contributing to the exchange. Several attributes are important in an exchange. They are reciprocity, balance, cohesion, and power (Emerson, 1972). The need to reciprocate the benefits received acts to reinforce the characteristics of the exchange. Balance refers to the balance of dependence of one actor in the exchange over the other and vice versa. Cohesion occurs when one or both actors in the exchange encounter conflict involving the exchange. Power is defined as the level of cost one actor can induce over the other. Trust is also an important tool in social exchange. According to the social exchange theory, the client and the vendor should move towards a closer relationship that operates within the 'spirit of the contract'.

The power theory has tried to study the impact of power on outsourcing decisions. Power is often defined as the potential of an actor to influence the behaviour of another actor on a particular issue within a social system.

Outsourcing is something like the regular buyer-supplier relationship. Thus, the social theories are mainly used to explain the process of inter-organisational relationship. The difference between Transaction cost theory, Agency theory and Social exchange theory is that TCT and Agency theory studies conditions leading to an inter-organisational relationship while the Social exchange theory explains the process of inter-organisational relationship.

Some scholars discussed about the **modular systems** in connection to outsourcing. Modularity is an approach for organising efficiently the design and production of complex products and processes. Complex tasks are decomposed into simpler elements so that they can be managed independently and yet operate together as a whole. Modularity in terms of maximizing economies of scale through standardization of components was already practiced in the early 1900s. According to some scholars, the higher the level of modularisation the easier it is to outsource manufacturing or its constituent components (Mikkola, 2000). The central focus of the modularisation strategy is that a system should be decomposed in such a way that interfaces of the components are well specified and standardised so that the outsourcing can be easily realised. Modularity strategy believes that outsourcing creates a certain degree of supplier-buyer interdependence and possibilities for inter-firm learning.

Motives behind outsourcing:

The outsourcing decision of a farm is influenced by many factors. However, scholars from different field of study have clearly agreed on some common factors which could influence a firm to take outsourcing decision.

Most organizations engage in outsourcing for economic or strategic reasons. Economically, outsourcing is attractive when the tasks being outsourced can be performed by the provider at a lower total cost. Strategically, outsourcing is attractive when a firm does not have requisite quantity of human resources and skill, or sufficient physical capacity to deliver its product of services within a required time frame, it either has to postpone the work, or outsource to get the work done within the required time frame and level of quality (Singh and Zack, 2006).

Henry L.F. de Groot (1998) suggests that motives for firms to engage in outsourcing are transaction cost, exploitation of economies of scale, savings on wage and benefits and strategic consideration in which saving the transaction cost plays the most important role. In other words, outsourcing is possible when transaction costs are low.

Quinn (2000) argues that outsourcing is a strategic necessity in today's innovation-dependent economy. He argues that no single firm can innovate as efficiently or as effectively alone as it could with the collaboration of other firms through outsourcing.

Kakabadse and Kakabadse (2002) in their study have mentioned about the financial motive, i.e., the cost reduction, conversion of fixed cost into variable cost as important factors which influence the decision to outsource. Strategic motives, according to Quinn and Hilmar (1994), behind outsourcing are gaining flexibility, improving service and quality, access to technical talent and to new technology etc.

Decision to outsource may also be motivated by many other factors like nature of the activities, vendor's capabilities, client's ability to manage vendors, availability of vendors, and maturity of outsourcing market, and so on (Ravi, Jain and Sharma,2011).

In brief, it can be said that, the following are the main changes which have motivated the organisation to undertake the outsourcing as an important restructuring tool-

- large organizational size is no longer a competitive advantage.
- Competitive pressures are more severe in a global economy.
- Product and service cycle time have reduced dramatically, and time based competition demands quicker response.
- Bottom line performance, growth, and size are no longer predictors of future profits.
- Supplies of technical specialists are reasonably plentiful, thus employing them internally is unnecessary to their availability.
- Cutting edge technology and knowledge are now recognised as competitive weapons but are expensive to acquire and successful results are often elusive when implemented internally.

There are several other factors that are influencing firms to consider outsourcing as a business strategy. Factors driving the need to outsource are:

- focus on core competencies
- cost savings
- global diffusion of knowledge
- increased of sophistication of IT
- rise of global knowledge workforce

Among these motivational factors, cost savings is the predominant reason for engaging in outsourcing. Historically, outsourcing was used when organizations could not perform, perhaps due to incompetence, lack of capacity, financial pressures, or technological failure. Now outsourcing is being used to restructure organisations that have been quite successful. These organisations now recognise that building core competencies and serving customer needs are the critical tasks and anything that distracts from this focus will definitely motivate the organisation to adopt outsourcing to solve the crisis (M.F.GreaverII, 1998).

III. CONCLUSION

Outsourcing is an increasingly common practice in the business world today. There are sound financial reasons for not employing permanent staff when an organisation can buy outside expertise which may be able to do the job better, cheaper and more quickly. The ongoing analysis has made it clear that the outsourcing practices of the firms are based on different theoretical perspectives. Every theory underlies some distinguishing features which make it easier to understand the term 'outsourcing' clearly to a large extent. The strategic importance of the practice of outsourcing by the business world has persuaded to carry this study. This study is an attempt to find out the theories used in the study of outsourcing by the researchers as well as the motivational factors behind outsourcing and to some extent it has been successfully come out in this respect. In addition, there is vast scope to explore more in this area of study.

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