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Outsourcing Process and Theories

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Abstract
The studying of the outsourcing phenomenon has been grounded in many theories. Some of them are complementary, the other are contradictory. This creates confusion among the researchers of the outsourcing phenomenon. This paper has an aim to contribute to the existing body of knowledge on outsourcing process by exploring how theories have been used to study, understand and describe activities within the phases of the outsourcing process. We associate those theories with certain phases of the process, where they could contribute towards understanding the embedded activities and mechanisms. The final result of the paper is a map showing the phases of the outsourcing process with the associated theories that have been used and could be used in exploring and explaining the outsourcing process.

Key words: outsourcing process, theories, map

1. Introduction

The outsourcing phenomenon has been increasingly receiving attention both from academic and practitioners communities. The result of the research has lead towards the emergence of several process frameworks depicting the phases of the outsourcing process. It is commonly recognised that the outsourcing process consists of the preparation, vendor(s) selection, transition, management of relationship, and reconsideration phases. Each of the phases has been broken down in the serious of activities that an outsourcing company performs.

At the same time, the phases were subject to a flow of theoretical explanations. The studying of the outsourcing phenomenon has been grounded in many theories. Some of them are complementary, the other are contradictory. This creates confusion among the researchers of the outsourcing phenomenon. This paper has an aim to contribute to the existing body of knowledge about the outsourcing process by exploring how theories have been used to study, understand and describe activities within the phases of the outsourcing process. In addition, we analyze the explanatory power of various theories that haven't been much used in studying the outsourcing. Consequently we associate those theories with certain phases of the process, where they could contribute towards understanding the embedded activities and mechanisms. The final result of the paper is a map showing the phases of the outsourcing process with the associated theories that have been used and could be used in exploring and explaining the outsourcing process.

The paper is structured as follows. In the next section we describe the outsourcing process framework and enlist the key activities and issues embedded in each of the phases of the process. In the third section we present the literature study of the theories that have been used in the research on the outsourcing process and provide a map associating the theories with the phases of the

outsourcing process. We conclude the paper with suggestions for the future potential utilization of theories across the outsourcing process.

2. Outsourcing process

Outsourcing is the process of establishing and managing a contractual relationship with an external supplier for the provision of capacity that has previously been provided in-house (Momme, 2001). In spite of an impressive research intensity of the outsourcing process, there are only few frameworks depicting the actual stages and the layout of the overall process of outsourcing. Figure 1 presents an overview of some of the frameworks.
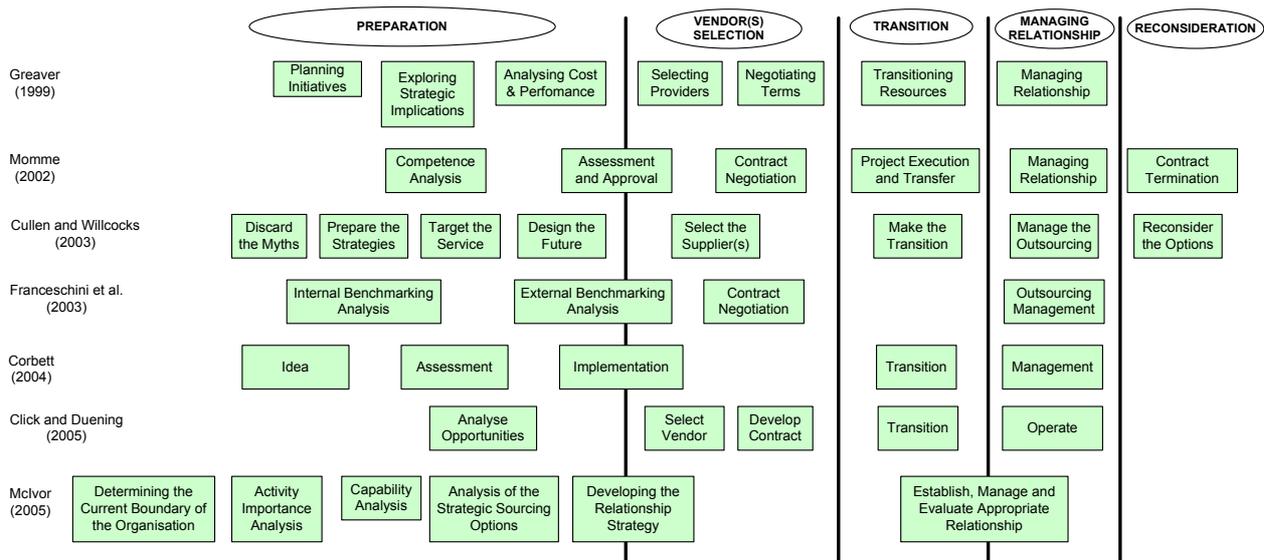
	PREPARATION				**VENDOR(S) SELECTION**		**TRANSITION**	**MANAGING RELATIONSHIP**	**RECONSIDERATION**
Greaver (1999)	Planning Initiatives	Exploring Strategic Implications	Analysing Cost & Perfomance		Selecting Providers	Negotiating Terms	Transitioning Resources	Managing Relationship	
Momme (2002)		Competence Analysis			Assessment and Approval	Contract Negotiation	Project Execution and Transfer	Managing Relationship	Contract Termination
Cullen and Willcocks (2003)	Discard the Myths	Prepare the Strategies	Target the Service	Design the Future	Select the Supplier(s)		Make the Transition	Manage the Outsourcing	Reconsider the Options
Franceschini et al. (2003)		Internal Benchmarking Analysis		External Benchmarking Analysis		Contract Negotiation		Outsourcing Management	
Corbett (2004)		Idea	Assessment		Implementation		Transition	Management	
Click and Duening (2005)			Analyse Opportunities		Select Vendor	Develop Contract	Transition	Operate	
McIvor (2005)	Determining the Current Boundary of the Organisation	Activity Importance Analysis	Capability Analysis	Analysis of the Strategic Sourcing Options	Developing the Relationship Strategy		Establish, Manage and Evaluate Appropriate Relationship		

Figure 1 - Overview of the outsourcing process frameworks

After carefully examining the content of the stages of each of the proposed outsourcing process frameworks we have aligned the frameworks and grouped the stages into the following sequence: preparation, vendor(s) selection, transition, managing relationship and reconsideration (See Figure 1). Each of the stages has to provide an answer on various questions, thus emphasising the complexity of the outsourcing process and arguing for a need that it has to be managed carefully throughout all of its life cycle (See Figure 2). Cyclic and holistic characteristic of the outsourcing

process management is stemmed in the evolutionary economics (Nelson and Winter, 1982). The evolutionary economic theory is in the core of process theories. It has received significant application in exploring firm's learning characteristics for improving performance (Simonin, 1997), creating value (Anand and Khanna, 2000), and capabilities (Kale et al., 2002).
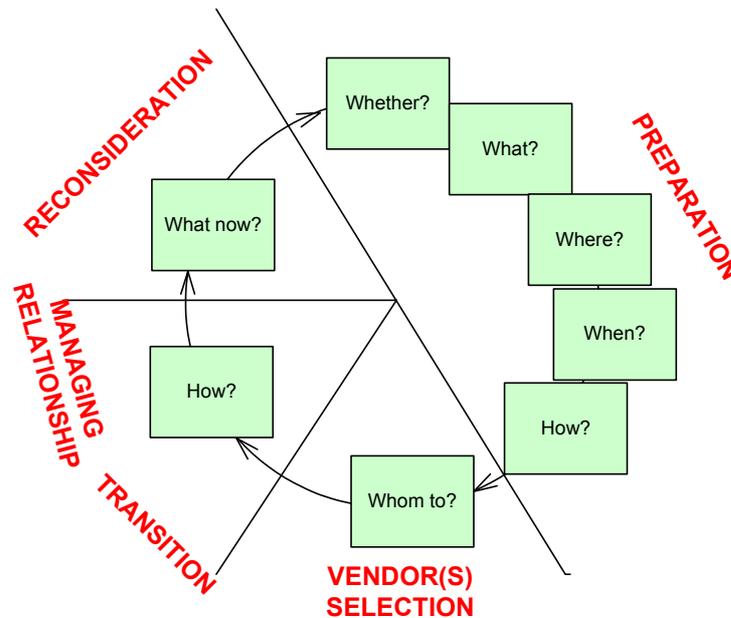

Figure 2 – Framework for the process of outsourcing (Source: Perunovic et al., 2006)

A more detailed insight into the contents of the phases is given in Table 1.

Phase	Key activities	Some key issues
Preparation	Strategy	Underlying philosophy
	Sourcing options	Why and what to outsource
	Approach	Big Bang
		Incremental
		Piecemeal
	Configuration	Many suppliers
		Preferred suppliers
		Prime contractor with subcontractors
		Sole supplier (one stop shop)
	Screening of potential vendors	
	Preferred relationship	Contractual or collaborative
	Preferred length of the contract	
	Drafting the SLA	
Vendor(s) selection	Announcing outsourcing	RFP
		Evaluation
	Choosing the vendor	
	Negotiating	Creating a win-win situation
	Finalizing the contract	Type, flexibility and content of the contract
Transition	Defining communication and exchange of knowledge and information	Change management
	Transferring assets, people, information, knowledge, hardware, software	Reengineering
		Adopting organizational structure and processes

	Human resource management	Job loss, transfer
Managing relationship	Type of relationship	Reciprocal
		Client dominant
		Vendor dominant
		Preferred vendor
	Maintaining relationship	Contracts
		Trust
		Hostages
	Handling meetings and communicating	
	Performance monitoring and evaluation	
	Applying incentives and penalties	
	Solving problems	
	Re-negotiating and managing variations	
	Managing success factors	Economic factors
		Character of the exchange
		Co-operation between buyer and supplier
		Distance between buyer and supplier
Reconsideration	Reconsidering	Continue
		Change vendor
		Backsource
		Switching costs

Table 1 – Key activities and issues within the phases of the outsourcing process

3. Theories in the Research of the Outsourcing Process

The outsourcing process is a complex structure consisting of numerous activities and subactivities, carrying many managerial dilemmas. It is no wonder that many theories have been utilized to help the academics to understand the nature of those activities, and to help practitioners successfully manage the process. It is a common knowledge that each phenomenon can be described by several frameworks that are embedded in various theoretical approaches. From its occurrence, the outsourcing has been approached by different theories. This creates confusion among the researchers of the outsourcing phenomenon. Various authors identified significant number of theories that could explain the outsourcing phenomenon (cf. Gotttschalk and Solli-Sæther, 2005; McIvor, 2005).

In order to depict the utilized theories we have conducted a literature study of the research papers in outsourcing from the 1990 up to 2006. Table 2 shows the papers and the theories utilized. The last column indicates phases of the outsourcing process the paper and its theoretical grounding have

addressed. The abbreviations P, VS, T, MR, and R stand for the phases of the outsourcing process i.e., Preparation, Vendor(s) Selection, Transition, Managing relationship, and Reconsideration.

Year	Authors	Theory	Method	Key points	Applicability to outsourcing process
1995	Lacity and Willcocks	Transaction Costs Economics (TCE)	Case study	Experiences to the TCE framework of efficient governance structures resulted in anomalies	P, VS, MR, R
1995	Pinnington and Woolcock	Core competences	Case study	Growth of IT vendor industry is creating a new firm relationship for the IS function	P , R
1995	Willcocks and Choi	Relational view	Case study	Defining characteristics of total IT outsourcing strategic alliances and identifying problems of managing them	P, MR
1995	Willcocks et al.	Core competences	Conceptual framework	Factors around which IT outsourcing decisions can be based	P
1996	Aubert et al.	TCE, Incomplete contract theory	Case study	TCE and Incomplete contract theory support the choice of activity to be outsourced and contract management between the outsorucer and its vendor	P, MR
1996	Ulset	TCE, Property rights theory	Survey	When substantial externalities are involved, like in the supply of R&D, TCE should be combined with property rights theory to explain the use of governance mechanisms	P, VS, MR
1997	Brandes et al.	TCE, Core competences	Case study	Outcomes are more successful if outsourcing decision is based on core competence and cost efficiency and if outsourced unit is able to develop strong resource base	P, MR, R
1999	Vining and Globerman	TCE	Conceptual framework	Framework for making the outsourcing decision	P
2000	Arnold	TCE, Core competences	Conceptual framework	Framework for making the outsourcing decision	P
2000	Baden-Fuller et al.	Core competences	Conceptual framework	Framework for making the outsourcing decision	P
2001	Lee	Knowledge-based view, Core competences	Survey	Knowledge sharing is positively related to outsourcing success	MR
2001	Mahnke	Evolutionary economics	Conceptual paper	Propositions regarding scope, speed and switching costs have been developed	P, T, MR, R
2001	Roy and Aubert	RBV	Case study	The best predictor of success and failure is the governance mode and the position of project in the value matrix	P
2001	Zviran et al.	Relational view	Case study	Factors determining success from outsourcer's and vendor's perspective – good project definition and specifications, good project management, trustworthiness, technical competence	P, VS, T, MR, R
2003	Barthélemy	Agency theory, Relational view	Case study	Managing outsourcing by contracts and trust	MR
2004	Aubert et al.	TCE, Incomplete contract theory	Survey	Uncertainty is major deterrent to outsourcing, while the level of technical skills is the most	P

				important reason to outsource	
2005	Barthélemy and Geyer	TCE	Survey	Determinants of outsourcing and quasi-outsourcing decisions	P
2005	Gottschalk and Solli-Sæther	11 theories	Case study	Core competences and stakeholder theory explain best critical success factors	P, MR, R
2005	Pati and Desai	Core competences	Conceptual framework	Framework for making the outsourcing decision	P
2006	Barthélemy and Quelin	TCE, Resource-based view	Survey	To restrict vendor's opportunism, contracts must contain incentives and penalties, as well as pricing and monitoring clauses	P, VS, MR, R
2006	Gottschalk and Solli-Sæther	Cumulative theory, TCE, Agency, Contracts, RBV, Core competences, Relational view, Social exchange	Conceptual model	Maturity model of IT outsourcing relationships	P, VS, T, MR, R
2006	Halldórsson and Skjøtt-Larsen	TCE, Agency theory, Contract theory, Relational view	Case study	Challenges TCE, agency, and contract theories and argues for relational view	P, VS, T, MR
2006	Miranda and Kim	TCE, Institutional theory	Survey	The logic of TCE decision maker is contingent on institutional context	P
2006	Mirani	Evolutionary economics	Conceptual framework	Stages of relationships are contracts, networks and hierarchies	MR
2006	Whitten and Wakefield	TCE, Social-exchange theory	Survey	A second-order switching costs model for specifying switching behaviour	R

Table 2 – Theories utilized in the research of the outsourcing process

The research communicated in the selected papers (Table 2) was grounded in most of the cases in one or two theories. The exception is the work of Gottschalk and Solli-Sæther (2005, 2006) where the authors examine 11 theories in order to establish their explanatory power. The results suggest that the theory of core competences, the stakeholder theory and the neoclassical economic theory best explain the most important critical success factors of outsourcing relationships (core competence management, stakeholder management, and production cost reduction). In their later work (2006), the same authors apply cumulative theory to examine critical issues in stages of maturity in outsourcing relationship. They conclude that at the beginning of an outsourcing arrangement a Cost Stage occur, which is grounded in TCE and agency theory. After several years of having outsourcing the focus of the outsourcer shifts into the Resource Stage, where resource based view and core competences are the most important explanatory theories. At the end, the stage of Partnership may occur with the explanations sought in relational view, social exchange, and the stakeholders theory.

A content analysis of the selected research papers provides the distribution of the most utilized theories across the phases of the outsourcing process (Table 3). Letters in the cells indicate if a theory has been utilized to explore or explain some of the key activities and issues of a certain outsourcing process' phase in a large number of cases (L - more than 7), medium (M – between 4 and 7 inclusive), or just a few (F – less than 3 inclusive).

	Preparation	Vendor(s) Selection	Transition	Managing Relationship	Reconsideration
Transaction Cost Economics	L	F		M	M
Relational View	M	F	F	M	F
Core Competences	M			F	F
Evolutionary Economics	F		F	F	F
Incomplete Contracts	F	F		F	
Resource-based view	F	F		F	F
Agency theory	F			F	F
Knowledge-based View				F	
Neoclassical economic theory	F				F
Social exchange theory					F
Economics of information	F	F			F

Table 3 – Utilized theories and phases of the outsourcing process

Transaction Cost Economics

Transaction cost economics (TCE) has been the most utilised theory of outsourcing. TCE is perceived to provide the best decision making tools to help organizations to decide to outsource and to prepare themselves for forthcoming outsourcing arrangements. The governance features of the theory influenced that it has been applied in studying the Managing relationship phase, whilst the concept of switching costs made the theory applicable in the reconsideration phase. Another useful issue for outsourcing provided by TCE is explanation of contractual complexity. Though TCE has not been utilized explicitly for studying the Vendor selection phase, its sub-theory (if we may say

so), the theory of incomplete contracting, has been applied in studying the structure and contents of outsourcing contracts, and related preparation and contract management activities.

Even though it has been exercised extensively in outsourcing applications, the TCE has several indulgencies. Lacity and Willcocks (1995) found that the original mapping to the TCE framework only explained few IT sourcing decisions and generated much more anomalies in their sample. Another critique could be that TCE relies on a single transaction as a unit of analysis, neglecting the contemporary industrial collaborative arrangements. Finally, TCE is static, which doesn't correspond to dynamism of current business environment.

Relational View

Relational view develops and explains how firms gain and sustain competitive advantage within inter-organisational relationships (McIvor, 2005). Its key premise – the concept of relational rents has been explored to explain how firms choose their future outsourcing partners and preferred type of the relationship. It has been also utilized in studying the Transition, Managing relationship and Reconsideration phases. This makes the relational view to be the only theory that has been applied in the research of all the outsourcing process' phases.

Concept of Core Competences

The concept of core competences has been developed on the basis of the resource-based theory. Prahalad and Hamel (1990) defined the core competencies as the collective learning in the organisation, especially how to coordinate diverse production skills and integrate multiple streams technologies. The application of concept of core competences in outsourcing became very popular among researchers. The concept has been predominantly use to develop and test various outsourcing decision frameworks arguing that the core activities shall remain in house. Learning

and communication premises of the concept made it also applicable in the Managing relationship and Reconsideration phases. Vendor's competences are assumed to be one of the most important factors that influence success of an outsourcing arrangement (Levina and Ross, 2003; Feeney et al., 2005).

Resource-based View

The core premise of the resource-based view is that resources and capabilities can vary significantly across firms, and that these differences can be stable (Barney and Hesterly, 1996). If resources and capabilities of a firm are mixed and deployed in a proper way they can create competitive advantage for the firm. The resource-based view in outsourcing builds from a proposition that an organisation that lacks valuable, rare, inimitable and organised resources and capabilities, shall seek for an external provider in order to overcome that weakness. Therefore the most prominent use of the theory is in the Preparation phase of the outsourcing process for defining the decision making framework and in the vendor selection phase for selecting an appropriate vendor. The theory has been also used to explain some of the key issues of the Managing relationship and Reconsideration phases.

Evolutionary Economics

Although mentioned for the first time in the 19th century, the evolutionary economics experienced revival after Nelson and Winter's work in 1982. The theory develops from Darwinism and includes some assumptions transposed to the economic "species". These assumptions include (Andersen, 1994):

- The agents (individuals and organisations) can never be perfectly informed and they have to optimize locally rather than globally
- The decision-making of agents is normally bound to rules, norms and institutions

- Agents are to some extent able to imitate the rules of other agents, to learn for themselves and to create novelty,

- The processes of imitation and innovation are characterised by significant degrees of cumulativeness and path dependency but they may be interrupted by occasional discontinuities

- The interaction between the agents are typically made in disequilibrium situations and the result is success and failures of commodity variants and method variants as well as agents

- The processes of change occurring in a context described by the above assumptions and characteristics are non-deterministic, open-ended and irreversible.

This makes the theory highly applicable in outsourcing. However, the actual research has been very modest studying issues predominantly within the Managing relationship phase. The other phases of the outsourcing process (expect the transition) have been also explored through the evolutionary economics but very scarcely.

Agency Theory

The focus of the agency theory originally was on the relationship between managers and stakeholders (Jensen and Meckling, 1976), but had spread over the time on explaining the relationship between two inter-firm subjects. In that context we associate the agency theory to understanding the relationship between outsourcer and vendor. Sources of the agency problem, moral hazards and adverse selection (Arrow, 1985) are should be resolved by monitoring and bonding (Barney and Hesterly, 1996). Consequently, the application of the theory in the outsourcing process research was in the Preparation Phase (when screening for vendors and defining its own attitude towards the type of the relationship. Naturally, the Managing relationship phase has been also explored, and to a very small extent the Reconsideration phase.

Knowledge-based View

The knowledge-based view provides insight in understanding how individuals co-operate to produce goods and services. The knowledge-based view distinguishes two ways how knowledge is shared among partners. They are knowledge generation and knowledge application. The knowledge-based view has been used in utilized in the outsourcing research to prove that knowledge sharing in the Managing relationship phase is positively related to the success of an outsourcing arrangement.

Neoclassical Economic Theory

The key characteristics of the neoclassical economic theory are (Hodgson, 1994):

- Assumption of rational, maximizing behaviour by agents with given preference function
- Focus on attained, or movement towards, equilibrium states
- Absence of chronic information problem

The neoclassical theory explains the initial motives for outsourcing demonstrated by some pioneering companies like Kodak. However, the theory has received a significant critique for not being able to explain contemporary business processes. Especially, the concepts of rationality and absence of chronic information problem have been criticised. However Gottschalk and Solli-Sæther (2005) showed that the neoclassical economic theory explains critical success factors of outsorucing that are being evaluated in the Reconsideration phase.

Social Exchange Theory

The social exchange theory explains interpersonal relationships by positing the economical cost-benefit analysis as precondition for social engagement and exchange. The theory presupposes that the exchange of resources (material or social) is a basic form of human interaction. Social exchange is an ongoing reciprocal process in which actions are contingent on rewarding reactions from others

(Gottschalk and Solli-Sæther, 2005). The theory has been used in combination with TCE to specifying switching behaviour in the Reconsideration phase.

Economy of Information

It has been admitted that the information is not perfect and new economical models emerged to explain situations where two parties possess unequal or none quantity of information. One of the first works in the area was development of the search theory (Stigler, 1961). The identification of sellers and the discovery of their prices are only one sample of the vast role of the search for information in economic. Another key concept of the economy of information is the concept of signalling developed by Spence (1973). His essay is about markets in which signalling takes place and in which the primary signallers are relatively numerous and in the market sufficiently infrequently that they are not expected to invest in acquiring signalling reputation. Application of the economy of information in outsourcing is associated to activities of searching, selecting, and contracting the vendor. However, the economics of information hasn't been used explicitly in the studies of the outsourcing process.

4. Conclusion

In most theories about outsourcing processes the perspective has been focused on exploring certain issues emerging within the phases of the process. The problem occurring in such approach is to choose between many different possible outcomes. In principle it is possible to find an optimal solution of this rather stationary problem.

However a more fruitful and practically useful approach could be taken if we ask questions about the dynamics in the outsourcing processes. What is important in such cases can be caught up under the term learning. The idea is that the outsourcing decision makers will take into account results of

former decisions in similar cases. This creates a need to study the outsourcing process as an evolutionary process. Evolutionary thinking in economics and more generally in social sciences as organizational theory and sociology has used these insights to draw one important conclusion namely that structure is not sufficiently to make an optimal solution in outsourcing considerations. It is also necessary to take into consideration the actors with their interpretation of history. In social sciences the problematic is well known as the structure – actor problem.

Applied to the outsourcing problematic the point is that the relevant discussion is not only to look at the mention theoretical models or explanations of the outsourcing phenomenon. It is also about doing matters in another way next time because you have some mistakes and failures done first time. Therefore we cannot draw a conclusion about the absolute optimal solution in beforehand. We can and shall learn from history but still at one point we shall stop and make a decision.

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