Track: Strategic Management / Organization & Management Theory / Full paper

To outsource or not to outsource? When RDT and RBV meet.

Introduction

Recently there have been a lot of discussions on outsourcing and outsourcing smartly. Outsourcing, to many, is a strategic issue of importance no less than that of M&A and integration, etc. For instance, areas related to outsourcing have become the heart of developing organizational capabilities for competitive advantages to Lowson (2002), Coates and McDermott (2002) and Vastag (2000). Indeed, more critical business areas rather than building maintenance, cleaning services, etc. are outsourced when organizations seek to get the most out of outsourcing (Mclvor, 2009). While firms outsource with various motives, the fundamental decision to reject the internalization of an activity makes outsourcing a highly strategic decision (Gilley and Racheed, 2000: 764). Furthermore, outsourcing has caught the attention of scholars in strategic management because outsourcing may, or may not, always work out as indented. (e.g. Inkpen & Curral, 2004; Tsang, 1999). It is important to know when and what kind of outsourcing will be beneficial, if not harmless, to the firm.

We try to see how outsourcing could be a common ground for resource dependence theory (RDT) and resource based views (RBV) and how the two theories would act together, and one-by-one, to provide insights for organizations who are considering outsourcing.

These two theories are chosen because they may be good partners in providing more comprehensive and powerful explanations for relevant evaluations and decisions. Some researchers have adopted Transaction Cost Economies (TCE) alone in outsourcing (e.g. Rieple, & Helm, 2008; Ellram, Tate, & Billington, 2008). There have been papers, mostly in operations management fields, that employed RBV and TCE to examine the costs and benefits of outsourcing (e.g. Mclvor, 2008; Holcomb and Hitt, 2007). These papers addressed both internal needs for outsourcing and external influences in outsourcing evaluations. Yet, the two theories only provide complementary or have consensus in some situations; in some, they offer contradictory directions (Mclvor, 2009). Some more recent papers such as Canie¨ls and Roeleveld’s (2009) work have introduced RDT in outsourcing decisions. This move provides more sociological perspectives which reveal firms operate in power and dependence relationships. So, how about RBV with RDT? Perhaps that will give us more insights than “either reduce cost or create value” (Mclvor, 2009: 46).

While RBV leads us think about which resources and capabilities of a firm are valuable, rare, costly to imitate and non-substitutable, (Barney, 1986, 1991), and to grow capabilities, we need resources to sustain and maintain that, outsourcing is considered when some activities are no longer at the core production of a firm. From RBV, we know that firms engage in outsourcing to increase their flexibility, mitigate risks, and reduce their capital investments, and concentrate on those areas in which values are created; while outsourcing cannot be carried out on activities that are related to the core competences and advantages. De Fontenay and Gans (2008) found compared the positions of firms in the production stream and found that a trade off is faced by the down-stream firm when deciding which firm to outsource with. While these sayings have significant implications of when and what to outsource, we speculate there are still other areas to consider.

When we turn to RDT, there have been relatively less publications talking about outsourcing. As Pfeffer (1987) suggests, when a firm tries to mitigate or lessen external dependencies, unintended consequences such as new patterns of dependence may be produced. Outsourcing, just as M&A, political actions, and board of directors composition management do, are good strategic actions to be studied. Outsourcing is particularly useful for us to look at how new dependencies are formed. Scholars have previously found if information between partners may cause knowledge spillover (Inkpen & Curral, 2004) and information asymmetry may create a power imbalance (Tsang, 1999). We would like to answer to the call from Hillman et al. (2009) to focus on outsourcing as a mechanism to explain the new dependence. Firms can outsource because some productions are dependent on the other firms but that dependence is “too big of the proportion”. When firms conduct activities in-house, dependence may not be the smallest necessarily because productions require resources. On the other hand, when firms carry out productions and those productions can be the resources needed by other firms, it is again not sure if more resources means better.

We aim to explain when outsourcing is beneficial to the firm as we draw on Casciaro and Piskorski’s (2005) study to examine both power imbalance and mutual dependence between the firms and the outsource supplier. We propose that when an organization sees there are internal needs to outsource some activities, it should also take into account the potential power imbalance and total interdependence that will result from an outsourcing before the outsourcing decisions are strategically justified.

In this study, we hope to contribute to the literature of RDT and RBV and finds situation in which these two important theories are complementary. We hope to provide insights for managers who are considering outsourcing too.

Outsourcing: Make or buy

Outsourcing could be an illustration of a firm’s scope (Holcomb and Hit, 2007). It concerns about the scope of firms and the boundary conditions considered in the sourcing or outsourcing evaluations (e.g. Gilley and Rasheed, 2000). A classical approach to determine the scope of firm is available in TCE literature. Firms need a hierarchical governance to internalize production to minimize cost, including transaction costs and costs incurred in generating contracts (Williamson, 1985). Asset specificity, uncertainty and frequency of transactions influence the potential of opportunism and size of transaction costs. The firms’ scopes are optimized for an appropriate level of cost (Grover and Malhotra 2003; Silverman et al., 1997).

RBV is another common approach to understand outsourcing decisions. Firm boundaries may be determined when we compare internal capabilities with those of competitors (Langlois and Robertson, 1995). Organizations differentiate as they employ various bundles of assets and resources. Some activities may be performed internally and some may not; performing activities internally requires the organization to commit resources, which may bind on the firm's strategic flexibility (Leiblein et al., 2002). Outsourcing is a part of the resource management cycle proposed in work such as Sirmon, Hitt, Ireland, & Gilbert, 2012; Sirmon, Grove, & Hitt, 2008. In other words, resources within firms are prioritized and orchestrated to maintain the best bundle.

We adopt Holcomb and Hitt's (2007: 466) definition of strategic outsourcing: "strategic outsourcing as the organizing arrangement that emerges when firms rely on intermediate markets to provide specialized capabilities that supplement existing capabilities deployed along a firm's value chain". According to Fine and Whitney (1999) and Quinn (1999), firms gain dependence on intermediate markets for production as they employ outside specialized capabilities to complement their internal productions.

RBV and outsourcing

According to RBV, bundles of assets and resources are employed in distinctive ways to create competitive advantages for firms (Peteraf, 1993: Conner, 1991; Barney, 1991). As proposed by Barney (1991), value, rarity, imitability and organization are four criteria that qualify a resource as one that provides competitive advantage. When organizations have resources like that, they enjoy types of competitive advantages such as premium quality that offer superior value to customers and high value for money at a low price given sources of competitive advantages such as robust quality control, privileged sourcing, etc. (Mclvor, 2009)

State of attaining superior capabilities are well illustrated by good operations management, which entails "the development of capabilities is strongly influenced by competitive priorities (such as cost, quality, flexibility and delivery) which are at the heart of an organization's operations strategy (Boyer and Pagell, 2000; Leong et al., 1990)" (Mclvor, 2009: 48) and the need to focus on and develop certain capabilities is at the heart of RBV, which in turn implies "which activities should be performed internally and which should be outsourced". The goal is still to establish competitive priorities, create competitive advantages and thus superior performances.

"'Managing capabilities' is itself a capability" (Loasby, 1998: 139). "That is firms develop capabilities over time that help them develop and link productive capabilities across a value chain." (Holcomb and Hitt, 2007: 475) Following contemporary stream of resource management under RBV, quality of the outsourcing decision counts on the firm's ability to organize, invest and develop the set of resources that helps "sustaining a superior performance position in the capability relative to the competitors." (Mclvor, 2009: 47) A firm may consider outsourcing an activity if no advantage could be gained from engaging in that activity.

Mclvor 2009 has proposed an excellent model in evaluating outsourcing initiatives using both RBV and TCE. Following RBV logically, activities and resources are first rated with their contribution to competitive advantage. As it is the goal of the organizations to organize and maintain a set of unique and valuable resources, these resources should not be discarded as long as they can be invested and developed. Such activities deserve greater attention from the management and will consume the scarce resources inside the firm.

Next, activities and resources are rated with their relative capability position to any party that can perform the same. By the end of the day, RBV tells how firms can outperform others with sets of resources organized by capabilities for sustainable competitive advantage. RBV theorists encourage firms to achieve superior performance position, instead of competitive parity, by focusing on activities that are difficult for others to replicate (Barney, 1991).

According to Mclvor, a resource or activity is said to be in a superior resource position if it contributes strongly the competitive advantage and has superior relative capability position.

Here, we follow Mclvor to propose the following, in the consideration of which activity to outsource, and deriving from the needs to focus on activities that lead us to strategic competitiveness:

P1: The more superior the resources or activities is in terms of resource position, the less likely for it to be outsourced.

P2: The more inferior the resources or activities is in terms of resource position, the more likely for it to be outsourced.

From TCE to RDT in Outsourcing

In explaining outsourcing, while some studies have found that high asset specificity leads to hierarchical governance (Rindfleisch and Heide, 1997; Clark et al., 1996; Shelanski and Klein, 1995), studies on the effects of uncertainty and frequency have not come to a consensus (Rindfleisch and Heide, 1997; Harrigan, 1986; Walker and Weber, 1987). While TCE offers certain level of explanatory power in this context, RDT seems to further elaborate dynamics in the concerned outsourcing relationships without rejecting the conclusions above.

Transaction costs are likely to increase with the complexity of interdependencies between business processes (Van der Vegt et al., 1998). While to Williamson, using Canie¨ls and Roeleveld (2009)'s words, power and dependence are not invited to say something regarding the situations in which asset specificity promotes possibility of opportunism in the outsourcing activities. However, Lonsdale (2001) has demonstrated that long-term secured contracting may not happen all the time and even if it is established, it cannot help much for buyers to get disengaged in a post-contractual dependence position that entails locked-in with the suppliers. Lonsdale argued "it is this risk of outsourcing, rather than that of outsourcing core competencies, that appears to be at the root of a majority of the problems firms have experienced (2001, p. 22)". It follows logically that concepts of power and dependence are introduced in analyzing outsourcing dynamics.

Some studies concern about dependence from the perspectives of both buyer and supplier (Buchanan, 1992; Geyskens et al., 1996). Cox et al.'s (2000, 2002) work were good examples of how Emerson's insights could be applied to buyer-supplier interactions. It is likely that the partner with more power will be tempted to exploit the relationship for advantages (Ireland and Webb, 2007; Geyskens et al., 1996). In other words, opportunism is likely to exist but it is governed by the dependence structure in the dyadic relationship. It follows that when thinking about opportunism may favors keeping activities in-house, (Walker and Weber, 1984; Monteverde and Teece, 1982), RDT may have more options for the firms.

Before we could talk about more options, power imbalance and interdependence are discussed (Casciaro and Piskorski, 2005). Power of an organization over another is the result of the net dependence of the one on the other (Pfeffer, 1987). Casciaro and Piskorski (2005) referred power imbalance as the differential dependence of one party to another, characterized by interdependence asymmetry. Blessed by power imbalance, the dominant party, i.e. the party that enjoys power advantage, may be tempted to exploit its power to negotiate for better terms in the exchange relationship (Ireland and Webb, 2007; Geyskens et al. 1996) Indeed, Canie¨ls and Roeleveld (2009) have demonstrated that relative power positions of the buyer with the supplier predict how likely the firm will outsource core activities. Researchers have proposed total interdependence, or the sum of dependence from both sides, should also be included in order to have a more comprehensive analysis of the power dynamics in a dyadic relationship (e.g. Casciaro and Piskorski, 2005; Gulati and Sytch, 2007). When there is low power imbalance, difference levels of interdependence may guide partners' moves differently. Often, low levels of interdependence are characterized by exchanges of non-critical routine products in small amount; High levels of interdependence are characterized by great amount of investment of time and commitment in the exchange relationship (Casciaro and Piskorski, 2005; Gulati and Sytch, 2007). Strong, co-operative relationship features mutual trust and mutual commitment (Geyskens et al., 1996). Opportunism may be weakened by high level of interdependence even when there is power imbalance (Casciaro and Piskorski, 2005) because the parties understand the partners are critical and acting opportunistically will risk losing trust or long term relationship stability. This encores to what theories of the embeddedness of economic exchanges in social relations suggest that when trading partners engage in high involvement relationships, the high level of interdependence will overcome luring problems streaming from power asymmetry (Granovetter, 1985; Uzzi, 1996, 1997). Thus, we follow Canie¨ls and Roeleveld (2009) and propose the following four statements:

P3: Buying firms that enjoy power advantage over a supplier are more likely to outsource core activities to that supplier than firms who do not enjoy power advantage.

P4: Buying firms that do not enjoy power advantage over a supplier are more likely to conduct the core activities internally than firms who enjoy power advantage.

P5: When interdependence between an outsourcer and a supplier is great, potential threats from power disadvantage may be attenuated.

P6: When interdependence between an outsourcer and a supplier is small, potential threats from power disadvantage may be amplified.

In between RBV and outsourcing and RDT and outsourcing

We begin this part with a metaphor. *How do people choose whom to fall in love with?*

Some people start by saying that "I need a partner." Then they choose their Mr./Ms. Right by first looking at others' statuses, for instance, people look at how rich and famous are the potential partners. Some put this more beautifully and say they value how capable the *potential partners are. It follows logically the pairs enter an atmosphere of expectations: expectations on the partner and expectations on the relationship. How one satisfies, or depends on another will dictate the relationship within the dyad. Trust and sharing may happen after all, but few people can be certain about these before entering a relationship.*

As Holcomb and Hitt (2007: 477) argued, firms *attempt* to "link value chain activities with intermediated markets to gain access to valuable specialized capabilities". The researchers also proposed (2007: 473) "bridging as the process by which firms establish linkages with intermediate markets, suggesting that new capabilities may be obtained through relationships established within and across a firm's relationship network (e.g. Burt, 1992; Granovetter, 1973)". In other words, firms borrow capabilities from their partners when those bridges are established. Strategists have also suggested firms gain more from synergies in the exchanges with their partners when capabilities are complementary (Penrose, 1959; Harrison et al., 1991; Rothaermel, 2001). Complementary capabilities support each other while they are different (Luo, 2002a); and they can help the firms achieve more if coordinated well (Richardson, 1972).

However, firms are to determine "whether the organization performs certain processes relative to competitors, and indeed suppliers when evaluating the suitability of process for outsourcing." (Mclvor, 2008: 26) "Disparity between the sourcing organization and potential external providers" has to be scrutinized. Outsourcing is not strictly beneficial for firms. Capability loss may cripple the functions of the sources of capabilities (Maley et al., 2015; Ethiraj et al. 2005; Weigelt, 2009). Lock-in effects may come up when a firm can hardly escape from an outsourcing relationship as a lot of assets have been equipped for the exchange or as a considerable amount of capital equipment has been sold to the supplier (Wright, 2004).

Meanwhile, while Benton and Maloni (2005) suggested supplier performance has positive effect on outsourcer's satisfaction, research findings also justify outsourcing from the perspective of knowledge management and RBV. From knowledge management perspective, the outsourcer may be able to get access to the multi-firm network for continuous innovation (Miles and Snow, 2007). Resources gained from this kind of network and capability of firms to manage these network are no different the resources that RBV talks about from the perspectives of some (Magretta, 1998). Indeed, firms do not only engage in competitions with other firms; competitions happen in supply chain level. Firms and even industries could improve their performances when partners' resources and expertise are well incorporated. This is a great motivation for firms to engage in outsource relationships.

When it comes to outsourcing partnership, both individual-alliance capabilities (Schreiner et al., 2009) and dyad-specific alliance capabilities count (Dyer and Singh, 1998; Wang and Zajac, 2007). The first one "focus on a firm's abilities to initiate, manage and terminate the contract with the supplier" and the second one "reflect the relational capability of a dyad" (Maley et al., 2015).

Goal congruence is critical for the success in exchange relationships (Luo, 2002a). Inter-firm behaviors may be beneficial to the sourcing firm may not promote the interest of the other partner(s) involved (Luo, 2002b), vice versa. Goal congruence also promotes cooperative behaviors and reduces conflicts (Parkhe, 1993). And according to Granovetter, (1985) and Uzzi (1996), the probability of opportunism could be reduced. "With the threat of opportunism reduced, exchange partners may be more willing to make additional resources available." (Holcomb, and Hitt, 2007: 474-475) So when will goals be congruent? Here, we propose:

P7: The higher the complementarity between the firm and its potential outsourcer, the more likely outsourcing will happen.

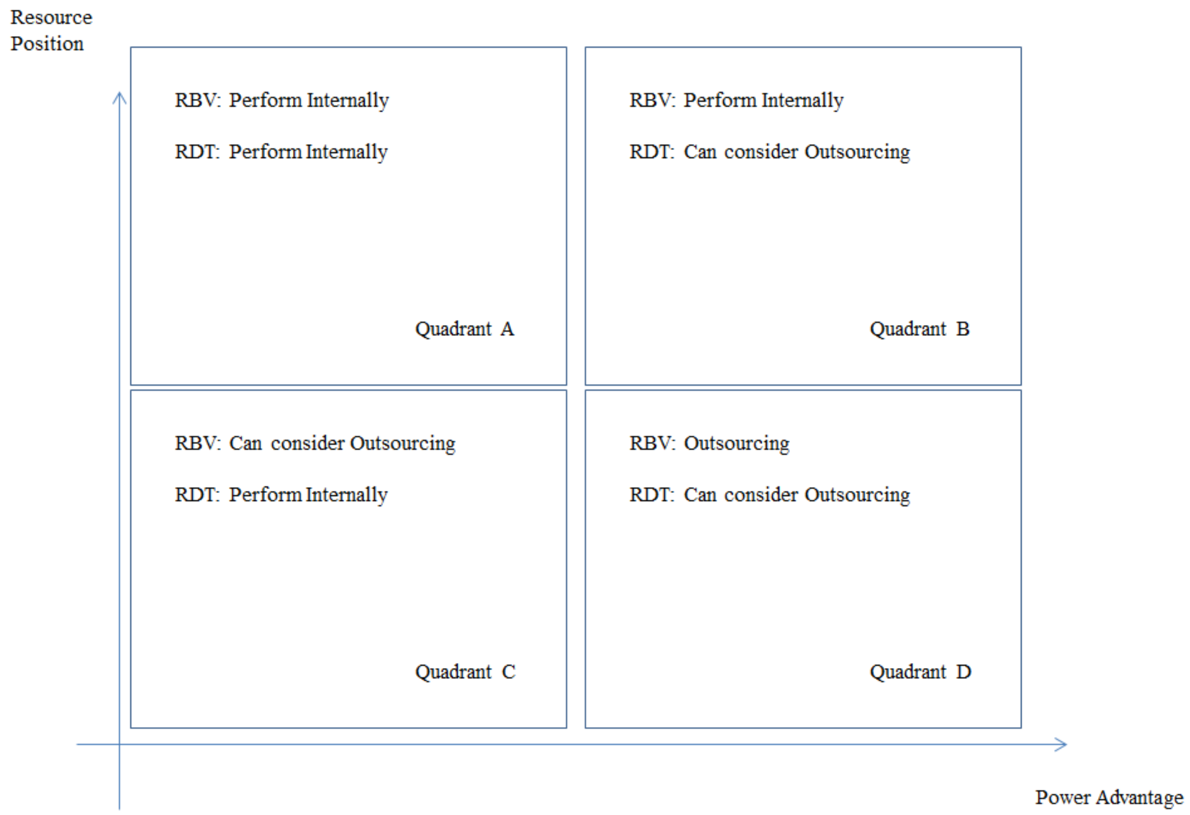
P8: The lower the complementarity between the firm and its potential outsourcer, the less *likely outsourcing will happen.*

Because of the high level of uncertainty in complementarity at the early stage of evaluation of outsourcing, we propose this assessment will be employed when outsourcing may be considered after P1 – P6.

A framework for evaluation of outsourcing

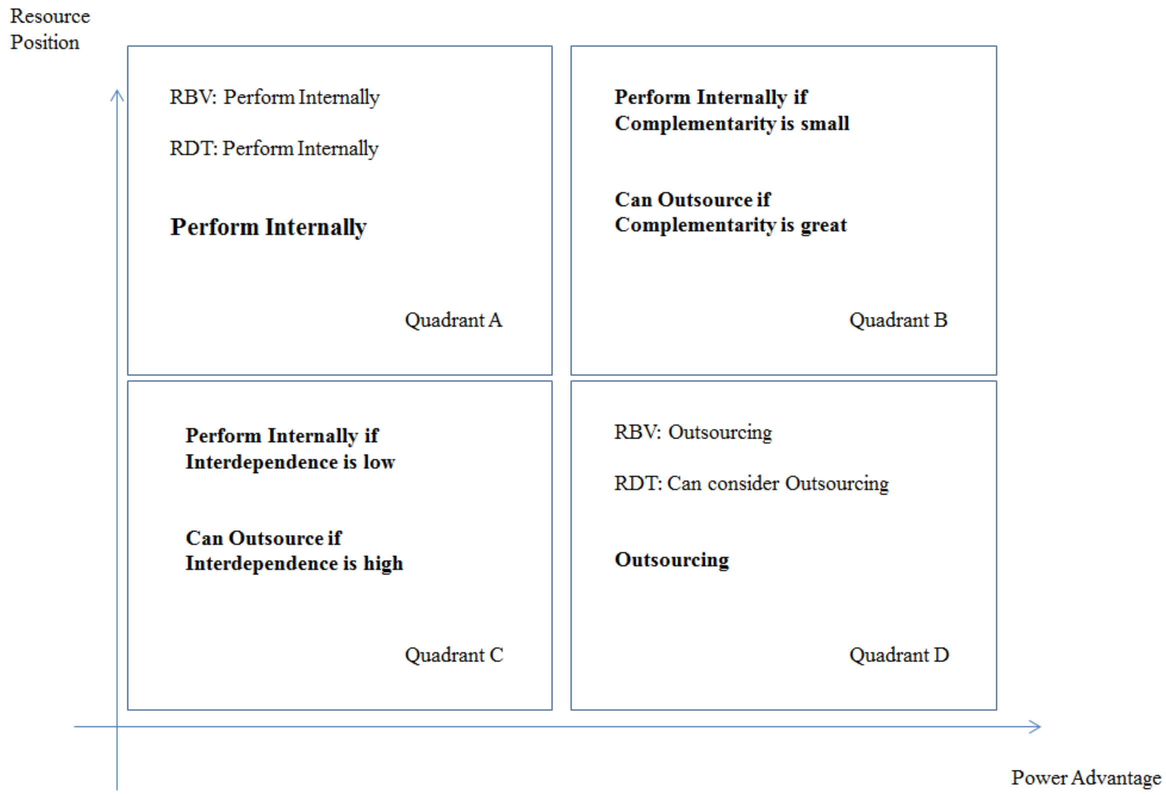
Here we, inspired by Mclvor, 2009; Canie¨ls and Roeleveld 2009; and Holcomb and Hitt, 2007, propose a framework for evaluation (Figure 1). First, P1 and P2 are applied to determine which activities may be outsourced from RBV (Mclvor, 2009). Next, P3 and P4 are applied based on RDT to determine if the firm can enter into an outsourcing exchange relationship with the potential supplier. Then, one may come across two seemingly contradictory situations in Quadrant B and C. From this point (Figure 2), P5 and P6 are applied based on RDT to Quadrant C and lastly, P7 and P8 are applied based on RBV to Quadrant B.

Figure 1



P1 and P2 are first applied because, as suggested by RBV, the foremost reason to consider outsourcing for a firm is that it attempts to focus on the activities of high resource position. P3 and P4 applied next because, as suggested by RDT, entering into some dyadic relationship may be problematic for the outsourcing firm.

Figure 2



P5 and P6 are then applied in Quadrant C because 1) resource position considerations and power imbalance concern together cannot lead to a clear direction, and more importantly, 2) RBV says outsourcing *may* be considered for the firm to gain superior performance but it does not say the firm *must* outsource that activity; in contrast, RDT clearly states that a firm in power disadvantage should not enter into a relationship with the supplier. RDT's implication is more critical in this Quadrant C before application of P5 and P6. Consequently, P5 and P6 are applied to obtain more insights from RDT.

Similarly, P7 and P8 are, at last, applied in Quadrant B because 1) as explained in the last section, complementarity is highly uncertain in the early stage in the evaluation, and more importantly, 2) RDT says outsourcing *may* be considered for the firm to gain superior performance but it does not say the firm *must* outsource that activity; in contrast, RBV clearly states that a firm should invest, develop and perform internally its activities with high resource position. RBV's implication is more critical in this Quadrant B before application of P7 and P8. Consequently, P7 and P8 are applied to obtain more insights from RBV.

Limitations and Implications

One limitation of this study is we examined dependence in a dyadic relationship. It is logical to move beyond this level to a network view of firms' dependence in which, we speculate, there are systematic similarities across buyer-supplier networks. In those networks, dependence may be more predictable on streams of value chains.

Another limitation is we viewed dependence based power imbalance and mutual interdependence in static positions. As Hallen et al., (1991) and Holm et al., (1996) suggested, structures of relationship may change and so it is good for future researches to look at how outsourcing exchange relationships may evolve over time.

One implication of this study is that it helps firms to evaluate outsourcing decisions from both RBV and RDT. When we apply both lenses, firms can adequately assess and draw conclusions from both internal needs and external appropriateness. When the objectives of outsourcing are clear, firms can better formulate effective exchange patterns and commonalities ex-post.

Another implication is when RBV and RDT are applied in the context of outsourcing; they together provide complementary insights for managers. In some situations, RBV are more critical while in some situations, RDT are more powerful for firms conducting evaluations. This may lead to more empirical researches in this line.

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