International Journal of Advancements in Research & Technology, Volume 7, Issue 7, July-2018
ISSN 2278-7763 

# A REALITY OR MYTH: OUTSOURCING FOR COST OPTIMIZATION

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**Abstract**

Outsourcing is not a new concept, and was researched, practiced and analyzed in different contexts. Outsourcing was first introduced in developed countries in order to use high skilled, low cost labor in developing countries, primarily in areas like manufacturing and IT. As such, the main idea was to optimize cost structures in different industries in the developed countries. This trend changed when outsourcing was starting to pick up momentum in developing countries, and the point of optimizing cost in countries where operational cost is already rock bottom was challenged. The objective of this paper is to analyze the relationship between outsourcing as a concept and cost optimization as an objective for outsourcing. Potential research areas like how outsourcing is applicable for technology related service sectors like telecommunication is also being proposed.

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**Key Words**

Cost Optimization; Outsourcing; Transaction Cost


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# 1 Introduction

Supply chain management is defined as "the systematic, strategic coordination of the traditional business functions and the tactics across these business functions within a particular company and across businesses within the supply chain, for the purpose of improving long-term performance of the individual companies and the supply chain as a whole" (Mentzer, DeWitt, Keebler, Min, Nix, Smith & Zacharia, 2001).

Outsourcing is a key factor in upstream supply chain management, and has been practiced and fine-tuned over a period of time through various research, practical scenarios and lessons learnt through experience.

According to Gilley & Rasheed (2000) defining outsourcing is a debatable). Sen & Shiel (2006) defines outsourcing as, "Outsourcing refers to the practice of transferring activities traditionally done within a firm to third party providers within the country or off-shore" whilst Lei & Hitt (1995) defines it as "reliance on external sources for manufacturing components and other value-adding activities". Outsourcing has been researched in various backgrounds and contexts, from different areas of the world, sectors of industries and even cultures and ethnicities. Literature has focused on IT industry for a couple of decades. According to Dolye (2000), 18 years back the total expenditure for outsourcing had already reached USD 1 Trillion.

Kremic, Icmeli Tukel, & Rom (2006) explains three main reasons to outsource their upstream activities. Companies have outsourced to clip escalating costs for a long time.

## 1.1 Purpose of Study

Outsourcing was first introduced to peg rising costs. Outsourcing to different parts of the globe was used by firms in developed countries, directing activities to service providing companies in developing countries to reduce costs (Troaca & Bodislav, 2012). The study was undertaken to review the validity of cost reduction or in other words, cost optimization through outsourcing. Currently companies focus on strategic goals, though it is in a way finally linked to outsourcing, when undertaking outsourcing as a strategic advantage. In this backdrop, the researcher intends to connect the outsourcing decision justification and cost reduction objectives, mainly focusing towards developing economies and in technology related industries. Therefore, this paper attempts to link these two factor, cost optimization and outsourcing through an empirical study.

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### 1.2 Methodology

The paper is based on literature reviews, and related theories have been connected and analyzed together with previous research and cases. The main information source of the study has been journal articles, but it has not prevented practical cases around the world to be correlated to theories of cost. Literature covers a large scope of contexts, industries and various economies but systematically narrows down to some commonalities. Various theories are linked to outsourcing decision making but the paper focuses on aligning cost related theories to the outsourcing decision keeping in line with the objective. Being a concept paper, it has used a deductive approach and the author also posts future areas to be analyzed in relation to costing and outsourcing.

## 2 Outsourcing as a Concept

### 2.1 Defining outsourcing and examining the evolution

International outsourcing has been the main subject throughout previous research. It could vary from components to sub-systems and even completed products (Bettis et al., 1992; Feenstra & Hanson, 1996). Scholars have also linked core competencies in relation to defining outsourcing has been brought in by Sharpe (1997), where it is looking at different suppliers for activities which doesn't fall in to a firm's core competence.

Gilley & Rasheed (2000) position it as "procuring something that was either originally sourced internally or could have been sourced internally notwithstanding the decision to go outside".

Hätönen & Eriksson (2009) defines three eras of how outsourcing has evolved over time. "Outsourcing is a phenomenon that as a practice originated in the 1950s, but it was not until the 1980s when the strategy became widely adopted in organizations. Since then, the strategy has evolved from a strictly cost focused approach towards more cooperative nature, in which cost is only one, often secondary, decision-making criterion. In the development of the strategy, three broad and somewhat overlapping, yet distinct phases can be identified: the era of the Big Bang, the era of the Bandwagon, and the era of Barrier less Organizations".


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## 2.2 Objectives of Outsourcing

Researchers have derived different objectives for a firm to look at outsourcing. Kremic et. al (2006) explaines 3 major categories of why companies look for outsourcing: cost, strategy, and politics. Here, the main focus has however been on the first two factors, and less emphasis has been given to political objectives. They describes how cost and strategy drives the decision to outsource mainly in the private sector, and naturally how political reasons do the same for the public sector. Further, the term political in original literature is more referred in terms of government politics.

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### 2.2.1 Cost Reduction

Low-skilled, labor-intensive work was shifted to low cost labor markets like South Asia, Latin America and South-East Asia. Having said that in later years, there were many other drivers than cost reduction which brought outsourcing to main stream company strategy. (Leavy, 2004). According to Leavy, large scale outsourcing commenced in early 1990s. In theory, outsourcing for cost can happen when suppliers' costs are essentially low enough that even with added overhead, profit, and transaction costs suppliers can still deliver a service for a lower price (Bers, 1992; Harler, 2000). Domberger & Fernandez (1999) as cited by Kremic, Icmeli Tukel, & Rom (2006) explains that cost savings outsourcing can be quite significant. Further, there are indirect cost savings where the fixed cost required for building and infrastructure, IT and other administrative and supportive functions also reduce from outsourcing. Certain companies look at having better control over their costs in order to be more flexible (Alexander & Young, 1996; Sheehan, 1993). Other companies try to convert their fixed costs in to variable costs. (Anderson, 1997). Transactional Cost Economies (TCE) is used to explain the link between cost reduction and outsourcing by many researchers. All companies want to improve their financial performance and as per above approach, outsourcing provides a silver bullet to achieve cost reduction. However literature emphasizes that it is not that simple due to many reasons. Kremic, Icmeli Tukel, & Rom (2006) goes on to explain this phenomena as below.

The first reason is that most companies miss on accurate cost structures, and when formulating the business model, often overestimate savings. Domberger & Fernandez (1999) is cited to explain how outsourcing in IT industry has caused a 9% cost increase.

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The second reason is more of an indirect one. It specially applies to the Sri Lankan context as observed by the researcher over his experience. It can be categorized as social costs that may incur where it could be oversights in contract formulation and monitoring, contract finalization and then procurement, intangibles, and certain transition costs which were missed to be accounted for. This category is the most difficult to quantify, but can have a significant impact as well. Going on, Kremic, Icmeli Tukel, & Rom (2006) highlights the effect of decreasing quality of employees due to certain contractors' low appetite for staff development. All this finally adds up to unidentified and unaccounted costs, which turns the profitability analysis.

### 2.2.2 Strategic Motivation

The concept of Core Competencies was introduced by Prahalad & Hamel (1990), and it has also been linked to outsourcing where firms are said to look at keeping their core competencies within whilst looking to outsource the rest. Adopting an outsource strategy releases valuable resources in order to focus better on Core competencies.

Kremic, Icmeli Tukel, & Rom (2006) explains how in recent times the main drivers have shifted towards strategic motives like enabling better focus on core competencies as well as achieving flexibility. Other than enabling better focus on core competencies, strategy related motives like organizational growth, dynamism in technology. When considering the context of research which essentially focuses on technology service sector, there are two important factors that needs to be considered when analyzing the environment.

As per Kremic, Icmeli Tukel, & Rom (2006), flexibility seems to be a key driver "not just from a scale perspective but also regarding the scope of product or service". They go on to explain this saying, "Organizations need to react quicker to customer requirements and outsourcing is seen as a vehicle to accomplish this. Outsourcing may also be perceived as a way to reduce the organization's risk by sharing it with suppliers and at the same time acquire the positive attributes of those suppliers. The partnerships that result from outsourcing may enable an organization to be a world-class performer for a whole suite of products and services where it could only be an average performer by itself." This links to what is usually called a virtual organization; where functions are done by different vendors under a single unified agreement where they supply the services in an integrated manner. (Kremic et al., 2006). This approach is favoured by the customers because the

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management overheads are comparatively lesser than them having to manage many individual contracts.

By considering all above, it is noted that cost reduction still remains a main reason for firms outsource.

## 3 Theoretical Links to Cost and Outsourcing

Sometimes there are contradicting theories pointing towards linking cost and outsourcing and leads researchers to be confused (Perunović, 2007). He has developed a map on how phases during the outsourcing process relates to each of these theories. The key phases represented were "preparation, vendor selection, transition management, relationship and reconsideration". Each of these phases has different theories to explain their relationships and interlinks. Perunović, subsequent to analyzing many litrature, has come up with a matrix specifying how many papers relate to each theory during different phases of outsourcing. This matrix points out that Transaction Cost Economics has a considerable link to all the phases whilst mostly contributing to the preparation phase. This means it has a large role to play in deciding whether to outsource and if so, the factors to consider. It also explains the phases of relationships and reconsideration to a certain degree. Relational view and core competence theories also contribute to the preparation phase. All other theories have some relevance to one or more areas but the contribution is not proven to be significant as per Perunović.

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### 3.1 Transaction Cost Analysis/ Economics

McIvor (2003) explains the initial theoretical background of outsourcing as transaction cost analysis. Transaction cost analysis, sometimes referred to as Transactional Cost Economics (Perunović, 2007) combines theories in economics and management to identify most effective types of relationships a company should develop in the market when outsourcing is considered. McIvor (2003) emphasizes that the "idea behind transaction cost analysis is governed by properties of a transaction which is determined by certain factors. Transactions basically occur between two parties (or more). As such. The multiple parties enter a bargain during the transaction, and the cost of transaction depends on two main things; the difficulties in the transaction and context". There are some factors causing difficulties in deciding transactional effectiveness. The first being bounded rationality, explains that the rationality of a human being is subjective. It is


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limited by the extent to which that specific person can process information. Therefore it is bounded by the same.

Opportunism is another such factor, where human beings tend to be opportunistic, resulting them working for self-interest. Small numbers bargaining, where the volume that needs to be bargained is sometimes too small, and doesn't make sense to obtain full information which usually is costly is another factor that makes transactions difficult. As such, the lack of information creates difficulties. Information impactedness is another main factor. Information is not equally available to all parties. Even under small-number bargaining, one party can afford to pay more for the same information which is prohibitive to the other. This asymmetry of information availability amongst the parties cause a difficulty in bargaining.

These difficulties and related costs increase based on certain scenarios. (Williamson, 1985):

First scenario is specified as asset specificity, where transactions needing relatively high investment, specific to the requirements of a given transactional relationship. Uncertainty is another scenario where the definition and performance of the transaction is sometimes not clear. Infrequency is if certain transactions rarely happen, the associated cost structures are not something which the parties are used to. This might also result in an escalation of cost.

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### 3.2 Value chain analysis vs. Core Competence model

Certain scholars challenge the value of using core competence model as a basis of identifying areas to be outsourced, and some literature suggests that analysis of Value Chain can have a greater impact than core competencies approach (McIvor, 2003).

Before understanding what is more important, the basics of core competence needs to be clarified. Prahalad and Hamel (1990) insists that core competencies are not assets which are physical in nature, but the ability of the management to consolidate an organization-wide set of non-physical assets like technology or production skills. This is because the assets can always be replicated over time, causing loss of core competence if it was based on the asset.

The value chain of the upstream partner needs to be identified in order to see whether it relates to a core competency of the partner. If it does not relate to such an activity, the


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partner might have to rely on another party to deliver the outcome, resulting a higher margin to be paid.

## 4 Conclusion and Further Research Directions

When we assume that cost is the prime reason for an outsourcing decision, the intricacies of the transaction or bargain will complicate the estimation of costs and potential savings. TCE/ TCA might be one of the most referred theories when explaining outsourcing. This might be true for many industries, especially manufacturing where cost is more of a tangible factor, but Lacity & Willcocks (1995) states that it only explains few Information Technology related sourcing decisions.

Although many scholars have studied outsourcing in detail, telecommunications has been rather a new area when comparing to manufacturing and even IT. Ahmed et. al (2014) has conducted a study on the telecommunication industry in Pakistan, a close enough proxy to Sri Lanka in many factors. They have carried out a quantitative analysis on the outsourcing phenomenon and its impact on the cost of doing business in telecommunication business in Pakistan. Factors considered to check the relationships are Critical Drivers, Core Activities, Benefits met by outsourcing in telecommunication, Benefits desired by consumers, Disadvantages more as compare to advantages to the employment level, Getting better result by strategic planning, Social, Financial and Ethical responsibilities fulfilment and Risks reduction related to outsourcing. They have concluded that the Critical Drivers and benefits met by outsourcing are the key reasons of better leverage of the telecommunication businesses in Pakistan.

Ahmed et. al (2014) has studied the cost impact due to outsourcing, but have gaps in certain critical areas like method on how to identify outsourcing activities from the value chain, partial outsourcing vs. Full outsourcing, how to zoom in on a supplier and type of relationship between the operator and supplier.

Further, the motive to reduce cost comes mainly from the western world during first days of outsourcing as explained by many scholars citied in this literature review time to time. Further, no study on service sector outsourcing, especially in a dynamic industry like technology has been done in a Sri Lankan context. In Sri Lanka, all equipment vendors

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like Ericsson, Huawei, ZTE and Nokia are global giants operating in the west, and naturally the set up cost of an outsource operation would be a high cost effort. This might actually result in not getting any cost advantages. Although there are multiple strategic benefits, in a highly volatile market like Sri Lanka, operators might not seek strategic benefits at the cost of eroding the bottom line. Again, there is no literature to support this fact however.

Further, Sri Lanka has a unique situation where the labor laws are extremely strict compared to regional counterparts. Troacă & Bodislav (2012) states that "although outsourcing may be expected to bring long term benefits, there may be adjustment costs in the form of job losses, a process visible especially at the microeconomic level, since even in the advanced process outsourcing service is started". Therefore, when moving from insourcing to outsourcing, many human resource related issues can come up. This again has not been adequately addressed in literature. This has profound cost implications as staff reduction might have direct implications of cost increase.

Therefore, the link between cost reduction and outsourcing decision still needs to be investigated in detail to conclude the applicability in technology related industries for developing countries where cost of labor is relatively low.

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