

# RULE 7: OUTSOURCE NON-CORE ACTIVITIES

*The Ruthven Institute has developed 12 rules for business success. Based on 45 years of analysis of Australia's top 1000 companies, the Ruthven Institute has distilled the essence of a winning business strategy. Research undertaken by the University of Melbourne between 1998 and 2001 supported many of these rules. In this series, the RI Hub examines the literature to assess the validity and continuing relevance of these rules. In each of the following sections, the literature is summarised, the key issues for implementation highlighted, and the questions for future research identified.*

"The term *virtual corporation* has come to mean a business where non-core activities are outsourced to specialist providers, narrowing the span of control management tasks. This enables executives to focus on intellectual property, organisational culture and a range of other core activities that can vary between businesses and industries. Today, the rise of outsourcing has resulted in the pursuit of a simplified business structure, enabling corporations to be lighter, faster and more responsive to our fast-changing external environments...

Outsourcing is often misattributed to a number of factors: Some believe it will reduce the cost of operations, and therefore the finished cost of the product; while others believe it is used to cut selling prices, or simply to increase profit. But ... [t]he *raison d'être* of outsourcing is to eliminate distractions from the more important core functions within one's business that lead to better or more competitive products, faster growth, higher profitability and sustained success"

Ruthven Institute (2019) *Business Success: In Brief the 12 Golden Rules*

RI Rule 7 reflects various arguments for the commonly observed phenomenon of organisations pushing non-core activities out to suppliers. It is surprising to find that the voluminous academic literature on outsourcing pays scant attention to the performance effects of this strategic choice. To gain an insight into the validity of Rule 7, below we provide a brief review of this literature with a focus on the performance implications of outsourcing and the factors driving the relationship.

## Defining outsourcing

A quick scan of the early academic literature on outsourcing reveals that outsourcing was defined differently across studies in the 1990s. Most of these definitions were based on the extent to which a firm relies on, or is supplied by, outside parties with

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respect to specific components or finished products. One of the earliest studies to formally define and explore outsourcing as a concept closest to its current use is Gilley and Rasheed (2000). As the authors point out, all firms purchase elements for their operations, so defining outsourcing as simply a purchasing decision does not capture the strategic nature of the issue. This also sets outsourcing apart from subcontracting. Using subcontracting and outsourcing as synonyms implies that “every decision to undertake an activity outside of the corporation (to buy-in rather than make) is a decision to outsource”, which is not the case (Deavers, 1997, p513).

Gilley and Rasheed (2000, p764) posit that outsourcing can be thought of as representing “a fundamental decision to reject the internalization of an activity.” Within this framework, they distinguish between two sources of outsourcing: substitution and abstention. The first is a result of a classic *make or buy* decision: the firm discontinues the internal production of some goods or services and substitutes these internal activities with external purchases. This can also be thought of as vertical disintegration. In the case of outsourcing through abstention, however, the firm has never produced those goods or services to start with. In such a case, the firm’s decision is considered outsourcing rather than a mere purchasing decision when the firm *could* produce those goods or services internally but instead opted to purchase them from external vendors (Gilley & Rasheed, 2000). To alleviate the possibility that the inconsistent results from different studies are due to inconsistent definitions of outsourcing, we exclude from this review the studies that define outsourcing too broadly (e.g., the reliance on external sources for manufacturing components).

## **Why do firms outsource: benefits and costs of outsourcing**

Firms outsource activities for various reasons, and their motivations to outsource may differ depending on their size (Roza, Van den Bosch, & Volberda, 2011). One of the most commonly raised arguments by researchers in support of outsourcing is the potential cost-savings. By outsourcing many of the in-house activities to specialised vendors, firms can reduce their total costs. Research suggests that cost reduction is in fact a strong motivation for outsourcing and that peripheral activities, rather than core or near-core activities, are more likely to be outsourced in response to cost pressures (Balakrishnan, Eldenburg, Krishnan, & Soderstrom, 2010; Loh & Venkatraman, 1992). Based on a study of small and medium-sized enterprises, Di Gregorio, Musteen, and Thomas (2009) also find that offshore outsourcing of

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manufacturing activities is more commonly motivated by cost savings than is service outsourcing. Offshore services outsourcing is more often associated with the intention to expand relations with strategic overseas partners.

Improved flexibility is another commonly proposed benefit of outsourcing as it allows firms to free themselves from committing to a specific type of technology and to quickly respond to environmental changes (Gilley & Rasheed, 2000; Liebeskind, Oliver, Zucker, & Brewer, 1996). Being able to take advantage of the latest technologies without investing significant amounts of capital into those technologies also reduces risk.

Perhaps more importantly, outsourcing non-core activities (i.e., peripheral activities) allows the firm to increase its focus and resources on its core competencies, which is important for its long-term survival (Dess, Rasheed, McLaughlin, & Priem, 1995; Gilley & Rasheed, 2000; Quinn, Doorley, & Paquette, 1990). Venkatesan (1992) posits that firms can improve their competitiveness by producing components that are critical to the product and at which the company excels making while outsourcing components wherein suppliers have a distinct comparative advantage. He further suggests that firms can use outsourcing as a means of generating employee commitment to improving manufacturing performance. Outsourcing peripheral activities to specialised firms can also greatly enhance the quality of those activities (Dess et al., 1995). Indeed, among the results of a 1991 Outsourcing Institute survey of 1200 companies, Deavers (1997) highlights improved company focus, freed-up resources for other purposes, and access to world-class capabilities as some of the most frequent reasons why companies outsource.

Researchers have also highlighted several potential costs and risks of outsourcing. Teece (1988) asserts that outsourcing can diminish a firm's innovative capacity because it is often used as a substitute for innovation. On a similar note, Rothaermel, Hitt, and Jobe (2006) list excessive reliance on external parties to perform certain value chain activities as one of the dangers of outsourcing. Weigelt's (2009) finding that outsourcing business process enhancing technologies lowers firms' integrative capabilities is consistent with this assertion.

Outsourcing can be especially dangerous if applied to activities that support the firm's core functions or to those that help the company distinguish itself from the competitors, as doing so may lead to a loss of crucial know-how with respect to its

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core competencies (Bengtsson & Dabhilkar, 2008; Bettis, Bradley, & Hamel, 1992; Lacity, Willcocks, & Feeny, 1996). Also, suppliers can grow to be competitors after gaining sufficient knowledge of the product, and market their own brands as substitutes to the original product. Willard and Savara (1988) argue that Japanese firms used this entry pathway into the US market and solidified their position in the US when the US firms did not see them as competitors. Many firms from other Asian countries have made their entrance into US markets by first entering supplier arrangements with US firms (Gilley & Rasheed, 2000). Considering these risks, Hoecht and Trott (2006) emphasize the importance of trust in outsourcing relationships.

In addition to these general costs and risks, outsourcing may bring in several hidden costs related to vendor search and contracting, transitioning to the vendor, and managing the effort (Barthelemy, 2001). Vendor search and contracting costs comprise expenses on identifying and evaluating suitable vendors and negotiating the contract. Costs associated with managing the effort include monitoring the vendor's performance and negotiating any needed contract changes. Although Barthelemy (2001) discusses these hidden costs in the context of IT (information technology) outsourcing, they are likely to be applicable to most other types of activities.

The cost-benefit dynamics of international sourcing may also significantly differ from that of local outsourcing and involve additional costs related to tariffs, exchange rates, inventories, transportation, and administration (Dess et al., 1995; Markides & Williamson, 1994). These costs can often be significant enough to reduce or even eliminate any benefits the firm hopes to gain from international sourcing. Levy (1995) finds that disruptions to an international supply chain can generate significant unexpected costs in the form of expedited shipping, high inventories, and lower demand fulfillment. The COVID-19 pandemic, and the associated interruptions to many trade routes, is a recent example of such challenges. Consequently, firms should be especially careful in evaluating the costs and benefits of outsourcing when the suppliers are overseas.

RI Rule 7 also differentiates international sourcing from local outsourcing. Specifically, it posits that in the process of outsourcing its (manufacturing) activities to overseas suppliers, a firm "ceases to be a manufacturer and morphs into a wholesaler". For example, the RI considers the operations of foreign companies like

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Apple in Australia to be more akin to wholesaling than anything else. Rule 7 calls the process of outsourcing all manufacturing activities to overseas suppliers *migration* and distinguishes it from outsourcing in the traditional sense and from subcontracting. In more extreme cases, the company becomes a franchisor by retaining IP rights while pushing all parts of operations to outsiders. Throughout the review, we follow the academic literature's definition of outsourcing and do not discuss the empirical evidence related to franchising.

## **Outsourcing and firm performance**

Despite the voluminous academic research and practitioner comments on the costs and benefits of outsourcing, empirical evidence on the performance implications of outsourcing is relatively sparse due to data limitations. Below we discuss the main studies exploring the outsourcing-firm performance relationship. Overall, evidence regarding whether outsourcing significantly affects firm performance is mixed. While some studies document a positive relationship for some types of outsourcing, others fail to find a significant association.

Using data obtained from a survey of US manufacturers, Bardhan, Whitaker, and Mithas (2006) provide evidence that production process outsourcing is associated with lower costs and higher quality improvement at the plant level. Also using survey data, Gilley and Rasheed (2000) find that outsourcing affects firms' financial and innovation performance differently depending on the type of strategy the firm pursues. Specifically, results indicate the outsourcing of non-core activities improves the financial performance of cost leaders and the innovation performance of firms pursuing differentiation strategy. It does not, however, seem to improve the financial performance of the latter. The first set of results is consistent with the argument that the outsourcing of peripheral activities allows firms to focus on their core competencies, leading to performance gains. Interestingly, however, evidence from Bardhan et al. (2006) suggests that quality-focused plants are more likely to outsource IT than the plants focused on minimising costs.

Gilley and Rasheed (2000) also find that outsourcing is more likely to improve firm performance in stable environments than in dynamic environments. This finding is somewhat inconsistent with the frequently advanced argument that outsourcing in fast-paced environments is beneficial to firms because it allows firms to take advantage of cutting-edge technologies without committing to a specific technology. As the authors suggest, a potential driver of this apparent inconsistency is the

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higher transaction costs associated with negotiating, monitoring, and enforcing outsourcing arrangements in dynamic environments, which may deter firms from outsourcing. Alternatively, powerful suppliers with specialized skills may be able to exert higher bargaining power in such environments (Gilley and Rasheed, 2000).

It is unclear if the insignificant results from Gilley and Rasheed (2000) are driven by weak performance impact of outsourcing or by the possibility that the effects of outsourcing are realised over a longer period than that afforded by the study's research design. In a study of German firms over the 1992-2000 period, Görzig and Stephan (2002) fail to find strong evidence that outsourcing improves profit margins either in the short-run or in the long-run. Mol, van Tulder, and Beije (2005) obtain similar results after examining the international outsourcing decisions of 200 Dutch manufacturing firms. Gilley, Greer, and Rasheed (2004) find neither payroll nor training outsourcing significantly affects financial performance.

Leiblein, Reuer, and Dalsace (2002) argue that using simple regression techniques to compare the technological performance implications of outsourcing versus vertical integration is likely to lead to misleading conclusions as a firm's decision to outsource is strongly related to the distribution of relevant capabilities. After controlling for selection biases, they find that the decision to outsource or vertically integrate per se does not improve performance. Instead, the performance differences observable between the firms following either path are likely to be driven by more fundamental factors. Similarly, upon analysing survey data from Swedish manufacturing plants of engineering firms, Bengtsson and Dabhilkar (2008) conclude that investments in technological and organisational capabilities, rather than outsourcing, drive the performance of individual plants.

Rothaermel et al. (2006) explore whether a combination of outsourcing and vertical integration improves firm performance to a greater extent than either organisational form on its own. The main construct proposed in the study is *taper integration*, which refers to a case wherein the firm simultaneously uses vertical integration and outsourcing for the same value chain activity. The study finds that taper integration positively affects both product development and the success of those products. To achieve optimal results, however, the two should be carefully balanced: pursuing either strategic outsourcing or vertical integration in isolation is suboptimal. The authors also suggest that to achieve a good balance, firms ought to internalise activities that are more easily integrated and outsource those in which the firm

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should participate but which are difficult to integrate.

The idea that partial outsourcing (within each activity category) is more beneficial than full or no outsourcing has been posited by other researchers as well. For example, Kotabe, Mol, and Murray (2008) argue that too little outsourcing leads to internal bureaucratic and other inefficiencies, while too much outsourcing leads to relational inefficiencies and technological dependence. Using a sample of Dutch manufacturing firms, Kotabe and Mol (2009) provide empirical evidence that suggests outsourcing improves firm performance up to a certain point, beyond which it has a negative impact on performance. Upon examining sixty-two IT outsourcing decisions in detail, Lacity et al. (1996) find that selective sourcing of IT activities provides a better performance outcome than all-or-nothing approach to outsourcing.

Weigelt and Sarkar (2012) examine firms' decisions to outsource from a similar angle but further argue that the nature of the outsourced activity significantly affects the extent to which it is successful. Specifically, they suggest relatively simple tasks with formal, standardized, and replicable routines – called efficiency-related problems in the study – are more suitable for outsourcing, while tasks that are complex and which require experimentation and novel approaches – called adaptability-related problems – are best performed in-house. This argument is consistent with Williamson's (1981) model of efficient boundaries, which asserts that suppliers enjoy a production cost advantage over buyers when asset specificity is low due to greater economies of scale. Such production cost difference disappears as asset specificity increases. Using a sample of banks for their analyses, Weigelt and Sarkar (2012) provide evidence supporting their hypotheses: outsourcing increases efficiency in customer service delivery up to a certain point, beyond which gains begin to disappear. In contrast, process outsourcing negatively affects adaptability.

Lacity et al. (1996) also provide a detailed discussion of which activities firms should outsource. Specifically, activities that are critical to the business and differentiate the firm from its competitors should be kept in-house, and those that are critical to the business but are not differentiators should be outsourced only if a high-quality vendor is available. The firm is likely better off by outsourcing activities that provide incremental benefits to the company but fail to distinguish it from its competitors (Lacity et al., 1996). These activities are prime candidates for outsourcing especially if they are easily standardisable as vendors can achieve low costs and specialise in such tasks (similar to the arguments discussed in earlier paragraphs). The degree of

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integration of technical systems with business processes is another important point of consideration. When such integration is high, the risks of outsourcing also increases (Lacity et al., 1996). Indeed, based on a case study of several large IT outsourcing contracts, Miozzo and Grimshaw (2005) find that firms have incentives to retain in-house capabilities to ensure coordination between IT and business strategy when IT outsourcing is accompanied by a more extensive transformation in the firm's production technologies.

## Conclusions

The aim of this review was to provide a discussion of the academic work on the performance implications of outsourcing. The outsourcing literature differs from the other streams of management literature we have previously reviewed in that despite the existence of well-established theories and practitioner comments regarding outsourcing, empirical evidence on the outsourcing-firm performance relationship is relatively sparse. This is primarily due to data limitations as the only ways of obtaining data for such an analysis are surveys and case studies.

The empirical evidence on whether outsourcing improves firm performance is mixed. Overall, the findings seem to point to an inverted-U shaped relationship where outsourcing improves firm performance up to a certain point, beyond which performance gains disappear. Researchers agree that firms should outsource activities that are routine and standardisable because vendors can specialise in these tasks, which is likely to lead to higher quality and/or lower costs. Activities and capabilities that distinguish the firm from its competitors (i.e., core competencies), however, should be kept in-house. For remaining activities, firms should carefully weigh the benefits of outsourcing the activity against the costs. Outsourcing may improve the firm's competitiveness if it outsources sensitive non-core activities (e.g., those that support core activities) to trustworthy and high-quality vendors or forms strategic partnerships with them to co-work on those activities, but the firm should ensure that such arrangements do not lead to loss of know-how or leakage of sensitive information to competitors.

Although in this review we focused on the studies that have examined the outsourcing-performance relationship from for-profit organisations' point of view, several studies have also provided evidence on the benefits of outsourcing in the public sector. Domberger and Jensen (1997) and Hodge (1998), provide a discussion and a meta-analysis, respectively, of the main empirical studies in this literature.



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These studies generally find that the outsourcing of an activity by the public sector leads to cost savings without a change in quality, and even results in increased quality in some cases. They further find that, more often than not, the winning bids in public sector tenders were offered by the employees themselves, suggesting that the improvements were likely the result of increased efficiency, better management, and greater innovation spurred by competition. A 1996 inquiry by the Australian Industry Commission also found reduced costs and increased quality following the outsourcing of some services, and concluded that the improvements in quality “appear to rise because of a much clearer focus on what is required in the service, improved performance monitoring, and the ability to choose among alternative providers” (Industry Commission, 1996, p124). This conclusion is consistent with the theoretical propositions and the results from the studies on private sector firms. Taken together, the empirical findings discussed in this review are broadly consistent with RI Rule 7.

## **Future research opportunities**

The outsourcing literature can be expanded in several ways. First, although many studies find that outsourcing improves firm performance only up to a certain point, we do not know when firms reach this point. This issue is also closely associated with what types of activities the firm should outsource and their nature. If such a threshold is identifiable, does it differ across firms or industries?

Second, we still do not have a good understanding of the extent to which performance implications of outsourcing vary across different types of firms. For example, do services firms outsource a lower proportion of their activities compared to manufacturing firms, and is the effectiveness of outsourcing different between these firms? Another potentially fruitful avenue for future research in this area would be to explore the extent to which outsourcing and its performance impact differ between public and private firms. To the best of our knowledge, an analysis of family firms’ outsourcing decisions and their consequences by Pongelli, Calabrò, and Basco (2019) is the only systematic study in this area.

Third, there has been insufficient work done on whether the strength of the outsourcing-firm performance relationship varies with firm motivations. The two most commonly offered arguments as to why firms outsource are to reduce costs and to better focus on their core competencies. RI Rule 7 posits that the latter is a more important reason to outsource. Does a firm perform better or worse in the short-run and/or the long-run if its primary motivation to outsource is to spend

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more of its resources on its core competencies rather than the potential cost-savings? If yes, why?

One final aspect which may warrant investigation is the performance of the firms who have work outsourced to them. As the public sector examples above illustrate, new firms and even industries can emerge from the specialisation in tasks previously performed in-house across disparate industries. Industries such as advertising, market research, logistics, recruitment and cleaning are all examples of activities which were once more commonly performed in the back office of most firms. This trend continues today, perhaps at an ever more finely-sliced level, with various business processes moving to service providers. Digitisation appears to be accelerating this process. Here we also see an intersection with RI Rule 2 regarding knowing the industry life cycle. Do firms who innovate in offering the outsourcing option perform highly, and for how long? We believe addressing these questions would make significant contributions to the outsourcing literature.

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