# Scales and Dynamics in Outsourcing

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## INTRODUCTION

*Outsourcing* is used to describe the situation where a firm decides to subcontract assembly and/or service functions to an external supplier, either locally or abroad. When activities are subcontracted abroad, the term *offshore outsourcing* often applies. While offshore assembling activities have taken place for some time, the phenomenon of outsourcing services abroad is quite new. Several factors have contributed to these altered circumstances. First, the development of information and communication technologies (ICT) implies that services can, to a great degree, also be located at arm's length or elsewhere in the *flat* world (Friedman, 2005). Second, institutional changes have opened access to *new* markets for goods and services as well as skilled labor, for instance in Eastern Europe and China. Third, the increased competition through globalization pushes firms to adapt quickly to new contexts and to achieve efficiency in order to maintain competitiveness.

Recent trends show that companies in all sectors outsource a growing number of assembling and other services abroad to exploit the wage gap between developed and less-developed countries (and regions). This is especially the case for large transnational companies (TNCs) but also applies increasingly to smaller companies. Improvements in transportation and lower tariffs reduce the trade costs of intermediate products and services. At the same time, the potential impact on job losses in developed countries has unchained a heated debate on the advantages and disadvantages of offshore outsourcing.

As firms are reconstructed to take advantage of outsourcing and offshore outsourcing as a means of improving flexibility and concentrating on information and knowledge-intensive core functions, they create or become involved in networks of relationships. In these increasingly complex and multilevel networks, the nodes are other firms to whom functions are externalized or inputs of goods and services are subcontracted. These networked organizations, which vary in size and geographical scope, may be very flexible, as the network could easily be rearranged by releasing some nodes while integrating new ones. The chosen solution again depends on the economic and market context.

## DEFINITIONS

Outsourcing involves the transfer of specific activities that have usually been undertaken in-house, to another company (Greaver, 1999). This means that a company decides to contract out some, normally noncore, activities to concentrate on core activities as a means of lowering production costs and optimizing the use of available resources.

Variations in terminology (offshore outsourcing, business process outsourcing, ICT outsourcing, international sourcing, cosourcing, backsourcing, multisourcing) are frequent (Millar, 2002). Nevertheless, international regulatory institutions are attempting to homogenize the data collection process to facilitate international comparison studies.

Several typologies on the transfer of some of a company's activities exist (Table 1). Of these, the Organization for Economic Co-operation and Development (OECD) and United Nations Conference on Trade and Development (UNCTAD) typologies are the most well known. Basically, the location of the transferred business activities (in the home country or abroad) and the organizational forms (outsourced to third parties or kept under own management) are used to define the different typologies. The typologies embrace a wide range of situations, as assembling activities and services can be contracted within national borders (domestic outsourcing), can involve foreign affiliates (captive offshoring) or can be contracted out to other companies abroad (offshore outsourcing) [1] (Table 1). The term offshoring applies to offshore outsourcing as well as to captive offshoring.

*Table 1. Typologies on the transfer of a company's activities*

| | | Internal to the enterprise | External to the enterprise | Within the home country | Across borders |
|---|---|---|---|---|---|
| Kirkegaard | Outsourcing | | X | X | |
| | Offshore outsourcing | | X | | X |
| OECD | Domestic supply | X | | X | |
| | Domestic outsourcing | | X | X | |
| | International insourcing | X | | | X |
| | International outsourcing | | X | | X |
| WTO (adapted from OECD) | Captive onshore outsourcing | X | | X | |
| | Noncaptive onshore out-sourcing | | X | X | |
| | Captive offshoring | X | | | X |
| | Noncaptive offshoring | | X | | X |
| UNCTAD | Intrafirm (captive) offshor-ing | X | | | X |
| | Outsourcing | | X | | X |

*Sources: WTO, World Trade Report, 2005; UNCTAD, World Investment Report, 2004; Kirkegaard, 2004; OECD, 2005*

## OUTSOURCING: DRIVERS AND DETERMINANTS

Outsourcing is the result of a decision process undertaken at the management level to substitute a service previously developed inside the company by another acquired outside the company. After deciding which particular function or functions to delegate, a further decision is required so as to choose between a subsidiary and a third-party supplier. A range of factors influences the *make-or-buy* decision. Grossman and Helpman (2002) emphasize the trade-off between the costs of running a larger and less specialized organization and the costs that arise from search frictions and imperfect contracting. In choosing between a domestic and a foreign supplier, the company considers the trade-off between variable and fixed organizational costs (supervision, quality control, accounting, and marketing) (i.e., the benefits of lower variable costs in less-developed countries against the benefits of lower fixed organizational costs in more-developed countries) (Antràs & Helpman, 2004). A final decision results from the balance between the adequacy of the dimensions and the variable and fixed costs. This will vary across sectors and firms (Figure 1).

Outsourcing is not a recent phenomenon. The development of the automobile industry at the beginning of the 20th century and the increasing complexity involved in production was one of the driving forces behind outsourcing. More demanding consumers and the exigencies of comfort and security increased the number of tasks to be performed and the variety of skills. As cars became more complex, it was not possible to combine mass production and specialization within a single plant. The tendency of outsourcing resulted in an increasingly fragmented process of production and interdependencies of firms within a global context. Cars are now a product *made throughout the world* with compounds created in dozen of facilities in several countries (WTO, 2005). As a result, early uses of the term outsourcing tended to be related to the automobile industry (Amiti & Wei, 2004). Another relevant driver for outsourcing was the increasing competition in a *borderless world*. Companies must constantly adapt, including by restructuring, otherwise they could be forced to exit. Tasks that can be performed more

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