Chapter 12
Transaction Cost Approach to the Outsourcing Decision Problem

Dilek Erdogan
https://orcid.org/0000-0002-2079-777X
Gaziantep University, Turkey

ABSTRACT

Outsourcing has become a management tool that is increasingly involved in the manager's agenda, but the decision to outsource is a problematic issue for decision makers in organizations. Outsourcing provides many benefits but also includes many risks, so every outsourcing agreement does not result in success. This chapter aims to provide a better understanding of the outsourcing problem in light of transaction cost economics. For this purpose, the concept of outsourcing is first explained. The transaction characteristics and the behavioral assumptions of the theory, which play a role in increasing or decreasing transaction costs, are clarified. Finally, governance decision (outsource or not) and some critical issues (safeguarding mechanism against opportunistic behavior by supplier, adaptation, and performance evaluation problem) that will arise after the outsourcing decisions are discussed.

INTRODUCTION

The outsourcing discussion refers to a situation which is traditionally well known in theory and practice as "make or buy" a decision. One of the traditional definitions of outsourcing is "outside resource using" (Quinn & Hilmer, 1994). Outsourcing is the handover of an activity to a supplier; it is an alternative to internal production (Aubert, Patry, & Rivard, 2002). Outsourcing subject, outsourcing object, outsourcing partner, and outsourcing design are four major elements of outsourcing. Outsourcing subject is the economic institution which decides outsourcing decision (or not). Outsourcing objects are transaction or transactions that are outsourced. Transactions can take place at different levels of activity of an organization and activities of an organization are divided mainly into four groups: the core business activities (activities related to the existence of a company), core-close activities (linked directly to core activities),

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core-distinct activities (supporting activities), and disposable activities (activities with general availability). For example, while information technology is a supportive activity, the flight operation is the core activity for an airline company. The decision to outsource support activity or core activity will be at different levels of difficulty because outsourcing of the core activity will be a more strategic decision, while the outsourcing of support activity will be a more operational decision. All potential suppliers who can provide the activities needed by the organization are called outsourcing partners (Arnold, 2000). The outsourcing design is a matter of governance structure and will be explained in more detail in the following sections.

Outsourcing has become a vital source of competitive advantage because it provides several benefits for organizations, such as reducing the cost of ownership of products/services, resolving technical problems without increasing the number of staff, and enabling the company to focus on its core business. However, it is not always easy for to organizations to manage outsourcing deals as it also involves many risks, such as increase of dependency on the supplier, loss of knowledge of how to conduct business, the difficulty of calculating transaction costs, and opportunist behaviors by the supplier. These risks of outsourcing lead to failures in some situations, so it is vital that managers have a good understanding of what makes outsourcing useful. For instance, according to a survey conducted by Deloitte Consulting in 2012, it was found that 48% of companies were not satisfied with the IT outsourcing contract (Qi & Chau, 2015). Given all these risks, it is essential that decision-makers know what increases or decreases transaction costs to achieve the set goals.

The transaction cost economy (TCE) focuses on whether the transactions are more effective through which mechanism (hierarchy or market). This also refers to as make (refers to hierarchy) or buy (refers to market) decision in the transaction cost economics (Williamson, 1998 p. 30). This chapter's objective is to provide a better understanding of economic factors affecting outsourcing decision, and governance of outsourcing transactions in the light of transaction cost economics.

THE CONCEPT OF TRANSACTION COST

The roots of the transaction cost economics are based on Ronald Coase's 1937 article "The nature of the firm". In this article, Coase criticized the simplified view of the economy by asking his famous question, "why are there firms?" Price theory could not answer this question, because according to the theory, there is no cost element other than production and transport costs. However, Coase emphasized that the complexity of the price system by stating how complex a transaction is, it is more costly to negotiate, compose and implement the agreement between the parties concerned (Coase, 1937). He was the first economist arguing that price theory not able to explain about costs that accompany exchange relationship on markets. In his article, he tried to answer the reasons for the existence of the firms and the determinants of the firm size. According to him, the main reason as to why it is profitable to establish a firm, is that there is a more costly way of using the price mechanism (Coase, 1937 p. 389). The price includes costs associated with negotiating and concluding contracts, in addition to production costs. Therefore, it is likely that firms will emerge when contracts become too expensive. According to Coase, firms exist because they can sometimes reduce the costs of transactions relative to market transacting. Coase asked the following questions to explain the determinants of firm size. Why, if by organizing one can eliminate certain costs and in fact reduce the cost of production, are there any market transactions at all? Why is not all production carried by one big firm? According to Coase, if all transactions are completed within