Outsourcing and Strategic Outsourcing

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The production of a good or service frequently requires that the supplier performs a wide range of activities. The coordination between those activities implies that the firm must determine its *boundaries*, which means that it must define the supply chain activities that will be performed internally, and those that will be trusted to *external suppliers*. The process of obtaining goods and services from outside suppliers, instead of developing them within the organization, is called *outsourcing* (Anderson & Naurus, 1991).

Broadly speaking, outsourcing presents advantages insofar as *external suppliers* are able to attain economies of scale that an internal department, producing exclusively to meet the firm's needs, cannot. Moreover, an *external supplier* is subject to the discipline of the market, which creates a greater incentive to efficiency and innovation than is the case in an *integrated firm*, where overall success may disguise inefficiencies in certain areas. However, the decision to give away a link of the value chain to an *external supplier* presents challenges when it comes to coordinating the production flows and managing a relationship with an independent entity. In addition, close cooperation with another firm increases the risk of privileged information leakage (Baldwin & Clark, 2002). Regarding the difficulties of coordinating production flows between a firm and its outsourcing suppliers, Novak and Eppinger (2001) analyze the relationship between the design complexity of components (which are potential targets for outsourcing) and the degree of vertical integration. They conclude, based on an empirical analysis of the automobile industry, that complexity is decisive in explaining the proportion of components that is *manufactured in-house***.**

The potential impact of an outsourcing decision justifies an adequate analysis, and an approach that places this option within the context of the strategic orientation of the firm. According to Quinn and Hilmer (1994), a firm can leverage the use of its resources if it chooses to follow a combination of two strategic approaches. On the one hand, it should develop a small set of carefully selected *core competencies*, on which investment and management time must be concentrated. On the other hand, the firm should outsource all other activities, even if these include areas that were traditionally considered too fundamental to the firm's business to be performed externally. The importance of a differentiated treatment of *core competencies* is evident in Quinn's (1999) statement, according to which a firm loses a competitive edge when it performs an activity internally without having a world-class performance at it. It would be better off by handing over that activity to an outside supplier.

Core competencies are the activities that allow a firm to maintain a competitive edge in the long run. They generally include two or three steps of the value chain and have to do with areas such as product (or service) design, technology creation, customer service and logistics, in which the firm can achieve a performance that is superior to that of any competitor. *Core competencies* must concern matters that are important for client satisfaction in the long run, and not only for the needs of today's customer. It is fundamental that they be embedded in the organization, and not merely present among a subset of individuals within the organization. To Nieminen and Nummela (2004), *core competencie***s** possess four fundamental characteristics: they are *valuable*, in the sense that they allow the firm to provide satisfaction to its customers; *rare*, distinguishing the firm from its competitors; *hard to replicate*, contributing to the sustainability of the competitive advantage; and last, they must be *embedded in the functioning of the organization*, so that its potential benefits can be totally realized.

By following the strategy of concentrating the firm's attention in *core competencies* and outsourcing all other activities, it is possible to improve competitive advantage and profitability. Committing to the development of *core competencies* concentrates the firm's

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activity on areas in which it has better performance, in that way maximizing the profitability of resources, and building effective barriers to the entry of present and future competitors. Trusting production to external suppliers allows simultaneous access to investments, innovations and specific competencies of one or several firms, which would be very expensive, or even impossible to duplicate internally; moreover, the risk associated with the development of components and technology is now shared between various suppliers, instead of being concentrated in the firm. This sort of relationship also introduces flexibility and a greater ability to respond to changing customer needs.

According to Quinn (1999), the emphasis is currently shifting from outsourcing relationships that are limited to well defined production activities (e.g., the production of parts and components), toward knowledge-based activities, with higher value added. This occurs because specialized service firms are becoming larger and more sophisticated relative to the scale that a single division within an integrated firm can achieve. This trend leads inevitably to the need to redefine the relationship between a firm and its suppliers, in the direction of greater proximity; as Anderson and Naurus (1991) state, the relationship of a firm with its suppliers is increasingly one that can be characterized as a partnership, instead of a simple buyer-supplier agreement. These authors point out the tendency for firms to outsource activities that are increasingly close to the final consumer, like sales or customer support. Thomke and von Hippel (2002) present an approach focusing on innovation, where firms outsource the design of new products, handing over to their customers a significant part of the responsibility for drawing and developing products with the desired characteristics, through computerized tools that are made available to them. Kopczak and Johnson (2003) also refer to the shift toward the increasing participation of "collaborators" that do not belong to the firm, in the design of products, processes and the supply chain.

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The range of possible relationships between two firms that are doing business with each other can be adequately represented as a straight line, in which we have at one extreme the purely *transactional* relationships and, at the opposite end, the totally *collaborative relationships* or partnerships (Anderson & Narus, 1991). In the first kind of relationship, the attention of buyers and suppliers is focused on competitive prices and timely deliveries. In *collaborative relationships*, buyer and supplier develop close ties through time, with the goal of reducing total costs and/or increasing the value that can be obtained from the relationship, reaching mutual benefits as the partnership develops.

Strategic, or integrated, outsourcing develops along the existing trend to widen the traditional notion of outsourcing, from *peripheral activities* to higher value added activities of vital strategic importance, such as marketing and sales. This trend to externalize activities, and entrust them to *external suppliers* with a high degree of specialization, is in accordance with the movement of value migration that is referred to by Swhney and Parikh (2001). These authors claim that in a world of business networks, there is value in *modularity*, which means the ability to integrate equipment, software, organizational abilities or business processes in several networks or, put differently, in several value chains. Strategic outsourcing can also be analyzed in the context of recent shifts in business thinking regarding supply chain management, as Kopczak and Johnson (2003) point out. One of them is the shift from cross functional integration to cross enterprise. According to these authors, enhanced coordination can lower supply-chain-related costs and improve responsiveness within a chain of companies. Another shift is the one from the pursuit of physical efficiency (cost minimization in production and distribution) toward market mediation, which concerns the matching of the quantity and variety of products supplied through the chain to those demanded. Significant progress can be made in market mediation, through closer relationships—like *integrated outsourcing*—between suppliers and buyers. A third shift concerns the evolution of mass-market supply into tailored offerings, serving each customer or segment uniquely.

Quélin and Duhamel (2003) define strategic outsourcing as the transfer of a transaction that was previously an internal responsibility, to an external supplier through a long-term contract (often without a pre-defined date for its termination). This contract may involve the transfer of some of the firm's human resources to the supplier. In the same article, the authors point out five characteristics of strategic outsourcing:

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