

## Chapter XI

# Outsourcing of Services by Service Firms: An Empirical Investigation

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## Abstract

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*The traditional “make-or-buy” decision has been widely studied in the context of the theory of the firm and vertical integration. One of the most popular frameworks for examining this strategic decision has been the transaction cost analysis (TCA) framework. However, much of past research has focused on the make-or-buy decisions of product manufacturing activities, to the neglect of services. The make-or-buy decisions of services and service activities, due to their inherent characteristics (i.e., intangibility, inseparability, heterogeneity, and perishability) and the unique nature of their “production” and “delivery,” necessitate modifying and revamping the existing framework. The authors develop and empirically test a conceptual framework that examines factors influencing a firm’s decision to use outsourcing or in-house sourcing for a service (service activity).*

## Introduction

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Due to intense pressure to improve the efficiency and effectiveness of procurement efforts, firms are seeking new ways to perform these critical functions and to reduce costs in the value-added process (Cannon & Perreault, 1999). Increasingly, both large and small firms are outsourcing various service activities that were traditionally performed within the firm by shifting them to external suppliers. Outsourcing of routine operational service activities alone amounted to more than \$1 trillion worldwide in 2000 (Auguste, Hao, Singer, & Wiegand, 2002). While firms have obviously embraced outsourcing of service activities to an overwhelming extent, their experience has been mixed (Hsieh, Lazzarini, & Nickerson, 2002; Lacity, Willcocks, & Feeny, 1995). The reasons are the lack of documentation of good business practice for the buying firm to evaluate its service suppliers, the lack of a practical management framework to guide managers to critically evaluate how to enhance value by deliberately managing outsourcing of services, and the variability in performance when outsourcing of services is used. One of the most critical decisions in outsourcing is how firms decide which service activity should be outsourced or retained in-house (i.e., in-house sourcing). As Venkatraman (1997, p. 60) points out, “the issue that senior managers face is not whether to outsource, but what to outsource.”

Although scholars in operation research have made valuable contributions in purchasing or sourcing related issues, for example, inventory management, reorder points, order lot sizing, discount pricing, and order proportioning among multiple suppliers (Das & Handfield, 1997), research in services sourcing is lacking. Likewise, Fisk, Brown, and Bitner (1993) have explicitly identified outsourcing of services as one of the research gaps in services research, and extant literature reflects little work in this area. Furthermore, researchers should critically rethink previously embraced theories, empirical findings, and normative prescriptions in the area of outsourcing of goods before they should be applied to outsourcing of service activities, since some of which are becoming outdated in today’s highly competitive global markets (Cannon & Perreault, 1999, pp. 8-9). Our study aims at filling these research gaps. Thus, the purpose of our study is to contribute to both the operations research and service literature by developing and empirically testing a framework to help describe the factors that influence a firm’s decision to use outsourcing or in-house sourcing for a service activity. Furthermore, we develop our framework from the perspective of the firm using outsourcing for a service activity (i.e., potential/actual buyer of the service activity). The buyer of the service activity is the firm outsourcing the activity, and is termed the “outsourcer.” The firm to which the service activity is outsourced (i.e., potential/actual supplier of the service activity) is the “outsourcee.”

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