4. The Business Management Literature

<table>
<thead>
<tr>
<th>Outline</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Transaction Cost Economics (TCE)</td>
</tr>
<tr>
<td>• Evidence regarding transaction cost theory</td>
</tr>
<tr>
<td>• The business management approach to outsourcing</td>
</tr>
<tr>
<td>• Evidence from the business management literature</td>
</tr>
<tr>
<td>• Implications for the Air Force</td>
</tr>
</tbody>
</table>

Next, we examine the business management literature’s approach to outsourcing. In contrast to the transaction cost literature, the business management literature makes a presumption that outsourcing should be preferred to vertical integration except for activities that are core competencies, and focuses on how to determine which activities should be outsourced, make source selection decisions, structure the buyer/supplier relationship, and monitor supplier performance. Its conclusions tend to be based on anecdotal evidence (such as descriptive case studies of outsourcing activities at specific firms) and informal surveys rather than rigorous statistical methods. However, the literature seems to make a consistent set of recommendations regarding the choice of activities to outsource and how to select and manage outside providers.
Identify the Organization’s Core Competencies

- Organizations have limited financial resources and managerial time to invest in activities
- Need to identify “core competencies” and focus resources on achieving world-class performance
  - Two or three activities that are most critical to the organization’s future success
  - Organizational skills and knowledge that are difficult to duplicate and create unique sources of value
- Gain expertise from other organizations in areas that are not core competencies

Identify the Organization’s Core Competencies

In the 1990s, the business management literature began to emphasize that a single organization has limited senior managerial time and financial resources to invest in maintaining world-class competitive status. Prahalad and Hamel [1990] developed the concept of “core competence,” which has been widely adopted in the literature as the recommended strategic focus for organizations. They describe core competencies as “the collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies.” Excellence in a few core competencies is the source of the organization’s competitive advantage. Examples include Sony’s competence in miniaturization, 3M’s competence in adhesives, and Black & Decker’s competence in small electric motors. Some suppliers assume responsibility for the buyer’s inventory as one of their core competencies. Suppliers may manage the buyer’s inventory of items purchased from their companies, or take over the management of the buyer’s internal flow of materials and assembly-line supplies from multiple suppliers. (See Sheridan [1997a] and Lima [1997].)

Core competencies should be limited to the two or three activities most critical to the organization’s future success, activities in which it must maintain absolute
preeminence. They should be narrowly defined at a high organizational level, so that sub-units of the organization do not define their own activities as core competencies when they should be considered for outsourcing. Additional activities may be retained internally to keep existing or potential competitors from learning, taking over, eroding, or bypassing the organization’s core competencies. By focusing resources in a small number of activities, the organization’s preeminence in selected fields becomes increasingly difficult for competitors to overtake.

Quinn and Hilmer [1994] note several characteristics of core competencies:

- Sets of skills or knowledge that cut across traditional functions and allow the organization to consistently perform an activity better than its competitors, such as product or service design, technology creation, customer service, or logistics;
- Flexible, long-term platforms (rather than specific products) that are capable of adaptation or evolution to meet customers’ needs over time;
- Unique sources of value that are difficult to duplicate and in which investments in intellectual resources will have the highest payoff;
- Activities in which the organization is a market leader and can focus its managerial and financial resources to maintain leadership;
- Elements that relate directly to understanding and serving customers, which the organization can provide at lower cost or more effectively; and
- Activities that are embedded in the organization’s values, structures, and management systems—not dependent on a few talented individuals.

Because senior managers may not be able to devote as much attention to non-core activities, internal service and support activities often act as monopolies, with little incentive to improve their productivity or achieve world-class performance standards. (See Blumberg and Blumberg [1994].) This creates a presumption in favor of outsourcing (or introducing external competition) for activities that are not core competencies, particularly if the organization can gain access to world-class performance from an outside specialist provider.
Reducing Costs Should Not Be the Only Objective of Outsourcing

Having identified the set of non-core activities that are potential candidates for outsourcing, the organization must then determine what it hopes to achieve by outsourcing. Many authors emphasize that lower costs should not be the primary or the only goal of outsourcing. For example, Corbett [1995] lists the following goals (in order of importance):

- Improving business focus by reducing management resources and attention spent on non-core activities and freeing them for use in core areas;
- Gaining access to the world-class capabilities (including investments in technology, methodologies, and people) of firms whose core competency is to provide the outsourced activity;
- Accelerating re-engineering efforts to reduce cycle times and improve quality by having a provider that is already re-engineered to world-class standards take over the process;
- Sharing risks by pooling investment costs in the outsourced technology made by the provider on behalf of multiple clients;
• Reducing operating costs by contracting with a provider that can achieve economies of scale or other cost advantages based on specialization;

• Converting capital investment in non-core business functions into operating expenses, and targeting capital funds on core areas; and

• Gaining better control over a function currently being provided in-house that is not meeting performance goals or customer expectations.

The goals and priorities of the organization making the outsourcing decision will determine the most important criteria for source selection, contract design, and performance monitoring.
Forming Strategic Alliances with Suppliers Can Enhance the Benefits of Outsourcing

- Changes in the market environment favor alliances
  - Rapidly changing technology
  - Increasing capital requirements for new projects
  - Pressure for smaller, more frequent deliveries
  - Improved computer power and communications
- Alliances benefit buyers and suppliers
  - Opportunity to access partner’s complementary strengths
  - Ability to share risks and costs
  - Enhanced capacity to develop new products, services, and technologies
  - Willingness to make long-term investments in the relationship

Forming Strategic Alliances with Suppliers Can Enhance the Benefits of Outsourcing

Buyers of complex or customized products or services can often get better performance at lower cost by forming partnerships with their suppliers rather than treating them as arm’s-length vendors of standardized products or services. The business management literature refers to these arrangements as partnerships or strategic alliances. Strategic alliances often involve more formal connections between firms, which Badaracco [1991] describes as

> [O]rganizational arrangements and operating policies through which separate organizations share administrative authority, form social links, and accept joint ownership, and in which looser, more open-ended contractual arrangements replace highly specific, arm’s-length contracts. Such arrangements blur the boundaries of firms . . . [p. 4]

Harrigan [1987] proposes that recent changes in markets and the environments in which organizations operate have created opportunities for them to benefit from strategic alliances. First, rapid technological change is decreasing the useful lives of products and technologies. Organizations must innovate to keep up with new technologies, but shorter product life spans increase the risk of being unable to
recover the cost of investment in each new generation of technology. Second, capital costs associated with development of new generations of products and services have increased, requiring a broader customer base or higher prices to recover development costs. These two changes have made it more difficult for organizations to improve their products and services on their own. Third, adoption of lean production techniques requires closer cooperation with suppliers to improve quality and make smaller, more frequent deliveries. And fourth, advances in computer power and communications systems facilitate transfer of knowledge and coordination of activities between organizations. Thus, alliances are becoming necessary for sharing costs and risks at the same time that they are becoming more feasible.

Buyers and suppliers benefit in numerous ways from sharing resources through strategic alliances. Harrigan and Newman [1990] suggest that alliances allow an organization to gain access to resources that it would not develop on its own because of the proprietary nature of the resources, the amount of time needed, the cost, or the associated risk. These resources can range from physical inputs and skills to knowledge of new technologies or processes. (See also Badaracco [1991].) Lima [1997] describes an alliance between Volkswagen and its suppliers at a truck and bus plant in Resende, Brazil. Each supplier-partner occupies a section of the plant and takes full responsibility for assembling the components it provides into vehicles on the Volkswagen production line. Volkswagen invested $250 million in the basic plant infrastructure, and each partner invested $50 million in its production module. The close interchange of information allows for enhanced flexibility in solving problems, in customizing products based on demand, and in designing and developing new products.1

Alliances allow organizations to share the risks and costs associated with development of new products, services, and technologies, which can lead to more new products and services with shorter development times than if organizations worked alone. (See Harrigan [1986] and [1987] and Badaracco [1991].) In addition, organizations that form long-term strategic alliances are more willing to make investments in the relationship than they would be under arm’s-length contracts. For example, Dyer’s [1996] comparison of the U.S. and Japanese automobile industries indicates that suppliers in long-term relationships locate closer to the buyer, participate in more employee exchanges

1Another example of a buyer/supplier alliance is the relationship between Motoman, a leading supplier of industrial robotic systems, and Stillwater Technologies, a contract tooling and machining company. The two companies occupy office and manufacturing space in the same facility, which allows them to synchronize production of components and delivery to the final assembly line. Employees can share ideas on improving quality and reducing costs. (See Sheridan [1997b].)
and face-to-face contact, and invest a higher fraction of their total capital in assets that could not be redeployed to other customers.

There are many types of strategic alliances, ranging from simple cooperation to full equity ownership, representing trade-offs between flexibility and long-term commitment. (See Harrigan [1986] and [1988] and Harrigan and Newman [1990].) Cooperative agreements provide more flexibility, but they also may yield fewer benefits because of the reduced levels of effort and resources invested. There are several types of cooperative agreements—two, in particular, are relevant to buyer/supplier relationships. First, organizations use cross-licensing agreements to learn about technologies that were developed for similar products or services. For example, Eli Lilly and Genentech had such an agreement for insulin. Second, organizations can use R&D partnerships to accelerate technological innovation. (See Harrigan [1986] for a more complete description of cooperative agreements.)

Closer alliances are often cemented by equity investments. In a minority investment arrangement, one organization invests in the other, but no new entity is formed. For example, IBM made such an investment in Intel. Minority investments often support an innovative organization whose products have not yet been widely accepted. In a joint venture, partners form a new organization in which they share equity, risks, returns, and decisionmaking responsibility. Examples include New United Motor Manufacturing Inc. (NUMMI, a joint venture between GM and Toyota), Dow Corning, and Tri-Star Pictures. Some organizations prefer to form a “spider’s web” of joint ventures in which a central partner forms alliances with several different partners. The central partner is thus able to increase its chances that one of its partners will be at the leading edge of the industry in the future.2

2See also Ernst and French [1996] for a description of alliances in service industries.
Strategic Alliances May Not Be Appropriate in Some Circumstances

Despite the potential benefits, strategic alliances may not be appropriate for all suppliers. The closeness of a buyer/supplier partnership should depend on the complexity of the product or service and the degree of integration that is needed with the buyer’s internal processes. The closest partnerships should be reserved for suppliers that provide technological capabilities and know-how that are superior to those of the buyer, and whose products are complex or customized enough that they are not readily available in arm’s-length markets. Kamath and Liker [1994] report that in the Japanese automobile industry, buyers limit the number of suppliers they deal with directly by organizing them into tiers. First-tier suppliers coordinate the activities of the second tier and so on down the hierarchy. Among 100-200 first-tier suppliers, only about a dozen with outstanding technology, sophisticated management, and global reach have full-blown partnerships with the buyer.

The number of close partnerships that a buyer or supplier can enter into is limited by the cost and potential risk to the organizations involved. Information exchanges and coordination of activities between partners require both time and
money. Ernst and French [1996] suggest that each partner spends twice as much
time managing an alliance as it would operating an independent venture.\(^3\) In
addition to the direct costs associated with alliances, there are opportunity costs.
Each organization forgoes other potential projects and other uses of resources
when it commits to the alliance. Finally, strategic alliances limit an
organization’s ability to respond to changes in its environment and to enter into
alliances with others. For example, an organization that forms an alliance as part
of a spider’s web may be bound to the center organization for the strategic
activity involved. (See Harrigan and Newman [1990].)

The business management literature, like the transaction cost literature,
highlights the potential for one party in a transaction to try to capture the value
of transaction-specific investments made by the other party. Badaracco [1991]
argues that unless the buyer and supplier are mutually interdependent, they
place themselves at risk of opportunistic behavior by their partners. GM learned
this lesson the hard way through NUMMI. Toyota allowed GM to sell only the
4-door version of the Nova, NUMMI’s first car, and Toyota preserved its own
engineering and production expertise and enjoyed scale economies by producing
the main components in its own facility.

Both Badaracco [1991] and Harrigan and Newman [1990] discuss the potential
for knowledge leaks when organizations work closely together. An organization
should be wary of entering into alliances that could expose knowledge associated
with its core competencies, which provide the source of its competitive
advantage. In the 1960s, Honeywell used NEC to sell computers and supply
basic components to Japan. Honeywell was the partner with the established
technology. Over time, NEC learned these capabilities from Honeywell and
ultimately became the primary hardware supplier to a three-way joint venture
with Honeywell and France’s Group Bull. Prahalad and Hamel [1990] argue that
such problems can be avoided if the organization’s goals for its core
competencies guide its alliance or sourcing strategy. Alliances should be used to
develop competencies the organization needs but currently lacks.

Legal factors can also limit potential gains from strategic alliances. Badaracco
[1991] notes that in the commercial world, antitrust laws can place limits on
allowed coordination between firms—especially firms that operate in the same

\(^3\)Thus, there is a trade-off between the number of suppliers and the depth of buyer/supplier
relationships. Each partnership requires more time to manage, but the buyer maintains relationships
with far fewer individual suppliers. Once partnerships are established, they may require less total
manpower than arm’s-length relationships with many suppliers, since partnerships help the buyer
cut back on purchasing personnel, quality inspection of incoming components, and design
engineering staff.
market. Similarly, rules of fairness place restrictions on the kinds of relationships government organizations are allowed to have with suppliers and contractors. Long-term partnerships may reduce opportunities to bring contracts up for recompetition and reduce the ability of other contractors to bid for follow-on work. We discuss these issues in greater detail in Section 6 below.
Source Selection Should Fit Strategic Needs

Prior to entering an agreement, the buyer should

- Evaluate its current and desired capabilities
- Consider the costs and risks of collaboration
- Tailor the buyer/supplier relationship to the product or service being outsourced
- Consider supplier characteristics in addition to cost
  - Complementary knowledge and skills
  - Breadth and depth of experience; past performance
  - Financial strength
  - Commitment to technological innovation, quality improvement, and customer satisfaction

Source Selection Should Fit Strategic Needs

Much of the business management literature on buyer/supplier relationships and strategic alliances is devoted to the study of how organizations can increase the chance of accomplishing their outsourcing goals. These recommendations can be divided into (1) actions organizations should take prior to entering into an agreement or an alliance and (2) actions managers should take once a relationship is formed. We start with the former.

Badaracco [1991] recommends that organizations consider several issues prior to entering into outsourcing relationships. First, the buyer should have a clear strategic understanding of both its current capabilities and the capabilities that it will need to remain viable in the future. Only after such introspection can it decide what it hopes to gain from a decision to outsource a product or service. Next, the buyer should carefully evaluate the risks and costs associated with outsourcing. Are the benefits substantial enough to warrant proceeding? If so, then the buyer must decide what form of relationship with a supplier is

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4Harrigan and Newman [1990] add that the urgency of the organization’s need for the product or service should also be taken into account.
appropriate for the product or service being outsourced. Is an arm’s-length contract adequate? Should the buyer invest equity in a partnership or rely on less risky and constraining forms of cooperative agreements? Finally, the buyer must choose the appropriate supplier.

Badaracco [1991] and Blumberg and Blumberg [1994] recommend the following criteria for choosing suppliers:

- Knowledge and skills that the buyer values;\(^5\)
- Breadth and depth of experience, including a proven track record in the field, skilled and experienced personnel, and unique service capabilities;
- Financial solvency, to ensure that the supplier can provide the desired service over the length of the outsourcing relationship;
- Commitment to technological innovation, quality improvement, and customer satisfaction;
- Good reputation, including a willingness to offer customer references and performance guarantees; and
- Commitment to working with the buyer to help the relationship succeed.

By broadening the source selection criteria rather than focusing solely on bid price, the buyer can winnow out suppliers that are unqualified or have submitted extremely low bids. Accepting unusually low bids can result in renegotiation after the contract has been awarded, frequent contract disputes, or contractor default. The buyer should have some idea about the personnel requirements, experience levels, technical capabilities, and physical assets that will be needed to provide the required product or service to ensure that the supplier is capable of providing it. Many outsourcing relationships fail when suppliers cannot deliver what is promised because they lack experience or cannot provide the full array of services needed. Innovative firms such as Chrysler often “presource” their suppliers—choosing them before subcomponents are designed and virtually eliminating competitive bidding for particular parts.\(^6\) (See Kamath and Liker [1994].)

To define its outsourcing goals and source selection criteria, Sterling [1994] suggests that the buyer organization should put together a team of experts who

\(^5\)See also Bleeke and Ernst [1995].
\(^6\)When suppliers are involved in the design process, they must be selected early, rather than bidding to produce a predesigned component. In some cases, more than one supplier participates in the early design stages, and the winning supplier is chosen based on the strength of its input to the design process, as well as its past performance on design, quality, and cost.
are knowledgeable in all of the areas or functions that will be responsible for, or affected by, the outsourcing relationship. This will also help ensure acceptance of the outsourcing and source selection decisions across many areas of the organization, and give more individuals a personal stake in the success of the venture.
Good Management Can Increase the Likelihood of Successful Long-Term Relationships

- Carefully define the buyer/supplier relationship
  - Goals, scope of activities, performance measures, conflict resolution mechanisms
- Build trust between buyer and supplier
  - Begin with small projects that are likely to succeed
  - Share both positive and negative information
  - Limit turnover of key personnel
- Make organizational and cultural changes to benefit from the relationship
- Accommodate changes in environment and needs

Good Management Can Increase the Likelihood of Successful Long-Term Relationships

Once a buyer and supplier have decided to enter into an outsourcing relationship, managers can take actions that increase the chances of success. Sterling [1994] emphasizes that contract design and post-contract management of the relationship should reflect the goal of establishing a mutually beneficial, long-term relationship.

First, the buyer/supplier relationship should be carefully defined. Badaracco [1991] and Sterling [1994] suggest that the buyer and supplier should agree on the overall goals of the relationship, scope of the products or services to be provided, performance measures, and expectations. There also should be a formal mechanism for resolving conflicts. (See Bleeke and Ernst [1995] and Ernst and French [1996] for related discussions of conflict resolution.)

Peisch et al. [1995] points out that an agreement that clearly spells out what constitutes acceptable performance and describes procedures for dealing with sub-par performance can help ward off problems. The buyer should also hold regular, formal meetings with the supplier to review performance against
expectations, discuss issues, clarify roles, share information about new services or technology, etc. If, despite ongoing discussions, the supplier is unable to meet performance requirements, a clearly specified agreement provides a firmer legal foundation for ending the relationship.

Second, partners must learn to trust one another. Badaracco [1991] notes that it can be difficult for organizations to communicate the knowledge and skills that are required to achieve the goals of the relationship. These capabilities are often part of an organization’s internal practices and culture; thus, they can be effectively communicated only through an open working relationship based on trust. The desired level of trust may be especially difficult to achieve between government agencies and contractors because of a past history of mistrust, congressional limitations on the use of long-term contracts, and the government’s emphasis on full and open competition. (See Kelman [1990].) Methods of building trust include working with suppliers on small projects that are likely to be successful, establishing integrated product teams with shared membership, and joint training and facilitation. Sterling [1994] adds that the buyer and supplier should discuss both good and bad aspects of their relationship so that problems can be resolved before they turn into crises. Furthermore, both buyer and supplier should limit personnel turnover in important positions in order to build personal relationships that provide continuity over time.

Speh et al. [1993] suggest that the formal contract defining a buyer/supplier relationship should be thought of as a framework for less-formal interactions between the two organizations. The parties need to establish a working relationship based on trust and information-sharing. If they reach the point of consulting the contract, this implies that the working relationship has broken down. The authors’ survey of contract warehousing for the Warehousing Research Center found that contracts are not standardized and depend on the relationship between the buyer and supplier, including which functions are outsourced.

Third, the buyer and supplier should be willing to make changes to their organizational forms that will enhance the benefits of their relationship. Prahalad and Hamel [1990] argue that learning within an alliance requires a positive commitment of resources, such as travel, a pool of dedicated employees, test-bed facilities, and time to internalize and test what has been learned. Badaracco [1991] relates that during GM’s alliance with Isuzu and Suzuki, GM had marketing and manufacturing personnel, engineering consultants, planners, procurement and distribution managers, and industry analysts in Tokyo to facilitate dealings between Chevrolet and its Asian partners. Similarly, approximately two thirds of GM’s Japanese suppliers maintained sales offices in
the United States. Their representatives could visit GM divisions and obtain engineering support from either the United States or Japan.

Cultural changes may also be needed for buyers and suppliers to fully benefit from outsourcing relationships. Sometimes the buyer’s employees are not receptive to partners. This may be linked to a “not-invented-here” syndrome, or it could stem from a feeling that the outsourcing decision is a result of some failure on their part. These problems must be overcome for the outsourcing relationship to be successful. (See Badaracco [1991].) In addition to organizational and cultural changes, Harrigan [1987] recommends that managers develop liaison skills to help overcome the conflicting loyalties and goals that often arise in buyer/supplier relationships. (See also Ellis [1996].)

A firm may receive fewer benefits than expected from an outsourcing relationship if its employees do not make an active effort to communicate with and learn from supplier personnel. Badaracco [1991] notes that GM did not take full advantage of the potential benefits from NUMMI, its alliance with Toyota. Although the NUMMI factory in Fremont, California approaches the productivity levels of Japanese-owned factories in Japan, GM has not been able to transfer these gains to other facilities.7 GM relied on plant tours, videos, and manuals to diffuse knowledge from Toyota about better business practices. It failed to invest the people, time, and money needed to gain an in-depth understanding of the skills that Toyota brought to the alliance.

Fourth, buyers and suppliers should be willing to adapt to changes that affect their relationship. Harrigan and Newman [1990] suggest that it is inevitable that many factors relevant to the relationship will change over time. For example, a change in the needs of the buyer may result from the availability of a new technology or a change in the price of raw materials. Such changes can affect the importance of the outsourcing relationship to the buyer. Therefore, partners should be prepared to modify the relationship when the underlying conditions change. (See also Bleeke and Ernst [1994] and Doz, Prahalad, and Hamel [1990].)

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7For more information on NUMMI, see Adler and Cole [1993] and [1994]; Berggren [1994]; Wilms, Hardcastle, and Zell [1994]; and Henne, Levine, Usery, and Fishgold [1986].
Full Costs and Benefits of Outsourcing Are Difficult to Measure

- In addition to direct costs, outsourcing influences:
  - Management and monitoring costs
  - Long-term investment needs
  - Strategic focus of the organization

- Need to weigh changes in performance against changes in cost

- Risk due to loss of direct management can be counterbalanced by risk due to poor internal performance

Full Costs and Benefits of Outsourcing Are Difficult to Measure

Because outsourcing influences management and monitoring costs, long-term investment needs, and the strategic focus of the organization in addition to the short-term direct costs, its overall costs and benefits must be carefully evaluated. (See Quinn and Hilmer [1994].) The development of long-term partnerships between the organization and its suppliers does not require more personnel or more time than managing large numbers of arm’s-length relationships, but is likely to require a more professional and highly trained purchasing and contracting staff, as well as better information systems to track and evaluate suppliers. A well-designed information system can provide enhanced monitoring of both internal processes and those of suppliers. Contracting and monitoring activities may need to be elevated to higher strategic levels in the organization to ensure that outsourcing relationships are managed effectively. In the aerospace industry, for example, outsourced components account for 50-70 percent of total value-added, so it pays to invest more of top management’s strategic effort on these relationships. (See Sabbagh [1996].)
A good cost analysis of outsourcing vs. internal provision requires a well-articulated comparison that includes the effects of a decision on all parts of the organization. Since there may be trade-offs between lower costs and better performance, it is important for the organization to be able to evaluate the benefits of improved performance. These can include better strategic focus on core activities as well as improvements in the function being considered for outsourcing. A failure to consider performance gains could cause the organization to focus on the short-term cost savings from choosing the lowest-cost provider, which could be outweighed by the long-term costs of poor performance.

An organization considering outsourcing should also consider the potential for strategic risks, such as the loss of critical skills or loss of control over a supplier. These risks can be mitigated by careful source selection and effective management of the outsourcing relationship. The organization should also consider the potential risks of not outsourcing. Internal providers may fail to perform to expectations, and may require management and monitoring resources to improve performance. The organization may find it more difficult to enforce performance goals for internal providers than for external suppliers, since internal providers do not face the threat of contract termination. Furthermore, the organization may fall further behind industry best practices if internal support activities are not world-class providers. (See Blumberg and Blumberg [1994].) Allowing for competition between internal and external providers may help to mitigate both types of risk when the cost structure of the activity makes multiple sourcing feasible.