Decisions on governance mode: make/do, buy or ally?
Objectives of this session

To shed light on

- Basic theoretical approaches to make/buy decision: transaction cost theory and resource-based views
- Core competence concept
- Choosing between market, hierarchy, and hybrid form of governance
- Key considerations when making outsourcing decisions
- Lessons learned from unsuccessful outsourcing projects
Basics of transaction cost theory TCE

- Basic principle: if the costs of making a product self is more than market price plus transaction costs, the product should be bought from markets, else it should be made in-house.
- Transaction costs accounts for the actual costs of buying a product or a service from the markets
- The actual cost depict market price and transaction costs that can be divided into three broader categories:
  1) Search and information costs
     - finding suppliers, determining product’s availability, prices, and suitability to the need etc
  2) Bargaining costs
     - negotiating an appropriate contract with the supplier
  3) Policing and enforcement costs
     - the costs of making sure that the other party sticks to the terms of the contract
- Basic concepts: bounded rationality, opportunism, environmental and behavioral uncertainty, relationship-specific investments
Bounded rationality, opportunism and uncertainty

- **Bounded rationality:**
  - *Rationality* of individuals is limited by the information they have, the cognitive limitations of their minds, and the finite amount of time they have to make a decision.
  - Therefore purchasing contracts are always incomplete.

- **Opportunism**
  - Practice of exploiting circumstances in self-interest, specially without regard to moral principles or others' interests.

- **Environmental uncertainty**
  - Volume and technology uncertainty

- **Behavioral uncertainty**
  - Difficulty in ascertaining ex post whether contractual compliance has taken place.

- **What are the implications to make or buy decisions?**
Relationship-specific investments

Non-recoverable expenditures that a firm makes to support a specific interorganizational relationship

(1) site investment, referring to the proximity of the production facilities,
(2) physical investments, representing specialized equipment for a particular customer
(3) dedicated investments, referring to the general purpose investments that have been made for a particular relationship
(4) human investments, referring to the efforts the individuals in the organization make that are idiosyncratic to the relationship

Implications, if the buyer invests?
Implications, if the supplier invests?
  ◦ What is the situation a couple of years after the investment?
The extensive research on TCE provide strong support to two design propositions in the context of high asset specificity, volume uncertainty, and behavioral uncertainty. Choosing hierarchical governance leads to enhanced performance (Geyskens et al., 2006).

In the context of low asset specificity, volume uncertainty, and behavioral uncertainty, choosing market governance leads to enhanced performance (Geyskens et al., 2006).

Implications of TCE: When would it be wise to make, when to buy from the market?

Should we make or buy, if

- Activity / product / service is needed seldom?
- It is difficult to forecast needs, but there is offering on the markets
- Activity / product / service is needed regularly, but availability from the market is uncertain
You are CEO of an airline company, where luggage handling has been suggested to be outsourced to improve efficiency.

1. What are the reasons favouring outsourcing?
2. What are the reasons favouring keeping it internal?
3. Which issues should be evaluated and discussed before the decision?
Basic principle: an organization gains superior performance and competitive advantage if it is able to create resources that are valuable, rare, imperfectly mobile, not imitable and non-substitutable (VRIN criteria)

- Resources depict all tangible and intangible factors that the organization owns or controls, like stocks of knowledge, financial assets, physical assets, and human capital

The question “why outsource?” has turned the other way around, and today firms more commonly ask “why do self?”

Doing something self has become more a strategic choice, and is not based on short term economic efficiency
What are core competencies?

- Skill or knowledge set, not products or functions
- Flexible, long-term platforms – capable of adaptation or evolution
- Limited in number
- Unique sources of leverage in the value chain
- Embedded in the organization’s systems
- …

Source: Quinn & Hilmer, 1994
It is crucial to understand, where the competitive edge really is

If a special product, component or service is crucial for our competitive edge, where is the real core capability:
- In doing it?
- In designing it?
- In managing the design work?
- In understanding the customer needs for it?
- In capability to combine it with other entities?
- In specifying it?
- In buying it?
To enable and protect core competencies, also other capabilities may become important.

Source: Quinn 1999
Supplier markets must be evaluated before making the outsourcing decision

What is the potential vulnerability that could arise from market failure if the product/activity is outsourced?

- Is there a real competition between suppliers?
- Is the long-term availability of outsourced product/activity ensured?
- What will be the power balance between our firm and the suppliers?
- Are we an attractive customer to the best suppliers?
- Are the suppliers willing to share information with us?
- Does the supplier need to make specific investments when we outsource this product/activity?
Synthesis: Make or buy? Choosing between market, hierarchy, and hybrid form of governance

- **High Potential for Competitive Edge**
  - **High Degree of Strategic Vulnerability**
    - Strategic control (Hierarchical governance: Do/make internally)
  - **Low Degree of Strategic Vulnerability**
    - Moderate control needed (Hybrid governance: special venture of contract arrangements)
- **Low Potential for Competitive Edge**
  - **High Degree of Strategic Vulnerability**
    - Low control needed (Market governance: buy)
Important considerations when outsourcing

- Evaluate long term economic benefits
  - Take into account transaction costs and indirect costs of both making and buying
- Consider the value of cross-functional interaction and coordination
- Consider the need of flexibility
- Ensure that the organization has resources and capabilities to manage the outsourced activities
- Maintain some knowledge of the outsourced activity/technology inhouse
- Ensure goal and value congruence of the buyer and the supplier
- Fully leverage suppliers capabilities
  - Outsourcing is not just getting rid of "non-core" activities
The level of satisfaction with outsourcing varies by complexity of the task outsourced.

- Other Sales: 65%
- Telemarketing: 74%
- Data Management: 74%
- Product Development: 75%
- Market Research: 90%
- Direct Mail Sales: 90%
- Customer Service Centre: 90%
- Legal Services: 92%
- Tax Compliance: 94%
- Payroll: 95%

“The more complex service, the more dissatisfaction.”

Source: Association Management February 2000 Art of Outsourcing
## Reasons of failure in outsourcing projects

**FLAWS IN DECISION MAKING**
- Unclear understanding / definition of the strategy: What really is the source of our value? What do we really want to buy?
- Reasoning or decision making criteria is not clear
  - Solving wrong problems with outsourcing
  - Outsourcing because of outsourcing
- The full cost and benefit of outsourcing has not been considered carefully

**FLAWS IN IMPLEMENTATION**
- Limited attention on supplier selection
- Weak management of the supplier relationship
  - Inability to change the organisation to manage the buy-company instead of a make-company

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From "Profits or perils? The bottom line of outsourcing", Jackson, Iloranta, McKenzie, Booz Allen Hamilton 2001