Will Outsourcing Lead to the End of the Firm as We Know It?

Using INPUT data, Tom Tunstall completed provocative research at the University of Texas at Dallas that attempted to answer empirically the question “will outsourcing lead to the end of the firm as we know it?”

Tunstall’s study explores the proposition that, because of decreasing transaction costs, firms are actively exposing operational functions to direct market forces. They are driven by the need to increase economies and, in the process of doing so, make more efficient use of the factors of production. Lower transaction costs increase the number of possible transactions and thus allow an economy to build wealth at a much faster pace than would otherwise be possible. In theory, outsourcing better matches market signals with the factors of production and enables greater economic efficiency.

If outsourcing is one of the tools that firms use to bring wage rates and costs into equilibrium, it is worth asking why firms outsource and what the result has been.

The Problem

Buyers and vendors alike have been puzzling over a fundamental dilemma at the heart of it outsourcing: how to determine if outsourcing either saves money or makes firms more successful even when it doesn’t save money.

Approach

Tunstall used INPUT IT outsourcing data gathered between 1990 and 1999, including 299 outsourcing contracts and financial data reported prior to the decision to outsource. The evidence strongly suggests that IT outsourcing by firms has increased substantially during the past decade. More importantly, firms engage in outsourcing as a way to decrease overhead costs. Smaller firms outsource more than do larger firms, although the effect, while highly significant, is modest. Also, two industry groups—banking/financial services and transportation firms—have higher outsourcing intensity than firms in other industries, probably as a function of their use of centralized systems, which are generally easier to outsource than distributed information systems.

In addition, there is strong evidence that firms are entering into IT outsourcing contracts for increasingly shorter periods of time, apparently to avoid becoming hostage to outsourcers and to maintain an atmosphere of competition with regard to their suppliers.

Unfortunately, a preliminary look at the effects of outsourcing on firm performance using the available subset of the 299 companies in the original data set is inconclusive. There is no clear evidence that IT outsourcing alone impacts firm performance as measured by revenue per employee, asset efficiency, return on investment, return on sales, market-to-book ratios, or revenue growth.

Firms integrated vertically in the past because market transaction costs were relatively high or because of the absence of available suppliers of a given function in the marketplace. More recently, however, particularly over the past 10-20 years, it is less clear that bringing transactions within the boundary of the firm creates economies, or cost savings. Given widespread deregulation that began around 1978, globalization of industries and falling trade barriers, and
increasingly mobile labor and capital, the costs of economic transactions continues to come down.

Many of the arguments that apply to globalization could be pertinent to outsourcing. Globalization clearly benefits producers by giving them greater choice over their raw materials, production techniques, and human talent, not to mention over the markets where they sell the goods. Equally clearly, globalization benefits consumers by providing them with better goods at better prices. Globalization increases efficiency and thus prosperity.

The Outsourcing Decision

A central question related to the structure of firms is why managers choose to place the performance of certain functions outside the boundaries of the firm. Both research and common sense tell us that they will do so only if it is more economical, explicitly including the cost of transactions. In economic theory, economists assumed frictionless markets. In fact, markets are not frictionless, and the method, or mechanism, by which firms choose to organize their production activities (their governance mechanism) matters very much on a variety of levels.

Governance across the boundaries of the firm is a mechanism also commonly referred to as outsourcing. Not only is the overall cost structure of the firm potentially affected by the governance mechanism—in this case the decision to outsource—so are the characteristics of control, or power used by management, and the degree of specialization exercised by different functional areas.

While it is sometimes argued that outsourcing will tend to reduce the average size of firms, such claims are misleading. Outsourcing does not reduce the average size of the firm, at least when measured in revenue, since one company's expense is another company's revenue. An outsourced activity shows up as cost of goods sold, or the general overhead on a firm's profit and loss (P&L) statement, the same as it would if it were performed and managed in-house. Revenues must exceed costs, which include outsourcing, for a firm to be profitable. Outsourcing simply increases the number of market transactions, exchanges, or interactions that occur during the process of taking a product or service to market. As a result of decreasing transaction costs and the rise of the virtual corporation, then, outsourcing changes the nature of firm boundaries and establishes more of them.

Interestingly, while power exercised by firms within their boundaries is presumed to confer greater control, the evidence in this study suggests otherwise. In fact the evidence shows that market competition enables firms to achieve greater control over their costs and that outsourcing exposes above-market costs for factors of production, particularly labor (as a principal component of services) in a way that internal bureaucratic control cannot. The increased use of outsourcing during the 1990s shows that firm boundaries are becoming increasingly permeable. Further, greater numbers of transactions imply lower transaction costs throughout an economic system. Many of these changes, especially those associated with the Internet, suggest better supply chain linkages (that is, the ability to choose from a multitude of suppliers) and the release of factors of production to their most productive use by unbundling, decoupling, and redeploying them.

However, there is a cost associated with using the price mechanism, such as the search costs of discovering the relevant prices. And while many products lend themselves to spot market transactions where competitive prices are easy to discern, some products (and even more services) are more complicated. To economize on numerous individual exchanges, parties could opt to enter into longer-term contracts and thus avoid some transaction costs in the process. This is where the case for the firm is made.
Benefits of Outsourcing

Outsourcing enters the picture as a sort of middle ground between transactions amenable to the spot market and vertical integration (that is, taking the entire activity or function in-house, thus expanding the boundaries of the firm). It is here that the market (outsourcing) serves increasingly to erode traditional firm boundaries. Successive levels of bureaucracy make organizations less efficient because of subjective diffusion of communication. Coupled with differing goals at each level, the firm can become quite inefficient.

While economic theory assumes that the market gives preference to the form of organization that could be termed the “least-cost performance mechanism” over the long term, survey evidence suggests drivers other than cost reduction. These other drivers, such as the need to improve organizational focus, suggest that outsourcing is evolving into an effective organizational management tool. Yet a clean, unambiguous definition of what has been termed “core competency” remains elusive, even potentially unique for every firm. This defies any consistently measurable definition. Nonetheless, management theorists identify the general theme of improved firm performance through increased focus and greater specialization.

Increased specialization is one way in which an economy increases overall output relative to input. It might be useful to think of outsourcing as an organizational tool by which a firm increases its ability to specialize. Yet increased specialization necessarily leads to asset specificity of both labor and capital. Asset specificity can in turn lead to “rent appropriation” by the outsourcer, leaving the firm with little leverage and subject to a hostage situation.

Rent appropriation is one of several issues that can arise given asset specificity. In effect, the inability of economic concerns to allocate assets efficiently because of asset specificity, although typically viewed from a microeconomic perspective, has macroeconomic implications as well. While contracting techniques can mitigate some of these issues, others result from the shifting balance of power of the market as it pushes toward macroeconomic efficiency. Buffers that slow or impede this competition-driven push occur in the power relations among competing concerns and the institutional framework, either at the state or industry level. These include nonmarket institutions such as labor unions, federal agencies, state agencies, and, as mentioned previously, excessive regulation.

Outsourcing can strip away selected firm functions and remove the buffers or impediments to high-powered market signals. This, in turn, releases resources to flow to their most productive use, or at least to relatively more productive uses. Closed organizational structures, whether countries or firms, become rigid, hierarchical, and ultimately resistant to innovation. Outsourcing is usually a response to outmoded organizational structures that cannot transform quickly enough on their own.

Firms that tend to diversify narrowly appear to have a lower outsourcing intensity. It could be that firms with a narrow product focus are more progressive in terms of their IT capabilities and better able than outsourcers to perform such functions, or there could simply be a lack of sufficient outsourcers in the marketplace. Related diversification measures only the most salient aspects of a firm’s output and has been largely biased toward manufactured goods over services.

Firm focus, as measured by core competency, is devilishly difficult to define. A firm that transports natural gas and owns the rights of way can decide that its core competency enables it to lay fiber optic cable over those rights of way and sell broadband telecommunication services. The SIC codes for two such lines of business are very distinct. In reality, firms can be sliced, diced, and categorized in a number of ways, most of which are not formally measured by government agencies or research firms. The significance of the RD coefficients then can lead to
more questions than answers, and objective measures of firm focus or core competency remain elusive.

### Outsourcing Effects

While it is important to examine the reasons why firms choose to outsource, equally important is whether or not firm performance improves as a result of outsourcing. Data are much more limited in this regard, and a preliminary look at the impacts of outsourcing using six measures referenced in the literature does not shed much light on the subject. These indicators deal with issues such as efficient use of assets including human and physical capital (revenue per employee; revenue divided by assets), earnings as a function of dollars invested (return on investment), earnings in comparison to revenues (return on sales), market valuations (market-to-book ratio), and year-over-year revenue growth.

The limited results indicate that outsourcing intensity appeared to be positively related to firm return on investment in the first year after the outsourcing event, but negatively related to market-to-book ratios one year following the event.

### Ramifications of Outsourcing for the Firm’s Evolution

Outsourcing and all of its many evolving variations up to and including joint ventures provide a different notion of the firm’s nature. Outsourcing represents an attack on traditional hierarchies. It adds a new dimension—a functional dimension—to hierarchies previously based primarily on industry or geographical lines of demarcation.

As manufacturing productivity has increased and firms have shifted their output from goods to services, the logic of the existing regulatory framework begins to break down. The challenges to the state are significant and will require an entirely new theoretical foundation. Information economies are fundamentally different from those that produce goods. Current thinking is still based on antitrust sentiment codified over a century ago. However, new economies, based on network effects and increasing returns to scale—essentially the creation of products or services requiring large capitalization, but also now subject to more rapid obsolescence—imply a new set of rules for policy makers. In such a scenario, Joseph Schumpeter’s postulations regarding sequential monopolies suddenly increase in relevance. Schumpeter argued in 1934 that no company could rest on its laurels for very long, lest innovative new companies and products overtake it. Large companies would either innovate or perish.

In such a world, the monopoly-like firm either loses customers to myriad new competitors in a death by a thousand cuts, or it is rendered obsolete by the next technological wave. The state cannot presume to know better than the market, where, in such a landscape, even the brightest innovators are often caught unaware. Attempts by the state to intervene in order to “improve” the competitive environment are misguided at best and, from the standpoint of improved productivity and standards of living, potentially disastrous.

The final irony is that the more onerous or expensive market exchanges are to conduct or execute—because of such policy tools as taxation and regulation, both of which increase transaction costs—the more likely the firm will be to expand. Yet, it is small firms that drive much of the innovation in information economies. And it is toward the creation of small firms that much of public policy is ostensibly focused. Since, in addition to other factors, firms expand and contract in response to public policy, such tools should be used judiciously. If firms grow, it should be because of innovative business models or scale economies, or to organize inherently complex operations, not to avoid high transaction costs. For outsourcing, and the much needed challenge
to traditional hierarchical structures it offers, lower transaction costs make such a governance mechanism viable.

The Services Sector in the Macroeconomy

The domination of the service sector in advanced economies is relatively recent, and the data are more difficult to measure and less well developed as a result. The categorization of services outsourced by firms is outlined in Table 1. A firm can outsource nearly all types of services if it chooses to do so.

Table 1. Categorization of Outsourced Services

<table>
<thead>
<tr>
<th>Organizational Function</th>
<th>Percent</th>
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<tbody>
<tr>
<td>Information Technology (IT)</td>
<td>40%</td>
</tr>
<tr>
<td>Distribution</td>
<td></td>
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<tr>
<td>Logistics</td>
<td>30%</td>
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<tr>
<td>Real Estate</td>
<td></td>
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<tr>
<td>Facilities Management</td>
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<tr>
<td>Administration</td>
<td></td>
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<tr>
<td>Human Resources</td>
<td></td>
</tr>
<tr>
<td>Customer Service</td>
<td>30%</td>
</tr>
<tr>
<td>Finance</td>
<td></td>
</tr>
<tr>
<td>Marketing and Sales</td>
<td></td>
</tr>
<tr>
<td>Transportation Functions</td>
<td></td>
</tr>
<tr>
<td>Total Services Outsourcing</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Outsourcing Institute

Outsourcing as a Governance Mechanism

Inefficiency can occur for a variety of reasons. One stems from the ability of managers and employees to mask the true costs of coordinating and performing functions—an outgrowth of information asymmetry. In-depth knowledge by workers increases their task expertise, but the benefits are not necessarily passed on to the firm. Instead, workers might choose to use their knowledge to accomplish personal objectives instead of increasing organizational efficiency, particularly if those objectives are not closely aligned with the firm’s goals.

To a large extent, the ability of a firm’s employees to obscure agency costs is driven by the complexity of the function involved. IT functions are inherently more complex, for example, than facilities maintenance such as landscape services, which are more widely understood in terms of definition and scope, use less-skilled labor, and are subject to greater market competition. As a result, there are probably more significant opportunities for masking inefficiency within the IT functional arena.

By the same token, keeping functions within the firm might make sense outside strict scale economy advantages. Complex ownership relations, for example, makes contracting more
difficult. Explicit contracts increase relationship rigidity more than implicit contracts. For this reason, outsourcing, which relies on contracts instead of hierarchical control, is not without risks, particularly with regard to long-term contracting and the associated hazards of appropriable quasi-rents. In effect, while agency costs can be high, so can the costs associated with asset specificity and opportunism by outsourcers.

Nonetheless, because principals (shareholders, senior managers) do not immediately act when agency costs are higher than transaction costs, two scenarios tend to play out as a result. Either a firm will at some point adopt a more innovative organizational form, or others that operate more efficiently (as suggested by the Schumpeterian notion of creative destruction) will eventually displace it. If government regulation makes contracting a more expensive alternative because of uncertainty (weak property rights) or bureaucracy, then unproductive firm hierarchies will result. As pressure builds, buffered in the short-term by protection from direct market signals, the market eventually exerts its influence through less direct means, such as capital markets, management labor markets, new firm entrants, and outsourcing proposals to senior management.

Outsourcing emphasizes existing splits along functional lines and is another Schumpeterian disruptor that challenges old hierarchies and ossified business models.

In view of the relative difficulty of minimizing agency costs in a firm as it grows larger, a comparatively low transaction cost environment should serve to increase economic well-being by ensuring competition with intra-firm transaction costs (agency costs). It is in this way that agency costs have the greatest likelihood of being minimized and that competition, flexibility, and adaptive organizational response are maximized. In such an environment, firm size will be governed by compelling coordination needs, complexity of tasks, or scale economies—in short, activities that improve efficiency and economic surplus.

Lower transaction costs encourage both greater specialization and increased interaction and trade among firms. Accordingly, data in Table 2 from the Federal Reserve Bank of Dallas show significant growth in computer-services providers since 1980. Such growth clearly indicates that the use of IT outsourcing as a corporate governance mechanism is expanding.

### Table 2. Growth of Outsourcing Firms Since 1980

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1990</th>
<th>1999</th>
</tr>
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<tbody>
<tr>
<td>Number of U.S. computer services firms</td>
<td>26,370</td>
<td>78,788</td>
<td>211,323</td>
</tr>
<tr>
<td>Market value of publicly traded U.S. computer-services companies</td>
<td>$91B</td>
<td>$106B</td>
<td>$416B</td>
</tr>
</tbody>
</table>

*Source: Federal Reserve Bank of Dallas*

### Snapshot of the Outsourcing Market

INPUT’s overall forecast as of summer 2000 for the U.S. outsourcing market, including business process operations, appears in Figure 1.
Evolution of the Outsourcing Market

The U.S. market for operational services splits along two tracks—traditional, legacy services and Internet-centric services. INPUT’s immediately prior forecast report included “Internet/intranet management” as a single, functional segment. In the most recent forecast, virtually every functional segment was split, and forecasts were provided for each.

Although the year-over-year growth of the Internet-centric segments is forecast to remain high over the next few years, before the end of the forecast period a convergence will begin that signals the effective disappearance of a non-Internet-enabled legacy IT infrastructure. At that point, the Internet will be so thoroughly integrated into business processes and operations that all operational services will take it into account. Accordingly, the decline in mainframe platform operations services that would otherwise have been expected will reverse itself as the demands of e-commerce and the requirements for massive data storage for e-business give mainframes new importance.

Currently, applications services are separated into three streams:

1. those required by traditional enterprises for their own licensed software (or customized software to be purchased on a license basis),
2. applications purchased on an outsourced basis directly from software developers, and
3. applications provided to value-added resellers (application service providers) of various types that make them available on a pay-as-you-go basis.

The last two market segments will grow rapidly over the next few years, but before the end of the forecast period INPUT foresees much of today’s business in this market falling into the business process operations and processing services categories. The key criteria will be the extent and nature of the responsibility assumed by vendors for their customers.

As with the outsourcing market, the fastest growing segments of the processing services will be Internet-centric ones. Yet, before the end of the forecast period, they will begin to converge with the legacy or traditional segments of the market as the Internet is used ever more widely and as the transformation of enterprises to e-business (and e-government) continues. Eventually, the distinction between the two streams (Internet-centric and legacy) will lose relevance.
Other Spending Estimates

Researchers analyzed a data set of 400 large and medium-sized U.S. corporations obtained through the mail and interviews by the editors of Computerworld and matched with accounting data obtained from Compustat. The study found that IT investment results in lower average production costs but higher average overhead costs. Significantly, there was no evidence of a reduction in labor costs.

Preliminary Conclusion

This study examined IT outsourcing as a form of firm governance and tested various determinants of outsourcing. It explored the prospect that firms are evolving into increasingly specialized, more focused organizations that grow either organically or through related, horizontal acquisitions—in contrast to conglomerate-style horizontal acquisitions or vertical integration. The study focused on the impact of IT on firm performance but did not measure possible determinants of outsourcing by those firms. Some conclusions follow:

Corporate evolution appears to be moving toward the use of full or partial spin-offs (divestiture) as a way to retain focus and reward principals. When new lines of business become increasingly unrelated, as indicated by a different set of goals from that of the parent, firms often seek to create separate hierarchies to manage them.

Internal transfers between the parent and the spin-off then become purchases and sales structured as market transactions (outsourced functions) between each other, as well as between other companies. These developments imply lower transactions costs and more specialized firms, with outsourcing as the enabler.

IT outsourcing has been approached from a variety of perspectives and with differing degrees of rigor. While many articles have relied on anecdotal evidence to suggest outsourcing’s role as an emerging corporate governance mechanism, they have nonetheless been useful in framing the discussion.

Increasingly, academic work on outsourcing is becoming more systematic in nature and is a logical extension of prior conceptual and case study work. Currently, researchers appear to be focusing on data obtained from wider, more representative samples. Both primary and secondary data have been employed. The use of surveys, as an example of primary data collection, has been widely adopted because of the difficulty in otherwise obtaining data on outsourcing from secondary sources. While effective in allowing researchers to tailor questions to their needs, they are nonetheless subject to respondent bias.

Some of the difficulties associated with measuring outsourcing activity by firms result from the paucity of information and the elusiveness of satisfactory indicators. Firms do not regularly report their outsourcing activities or the dollar amounts spent on them. Further, IT expenditures tend to permeate the organization and often cannot be captured by a single departmental budget. Probably the easier approach to use when measuring outsourcing is a dual measure. This has the advantage of relying exclusively on publicly available information.

A more robust alternative invariably relies on surveys. It uses a comparatively continuous measure of outsourcing activity, which attempts to capture the degree of outsourcing by a particular firm based on IT dollars spent (normalized in some fashion).

In essence, this study used three key elements of firm business planning and reporting mechanisms:

Assets are the foundation with which firms create products and services.
Revenues are a measure of the actual output of a firm in economic terms.
Budgets are short-term predictions of key financial indicators, including revenues and assets. The INPUT database tracked outsourcing expenditures where the information was available. Combining that data with an annual *Information Week* survey that polls respondents with regard to their IT budget as a percent of sales by industry, it is possible to estimate IT budgets to standardize IT expenditures, as they are similarly standardized over assets and revenues.

Modest evidence indicates that firm size is in fact negatively related to outsourcing intensity; the opposite result was expected. This could be due to effects seen later in the analysis, which suggests that younger (typically smaller) firms use outsourcing as a way to augment staff faster than would be possible through organic growth. However, similar to return on assets and return on equity, the impact of real revenue goes away when the regression is elaborated with industry effects. This suggests that the negative relation between firm size and outsourcing intensity only holds for particular industries, specifically professional services, media and entertainment, pharmaceutical and medical, and retail and distribution. Perhaps as such firms grow larger, they can bring IT capabilities in house and have less need to look to an outsourcer for support.

**Firm Growth and Outsourcing**

The study results indicate that somewhat faster growth two and three years prior to the outsourcing event increased the degree of outsourcing by firms. This suggests that faster than average growth can influence firm management to look at outsourcing as a way to better accommodate growth.

Firms can outsource IT because internal or organic growth of an IT infrastructure cannot be achieved quickly enough. Again, the results are somewhat counterintuitive, although it is certainly possible that outsourcing is increasingly being treated as a kind of joint venture, which firms often enter into to augment internal resources.

In essence, it appears that firms with higher revenue growth rates have higher outsourcing intensity. This result supports comparatively recent work that suggests younger firms and start-ups use outsourcing as a means to create a virtual organization, where literally all non-core functions are contracted out in order to bring a product or service to market more quickly.

**Firm Overhead and Outsourcing**

Research results strongly suggest that firms outsource as a way to gain control over general overhead costs. Firms with comparatively high overhead are at a significant disadvantage to competitors. By transferring such functions from hierarchy to the market, firms clearly hope to use outsourcing as a means to better control indirect expenses. Specifically,

Cash flow and outsourcing intensity are negatively related. Essentially, it appears that firms can outsource IT functions in response to cash flow problems.

Organizational focus and outsourcing intensity are positively related. Organizations outsource because they want to focus on core competencies.

This suggests that firms with high outsourcing intensity have fewer employees involved in non-core activities and, thus, should have higher revenue per employee (RE) ratios or higher revenue to asset (RA) ratios. RE and RA are highly correlated. Because RA is also highly correlated with other independent variables, it was dropped from the reported regressions. However, RA was substituted in a separate regression run; in neither case did RE or RA have significant coefficients.
Research Findings

The data set consisted of 299 outsourcing events during the 1990–1999 timeframe, combined with financial data reported prior to the event. Several conclusions can be drawn from the analysis:

Evidence suggests that IT outsourcing by firms has increased during the past decade. Firms also appear to increase IT outsourcing intensity as a response to high overhead (sales, general, and administrative) costs or as a response to cash flow pressures. Smaller firms appear to outsource to a greater degree than do larger firms. Further, banking, financial services, and transportation firms appear to have higher outsourcing intensity than firms in other industry groups. There is strong evidence that firms are entering into IT outsourcing contracts for shorter periods of time, apparently to avoid becoming hostage (that is, through the creation of appropriable quasi-rents) to the outsourcer and to maintain competitive pressures. Firms are attracted to outsourcing in part because outsourcing provides the means to more closely match wage levels with the labor supply and demand function. Within firms or within industries, workers can be insulated from market signals. Outsourcing tends to expose middle managers whose job functions are redundant or employees whose wage rates are above market. The boundaries of the firm that workers or managers can use to insulate themselves—with their hierarchies, protected turf, and departmental silos—are stripped away when outsourcing is employed as a governance mechanism.

Outsourcing and Labor Economics

Perhaps surprisingly, the effects of outsourcing on wage levels are mixed. While political rhetoric bemoans wage losses stemming from the use of outsourcing, particularly across international borders, highly skilled workers often benefit. Knowledge workers are highly specialized and have often improved their prospects as manufacturing industries have shed nonproduction jobs. This occurs because outsourcing has tended to increase the demand for skilled labor. Further, the impact of outsourcing on wages is predominantly across industries, not within them. In other words, it is not certain industries per se that receive the brunt of the impact from outsourcing, but rather particular job functions across all industries, functions that are typically less skilled.

The evidence also suggests that outsourcing makes the demand for skilled labor less elastic, while demand for unskilled labor becomes more elastic because of the prospect for moving operations offshore. With skilled labor, this is more difficult because of coordination issues, specialization, decreased opportunities for substitution, and limited supply.

Though outsourcing is presumed to be the culprit, social divisions may ultimately have less to do with outsourcing, which is simply a symptom of economic restructuring, than with the growing chasm between less skilled and highly skilled (typically nonproduction) workers. Outsourcing is merely one of the market mechanisms by which the relative demand for different skill sets and capabilities is matched with the available supply.

More fundamentally, outsourcing can provide workers an alternative to traditional corporate hierarchies. Functional expertise, rather than career options based on industry focus, is the basis for the concept of outsourcing. Such functional specialties, which almost invariably cross industry boundaries, now command equivalent importance in the marketplace. Liberation from hierarchy, or at least the ability to choose among a greater number of hierarchies, paves the way for greater individual freedom and choice.
A Force for Democratization

Outsourcing chips away at hierarchy because by definition it relies on the market, not nonmarket institutions. When regulated industries or governments choose to outsource, they are in effect attempting to impose market discipline on nonmarket institutions and their typically rigid hierarchies. As a governance mechanism, outsourcing offers firms and other types of hierarchies an opportunity to increase the use of specialization as a way to increase economic efficiency and improve performance.

Firms engage in outsourcing to acquire critical capabilities more quickly than would be possible through in-house development. Firms also outsource to restructure themselves from an organizing logic based on the industrial era to the organizing logic emerging in the information age. On the flip-side, outsourcers can take advantage of economies that individual firms cannot because of their ability to aggregate demand pooled across many firms for the performance of specific functions. And, finally, individual freedom can be enhanced because workers have a greater number of potential options than in comparatively hierarchical institutional structures typically emblematic of traditional firms or governments.

At the extreme, one might infer that outsourcing produces the end of the firm as we know it. Yet, the firm remains a viable governance mechanism, even if its form undergoes significant transformation. Firms appear likely to stay with us for some time, but clearly they are being transformed. For this reason, research results in this study strongly suggest that outsourcing in and of itself is not a panacea. The private sector continues to experiment with organizational innovation and uses the market to operate more efficiently and effectively.

Cautionary Note

In many cases, outsourcing has not fulfilled expectations. If, in fact, firm (or government) performance cannot systematically be improved through the use of outsourcing, then the question is not whether outsourcing helps improve firm performance, but rather what factors do influence it, such as good management. In that case, the decision to outsource would simply be an incidental event.