The Strategies of Outsourcing and Offshoring

Piero Mella [1]

Michela Pellicelli [2]

Abstract

In recent years, however, outsourcing strategies have undergone a profound evolution, from simple forms of production contracts made with third parties to agreements that involve functions and activities which, requiring "core competencies", or being part of the "core business", have until now been considered inseparable from the company and not capable of being outsourced.In order to decide on outsourcing and formulate a satisfactory outsourcing contract, it is fundamental to identify the "strategic intent" behind the choice to outsource, since this depends on the organizational culture of the two sides in question, which are often diverse and lead to different evaluations regarding the functions and processes to outsource. Precisely for this reason, the greater the strategic importance assigned to the outsourcing, the more important it is for all parties involved that top management be given the responsibility for managing the outsourcer-outsourcee relationship. The tendency today is to attain "global sourcing" and offshoring; that is, outsourcing that involves outsourcers located in countries other than that of the outsourcee. This tendency to outsource most of the functions and processes can take on an extreme form, which we can define as "extreme outsourcing", and lead to the formation of a virtual organization, a company characterized by the pure business coordination of its businesses, where all the productive and economic processes have been outsourced through the formation of a stable but flexible network.

1. The rationality criterion implies rethinking the businesses and the organization

In a highly dynamic, interconnected and competitive capitalist environment the only truly general principle firms must abide by is that of *corporate rationality,* according to which every managerial action must be decided on by choosing the alternative that maximizes both *economic efficiency* (ratio of revenues to costs) and *profitability* (Mella, 2008), conditions which guarantee the maximum production of *shareholder value* (Mella, 2005). The ultimate criterion of *corporate rationality* is applied to both the business level and the organizational functions and production processes.

At the *business level,* this criterion is valid for the business *portfolio* as a whole as well as for the *individual* businesses that make up the former; the *corporate rationality* criterion can be translated into the following rules that specify how to select the businesses to include or remove from the portfolio in order to maximize the production of *shareholder value* (Pellicelli, 2007; Mella, Pellicelli, 2008):

a) in deciding whether or not to start up or continue businesses attention must be paid to their economic efficiency, to the capital invested in starting them up, and to the sources of available financing;
b) when choosing between two businesses, choose the one which has had the largest average ROE over its lifetime (best operating results and/or lower volume of invested capital and/or lower WACC, understood as the average weighted cost of capital raised at the rate of return expected by financial backers;

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[1] Chair of Business Adminstration, Faculty of Economics, University of Pavia, Prof. Piero Mella teaches CONTROL THEORY (ADVANCED) and BUDGET ANALYSIS..

[2] Researcher in Business Administration, Faculty of Economics, University of Pavia, Michela Pellicelli teaches BUSINESS ECONOMICS and ECONOMICS OF GROUPS AND OF BUSINESS CONCENTRATIONS. The article was written by both authors. Nevetheless, sections 1, 2, 3, 4 are mainly the work of Piero Mella, while the remaining sections of Michela Pellicelli.

c) when average ROE is equal, choose the business with the shortest *pay-back* period;
d) a business with an average negative ROE for its remaining existence must be eliminated from the portfolio

At the *organizational functions level*, assuming that these functions do not involve the production of services necessary for the functioning and maintenance of the firm's integrity, the corporate rationality criterion can be translated into the following rule: carry out internally only those functions that provide services at lower costs with respect to similar services available from outside firms, assuming equal reliability (quality and timeliness) and risk regarding uninterrupted supply, and externalize those functions which are "losers" with regard to the market.

Finally, the *corporate rationality* function is applied to those *business processes* necessary for production based on this rule: to maximize economic efficiency and corporate profitability, any activity not necessary for production should not be undertaken; any process whose costs are greater than those for similar results from outside suppliers must be outsourced. The corporate rationality criterion is the logical basis that justifies the increasingly widespread recourse to outsourcing.

2. Outsourcing and what to outsource

The term *outsourcing* was used in 1982 (Van Mieghem, 1999) to identify the decision by which one or more processes or activities necessary to obtain a product or a component, even an organizational function – originally undertaken in-house by a certain organization – are regularly entrusted by a firm – the *outsourcee* – to an outside organization, the *outsourcer* (supplier or provider), who carries out the activity and sells the results to the former.

The *first feature* of *outsourcing*, from the production point of view, is that the outsourcee "takes outside" the firm processes and functions already carried out internally and does *not* only acquire – "brings inside" the firm – factors or services that were until then produced by outside firms.

This feature is not always clearly explicit. For example, the *Dictionary of Business* (Collins, 2005) defines *outsourcing* as the "*purchase of components, finished products or services from outside suppliers rather than their production within the firm"*. "*In some cases this is done because turning to outside suppliers lowers costs, because the outside suppliers have greater technical competencies, or because they offer a greater variety of products."*.

The *outsourcing* process can occur physically outside the premises of the outsourcing organization or inside the organization.

In the first case, *outsourcing* can be viewed as *service contracting-out*: that is, as the outsourcing of services necessary for production (Domberger, 1998). In the latter case it is *service contracting-in* – or *co-sourcing*: that is, the carrying out within the organization of processes with capital and know-how resources owned by others.

The document "ISO/TC 176/SC 2/N 630R – ISO 9000 (2008) Introduction and Support Package: Guidance on Outsourced Processes" states that the Oxford English Dictionary defines the verb "*outsource*" as *"to obtain….. by contract from a source outside the organization or area; to contract (work) out",* and then specifies that *"An outsourced process can be performed by a supplier that is totally independent from the organization, or which is part of the same parent organization (e.g. a separate department or division that is not subject to the same quality management system). It may be provided within the physical premises or work environment of the organization, at an independent site, or in some other manner."*

The outsourcing can be *domestic* or carried out in another country; in the latter case it becomes *offshoring* (a term that is a mixture of *offshore* and *outsourcing*) if the country of the *outsourcer* is on another continent, or in any event a considerable distance away from the *outsourcee*. Forrester Research considers offshoring the production that occurs at a distance greater than 500 miles from the site of the final assembly.

Outsourcing allows us to also examine the inverse process of *insourcing* that originates from the decision to internally carry out processes, phases or activities originally carried out by outside suppliers.

A *second feature* of outsourcing is the creation of a lasting and continuous supply relationship between the *outsourcee* and the *outsourcer.*

This feature allows us to distinguish outsourcing from apparently similar operations such as subcontracting (Van Mieghem, 1999), which can take the form of an outside commission, a sub-supply contract or a subcontract.

Outsourcing is a flexible phenomenon; in theory everything can be outsourced, with the exclusion only of business or managerial activity.

Regarding the logic behind the definition of outsourced processes, we can distinguish between:

a) *Business Process Outsourcing*, which indicates the *outsourcing* of the different phases of industrial production, distribution, R&D, maintenance, etc.;
b) *Business Transformation Outsourcing*, which indicates a broad outsourcing process involving all the corporate functions, a true program of transformation of the business process that uses *outsourcing* as a resource to increase the firm's performance level

In general, the more that processes and functions are easily replicable and standardizable, the greater the advantages of outsourcing.

In fact, more frequently outsourcing involves: a) the production of parts, components and finished products; b) the production of industrial services such as maintenance, quality control, and the manufacture of accessories; c) research and development of new products and services; planning and design; d) administrative services such as accounting, managerial control, auditing, personnel management; e) the information system sector, which represents one of the focal points of the *outsourcing* process; f) managerial consulting services; g) logistical and transport services; h) canteen and cleaning services; i) the distribution network, promotions, advertising, and other marketing services; l) the management of liquid assets and the corporate treasury; receipts and payments services; m) the search for sources of financing.

3. Outsourcing as a remedy for process complexity

Technical innovation and competition have made products increasingly complex. The Model FORD T was composed of 700 parts, while there are thousands of components in modern-day cars.

Given this context, car manufacturers tend to manage the complexity of their products by outsourcing part of their production.

The outsourcing does not involve only acquiring components – through normal supply relationships – but externally acquiring *systems* of components that before were assembled in-house. This allows the firm with complex production activities to specialize in only a single part of its overall activity, outsourcing the other parts to specialized suppliers.

For example, in car manufacturing several firms specialize in fuel injection (Bosch), others in electrical systems or brake systems (Brembo).

Thanks to production specialization, at each production level outsourcing can divide a growing complexity into more easily manageable parts.

With the decline in transport costs and the development of the merchant marine and container ships, globalization has begun to separate the "geography of production" from the "geography of consumption" (Mella, 2007).

However, with the continued industrialization in some emerging countries, China and India in particular, outsourcing has taken on new forms – with the delocalization of entire production processes – and in many firms is at the center of choices regarding how best to compete.

Global outsourcing and *offshoring* are processes that best illustrate this tendency.

Even the object of *outsourcing* is changing, with the birth of firms capable of stipulating contracts for the supply of outsourcing services on a global scale.

Indian firms such as TCS, WIPRO and Infosys have eroded the position gained by major firms such as EDS, Accenture and IBM. Whereas in the past they supplied only low-cost services such as softward maintenance, they now offer complex functions, often in their customer's country of origin, dealing with innovation, value added, and the analysis of the needs of the final users of their customers' products or services.

Outsourcing is transforming production from a relationship involving the supply of materials, components and services into a network of competencies involving research and development and planning.

Outsourcing has entered into new fields, from customer service to R&D to the study of new business models, even health care services.

For example, a few minutes after admittance to a hospital in Phildadelphis the x-rays of a patient are sent to a specialist in South Africa, who examines them and draws up a report which the physician in Philadelphia, through his own computer-aided tomography (CAT), uses to recommend the proper intervention.

The pharmaceutical industry provides another example of the rapid evolution of the concept of outsourcing and its entry into new fields (Arnum, 2008).

Along these lines Champy writes, in his introduction to Koulopoulos and Roloff's (2006) book: "*The forces of globalization have finally kicked in. … Material and product sourcing move between multiple countries as a function of price, quality, and speed. And customers are everywhere expecting to be served with consistent quality and price, independent of location. The Internet has made markets global, even for the smallest company. In fact, information technology is the great enabler of those changes*".

4. Outsourcing from make or buy decision to strategic choice

As Williamson (1989), Chalos (1995), and Roodhooft and Warlop (1999) indicate, from a theoretical point of view the *propensity* of firms to adopt outsourcing is a function of the difference between the price of the external producer (the marginal cost of the external service market) and the marginal cost of in-house production.

Along with this general motivation, other drivers spur on the decision to adopt outsourcing, with various studies attempting to indicate the most important.

Based on a survey of over 1,200 firms, Deavers (1997) identified five principal factors:

1) the need to increase the firm's focus on the core competencies
2) guaranteeing access to world-class capacities and competencies
3) accelerating the benefits from re-engineering, going so far as to rewrite the firm's processes from scratch
4) sharing the risks between the outsourcee and the outsourcer
5) the possibility of freeing up the firm's resources to focus attention on the management of the core competencies

According to other authors, outsourcing can be viewed as the answer to the competition from imports from countries with low unskilled labor costs, which forces firms to shift unskilled labor activities abroad.

According to Sharpe (1997), outsourcing arises to reduce the costs the firm faces in order to respond to economic change, and thus it is a means for creating flexibility; Abraham and Taylor (1996), on the other hand, believe firms adopt outsourcing for manufacturing and service transformations in order to give stability to production cycles and to benefit from the specialization of other firms.

Heshmati (2003) instead notes that the outsourcing decision is complex due to sunk costs, stating unequivocally: "The choice to continue production in-house or to undertake it externally through outsourcing involves considerations other than just the difference between production cost and supply cost", going on to claim that outsourcing should not be considered as simply a make-or-buy decision, based solely on a comparison of *explicit costs,* but also refer to previous investments that give rise to "sunk costs" for the firm. Without their total amortization, sunk costs can have a negative effect on the decision to adopt outsourcing for production.

In recent years outsourcing has moved from being a pure make or buy tactical decision to becoming part of a strategy for changing the way business is done.

In fact, by tradition firms originally considered outsourcing as a solution to short-term problems, such as a sudden or unexpected increase in demand, an interruption in plant or equipment functioning, or the launch of a new product.

Today firms consider outsourcing as a *network of stable aggreements* with specialized suppliers as part of a long-term *strategic perspective*.

According to Quinn and Hilmer (1994), from a *strategic perspective* outsourcing allows management to optimize the firm's resources in four principal ways:

1) by maximizing the output from internal resources by concentrating investment and effort on what the firm "does best"
2) by developing the core competencies by setting up barriers against present or future competitors who might try to enter the firm's areas of interest, thereby protecting its competitive advantages
3) by utilizing the investments of outside firms, as well as their innovations, skills and specializations, which could be maintained in-house only through continuous investments and innovation
4) by reducing the risks from rapidly changing markets and fast-evolving technology; an outsourcing strategy shifts the risks involving technological updating and R&D costs outside the firm, thereby shortening the production cycles and making responses to customer needs more flexible and rapid

It has never been easy to develop long-lasting competitive advantages, but in a competitive and technological environment that is vaster and more dynamic than in the past, firms must deal with complexity – from globalization, new technologies, and the emergence of new competitors – by turning to new strategies.

Prahalad and Hamel (1994) identified the core competencies – or fundamental competencies of the firm – as pertaining to a particular capacity: one or more specialistic functions, a particular technology, product design, and know-how. They also identified the requirements of a core competence: allowing access to several markets or segments; providing benefits for the customer; being difficult to imitate; acting across all the functions; being rooted in the organization and thus persisting even when certain individuals leave the firm. In the new *millenium* outsourcing and offshoring have by now become the standard for firms constantly in search of new frontiers in order to compete worldwide.

In reality, several firms that already have a defined outlet market – especially in the agro-alimentar, and for goods for which, in addition to their functions, the brand is also prevalent – produce partly in-house and partly by acquiring goods from outside producers in order to market them under their own brand. This policy is usually defined as "concurrent sourcing".

Concurrent sourcing refers only to the partial vertical integration of many homogeneous products or services by a single firm. "*In the literature partial integration indicates either backward or forward integration or some combination of these*"; "concurrent sourcing emphasizes that firms are making and buying the same good". (Porter, 1980; Harrigan, 1985).

5. Outsourcing as a strategic factor

Without claiming to be complete, we indicate below several strategies that consider outsourcing or offshoring as policies for achieving or consolidating competitive advantages.

An initial strategy favored by outsourcing is that which allows firms – by adopting the opposite approach to mass production as a means of reducing unit production costs – to segment the vertical production chain into a lean production process, therey allowing the firm:

1) to reduce the preparation times of machines and complex systems
2) to increase the use of machines and plants through better planning
3) to facilitate quality control over all the stages in the production process

Even in marketing decisions we note a symbiosis between production and marketing efficiency.

On the one hand, the reduction of costs is facilitated by increases in the market share, and thus by aggressive policies regarding pricing, promotions and distribution. On the other hand, such policies are possible only if the firm can produce products customers perceive as having high value but at lower production costs.

This interaction is perceived through the ratio between "customer defection rate" and unit costs.

Customer defection is an indirect indicator of the loyalty of customers, which in turn depends on the firm's ability to satisfy its clientele with production that exhibits the maximum ratio between utlity and cost for the customer. This means that the reduction of the customer defection rate is fundamental for acquiring significant cost economies.

If a function or phase of the *vertical chain* is outsourced, it is indispensable for the firm to closely control the quality of the production of components, even more so if this involves finished products.

If outsourcing involves outgoing logistics, from packaging to shipping, it is fundamental for the firm to maintain direct control over customer deliveries.

In general, if the objective is to maintain a low customer defection rate, then the key marketing functions should not be outsourced and the firm must always maintain regular contact with the customer.

The R&D function contributes in various ways to productive efficiency by studying new products and designing processes which are increasingly efficient and simple to realize through a reduction in the number of component parts and, as a result, in production times, necessary manpower, machine times, and high-potency energy as well.

Outsourcing R&D is a difficult choice, but in recent years this policy has spread widely through international agreements or participation in joint ventures for the research and design of products, parts or components.

Against such advantages is the risk entailed by the outsourcing not only of R&D activities but also of the most innovative and reserved business ideas, thereby clearly revealing to the outsourcer the present and planned productive strategies of the business transformation.

Thus for many firms the R&D function represents an essential function for the core business, and outsourcing this function should be undertaken with extreme care and caution.

Particularly interesting findings from recent empirical research are those by A.T. Kearney, who, in three main studies, investigated a sample of firms worldwide who have adopted outsourcing.

Among the different results from the studies, one that is useful to point out is that the outsourcing drivers can be grouped into three large categories, each of which includes four significant drivers: 1) cost reduction (reduction in operating costs, reduction in investments, variabilization of costs, managing downsizing); 2) access to competencies (focusing on the core business, access to technologies, access to skills, integration of competencies); 4) increase in revenues (improved reactivity, speed to market, quality improvement, customer response time).

6. Outsourcing and offshoring redefine corporate boundaries

As discussed in the preceding section, the spur toward outsourcing and offshoring has brought out two fundamental concepts regarding the choice of corporate boundaries: the "tactical" concept, according to which the boundaries of the firm's processes are defined by short-term "tactical" planning, and the "strategic" one, which defines the boundaries using long-term strategic planning.

According to the "tactical" concept, the firm's economic boundaries extend, in an "economically natural" way, only to those processes whose in-house cost is lower than that obtainable by outsourcing the processes. The make or buy decisions would guarantee the proper extension of the boundaries.

The boundaries are also tactically defined by the possibility of transforming part of the fixed costs – by reducing investments in machinery and equipment (Bettis et al., 1992) for in-house processes that cease after outsourcing – into variable costs, represented by the prices paid to the outsourcer, thereby gaining greater productive flexibility with the additional advantage of having access to the most recent technologies without any additional investment burden (Lei and Hitt, 1993).

In short, the tactical view considers outsourcing as a way of solving a specific problem, which could be the lack of in-house competencies or of financial resources, or the need to reduce the management workload and to leave room for the choice of core businesses.

The "strategic" concept focuses, on the other hand, on analyzing the ability to compete, the competitive advantages, and the competitive position with respect to competitors.

Ford and Farmer (1986) and Welch and Nayak (1992) explicitly accuse firms of being nearsighted with regard to past decisions, when outsourcing was viewed as a "tactical" instrument *par excellence*, as well as an instrument for cost reduction; these authors conclude that a "strategic" vision can give better results than could be obtained if only the cost factor is considered.

Considering outsourcing from a strategic point of view means also considering a set of key factors – such as the use of strategic alliances (Prahalad and Hamel, 1990; Reich and Manking, 1986), the concentration of resources on the core competencies, the analysis of activities that are part of the value chain, and the relations with suppliers and customers within the value chain itself – thereby evaluating and producing stable competitive advantages that can be sustained in the long run.

The most important reason for evaluating outsourcing from a strictly "strategic" point of view is linked to the need for the firm to redefine the boundaries of its business portfolio, concentrating resources not only on the core competencies – thereby allowing more time for management to deal with strategic activities (Blumberg, 1998) – but also, and above all, on the core businesses (Dess et al., 1995; Kotabe and Murray, 1990, 2008; Quinn, 1992). Concentrating resources on those market/sectoral businesses the firm knows best and can develop more efficiently in-house allows the outsourcer to search for the factors of efficiency in the production activities of the outsourced businesses.

Quinn and Hilmer (1994) have pointed out that, in order to make rational decisions regarding outsourcing from a "strategic" point of view, firms must above all identify the sources of their competitive advantages in order to: 1) concentrate resources on those core competencies that create value for the customer in a distinct and unimitable manner; 2) outsource those processes and activities for which the firm has neither any particular strategic needs nor particular competencies, often including many which in the past were traditionally considered an integral part of any strategy.

Kedia *et al.* (2005) refer to Porter's (1985) generic strategies concept to assess the advantages and risks of outsourcing production, affirming that outsourcing – though their reasoning is even more pertinent to offshoring – can allow the firm to combine and obtain advantages from all three areas of generic strategies: cost leadership, product differentiation and focus.

The authors deal with the problem of how to select the functions, processes and, in general, the activities that can be outsourced, noting that this selection requires management to undertake a detailed analysis to: 1) clearly specify the firm's value chain; 2) distinguish the core and non-core competencies; 3) define the value chain of the core competencies; 4) distinguish the essential from the non-essential activities; 5) separate the core or quasi-core activities from the non-core ones.

7. Toward global sourcing

Since for each outsourcee the strategic intent is always to increase economic efficiency and profitability, outsourcing and offshore activities are based on a single strategy, called offshoring, whereby national firms that outsource become multinational ones.

Thanks to their presence in several countries, multinationals can undertake a quite vast array of decision-making policies: producing internally or externally, as well as decisions regarding the countries whose firms are to serve as outsourcers.

For such firms offshoring widens their field of application and evolves into a global sourcing strategy according to which the multinationals must develop a global view of the international supply of outsourcers in order to be able to rapidy shift offshoring from one country to another.

Offshoring and global sourcing may seem like strategies and problems of the modern globalized economy, but in reality, according to Kotabe and Helsen (1998), the shifting of production from one geographical area to another in the search for comparative advantages from location is not really that recent.

Over the last two decades several trends have further spurred outsourcing, making the links between firms located in different countries more widespread and stable, thereby favoring stable cooperation among them in an ever wider production network.

As far back as 1990 Chandler stated that the "…*cooperation among firms…represents one of the most fruitful and viable development paths for modernday capitalism. The use of cooperative relations among firms is a phenomenon that aims to deeply modify the governing mechanisms of the firm and the economic sectors, markets in particular, by redefining their operational boundaries.*" (Chandler, 1990: 175).

After pointing out how, in the '70s, the main currencies had strong oscillations, Kotabe and Helsen observe that in those years it was the changes in exchange rates that guided the sourcing strategies, together with differences in economic efficiency and labor costs among countries, especially in the Third World. Price was the main criterion – though not the only one – that guided the choice between in-house and domestic production, on the one hand, and outsourcing and offshoring on the other.

Toward the middle of the '80s the situation changed; variations in exchange rates lost some of their weight in the decisions to outsource abroad, and the focus shifted to quality and technology.

Given that time is needed to prepare a supplier that will guarantee given levels of quality and technology, from a "strategic" perspective offshoring must move to develop long-term relations with the outsourcer or foreign suppliers, and in this regard fluctuating exchange rates are never considered a decisive factor in the decision to outsource to a certain country.

Innovations and changes in the infrastructures of international exchanges, progress in communications and transport, and new financial instruments have made the move to offshoring simpler. This tendency has made it easier for firms that utilize components to obtain products from foreign suppliers on more favorable terms than those in-house production would allow (Pellicelli 2006).

The spread of just-in-time has strengthened the long-term relations between suppliers and customers and handed over more responsibility to management for purchases, shifting decision-making toward the top of the organization.

In this context, outsourcing and offshoring have evolved: from a "tactical" decision they have increasingly become a "strategic" one, opening up to global markets and favoring the development of global sourcing.

A growing number of firms have outsourced entire production processes by building production plants in various parts of the world which are closely controlled through various partnership forms.

The increase in the demand for components in new geographical areas has favored the birth of component producing firms that initially were local and then became global.

The long-term relations with these producers have, in turn, favored the transfer of R&D to the most disparate geographical areas, giving rise to what is tantamount to a "world" of firms without borders.

8. Global sourcing strategies

When the center of the global sourcing is a multinational company with several operational units in different countries, then the concepts of outsourcing and offshoring take on a specific meaning regarding both the way outsourcing occurs and the choice of country of origin of the outsourcers (Kotabe, Mol and Murray, 2009).

As regards the outsourcing decisions, multinational firms adopt various forms of sourcing which can be divided into two main areas:

a) "intra-firm sourcing", when the outsourcing of a unit belonging to the international group involves an outsourcer which is also inside the parent company or subsidiaries; in fact, at the group level there is no true outsourcing since, though the production occurs in different units with respect to the parent company, it is still a question of in-house production for the group; this form is typical of banks and insurance companies that outsource their accounting, auditing, oversight, liquidiation activities, to name but a few, entrusting these to companies which, though autonomous, are entirely controlled by the parent company;

b) "real outsourcing", when some of the group's units outsource by turning to independent companies outside the group by means of contracts or various forms of alliance.

As far as "where" is concerned, from the point of view of the geographical location of production, "intra-firm sourcing" and "real outsourcing" can be considered from two different perspectives depending on whether or not the suppliers are domestic or foreign producers with respect to the outsourcee's nationality.

The multinationals that choose the strategy of favoring their own group of operational units can acquire components, final products and services in the parent company's country of origin (domestic in-house sourcing) or the foreign subsidiaries' country (offshore subsidiary sourcing); in either case, within the group.

If they instead opt for "real outsourcing", the parent company or individual subsidiaries can either turn to producers in countries they operate in (domestic purchase arrangement) or to suppliers from other nations (offshoring).

The choice among the various types of sourcing is particularly complex for a multinational company since, in terms of convenience, it is necessary to consider not only the drivers of production costs but also the trends in exchange rates, the efficiency of transport and communications infrastructures in the various countries, economic transparency, safety, the economic and cultural environment, and the attitude of governments toward foreign investment in order to prevent against risks from the movement of goods and capital.

Beginning in the '80s, and parallel to the emergence of large companies based in low-cost-labor countries, offshoring gradually reduced its weight in production in many multinational companies with regard to R&D, marketing and financing activities.

According to Cohen and Zysmann (1987), many companies became convinced, wrongly in the opinion of many, that production could easily be transferred to other independent companies based on the differentials between internal and external production costs, without any loss of control over the capacity to compete. Precisely with reference to the cost of production as the sole, or prevalent decision-making criterion, many observers view offshoring and outsourcing as a genial solution to the cost differentials with emerging countries.

Nevertheless, this opinion is not unanimously shared, since the outsourcing of the industrial base means a true weakening in the capacity to compete. Maintaining for a while competitive advantages through R&D and marketing is possible, but over the short run firms in emerging countries manage to acquire distinctive skills even in these areas.

Some defences exist to avoid strategic weakening from the outsourcing of the production functions: 1) marketing the brand in such a way that where it is produced and who produces it becomes irrelevant. In the area of sports clothing, Nike and Adidas are examples of success in this regard; 2) concentrating activities on quality niches, image and high prices so as to reduce outsourcing to the necessary minimum, erecting barriers to competition through a high-profile product use function; 3) aiming at the emerging markets by offering products at mid-range prices while bolstering the firm's capacity for innovation. For several years Nokia has maintained high growth rates for revenues thanks to the growth in sales of mid-priced cell phones in emerging countries.

Along with the advantages it brings, global sourcing also has important disadvantages that operators and researchers view in a different way.

The most obvious disadvantages derive from the complexity in the management of contracts and from the differences among the partners in terms of traditions, culture and values.

Some observers even think that the outsourcing of production processes is behind the lower weight of this function in the value chain. Responding to the challenges from global competition by forming alliances with suppliers can represent an effective response, but in the long run there is no guarantee this strategy can always be repeated with the same positive results.

There are two obvious risks in this regard. The first arises from the uncertainty of suppliers, who are trying to stabilize their relationships with other firms by improving their performance by seeking out new buyers and expanding their markets; in the long run this behaiour stimulates, even favors, the birth of new competitors. In order to ensure orders, some outsourcers renounce long-run decisions and accept the "captive" position of subsuppliers.

Others decide instead to react to the uncertainty, trying to attain a position of autonomy by selling to other clients as well, in order to achieve economies of scale. For the multinational the result may be to open the market to new competitors (who use the same supplier), thus losing a once-dominant position. The second risk comes from the loss in designing capabilities (Pellicelli 2009a, 2009b).

Outsourcing through outside suppliers "disseminates" technological innovations, thereby once again favoring the birth or strengthening of competitor firms and, in the long run, weakening the firm's ability to compete in terms of both costs and innovations to the production process. It would undoubtedy be preferible to maintain control of critical know-how within the firm, but technological innovation and the new needs of consumers shorten products' life-cycles.

To decide whether or not to pursue an outsourcing strategy it is necessary to determine if this will lead to a long-term sustainable competitive advantage with respect to carrying out these activities internally. Management must focus attention on the core competencies and those areas in which the firm can develop a competitive advantage, transferring the other activities to several suppliers that are better able to carry these out. Thus outsourcing becomes one of the most effective options.

Nevertheless, there are numerous risks to this strategy, and this creates resistance on the part of management. Moreover some functions can be outsourced at considerably less risk to a company than others: for example, benefits administration, maintenance, and telemarketing are considered to be low risk. In contrast, customer service, accounting transactions and computer services are considered to be medium risk and such areas as investment analysis, cash flow forecasting, and product pricing are believed to be high-risk functions for outsourcing.

So management must be able to identify those activities to outsource and manage the outsourcing strategy phases' without risking negative effects on its competitive capacity.

9. Conclusions

The spread of global sourcing through the growth in outsourcing and offshoring, and the formation of stable relations between the outsourcee and the outsourcers/suppliers, is changing the nature itself of firms.

From unitary systems with definable productive, economic and financial boundaries, firms are taking on a nuanced form in a series of new "network" stuctures – also defined as a whole as *holonic networks* (Davidow and Malone, 1992) – that *widen* and make more *fluid* the boundary of the firm's economic activities, at the same time making it increasingly difficult to circumscribe its boundaries.

The typical structure of a *networked company* is made up of a group of firms linked by outsourcing or offshoring contracts that allow the interconnected firms to be autonomous while at the same time they cooperate and coordinate their activities through the network, which makes them similar to a single economic firm (Mella, 2007).

For this reason networked firms are also called *holonic firms*, or *virtual firms*. The most typical *holonic networks* are the *interfirm networks* – or *manufacturing networks* – which are made up of operating units which are relatively independent from a financial, economic and organizational, though not legal, point of view, being similar in nature to autonomous organizations.

Such networks are bolstered by participatory relationships, formal outsourcing contracts, alliances or joint ventures. What characterizes the networks are the common interests of its members regarding the operation of the value chain of a single business.

Even in *groups* that arise from the processes of intra-firm sourcing, with direct corporate control by the outsourcee, a network of firms can develop when stable production and economic relationships develop as a result of outsourcing.

Often the outsourcing relationships for a well-identified business develop in a single geographically bounded area which houses both the outsourcees and the outsourcers, thereby forming an industrial district.

Within these districts the inter-firm relations are not only of a productive nature but also concern knowledge creation, the passing on of knowledge, and training with regard to competencies.

In both cases new business models are developed which are carried out by outsourcees/suppliers that outsource to each other functions, processes and competencies to develop a *comakership* system, thereby favoring the spread of knowledge among all the network's units.

This tendency to outsource most of the firm's functions and processes can take an "extreme" form – what can be defined as "extreme outsourcing" – leading to the creation of a virtual organization, a firm characterized by *pure business coordination* in which all the production and economic processes are externalized through the formation of a stable but flexible network.

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