

Competitive Dimension of Outsourcing Relations in Global Networks

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Abstract

Over the past decades, outsourcing has been an important mechanism not only to reduce costs but also to organise both production and non-core activities of the company, in order to remain competitive and efficient on the market. The globalisation of the markets has radically changed competition rules. Companies must adapt their traditional strategies and policies to an ever changing and highly instable context characterised by a broad and complex environment. The solution adopted by big corporations is the creation of global business networks where companies work and interact with partners and stakeholders to enhance strengths and exploit opportunities. In this context, competitive outsourcing emerges as a new configuration of strategic alliance based on the network structure aimed at gaining shared advantages.

Keywords: Global Markets, Global Sourcing, Outsourcing, Competitive Outsourcing, Global Networks

1. Introduction

Outsourcing is “a conscious business decision to move internal work to an external supplier” (Elliott & Torkko, 1996). The traditional rationales for this practice have been cost reduction and efficiency gain on the one hand, together with the focus on core-business processes on the other hand. The theoretical basis for outsourcing can be found in the economic transaction costs theory (Coase, 1937; Williamson, 1981; Aubert, et al., 1996) and in the analysis of the relationship between transaction costs and make-or-buy decisions (Walker & Weber, 1984).

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Indeed outsourcing falls within a class of 'make-versus-buy' decisions in an organization (Loh & Venkatraman, 1992), as long as it is intended to reduce costs (Bryce & Useem, 1998; Vining, 1999; Van Laarhoven et al., 2000). On the other hand, outsourcing is a way to let the firm focus on its core competences (Prahalad & Hamel, 1990; Quinn & Hilmer, 1995; Fischli, 1996). By the turn of the millennium, the popularity of outsourcing had led to the situation where outsourcing as such no more was a competitive differentiator – it had become a norm rather than an exception (Arnold, 2000; Lawton & Micheals, 2001; Kremic et al., 2006) so that the management of the relationships with key suppliers has become increasingly important (Kadabase & Kadabase, 2005; Brondoni, 2010).

Managing outsourcing relationship became more dynamic in consideration of instability of the market and the complexity of network relations, from partner selection to collaboration and assessment.

2. Literature Review

2.1 Theoretical Basis of Outsourcing

Not only the theory of transaction-cost economics, but also the resource-based view and the core competencies approach have been extensively used to justify the rationale behind strategic decisions on outsourcing. Some of the companies have clearly underestimated the necessary control mechanisms for managing outsourcing, even though they have followed implicitly or explicitly the three theories for strategic decision making (Bustinza et al., 2010; Dekkers, 2011).

A transaction cost is a cost incurred in making an economic exchange or, as is has been defined by Coase, "the cost of using the price mechanism" (Coase 1937; 1988).

Transaction costs arise because of three problems: bounded rationality: it is not possible to foresee all possible cases that may arise and their outcome; information asymmetry: the contractors do not have the same information; moral hazard: the contractors are inclined to pursue their own interests above all else (even to the detriment of the other party).

It encompasses all the costs other than the money price, and can be divided into: search and information costs, bargaining costs and policing and enforcement costs (Dahlman, 1979). The first category, search and information costs, include costs whose existence is a consequence of information asymmetry (Akerlof, 1970) and imperfection about the quality of the product or service and about the existence or location of trading opportunities and alternatives between the part involved in the exchange.

A central thesis of economics of information research is that buyers search for information until the marginal cost of search exceeds the marginal benefit (Smith et al., 1999).

In his work Smith divide search costs into external and internal. Summarising in a few words his studies, we can notice that external costs are determined or influenced by factors that are beyond consumers' direct control, such as monetary costs to acquire information or the opportunity cost of time spent the search, while internal costs reflect the cognitive effort buyers must engage in to direct search inquiries. Furthermore he put three research hypotheses that, according to him, influence the decision whether to collect information and to what extent, related to the overall search level, the search source and the search pattern.

A more specific dissertation of the problem is not the main objective of this part but we can use his results to validate the following statement: the search and information costs vary depending on the type of the actors, especially of the buyer, and of course on the type of good or service. As a general rule, the more complex and expensive the product is, the higher the search and information costs will be. At the same time, type of product and type of good/service act similarly: an industrial buyer involved in a business-to-business exchange will put a great effort and rigour in the due diligence of a product, not only on the characteristics of the product itself but also on the existence of alternatives substitute both with another product or another producer. On the other hand, if we think about a less 'structured' buyer and/or about a more common product, e.g. supermarket customers buying a fast-moving-consumer-good, we can easily figure out that the effort they make in looking for information – which results in the search and information costs – will be less with respect to the previous case.

We could conclude arguing that search and information costs are linked with the nature of the transaction and, of course, must not exceed the value of the product/service in terms of money, time and energy.

The second category of transaction costs is the bargaining costs one. Once the search for information is over, bargain to come to an acceptable agreement between the actors starts. Once again, also this category of costs depend on the nature of the transaction, first of all because bargaining is not always a part of the exchange process.

On the other hand, "if one assumes rationality, no transaction costs, and no legal impediment to bargaining, all misallocations of resources would be fully cured in the market by bargains" (Calabresi, 1968). The scope of bargaining negotiations is not only the price of the product/service but also the other conditions of the exchange, such as contract, terms and requirements.

The last category, policing and enforcement costs, includes the costs that happen after the exchange process to ensure that all the conditions of the exchange itself are respected by the parts and nevertheless the costs of taking action in response to a misconduct.

Transaction costs economics is directly linked with Coase's theory of the firm. The reasoning starts from two main consideration: firms transform input in output and are made of employers and employees. However, also individuals are able to do the transformation job and market transaction can be seen as employers-employees relation as well. So the question is why do firms exist and what do they add to the individuals and market functioning.

The second main theory behind outsourcing is the so-called resource based view. The question Wernerfelt(1984) asked was: 'Under what circumstances will a resource lead to high returns over longer periods of time?'. He first exemplified what resources are; e. g. brand name, technology, skilled personnel and so on and then used Porter's five competitive forces model (Porter, 1985) to analyse them. An analysis of bargaining power of supplier and buyers as well as the threat of substitute is provided.

Finally, the last of the theories object of analysis: core competence approach.

A core competence may be defined as the main strengths or strategic advantages of a business; a company's unique characteristic or capability that provides it a competitive advantage in the marketplace, allows it to deliver value to its customers, and contributes to its continued growth (Prahalad & Hamel, 1990).

Both resource based view and core competence approach find a complete explanation and make sense together with the concept of competitive advantage, first introduced by Porter (1985), who started by the assumption that the competition is critical to the success or failure of a business.

The choice of a competitive strategy, i.e. the research of a favourable competitive position in the market, is driven by two main elements: the attractiveness of a market on the one hand and the characteristics of the relative competitive position on the other. None of these two elements is sufficient on its own: they both have to work together to provide a valid strategy for the firm.

According to Porter, there are two main alternative sources of competitive advantage: cost leadership and differentiation. Cost leadership is when a company is able to produce the same product or service at lower costs and thus offer it at a lower price with respect to competitors'. On the other hand, differentiation is offering a differentiated product or service at a higher price. The fundamental condition to apply this strategy is the recognition by the customer of the greater value added.

Outsourcing is traditionally associated with the cost leadership strategy: the cost reduction can be achieved in fact by innovation of the production process, by eliminating useless costs or by outsourcing. Differentiation, on the other hand, requires investments in marketing and communication.

There is actually also a third strategy, the so-called focus, which can be both cost focus or differentiation focus, that is different from the first two above because is based on the choice of a defined competition area, a segment of the market.

Once chosen the strategy, it is important to protect the competitive advantage from competitors' innovation and imitation policies.

2.2 Outsourcing Benefits and Costs

As every aspect of business management, outsourcing has its own benefits and costs, that can be translated into advantages and risks in managerial economics.

In a context of global supply chain competition, any single point of failures will cause problems in the entire network. Hence, it is the important for any organisation involved in the network to adopt effective risk assessment methods to manage and mitigate all possible risks. Outsourcing is a popular option for the firms as it keeps cost down and leans the supply chain. High responsiveness together with cooperation efforts with partners can help to formulate a good risk assessment strategy (Lee et al., 2012).

Advantages of outsourcing are numerous. We can divide them into three groups: strategic and organisational, economic and financial, and operational, as shown in the figure below (Figure 1).

Figure 1: Outsourcing Advantages

Strategic and Organisational	Economic and Financial	Operational
Core business	Costs	Product/Service
Flexibility	Fixed → variable	Efficiency
Stakeholders	Economies of scale	Human Resources

The first and most cited strategic and organisational advantage of outsourcing is the possibility for the company to focus on the “core business”. Outsourcing, indeed, decreases by definition the number of activities directly managed by the firm, and, at the same time, avoids the need to invest in secondary activities.

Another advantage that falls into the strategic advantages category is flexibility, i.e. a greater capacity to cope with sudden changes in volume in sales, as the partner, thanks to its specific organization, is able to compensate the peaks of a customer with others to contrary seasonality.

Several authors over the years have identified flexibility as an advantage, not only thanks to the partner specificity, but also to the ability to redefine the organisation of the firm itself (Downey, 1995; Akomode et al., 1998).

Nevertheless, a company may have image advantages, especially on how the operation looks to the stakeholders (Embleton & Wright, 1998; Lonsdale and Cox, 2000).

On the side of economic and financial advantages, the most important and common one is without any doubt the cost reduction. One of the main reason for outsourcing, coming directly from the make-or-buy dilemma, is that to buy (outsource) a product or service as a lower cost with respect of the alternative of making it in-house. This is possible because the company relies on specialized partners that have as their primary business the activity that the company outsources.

Another aspect linked with costs is that outsourcing make possible to transform some fixed costs into variable costs, since, for example, the costs of personnel and equipment (amortisation) involved are externalized together with the activity.

On the other hand, the larger economies of scale of the external supplier which brings together the activities of different companies in the same sector can lead to cost savings and therefore price reductions.

Finally, some operational advantages are involved: first of all, with outsourcing it is possible to improve the level of a product or service through the use of specialized partners. More generally, many authors have shown a greater efficiency and an improvement of operational performance, including costs, speed , quality and flexibility (McFarlan & Nolan, 1995; Embleton & Wright 1998; Akomode et al., 1998; Lonsdale & Cox, 2000).

Some benefits are reported also for human resources: outsourcing allows to enhance the personnel, as they are no longer engaged in routine work, and they can focus more on the aspects of firm's focal activities, improving professionalism.

Outsourcing is not only about advantages and benefits: also some risks and disadvantages are involved. The main disadvantages are summarised in the Figure below, presented in three categories: strategic, relational and operational. (Figure 2).

Figure 2: Outsourcing Disadvantages

Strategic	Operational	Relational
Flexibility	Human Resources	Dependence
Variety	Customer	Control
Know-How	Costs	Assessment

Flexibility can be one of the benefit of outsourcing but, at the same time, also a disadvantage falling into the category of the strategic disadvantages: outsourcing means in fact losing over time the skills necessary for the outsourced tasks, and the subsequent dependency on the vendors reduce the flexibility of the company. For the same reason, there is a risk of losing the opportunity to re-engineer, since, once any activity is outsourced, the priority in-house tends to focus on retained activities. The reduction of the variety is itself a bad thing: for example it reduces the economies of scope. More generally, a risk may be seen in the loss of the specific know-how, in the event that a member of staff to be absorbed by the service provider or in any case be transferred to another area of the company.

From the operative point of view, internal to the firm, a problem can be the demotivation of the staff, following the gradual demobilization of the internal structure; problems can emerge at the level of the workforce and there could be a potential negative impact on human resources, where outsourcing creates redundancies or limits careers.

On the other hand, some issues may occur because of the difficulty in controlling the level of service offered to end customers, due to the need for an adequate system of performance measurement of the supplier and internal interface of the company and, more generally, because of the loss of direct contact with the end customer.

Not less important, even though outsourcing is traditionally meant to reduce costs, a cost escalation is not unlikely to happen, due to management overhead and vendor profit margin.

Relational risks involve the management of the relationship with the outsourcing partner. Some disadvantages may occur if the dependence of the company to its partner is too strong: this may leads to opportunistic behavior by the partner itself.

Furthermore, one of the most frequently mentioned disadvantage concerns the loss control (in terms of quality, production technology, market, etc.). implicit in decentralization outside a certain activity; and, connected to the previous issue, the possible passage of important internal skills to competitors through the external supplier and also the disclosure of confidential information about the company. Finally, it is clear that to obtain adequate results from decentralization is not always simple: frequently complex relations systems and assessment are needed.

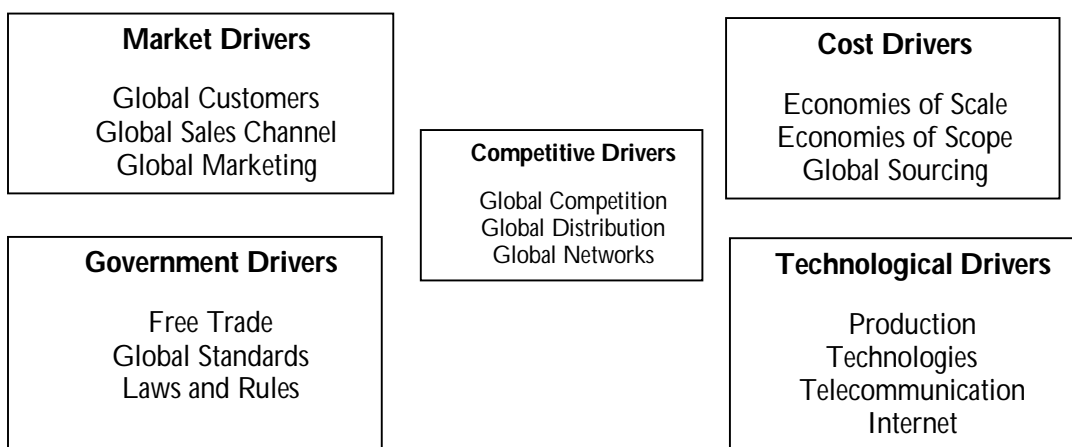
3. Outsourcing in Global Market

3.1 Global Market

Globalisation draws new competition boundaries that modify traditional competitive time and space relationships (Brondoni, 2005).

Managing time and space become vital for a company operating in global markets, beyond physical and administrative boundaries, and specifically underline the importance of certain distinctive drivers that characterised globalisation (Figure 3), from market to cost, from government to technology and, above all, to competitive environment.

Figure 3: Globalisation Drivers



Among the five categories of driver, the most important to describe for the purpose of this paper is the competitive driver; in particular the elements of global competition and global network.

Competition in global markets shapes a multi-dimensional space so that a given geographical context can imply the simultaneous presence of very different competitors. Moreover, competition practices are further revolutionized, as they must take into account: saturated markets, a situation of 'time-based competition', and finally, communication processes affecting sales and manufacturing (Brondoni, 2002, 2005).

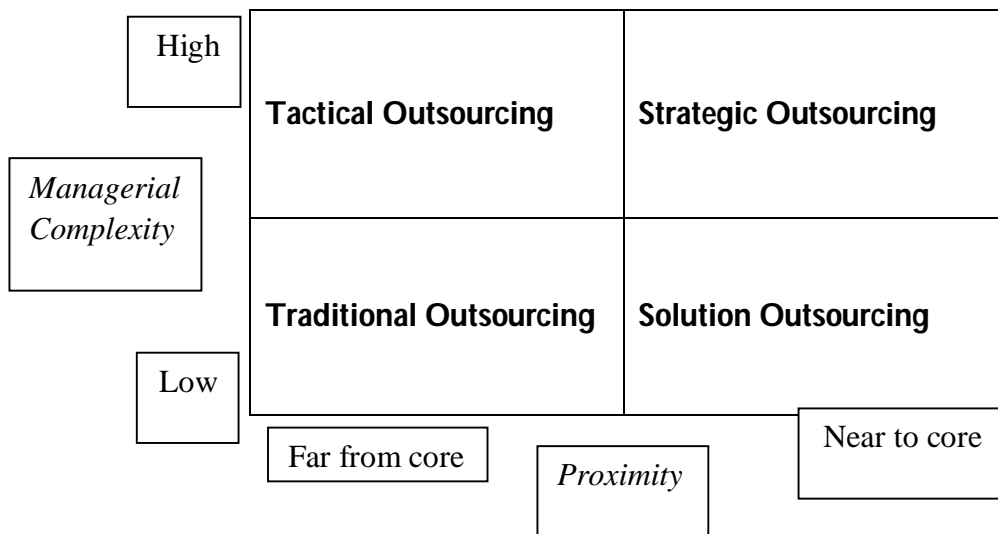
The development of network structures is a response to the challenges of globalisation: due to the gradual decrease in the importance of geographical, administrative, political, currency, tax, legislative, linguistic and other barriers networks have allowed companies to access broader and more open markets, with a large number of end customers but also with large numbers of companies operating at all levels of the supply chain (Corniani, 2013).

Networking allows companies to decentralize some functions and relative powers but to preserve a centralized strategic decision making. At the same time, requiring the coordination of several business activities located in various territories in global competitive space, strategic alliances involve a plurality of organizational costs and risk factors to be monitored.

The networking strategies shift the competitive comparison of a new action plan, in which the competition shift from firm-to-firm to a network-to-network (Arrigo, 2009, 2010).

3.2 Competitive Outsourcing

In the analysis of outsourcing evolution, an interesting classification has been proposed by Ricciardi(2000), who classified outsourcing based on Accabi& Lopez (1995) model of proximity of the activity to the core business and managerial complexity of the activity outsourced. Combining these two dimensions, we can identify four outsourcing typologies: traditional, tactical, strategic and solution (Figure 4).

Figure 4: Outsourcing Classification

Source: Ricciardi based on Accabi & Lopez, 1995

In traditional outsourcing, support activities are externalised. Because of them being not too close to core business nor too complex to manage, the relationship between the firm and its supplier is not strategic. Tactical outsourcing regards more complex activities, but still far from the core business of the company (e.g. personnel training or IT system). Solution outsourcing concern low-complexity processes that are on the other hand close to the core business: this situation calls for a common vision of the firms involved in order to achieve shared results. Strategic outsourcing, finally, can be seen not only as a buyer-supplier relations, but also as a true partnership where the outsourced activity is both complex and close to the core business at the same time.

In the lights of the characteristics of global markets and global competition, we can propose a new classification of outsourcing based on five indicators: motivation, perspective, activity outsourced, level of relationship, and duration (Figure 5). Alongside traditional and strategic outsourcing, we can define a new typology of competitive outsourcing.

Figure 5: Traditional – Strategic – Competitive Outsourcing

	Traditional	Strategic	Competitive
<i>Motivation</i>	Cost-driven	Strategy-driven	Relation-driven
<i>Perspective</i>	Economic	Organisational	Sharing
<i>Activity</i>	Non-core	Core	Core/Non-core
<i>Level of relationship</i>	Dyadic	Chain	Network
<i>Duration</i>	Short	Long	Long

Before entering into the details of the three typologies showed, it is useful to better define the five describing indicators. The first indicator is the motivation, the main rationale, that justify the choice to outsource. It represents the major benefit or advantage wanted by the company. Of course it is just the leading objective and not the only one. The second indicator, the perspective, is the reason behind the action and the point of view that clarify the meaning of the choice. The third indicator is the activity outsourced and more specifically the relevance of the activity in term of its distance from the core business of the company. The fourth indicator is the level of relationship that stand for the structure of the relationship itself in terms of partners involved. The fifth and last indicator is the duration of the relationship, not only in terms of time, but also with respect to frequency and easiness to change partner.

Once defined the indicators, we can easily proceed to describe the typologies. Traditional and strategic outsourcing are well known in the scientific literature, while competitive one represents an emerging issues in management.

Traditional outsourcing is cost-driven: the main reason to externalise an activity is to reduce costs, as a consequence of a make-vs-buy dilemma suggesting that is the cheapest alternative to buy a product or service from an external supplier rather than to make it in-house. The perspective behind this choice is therefore economic and the activity object of outsourcing are most of the time non-core. The level of relationship is usually dyadic, involving only two parts, and the duration is short, limited to unique activities.

Strategic outsourcing is instead strategy-driven and based on an organisational perspective. Since it normally involves core business activities, the main objective is not merely to reduce costs: outsourcing may be an useful strategy to gain quality for products or services and to better organise the activity of the firm.

The level of the relationship can still be dyadic, but it is more likely to be of a chain form, involving a more complex set of actors and organisations.

The list of differences between traditional outsourcing and strategic outsourcing must not be seen as exhaustive and the evolution from one form to the other does not mean that traditional form is antiquate and no longer used. Contemporary examples of traditional outsourcing may be found in standard supply contract, original equipment manufacturing, some form of IT outsourcing and so on. On the other hand, strategic outsourcing looks more like a real partnership of collaboration, although is not compulsorily set on a network base.

One of the main aspects that calls for the definition of a new outsourcing typology is indeed today's network predominance and the current phase of globalisation of the market.

Competitive outsourcing, unlike traditional and strategic, has a relation-driven motivation. Leaving untouched the cost and the strategy dimensions, a new need for relationship joins as a consequence of the network structure of nowadays companies. The perspective underneath is of sharing and collaborating to achieve common goals. Activities involved can be core or non-core, this is not a characterising feature of this typology. The level of the relation is the network level, where firms exchange with supplier as well as with competitors. The duration of the relationship is rather long, especially because of the instability of the global markets that leads to considerable competitive intensity. For the same reason, there is a relatively elevated difficulty to change partner, considering the concurrent reduction of the supplier base.

4. Conclusion

In the past decades, outsourcing has become a very common practice among companies, and it changed its characteristics over time. Initially born as a cost reduction mechanism, it quickly turned into a real strategic option within the production policies of the firm. The evolution of global markets, that reached a mature phase in many part of the world, and the advent and diffusion of global networks brought outsourcing relations to a new typology: the competitive one. The importance of outsourcing is still based on cost reduction and/or strategic advantages, but the relation dimension is now important enough to be analysed on its own, as a main feature.

Further research may help to better understand the relation side of outsourcing, both in the light of buyer-supplier relationship studies and with respect to changes in power and dependency. Another interesting point is to what extent a partner can be integrated in the business network (without using alliance instruments typical of the M&As) and in the vision of the company, with particular reference to corporate social responsibility and social and environmental issues.

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