

What Five Great Economists Can Tell Us about Outsourcing

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Want to improve your outsourcing efforts? This article unpacks the lessons of five "Big Thinkers" in the world of economics and shares how their insights can help you improve the way you outsource.

In the early 1990s, business gurus such as Peter Drucker and Tom Peters challenged companies to “do what you do best and outsource the rest.” Business leaders took their advice, and the late 1990s and first decade of the twenty-first century saw a rapid increase in outsourcing.

Though the rise in outsourcing is a relatively new phenomenon, the concept itself is anything but new. In many ways outsourcing is as old as commerce itself. As early as the thirteenth century, forms of commercial activities conducted under the “putting out system” linked artisans, merchants, and manufacturers as employers and service providers in what was essentially an outsourcing network.

Starting more than 200 years ago economists and academics began sharing their collective wisdom on ideas that would form the theoretical—and in some instances the practical—underpinnings of modern outsourcing. In this article we focus specifically on five “Big Thinkers” in the world of economics and explains how their insights can help improve your outsourcing efforts. Four of the five have received Nobel Prizes; the fifth, who lived before Nobel Prizes were awarded, is widely considered to be the Father of Modern Economics.

What mystifies us is not how prescient these thinkers were, but how slow businesses have been to understand and apply their concepts and principles. Part of the reason, we believe, relates to the old real estate adage about location, location, location. The “location” of these great economists’ works has been mainly scholarly journals and books written for and read by fellow academics. In these realms, the advancement of ideas and theory far outweigh the actual implementation of the concepts.

Our goal here is to show how these breakthrough economic theories relate to supply chain outsourcing in practice. To put this discussion in sharper context, for each great thinker we share our favorite examples of companies that have successfully



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Alex Williamson

implemented these ideas in their businesses. Finally, we offer supply chain practitioners a series of “lessons learned” that are applicable directly to their outsourcing initiatives. Our spotlight shines on these five great economists: Adam Smith, Ronald Coase, Robert Solow, John Nash, and Oliver Williamson.



Adam Smith: Do What You Do Best

We'll start with Adam Smith. What can we learn about outsourcing from the Father of Modern Economics? The answer is somewhat complicated: Nothing directly—but then again, everything.

Like the term capitalism, “outsourcing” was not in use during Smith’s lifetime (1723-1790). However, the concept existed in one form or another as markets and transactions developed and became more sophisticated. For example, when an entrepreneur formed a relationship with a guild of weavers to manufacture and sell garments, the marketing, distribution and manufacturing mixed

Adam Smith would have approved of today’s outsourcing trends in terms of specialization and the division of labor across global markets.

various outsource relationships. All of the parties used their unique skills to do what they do best for mutual benefit.

Smith, a somewhat eccentric academician at Glasgow University, observed humans’ propensity for self-interest. Drawing on these observations, he formulated the law of supply and demand with the publication in 1776 of *An Enquiry into the Nature and Causes of the Wealth of Nations*. Smith theorized that society as a whole benefits from a variety of trading transactions because humans will naturally seek what is best for them, resulting in fairness and honesty among equals. As demand for repeat transactions emerged, he wrote, trading preferences would evolve. Smith’s notion of transaction-based business models has been the cornerstone of conventional business relationships ever since.

Smith outlined this basic theory of international trade: “If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage.”¹ Substitute “company” for “foreign country” in the quote and you would have the basic idea behind

modern outsourcing. Put another way, what Smith said sounds very similar to what Tom Peters and Peter Drucker famously said more than 200 years later: “Do what you do best and outsource the rest!”²

Smith would have approved of today’s outsourcing trends in terms of specialization and the division of labor across global markets, says Lionel Frost, an associate professor of business and economics at Australia’s Monash University. “While Smith would acknowledge that some people are affected adversely by outsourcing,” Frost says, “he would conclude that on balance, society is better off when people are free to pursue the opportunities that the market presents. As Smith wrote, while widening the market is usually of general benefit, restricting competition and trade ‘must always be against’ the best interests of society.”³

Adam Smith for the Practitioner

One company that encapsulates “division of labor” lessons of Adam Smith is Nike. The sports footwear and clothing manufacturer knows that it takes much more than a love of sports to be successful; it requires a companywide commitment to nurture its core competencies, or doing what it does best. At Nike, this means outsourcing areas that are not core competencies. Nike has used outsourced providers to help them dominate the footwear market, capturing and building a 47 percent market share. While all of Nike’s design work is done in-house, all of its product lines—footwear, clothing, and athletic apparel—are manufactured throughout the Asia region using an extensive subcontractor network. Nike has applied outsourcing for over 25 years, and today there are over 500,000 people directly engaged in the production of their products. One could say Nike stamps perhaps its greatest competencies—inspiration and innovation—throughout a network that has factories in China, Indonesia, Vietnam, Italy, the Philippines, Taiwan, and South Korea. These factories are 100 percent owned by subcontractors, with the majority of their output consisting of Nike products.



Ronald Coase: Understand All of the Costs

Fast forward two centuries to the 1930s. That’s when a giant of modern economic science, Nobel laureate Ronald Coase, enters the picture. Coase is a British-born economist and the Clifton R. Musser Professor Emeritus of Economics at the University of Chicago Law School.

He was awarded the Nobel Prize in Economics Sciences in 1991.

One of Coase's landmark works is the "The Nature of the Firm." Written in 1937, it introduced the concept of transaction costs to explain the nature and limits of firms.⁴ In discussing transaction costs, he said it is not enough to include only production and transportation costs as the main expenses of doing business—i.e., the traditional way of thinking about business costs. Companies also need, for example, to include the cost of entering into and executing contracts, he said.

What later evolved into the Coase Theorem basically stated that you need to know all of the costs associated with each business problem. In presenting him with the Nobel Prize, the Royal Swedish Academy of Sciences explained the importance of Coase's work: "By incorporating different types of transaction costs, Coase paved the way for a systematic analysis of institutions in the economic system and their significance. Traditional theory had not embodied all of the restrictions which bind the allocations of economic agents. When transaction costs are taken into account, it turns out that the existence of firms, different corporate forms, variations in contract arrangements, the structure of the financial system, and even fundamental features of the legal system can be given relatively simple explanations."⁵

The Coase Theorem may seem obvious today. Yet it was innovative for the time and helped lay the foundation for outsourcing to become a major part of a firm's calculations and strategy. In his Nobel Prize lecture Coase said: "Businessmen in deciding on their ways of doing business and on what to produce have to take into account transaction costs."⁶ Good advice indeed.

Ronald Coase for the Practitioner

Coase's writings and teachings lead directly to the idea of accounting for all costs in any business or outsourcing endeavor, or "Total Cost of Ownership." A company that is heavily invested in this practice is SKF Group, a manufacturer of bearings and a provider of seals, lubricants, mechatronics and services. SKF has made TCO a vital part of its business model. For starters, it has a dedicated champion in the TCO quest in the presence of Todd C. Snelgrove, SKF's Group's General Manager, Value. Snelgrove sums up his company's view of TCO in a simple sentence: "It's not how little you pay, it's how much you get."⁷

Snelgrove travels the world passionately teaching others how looking at the entire cost picture gives you a truer sense of the real value of a business transaction. He has even worked on creating tools for SKF to help

business leaders and customers calculate their TCO to make better business decisions. "Without value creation," Snelgrove adds, "the buyer-supplier relationship inevitably breaks down. A TCO analysis helps identify ongoing, incremental and sustainable value-generation for the long haul."

Snelgrove offers this further insight into costs and value: "In place of 'squeezing' suppliers for lower material or component prices, companies are now looking to partner with a select few suppliers who have the expertise to look at the complete picture; suppliers who can see how their products or services impact their customer's operations, and make specific recommendations for improvement. The value of these improvements can add substantially to the bottom line—much more than the relatively small gains from price concessions."⁸



Robert Solow: Innovation Makes All the Difference

Does it really pay to innovate?

It was Robert Solow, the 1987 Nobel Laureate in economics, who made the breakthrough connection between innovation and economic growth⁹ More than 50 years ago, Solow wrote that "technological improvements"—which he defined as improvements in business processes or products—are the major driver of economic growth. These technological improvements are in essence the innovations that drive economic growth.

Solow received the Nobel Prize for his "contributions to the theory of economic growth." His growth model was first presented in a 1956 article entitled, "A Contribution to the Theory of Economic Growth." A key part of Solow's findings was that only a small proportion (13 percent) of annual growth could be explained by increased inputs of labor and capital. In other words, the technological improvements in products and business process are what make the crucial difference when it comes to spurring economic growth—an amazing 87 percent. Put more bluntly, brains are better at brawn if you want to grow your company.

But how does this relate to outsourcing? Companies that outsource searching for the lowest cost of labor or facilities in offshore countries are probably limiting (or missing altogether) the value of their outsourcing efforts. The goal instead should be to pursue outsourcing relationships that lead to longer term and sustainable paths to economic growth. And this means outsourcing to a partner that invests in and delivers on innovation through "technological changes." To repeat, Solow's findings showed that a full 87 percent of economic growth is

driven from technological change in process and product improvements.

Robert Solow for the Practitioner

Procter & Gamble is a good modern day example of a company that applies Solow's Law in practice. In 2000, the company's newly appointed CEO, A.G. Lafley, challenged P&G to reinvent its innovation business model. Questioning the sustainability of the "inhouse-invent-it-ourselves" mentality, Lafley's bet was that looking beyond P&G's walls could produce highly profitable innovations.

The result was P&G's "Connect and Develop" initiative. The initiative's main thrust was to engage with external partners that had already made investments in innovative processes, tools, and equipment. This resulted in an incredibly active innovation network in which commercial opportunities were welcome whenever and wherever they presented themselves. P&G's innovation efforts initially targeted product innovation, with Lafley setting a goal to acquire 50 percent of innovation from outside the company. The strategy didn't replace P&G's capabilities, but leveraged them better. "Half of our new products would come from our own labs, and half would come through them," Lafley said.¹⁰

It was a radical idea and a paradigm shift that required rejection of a not-invented-here mindset to enthusiastic acceptance for those ideas "proudly found elsewhere."



John Nash: It Pays to Play Win-Win

The breakthroughs of game theorist John F. Nash have been seminal in the development and success of modern outsourcing. Nash, a mathematician and Nobel Laureate, took economists a step or two beyond Adam Smith with his ideas on Game Theory and the art of collaborating for the "win-win." Nash received the Nobel Prize in 1994 for his work and the related work of two others who shared the prize with him that year, John C. Harsanyi and Reinhard Selten.

Nash concluded that playing cooperatively from the start of a business or contract relationship to achieve mutually beneficial goals is good for everyone, and will almost always yield the best result. His conclusion fits squarely into an essential tenet of what we call Vested Outsourcing. Based on research and fieldwork by University of Tennessee researchers, the vested business model incorporates collaboration, innovation and mutual trust to share value and achieve the win-win in an outcome-based environment in which the parties are vested

in each other success. (For more on Vested Outsourcing, see accompanying sidebar.)

The movie *A Beautiful Mind*, which is loosely based on the life of Nash, contains a brief scene that captures the essence of Game Theory in an entertaining way. It shows how the use of games—especially non-cooperative situations, which we explain below—can serve as a basis for understanding complicated economic issues.

In the scene Nash, portrayed by Russell Crowe, has a revelatory moment in a campus bar as he and his mates ponder the best ways to produce optimum results in their approach and pursuit of a beautiful blonde and her not-as-beautiful friends. Nash's inspiration is that Adam Smith's principle that the "best result comes from everyone in a group doing what's best for themselves" was incomplete and needed revision when it came to the challenge on hand. In approaching the young ladies the guiding principle should be: The best result comes from everyone in a group doing what's best both for themselves and the group.

How things eventually played out in that scene was

What Is Vested Outsourcing

University of Tennessee (UT) researchers began to study complex outsourcing as part of a research project funded by the United States Air Force. The study's purpose was to find out if there was better way to outsource for complex services. To the Air Force, a better way could translate into tens of millions of dollars of taxpayer savings.

As part of the project, UT researchers studied some of the world's most successful outsourcing arrangements, asking companies such as P&G and Microsoft to let researchers study "their most successful deal." What researchers found was a different kind of outsourcing agreement—one based on a true desire to create a "win-win" relationship. The researchers coined the term Vested Outsourcing because they found these successful agreements were the result of a company and its service provider having a vested interest in each other's success and working collaboratively to achieve mutually created "desired outcomes."

The research identified five things in common across all of the highly successful outsourcing relationships studied:

1. Focus on outcomes, not transactions.
2. Focus on the "What," not the "How."
3. Agree on clearly-defined and measurable outcomes.
4. Optimize pricing model incentives for cost/service trade-offs.
5. Insight, not oversight governance structure.

undetermined because the movie portrayed Nash as being so excited about his idea that he rushed out of the bar to begin his lifelong endeavor of proving his theories. Nash's pioneering work introduced the distinction between cooperative games (in which binding agreements can be made) and non-cooperative games (where binding agreements are not feasible). He developed an equilibrium concept for non-cooperative games that later came to be called the Nash Equilibrium.

A Nash Equilibrium is defined as a set of strategies, one for each player, such that no player has an incentive to unilaterally change her action. Players are in equilibrium if a change in strategy by any one of them would lead that player to earn less than if she remained with her current strategy. For games in which players randomize (mixed strategies), the expected or average payoff must be at least as large as that obtainable by any other strategy.¹¹

Simply stated, Nash demonstrated—by doing the math—that the sum of the parts can be greater when combined effectively through companies working together than if they work at cross-purposes. Simply put, 1 plus 1 can equal 3, 4 or even more because the parties can build on each other's strengths. This should be no surprise in outsourcing because companies should be turning to experts that can help them increase their ability to reach their goals.

Nash's lesson is simple but profound: Playing a game cooperatively to achieve a mutual goal is always better than playing it with self-interest in mind. Put another way, a win-win strategy to achieve a common objective is always better than a win-lose strategy aimed at promoting self-interest.

Many companies that outsource operate under the mistaken belief that if something is good for the service provider it is by definition bad for them. Both sides can and do play this game to no one's advantage. A true win-win approach is not a contest, a game of one-upmanship, or an abdication by one party to another. Outsourcing under the collaborative Vested Outsourcing approach, for example, is a partnership with regular, frequent communication to manage both the expectations and the work of everyone. Nash's genius was in showing the value of reaching equilibrium, or win-win solutions and outcomes in difficult scenarios, as the way to achieve successful business and outsourcing partnerships.

John Nash for the Practitioner

For insight into how collaborative win-win partnerships can develop and prosper over the long term, look no

further than the nearest Golden Arches. McDonald's is famous for the Big Mac's secret sauce, but the real secret sauce is how the company treats its suppliers. The secret sauce of McDonald's success is found within the long-term transparent relationships the company has forged with its suppliers. They are based on the firm belief that everyone in the "McDonald's System" can and should win—something John Nash would heartily approve of.

Company founder Ray Kroc put it succinctly when he famously said: "None of us is as good as all of us." That philosophy is very much on display with the "McDonald's System" that Kroc devised nearly 60 years

From John Nash, we learned that "win-win" is not an empty phrase—the best results really do come from all parties working to optimize results.

ago. That system established an innovative, collaborative supplier network and created an entirely new market. Kroc's vision was to effectively revolutionize the restaurant business; yet he intuitively understood that he could not implement his vision alone.

Kroc often referred to the business as a three-legged stool: McDonald's Corporation, the owner/operators running the restaurants, and the suppliers. He emphasized that each leg of the stool needed to be strong for the entity as a whole to prosper. If one leg of the stool did not grow in capabilities and profitability, it would weaken the stool. Kroc was committed to seeing everyone involved with the business thrive. The three-legged stool became known as the "McDonald's System."

The famed 15-cent hamburger, a staple on the McDonald's menu from 1955 to 1968, is a testament to Kroc's efforts to work with suppliers to drive gains in supply chain efficiency. Throughout his career, he worked with suppliers to develop products and processes that served the owner/operators and, at the same time, brought profit and growth to the supplier's bottom line. Instinctively, Kroc insisted that winning only happened when all parties were successful. It was a McDonald's supplier, after all, that perfected the frozen French fry and the famous secret sauce for the Big Mac. And it was suppliers who saved the day by figuring out how to get chicken into Asia during the Avian Flu crisis, when the other restaurants ran out.



Oliver Williamson: Style Matters

Another Nobel Laureate, Oliver Williamson, has taken threads from Smith, Coase and others, added a few of his own, and weaved them directly into modern outsourcing. In fact, Williamson may be the most influential of the economic scientists for outsource practitioners.

A professor emeritus of business, economics, and law at the University of California at Berkeley, Williamson took transaction cost analysis to a new level with the concept of “transaction cost economics” (TCE). TCE looks at the entirety of the costs of doing business with a particular lens on the cost of the contracting, negotiations and governance processes.

Over a long career, Williamson has applied TCE directly to outsourcing and to the cost of contracting. His 2008 article in the *Journal of Supply Chain Management* examined outsourcing from the TCE per-

P&G, McDonald’s, and Nike are among the leaders who have put the great economists’ theories into practice.

spective. In that article, Williamson states that “all complex contracts will be incomplete—there will be gaps, errors, omissions, and the like.”¹² He further advises that organizations shift to contracts that have a more flexible framework that allows and even encourages companies to revisit their contract in a quest to keep the relationship fair and in balance.

Williamson believes that having a contract that is too rigorous ultimately leads to higher transaction costs. Rather than encouraging rigidity, he said, companies should create mechanisms that preserve business continuity and that can cope with unanticipated disturbances as they arise. Put another way, “business happens.” Therefore, we should create outsourcing deals that embrace change, rather than fight or resist it.

One of the key takeaways from Williamson is that the method or style of working with providers of outsourcing services matters. He observed that “muscular buyers not only use their suppliers, but they often ‘use up’ their suppliers and discard them.”¹³ Organizations that flex their muscle to gain an advantage over suppliers may get a short term win, but they will lose over the long term. Simply said, not playing nice will really cost you. Williamson almost poetically states: “The muscular approach to buying goods and service is myopic and inefficient.”

Instead, Williamson urges companies to use a “credible” style of contracting that builds long-term trust. McDonald’s is an excellent example of this style: the company has had vested-type relationships with 16 of its suppliers, some lasting more than 25 years. If McDonald’s bullied its suppliers, it is doubtful that such long-term, win-win partnerships would have survived.

One effective tactic for building trust, says Williamson, is to leave money on the table during the negotiations process. Leaving money on the table may sound counter-intuitive, but it can signal a constructive intent to work cooperatively and forge a strong business relationship that will endure.

Williamson also takes John Nash’s concepts of win-win and Game Theory out of the theoretical strategic realm and into the reality of contracting. He does this by showing that the contract itself can have negative impacts on business if an organization does not think clearly about how to negotiate structure and govern the contract properly. Clearly, Williamson is a believer of win-win thinking with his advocacy for creating contracts with “mutual advantage.”

Williamson digs beyond the numbers to substantiate the value of a collaborative, win-win approach to outsourcing. His is the best academic work we’ve seen on how to build contract and governance structures that support advanced, collaborative outsourced relationships. The bottom line on Williamson’s work is that the bottom line is not always apparent; the contracting process is full of the hidden costs of doing business. In other words: you get what you pay for—and if you don’t “play nice,” you’ll end up paying more.

Oliver Williamson for the Practitioner

The McDonald’s example just mentioned exemplifies the importance of adopting a credible, long-term contracting approach with suppliers and developing collaborative win-win relationships with them. Kroc’s System was inherently about the best way to treat suppliers and service them. By playing nice he made it possible for everyone to prosper.

While many other companies focused on supplier rationalization, using their leverage and increasing their use of RFPs, McDonald’s concentrated on stepping up the already tight relationships with its suppliers. In 2003, the company’s senior management team instituted a revitalization proposal called the “Plan to Win,” which was a strategic blueprint that focused on the core drivers of McDonald’s business. The plan’s objective is to

keep the McDonald's brand relevant and meet the evolving needs of consumers. It concentrates on being better—not just bigger—while providing a common framework for global business that allows for local adaptation. The results have been staggering in terms of achieving alignment, transparency, innovation and sustainability goals—and crucially, in cementing long-term trust between McDonald's and its strategic suppliers.

Summing up the Lessons

We've traced the evolution of economic science as it relates to outsourcing from the Father of Modern Economics, Adam Smith, to some of the world's most prominent latter day economists.

- From Adam Smith, we learned that his economic philosophy closely aligns with modern day management guru Peter Drucker, who in the 1990s led a rallying cry to “do what you do best and outsource the rest.”

- From Ronald Coase, we learned the importance of looking beyond price and embracing a total cost of ownership approach when making sourcing decisions.

- From Robert Solow, we learned that it pays to focus on innovation.


- From John Nash, we learned that “win-win” is not an empty phrase—the best results really do come from all parties working to optimize results.

- And lastly from Oliver Williamson, we learned that style matters, and that not playing nice can increase your transaction costs.

But what is more rewarding than studying these Big Thinkers is seeing how their concepts are applied in practice. Our work at the University of Tennessee, which studied highly successful outsourcing relationships, shows that companies that put the economic teachings of these famous economists into practice leverage outsourcing and supplier relationships as a true competitive advantage in the market place.

We were so impressed with the relationships we studied, in fact, that we came to refer to them as “Vested Outsourcing” because the buyer and supplier created tight economic alliances that transcend price and focus on developing a real-world, win-win approach to business. The buyer and supplier truly became vested in working together to create value. The foundation of their relationship is built on sound economic principles designed for long term sustainable success—not short-term approaches aimed at simple price reductions.

We encourage companies that want to improve

their outsourcing efforts to take a step back and reflect on the tried-and-true lessons of the Nobel Laureates featured in this article. For those who are serious about improving their outsourcing relationships and want to learn how to apply the principles featured in this article, we suggest *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements*.¹⁴ 

Endnotes:

- 1 Quotes are from *Wealth of Nations* as cited by Lionel Frost, “What would Adam Smith think about outsourcing?” *The Age*, (April 19, 2010). Available at <http://www.theage.com.au/action/printArticle?id=1177159>
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- 4 R.H. Coase, “The Nature of the Firm,” *Economica*, New Series, Vol. 4, No. 16 (Nov., 1937) pp. 386-405. Available at the JSTOR website: <http://www.sonoma.edu/users/e/eyler/426/coase1.pdf>
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- 10 Larry Huston and Nabil Sakkab, “Connect and Develop: Inside Procter and Gamble's New Model for Innovation,” *Harvard Business Review* 84.3 (March 2006): 58-66.
- 11 Shor, Mikhael, “Nash Equilibrium,” *Dictionary of Game Theory Terms*, Game Theory.net, http://www.gametheory.net/dictionary/url_of_entry.html. Web accessed: Oct. 25, 2011.
- 12 Oliver E. Williamson, “Outsourcing: Transaction Cost Economics and Supply Chain Management,” *Journal of Supply Chain Management* 44, no. 2 (2008): 5-16.
- 13 Ibid.
- 14 See www.vestedoutsourcing.com