The Evolution of IT Outsourcing: From its Origins to Current and Future Trends

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1. Introduction

Outsourcing IT has become a top priority topic on executives' agendas since the 1970s. It started an outsourcing boom that now extends from single tasks to complex processes and which has considerably changed the structure of whole industries. This change will continue and IT outsourcing will remain to be a good predictor of where outsourcing in general is heading.

Reviewing academic literature as well as popular business press on outsourcing in general and IT outsourcing in particular, it becomes evident that much has been written and researched about this topic, as well as numerous studies conducted. Most studies though only concentrate on one specific aspect of IT outsourcing. This paper will be different. The aim is to give a broad overview over the whole topic by reviewing existing literature rather than concentrating on single issues in great detail. By doing so, readers shall be provided with what could be called an introduction to IT outsourcing. As such, the authors will analyze the history of IT outsourcing, discuss the main changes which have occurred over the years and point to the most significant future trends. But before all this is done, it is essential to provide the reader with a basic understanding about the topic.

1.1 Defining IT-outsourcing

Before analyzing in more detail what IT outsourcing is, we will first briefly address the question of what *outsourcing* generally stands for. Actually, the term itself is an artificial construction composed of the words "outside", "resource" and "using". It is usually defined as the transfer of tasks and services previously performed in-house to external vendors (Jenster and Pedersen 2000, p. 147; Hussey and Jenster 2003, p. 7), and is thus linked to the traditional make-or-buy problematic, i.e. the decision whether to purchase goods or services on the market or to provide them internally. As outsourcing usually externalizes activities, it leads to a reduction of a company's value chain activities (see for a description of the value chain concept, in particular Porter 1986, p. 62), paves the way to leaner organizational structures and

consequently to an increase of the division of labor within and sometimes across economies.

Turning now to the more narrow field of IT outsourcing, most writers, such as Hormozi et al. (2003, p. 18) or Pfannenstein and Tsai (2004, p. 72), to name just a few, define IT outsourcing as turning over various IT activities to external vendors. One should, however, not make the mistake to equate IT outsourcing automatically with a traditional buyer-supplier relationship. This type of IT outsourcing is just one among many others. The main types of IT outsourcing can be seen in figure 1.

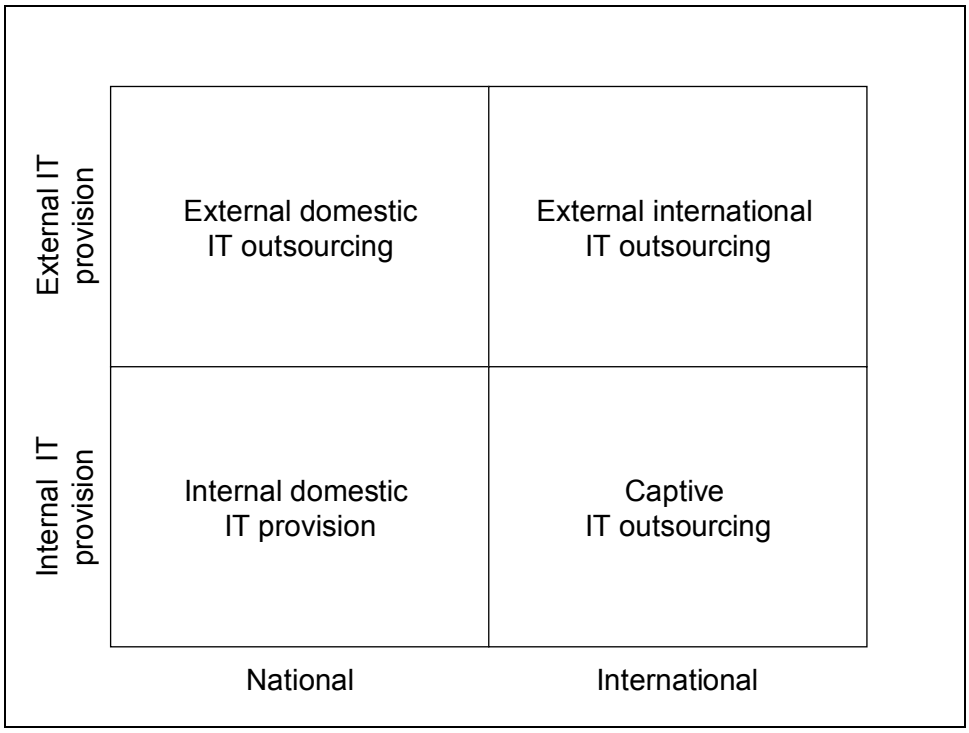

Figure 1: Main outsourcing types

Source: Adapted from Schaaf 2004a, p. 3.

Looking at these IT outsourcing types in more detail the following can be said:

- *External domestic IT outsourcing*: it can be regarded as the origin of IT outsourcing. Here, companies engage in an outsourcing relationship with a domestic IT provider. An example of such a relationship was Kodak's move to outsource its IT needs to IBM in 1989 (Hirschheim and Lacity 2000, p. 99).

- *External international IT outsourcing*: today, companies are no longer restricted to domestic IT outsourcing providers. The Internet and low communication costs provide the basis for transferring certain IT activities to almost any place on the globe. Now, international IT outsourcing relationships are able to exist where the IT provider is located thousands of miles away.

- *Internal domestic IT provision*: here, IT activities are not externalized but stay within the local organization. Some companies even pool the IT of all their units in so called *shared service centers*, i.e. independently working units responsible for the provision of IT services for the entire organization (see for a detailed introduction to the shared service center concept Hermes and Schwarz 2005). Perhaps the most prominent example in Germany in this context was debis Systemhaus, a former IT shared service center of Daimler Benz (Wißkirchen 1998, p. 145).

- *Captive IT outsourcing*: the difference to internal domestic IT provision is the locational aspect. Captive units are also part of the organization, but they usually take the forms of subsidiaries or joint ventures abroad (Schaaf 2004a, p. 3). Typical examples of this outsourcing type are the IT offshore subsidiaries of SAP or Siemens in Bangalore/India.

Thus, there is not only one single IT outsourcing type. IT outsourcing is heterogeneous and can take various forms, depending for example on the nature of the IT provider (external vs. internal) and the provider's location (national vs. international).

1.2 Extent of IT outsourcing

Today outsourcing affects nearly all organizational functions. However, IT is particularly affected as empirical studies show (Elmuti 2003, p. 36). This is probably the case because IT is not just a function such as marketing or accounting. It has become rather a cross-functional activity, which satisfies the organizational hard- and software needs. As numerous IT programs are nowadays highly standardized and as the widespread opinion exists that IT activities are not core activities, at least not for most organizations (King 2004, p. 83), it is argued that such non-core activities should be strategically outsourced (Quinn and Hilmer 1994, p. 43). Figure 2 shows which activities are prevailingly affected in this context.

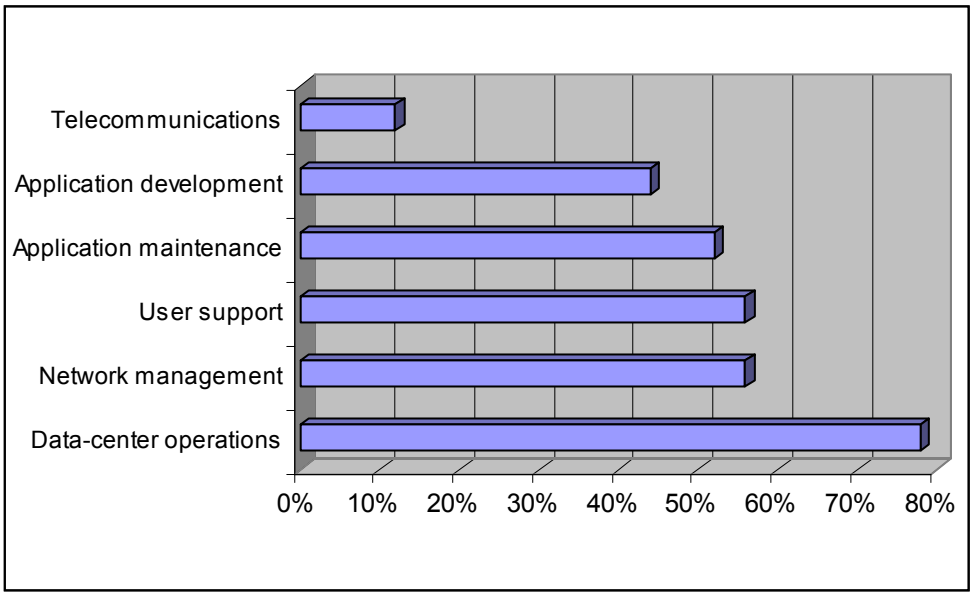

Figure 2: IT activities prevailingly outsourced[1]
Source: Barthélemy 2001, p. 62.

Outsourcing such activities is believed to allow companies to focus all its resources on core competencies, the basis of competitive advantage. It is hardly surprising then that IT outsourcing has become particularly popular in recent years.

Analyzing the literature further, the conclusion can be made that the extent of IT outsourcing varies considerably from country to country on the one hand and across different sectors of a national economy on the other. Pointing to national economies

[1] Figures are based on a sample of 50 companies. Multiple answers were possible.

first and comparing, for example, the extent of the German IT outsourcing market volume with the US IT outsourcing market volume, it has been found that Germany's volume was about € 10 bn in 2003. In 2008, it is expected to reach € 17 bn. This is already a considerable size within Europe as Europe had a total IT outsourcing market volume worth € 45 bn in 2003. This number is likely to increase to € 100 bn in 2008. However, compared to the US market German IT outsourcing activities are low. The US accounted for € 54 bn only in IT offshoring in 2003, which is a just fraction of total US IT outsourcing spending (Allweyer et al. 2004, p. 10).

Secondly, when looking at different sectors of an economy the extent of IT outsourcing varies considerably. Most outsourcing takes place in financial services, followed by manufacturing and governmental institutions. An overview of the development of outsourcing in different sectors in Europe is shown in figure 3.

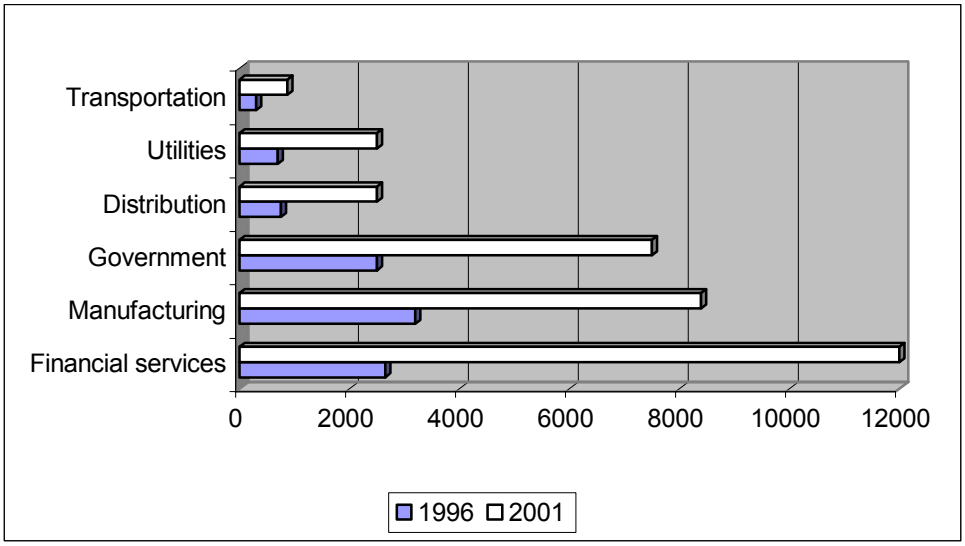

Figure 3: Extent of outsourcing in different sectors in Europe
Source: Diemer 1998, p. 74.

The figures show that outsourcing has grown significantly from 1996 to 2001. They also highlight that all major sectors are involved in outsourcing, although financial services stand out. In 2002, the whole financial services industry alone signed contracts with external IT vendors worth US-$ 33 bn (Allweyer et al. 2004, p. 4). A main reason for the dominance of this industry lies in their IT budgets. Relatively speaking, the financial services industry has the largest IT budgets of all industries. This is necessary to support their heavy IT dependent processes. By strategically

sourcing out part of these processes overall cost savings of 8% to 12% seem possible (Schaaf 2004b, p. 3). It is therefore not surprising that especially this industry is also a pioneer when it comes to the more risky, but also potentially more lucrative, IT outsourcing strategies, such as IT offshoring, which can offer even greater cost reduction. This topic will later be discussed in more detail in section 3.3. But before this is done, we will next address the question which factors actually drive IT outsourcing in general.

1.3 Main IT outsourcing drivers

That today's IT outsourcing market has a considerable size was shown in the last section. The growing importance of IT outsourcing and the increasing interest in the subject area might be seen as one reason why some companies decide to outsource some IT activities or whole processes themselves now. But the main forces – or "drivers" as they are sometimes called – that lead to further outsourcing growth have not been explained yet. Hence, this section will provide a brief literature summary of the main drivers that force companies to reshape their current organizational structure by undergoing IT outsourcing.

When analysing the rather diverse literature on outsourcing and IT outsourcing a large variety of multiple drivers can be identified. These drivers can be broadly classified into two categories:

1. The first includes drivers emerging from the business environment. Hence, these forces are 'external' to a firm and thus can hardly be controlled: in particular, (discontinuous) changes in the business environment, which manifest themselves in shortening product life cycles and intensifying competition are mentioned (Jenster and Pedersen 2000, p. 149; Wurl and Lanzanowski 2002, p. 1542). Relating this to the context of IT, it can be pointed out that life cycles of most hard- and software products have drastically decreased due to rapid innovations, which are particularly the result of intense competition in the IT industry. This rivalry has been further spurred through forces of globalization. As a result, various researchers regard globalization as one major driver for outsourcing

(Jenster and Pedersen 2000, p. 149; Middlemiss 2003, p. 27). They come to the conclusion that increasingly demanding customers force companies to concentrate all their resources on their core business to add additional value to products or services offered. And as most IT services are by many companies regarded as non-strategic (King 2004, p. 83; Pfannenstein and Tsai 2004, p. 75), they do not belong to the value enhancing core business and are as such increasingly considered for outsourcing.

2. The second category of drivers can be regarded as 'internal' to a firm. Managers are generally able to meet the demands deriving from these drivers by re-shaping the organization. Many writers regard focusing on core competencies as one primary outsourcing driver (Deavers 1997; Wurl and Lanzanowski 2002, p. 1541; Heikkilä and Cordon 2002, p. 183). Wide agreement exists that focusing on core competencies drives outsourcing in general and IT outsourcing in particular. This focus is believed to bring with it various advantages such as enabling managers and staff to undistractedly focus on key priorities (Hussey and Jenster 2003, p. 10; Erber and Sayed-Ahmed 2005, p. 103), or re-focusing the company strategically on those areas where business opportunities can best be achieved (Winkelman *et al*. 1993). Furthermore, reaching sufficient economies of scale drives the IT outsourcing decision. They can be reached on the supplier's side, for instance, as a larger number of computer manufacturers outsource assembly to one supplier. This supplier is then able to work on full capacity and thus save costs which can be passed back to the buyer in form of lower prices (Heikkilä and Cordon 2002, p. 186). Buyers can experience the same cost reduction results if they solely focus on specific operations and outsource those whose capacity is too small. Last but not least, other drivers may lead to IT outsourcing. We will not further discuss those here as the aim of this section, showing that various drivers exist, has been reached. However, we want to mention them in order to emphasize that an overwhelming number of drivers can be identified in the literature. Among those are, for instance, scarcity of capital, lack of know-how, flexibility, time to market, and asset utilization (Heikkilä and Cordon 2002, pp. 185-186).

Having looked now at some ‘external’ and ‘internal’ drivers, it can be concluded that changes in the business environment affects organizations in a way that the latter need to outsource IT activities in order to maintain or re-gain competitiveness.

2. The history of IT outsourcing

The global IT outsourcing market has a considerable size, as it was shown in section 1.2. Its volume is expected to rise to over US-$ 200 bn in 2005 (Willcocks et al. 2004, p. 7). This section will now investigate what and when IT outsourcing started, as well as presenting its most significant milestones till this day.

Some mark the start of IT outsourcing to the foundation of Ross Perot's Electronic Data Systems (EDS) (Erber and Sayed-Ahmed 2005, p. 101), probably the first company that can truly be called a professional IT outsourcing provider. It started by handling various data processing services for Frito-Lay and Blue Cross & Blue Shield in the 1960s (Lacity and Hirschheim 1993, p. 74). The deals' sizes between EDS and its customers were, however, considerably low. This changed significantly in the late 1980s. Back then, IT outsourcing really took off with Eastman Kodak's decision to outsource the majority of its IT operations to IBM in 1989. For many, this first mega-deal marked the true starting point of IT outsourcing (Lacity et al. 1996, p. 13; Lacity and Willcocks 1998, p. 364; Hirschheim and Lacity 2000, p. 99). The importance of this deal is especially emphasized by Lacity and Hirschheim (1993 p. 76). They regard all following mega-deals in later times as "imitative behaviour" of Kodak's decision.

After Kodak's decision the way was paved for the rapid growth of IT outsourcing. It did not take long for other organizations, both private and public, to enter IT outsourcing relationships with external vendors. Among these have been, for instance, British Aerospace, British Petroleum, Canadian Post Office, Chase Manhattan Bank, Continental Airlines, Enron, General Dynamics, Inland Revenue, JP Morgan, Lufthansa, McDonell Douglas, South Australian Government, Swiss Bank, Xerox, or the Commonwealth Bank of Australia (Hirschheim and Lacity 2000, p. 99). This list of organizations shows as well that IT outsourcing was, soon after it took off, not limited to the US economy any more. It spread rather quickly across the globe and grew extensively in financial volume, too. As an example in this context, table 1 on the next page summarizes top IT outsourcing deals involving buyer and supplier organizations with different national backgrounds. It shows that IT outsourcing drives the division of work not just within but also between national economies.

Lead company	Client	Country	Sector	Value US-$
IBM	Cable & Wireless	UK/Ireland	Telecom	3 bn
TranSystems consortium: IDS, Cubic Corp., ICL and WS Atkins	London Transport	UK	Transport	1.6 bn
Siemens	National Savings	UK	Banking	1.5 bn
EDS	Banka di Roma	Italy	Banking	1.5 bn
Sema Group	Department of Social Services	UK	Local government	500 m
ICL	Department of Trade and Industry	UK	Government	330 m
FI Group	First Banking System, Bank of Scotland	UK	Banking	246 m
IBM	IS Consortium Caricentro	Italy	Banking	235 m
IBM	Equifax	UK	Business	220 m
Siemens	Passport Agency	UK	Government	220 m

Table 1: Top 10 IT outsourcing deals in Europe in 1998

Source: Kakabadse/Kakabadse 2000, p. 673.

What has changed soon after Kodak's outsourcing deal was not just the volume of IT outsourcing deals or its influence on other companies world-wide. What has changed, too, are the activities being transferred. In the 1960s, computers were bulky and expensive. Consequently, an internal provision often exceeded many companies' budgets, so they entered into contracts with service bureaus, system houses and other IT outsourcing vendors. The 1970s saw the rise of computer software. Companies started to increasingly rely on software, and standard application packages began to enter the market (Lee et al., 2003, pp. 84-85). Standard packages are, however, by definition, not customized to the sometimes very specific company needs. Software programmers were needed, but many organizations did not employ enough and the labour market supply was insufficient. Thus, contracts had to be signed with outsourcing providers who were able to program, implement, run and monitor software (Clott 2004, p. 157). Then, in the 1980s, IT started to be viewed by managers as a commodity, which led to an increase of outsourcing IT activities (Kakabadse and Kakabadse 2000, p. 677), or as Carr (2005, p. 68) refers to it, as a 'general-purpose technology' that can be purchased more cheaply on the market than being provided expensively in-house. Kodak's IT outsourcing decision in 1989 may be seen in line with this thinking. At this

time, IT outsourcing had already grown to a lucrative business and so the number of IT outsourcing providers rose and their level of expertise with it. These providers were soon able not just to provide contract programming or other highly specific services. They were able to provide the whole IT package for their customers at a quality and at a price that most companies could not match. This paved the way to *total solutions outsourcing* in the 1990s (Lee et al. 2003, p. 85). These aspects will be explained in detail in section 3.1 and 3.2.

As such, it can be concluded that IT outsourcing does not look back on a very long but very dynamic history, in which the activities being externalized changed immensely. The major milestones outlined here can be seen again in figure 4 below.

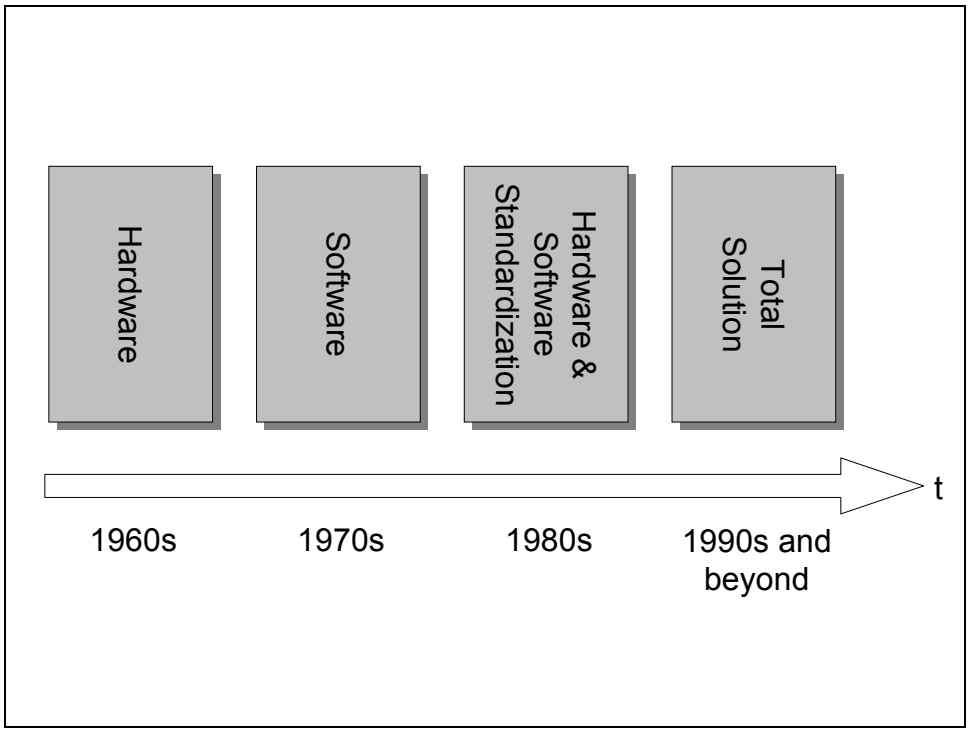

Figure 4: The timeline of outsourced IT activities

Source: Lee et al. 2003, p. 84.

3. The current and future trends of IT outsourcing

We have briefly outlined the history of IT outsourcing in the last section. Now, section 3 will build on these findings by looking more deeply into certain trends and by providing an outlook of the future. The authors are aware of the argument that more trends in IT outsourcing are discussed among academics, but will, however, given the dominance of certain trends in the literature, focus only on those, which seem to be particularly significant.

3.1 New IT outsourcing arrangements

IT outsourcing arrangements have changed quite dramatically over the last couple of years. While some organisations still follow the traditional path of conventional outsourcing, many have begun to use IT outsourcing as a strategic tool to complement missing internal capabilities, to exploit the full business potential of new technologies, and to even achieve partial or complete business transformation. This development will be described in section 3.1.1 first. Section 3.1.2 will then focus particularly on the effects of this trend on IT outsourcing relationships.

3.1.1 From conventional to strategic IT outsourcing – transforming business

In the early days of outsourcing, the focus was primarily on short-term cost reduction. Outsourcing was not much more than the traditional make-or-buy decision, i.e. the decision to provide certain goods or services internally or to purchase them on the market. This form of outsourcing is known as *conventional outsourcing*.

Limiting outsourcing to short-term cost cutting was then heavily criticised by several authors, especially from those, who followed the idea of *strategic outsourcing*. This idea has its roots in Quinn's and Hilmer's article of the same title in the Sloan Management Review in 1994, in which the two analysed how managers can achieve increased competitiveness and leverage their organisation's skills and resources.

The main message was that managers should concentrate their scarce resources on the company's core competencies and strategically outsource activities which are of no critical strategic need. It was argued that companies too often just consider short-term cost reduction benefits of outsourcing, instead of decreasing long-term capital investments through strategic outsourcing.

Strategic outsourcing gained additional momentum after benchmarking Japanese with Western production and supply systems. Analysing this outsourcing paradigm shift, Kakabadse and Kakabadse speak of a "westernisation of the *kieretsu* model" (Kakabadse and Kakabadse 2000, p. 670) and capture several aspects of the new outsourcing paradigm. In addition to the above mentioned strategic benefits, they find an increasing focus on flatter organisational structures as well as strategic re-positioning and higher value-creation to be new strategic outsourcing drivers (Kakabadse and Kakabadse 2000, pp. 708-715).

Despite these possibilities to achieve sustainable competitive advantage and business improvement through strategic outsourcing, it has to be said that strategic outsourcing is not overwhelmingly pursued. Various studies show that for the majority of organisations the main driver behind outsourcing decisions is still the focus on short-term cost reductions. Nevertheless, even these conventional cost considerations "have also been escalated to strategic levels of decision consideration" (Kakabadse and Kakabadse 2000, p. 673).

Instead of achieving more efficiency of just one single function at a time, outsourcing is now employed to redesign complete business processes and increase value across the whole value-chain. The so-called *business process outsourcing* (BPO) has turned out to be one of the most significant business trends and largest IT growth sectors in the last few years (Willcocks et al. 2004, p. 7).

A step that goes even further than BPO, and a term which has recently repeatedly appeared in literature, is *transformational outsourcing*. An emerging practice, transformational outsourcing aims to facilitate major and rapid organisational change, to enable the launch of new strategies and to reshape organisational boundaries (Linder 2004a, p. 52). Transformational outsourcing should be considered for radical

renewal of critical processes and functions as well as for achieving crucial improvements in under-performing activities, for communicating and executing organisational change or for being able to pioneer new products and innovations to markets rapidly (Linder 2004b, pp. 26-29). Accordingly, transformational outsourcing can be considered a further development of the strategic outsourcing idea.

Having briefly outlined the shift from conventional to strategic respectively transformational outsourcing in general, we will now explain how this shift has changed the field of IT in particular.

Traditional considerations of IT outsourcing view IT components as an extensive overhead cost burden. In most organisations IT activities were just seen as non-core commodities and not critical for business success for a long time (Hirschheim et al. 2004, pp. 104-105). IT outsourcing was therefore more common in industries where IT did not constitute a core competence and competitive advantage (Lacity and Willcocks 2001, pp. 314-315). With the growing importance of information and communication technologies though, many organisations have realized the critical role that IT nowadays plays for business success and the potential it carries to achieve strategic goals (DiRomualdo and Gurbaxani 1998, p. 69). As IT now pervades nearly all business functions and activities of the value-chain, it cannot be regarded as a commodity any longer, but must be managed as a strategic driver that can generate long-term benefits and create sustainable competitive advantage (Zhu et al. 2001, p. 373). Hormozi et al. (2003, p. 19) write: “IT is a strategic resource if it differentiates the positioning of an organisation and adds business value”.

This increasingly strategic importance that IT has gained for many organisations has given IT outsourcing a new direction. The focus here has also, as already described above, shifted from outsourcing IT in order to reduce costs, to forms were strategically sourcing out IT creates competitive advantage and fully exploits benefits of IT (DiRomualdo and Gurbaxani 1998, pp. 67-68). Emphasis has moved from contracting out IT hardware and IT facilities towards intellectual based forms of outsourcing, to complement missing internal capabilities and skills, to realize possible benefits of new IT, and to gain access to knowledge and innovation of “best of breed” suppliers (DiRomualdo and Gurbaxani 1998, pp. 68-71; Quinn 1999, p. 9; Quinn

2000, pp. 13-14). In such an approach, IT outsourcing also plays the role of a 'technology catalyst' to strengthen resources and flexibility, to focus organisational direction, and to re-focus business-critical activities, while the outsourcing provider supports routine IT operations (Lacity and Willcocks 2001, p. 317; Willcocks et al. 2004, p. 10). Strategic IT outsourcing is also implemented in a way to either break through radical innovations or to "innovate processes, skills and technology, while mediating financial risk to achieve competitive advantage" (Lacity and Willcocks 2001, p. 318).

In their research, DiRomualdo and Gurbaxani (1998, pp. 67-79) found three strategic intents for IT outsourcing, which go beyond the conventional cost reduction and efficiency improvement objectives:

1. *Information system improvement* ultimately aims to transform IT resources and skills to improve existing IT systems through accessing external capabilities – especially as the maturing IT outsourcing market offers more sophisticated solutions.

2. *Strategic business impact* is applied to achieve critical improvement of business performance by better aligning IT to business processes and objectives.

3. *Commercial exploitation* "aims to improve the return on IT investment by generating new revenue and profit or by offsetting costs" (DiRomualdo and Gurbaxani 1998, p. 76).

In addition, in an environment of growing global competition and increasing uncertainty, strategically outsourcing IT can enhance flexibility in a rapidly changing marketplace and act as a differentiator to competition. To offer such a strategic advantage over competitors though, "outsourcing must be a distinctive feature of specific firms in an industry" (Quélin and Duhamel 2003, p. 648). Otherwise firms in the same industry which select outsourcing as a solution would reduce or eliminate their competitive advantage. On another level, IT outsourcing is increasingly used to add or augment business value through re-shaping organisational boundaries and business transformation (Kakabadse and Kakabadse 2000, p. 709).

On the basis of what has been said so far, it can be concluded that the general shift in outsourcing has spilled over to the field of IT outsourcing. This shift has led to a further development of IT outsourcing towards an increasing strategic orientation offering enhanced competitive advantage. However, before ending this section, we think it is important to say that realizing the potentials strategic IT outsourcing seems to offer is by no means an easy task. For instance, the traditional view as well as the strategic perspective on IT outsourcing both argue to keep core activities in-house and source out those which are non-core to business. But already the basic task of defining what is core, non-core or core-close often imposes barriers on the outsourcing decision. Hence, the major challenge of strategic IT outsourcing is to determine which activities actually constitute the strategic advantage over competitors.

3.1.2 From buyer-supplier relationships to strategic partnerships

The changing structure of the IT outsourcing market and the continuously developing business models have had a significant influence on the type of outsourcing relationships. For example, many organisations have outsourced their customer relationship management services, which are highly sensitive sources of competitive advantage and require providers who know how to handle such services. In particular, the growing complexity of IT and of IT outsourcing processes, as well as increasingly sophisticated customers, require a different approach to establishing and managing IT outsourcing relationships. While traditional short-term arm's length contracts will continue to exist, various new forms of outsourcing arrangements have emerged, depending on the nature of the product exchange or the competitive situation in the market place. The leveraging of IT outsourcing to a strategic, transformational level and the various types of such new "configurational arrangements" (Kakabadse and Kakabadse 2000, p. 683) of IT outsourcing require different, more advanced forms of organisational arrangements and alliances, such as multiple vendor contracts, joint ventures or shared services. DiRomualdo and Gurbaxani (1998, p. 68) write that organisations which are outsourcing IT for strategic, not tactical benefits "are pursuing entirely new roles for IT outsourcing and pioneering new paths for IT outsourcing relationships". Emphasis has shifted towards

closer interaction between outsourcer and provider as organisations engage in network partnerships with multiple suppliers, each of which is best-in-class for the respective outsourced function and where one vendor often takes on the role as the coordinating prime contractor (DiRomualdo and Gurbaxani 1998, pp. 70, 71; Kakabadse and Kakabadse 2000, p. 677; Lacity and Willcocks 2001, p. 3).

The focus of this 'new' form of outsourcing lies on long-term strategic partnerships and alliances where risks[2] and rewards are shared, and where vendors can expect long-term revenues and are thus willing to invest in innovation, which will in the end benefit the client (Hirschheim et al. 2004, p. 106). Such alliances must be in line with the strategic intent of the outsourcing arrangement (DiRomualdo and Gurbaxani 1998, p. 69) and require trust, integrity and credibility for success (Hormozi et al. 2003, p. 19). Hence, the quality aspect of such relationships and their successful management has been gaining increased attention in literature and practice for some time now (Kakabadse and Kakabadse 2000, p. 683). Quinn (2000, p. 13) adds in this context: "Strategic management of outsourcing is perhaps the most powerful tool in management". To some extent, these partnerships could be seen as a compromise between vertical integration and market exchange. On the other hand though, real partnerships are not just a mixture between those two extremes, but are characterized by closer, more intimate bonds (Mohr and Spekman 1994, p. 140). They are "a relatively new concept of how relationships (...) can be formed, such that the relationship itself, and especially the trust engendered within it, effectively substitute for the ownership of assets" (Slack and Lewis 2001, p. 180) and can be defined as "purposive strategic relationships between independent firms who share compatible goals, strive for mutual benefit, and acknowledge a high level of mutual interdependence". These new types of relationships are an investment which tie outsourcer and provider together and determine a fit which makes it more beneficial to stay with this partner than to continuously having to establish new connections (Mohr and Spekman 1994, p. 135). Building such collaborative arrangements not only facilitates investment and innovation or accelerates critical reaction time, but enables rapid organisational change that can lead to competitive advantage as shown in figure 5 on the next page.

[2] On IT outsourcing risks see, for example, Earl 1996, pp. 26-32.

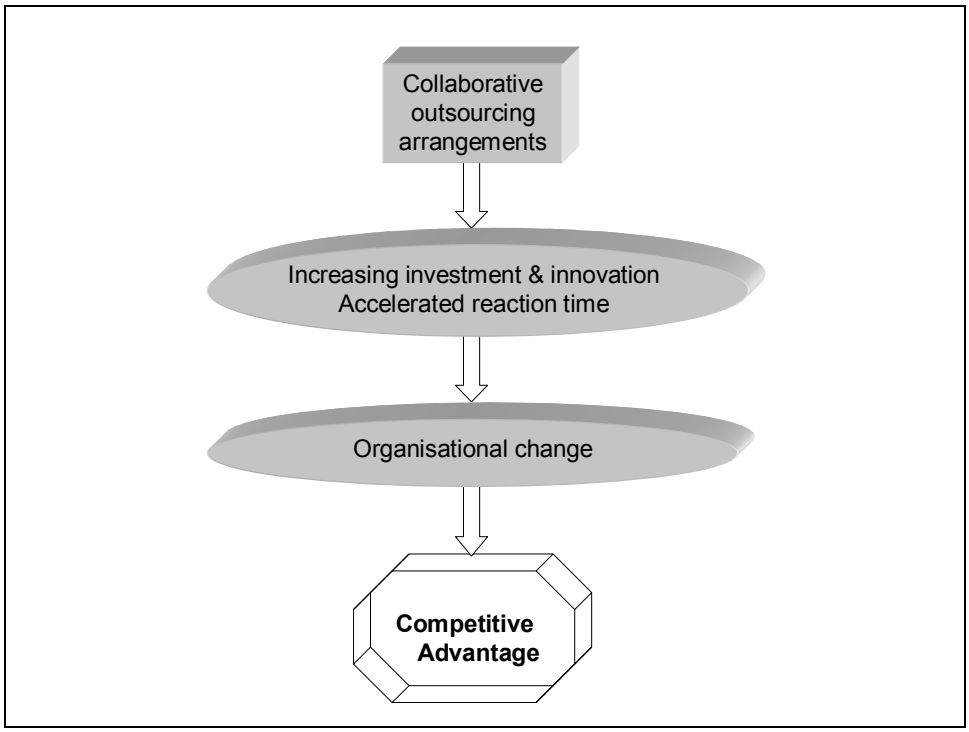

Figure 5: Achieving competitive advantage through collaboration

Source: Own figure.

In reality though, many outsourcing partnerships are not successful. As results of a study conducted by Dun & Bradstreet in 2000 show, 20% to 25% of outsourcing deals fail[3] within the first two years, 50% within five years (Jackson et al. 2001, p. 2). Only few enterprises have been able to strategically outsource IT to drive radical change and business transformation (Linder 2004b, p. 26). A statement made in a study on IT outsourcing even says: "In large enterprises the so-called strategic outsourcing is only strategic for the outsourcer" (Frühbrodt 2003). According to a research paper by Görg and Hanley (2004, p. 2), there does not even tend to be clear evidence of a value-enhancing link between outsourcing and profitability.[4] Other recent studies reveal that higher vertical integration is normally connected with a higher rate of return and that business value is not determined by decreasing capital, but by effective production (Wildemann 2005, p. 20).

[3] It has to be taken into consideration though that "failure" can be defined or interpreted differently, e.g. when having to switch to another provider, if certain objectives have not been achieved.

[4] In a study of outsourcing of services and non-service inputs, Görzig and Stephan find a negative relationship between profitability and outsourced services for a sample of German manufacturing firms (Görzig and Stephan 2002 as mentioned in Görg and Hanley 2004, p. 2).

Reasons for failure of (IT) outsourcing relationships can be manifold (Logan 2000, p. 21). For one, IT outsourcing, strategic or not, cannot be handled as other make-or-buy decisions. IT comprises a broad range of activities and is continuously evolving and accordingly cannot be easily assigned to providers (Lacity et al. 1996, p. 16). On the other hand, and especially in strategic IT outsourcing, the shift towards long-term collaborative partnerships requires a different set of capabilities in the outsourcing as well as in the provider organisation. Outsourcer, for example, must have the role IT plays for their businesses aligned with their strategic objectives, whereas providers need the capabilities to understand their customer's business and to respond flexibly to their needs. Both partners though must possess the ability to manage the partnership actively and continuously. The absence of this ability is still one of the main reasons for unsuccessful outsourcing arrangements (Jackson et al. 2001, p. 2).

One central problem of most buyer-supplier relationships is that the two parties have different perceptions and attitudes towards the partner (Spekman and Salmond 1992, p. 2). Often this becomes evident in unaligned goals and the unwillingness to share risks and rewards. Logan (2000, p. 21) states in this context: "The question is no longer whether outsourcing makes strategic or financial sense, but how to develop mutually beneficial relationships".

In conclusion it can be said that although the ability to manage and sustain strategic outsourcing partnerships is regarded increasingly critical to competitive advantage in numerous articles, the majority of companies does not seem to be even close to developing the necessary way of thinking to successfully manage such relationships in practice. Hence, the challenge will be to close the gap between the theoretical advantages and the practical barriers many companies seem to face.

3.3 From domestic IT outsourcing to international IT outsourcing

As it was discussed in section 2, the first big IT outsourcing deals were signed in the late 1980s between companies that were doing business within the same national economy. Later on, a shift has started from pure domestic towards international buyer-supplier relationships. Examples of such international IT outsourcing

relationships were shown in figure 1. They can be regarded as the result of the emergence of professional IT outsourcing providers in other countries (e.g. Germany's Siemens Business Services) on the one side and as the result of a growing world-wide demand for such IT outsourcing services on the other. What is important here is that both parties, the outsourcing company and the external provider, had been from developed economies only. Now, a new trend emerges, which is called *offshoring*. It is a sub-form of *international outsourcing* and generally refers to transferring activities to third parties located in low cost countries (Schaaf 2004a, p. 3, Venkatraman 2004, p. 14, Erber and Sayed-Ahmed 2005, p. 100)[5]. In the context of IT outsourcing, two main offshoring types can be distinguished, which are shown in figure 6 below.

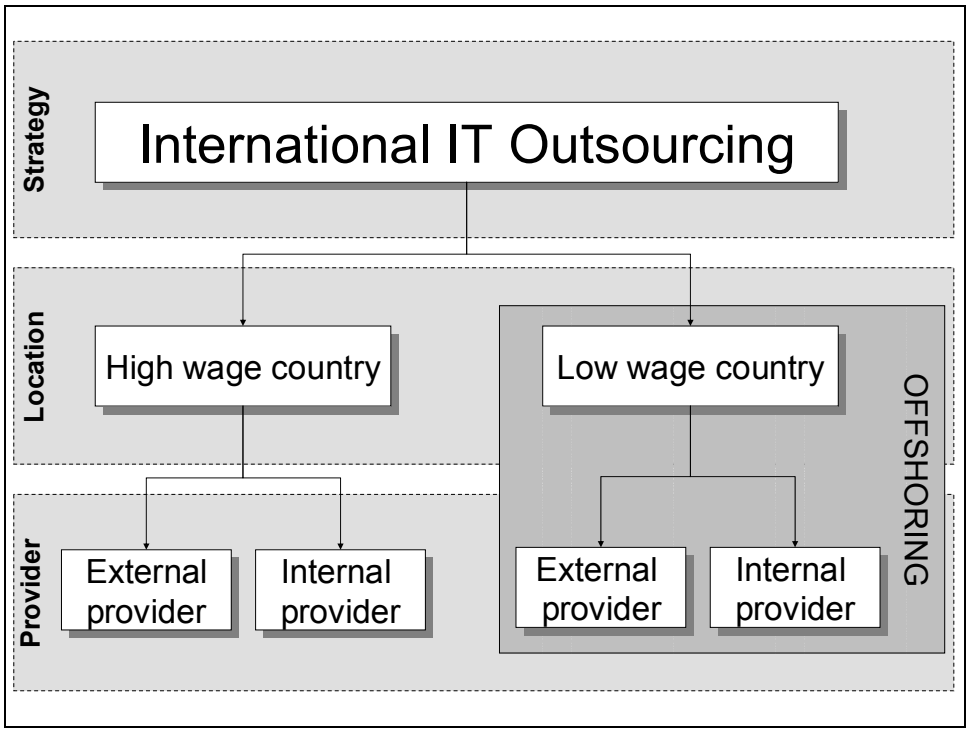

Figure 6: The connection of international IT outsourcing with IT offshoring

Source: Own exhibit.

The first main type of IT offshoring involves external IT providers. This strategy is also known as *offshore outsourcing* (Schaaf 2004a, p. 3). Although IT offshoring is

[5] It has to be said though that the low cost aspect is not the only criterion that qualifies a country as a preferred offshoring location. For instance, Singapore is among the top offshoring locations despite its high cost structure, see A.T. Kearney 2004, p. 2. However, wide agreement exist that the low cost aspect is the dominant decision criterion for most offshoring operations.

generally relatively new, offshore outsourcing is perhaps its latest phenomenon. This strategy was not possible to be pursued in the past, simply because there were no providers in low cost economies offering high quality IT services. It can be assumed that especially skill and infrastructure deficits were main obstacles hampering their emergence. Due to political and economic changes the situation has changed enormously. Especially India has become a leading IT service nation and a preferred offshoring location (e.g. India is ranked no. 1 in the 2004 offshore location attractiveness index by A.T. Kearney). Responsible for this success story are IT outsourcing providers such as Infosys, Wipro and TCS, which offer state-of-the-art services. They now establish themselves in the world market, compete in an increasingly successful way with the traditional players in this industry, and are important factors driving India's IT offshoring volume (see for an overview of the top Indian IT outsourcing providers Deloitte & Touch 2003, pp. 13-18).

The second main offshoring type does not involve external parties. Here, IT provision responsibilities are transferred to units being part of the organization. This offshoring type is known as *captive offshoring* (Schaaf 2004a, p. 3). It is the control aspect in particular that distinguishes captive offshoring from offshore outsourcing. The extent of control over own units is generally much higher than over external vendors.

Captive offshoring is currently the dominant offshoring strategy. It accounts for two-thirds of total global outsourcing volume (Schaaf 2004a, p. 3) and 61.4% of 572 companies asked in a recent survey prefer it to all other offshoring types (Schaaf and Weber 2005, p. 11). As such, it seems that the advantages linked to control currently outweigh the benefits offered by external IT specialists. It should be said though that the dominance of captive IT offshoring can also be explained by a much longer tradition of this strategy. IBM for example established captive IT units in India already decades ago. German companies as well can look back on a longer tradition in the Indian market, although they have only begun recently to expand their captive IT operations there. Especially SAP is hiring IT specialists for their software development centres. More of these centres are planned to be established in other offshoring countries such as Hungary (Anonymous 2005, p. 11).

Which offshoring strategy will dominate IT outsourcing in the future is difficult to predict. However, what seems to be sure is that IT offshoring in general will most likely expand extensively in the future. Improvements in local IT infrastructure, low wages and well-qualified local personnel in emerging countries such as India or China lay the foundation for its growing importance. Consequently, IT offshoring has the potential to be tomorrow's dominant IT outsourcing strategy.

4. Conclusion and Outlook

"Why should every automaker, publisher or doctor's office have to be a tech company, too, employing high-paid staff who spend all their time, fiddling around with computers?"[6]

Despite increasingly negative reports in the popular press on outsourcing and the difficulty to establish a link between outsourcing and profitability, the majority of studies on IT outsourcing still evidence this area future growth and a growing interest from top management as a priority issue. While the statement above constitutes a general view on IT outsourcing, the reasons why organisations engage in IT outsourcing and the different forms it can take are manifold. Having reviewed various different articles and studies on outsourcing in general and IT outsourcing in particular, it has become clear that there cannot be a "one-size-fits-all" solution for such arrangements but rather a variety of approaches, each of which is suited for the organisation's individual situation at that particular moment.

IT outsourcing has been no recent phenomenon. It has been continuously developing over time – in particular from tactical to strategic forms and from domestic to international outsourcing arrangements – and organisations will continue to consider IT outsourcing as a viable strategy for achieving short-term as well as long-term strategic goals. Especially, growing environmental uncertainty and extremely competitive markets have forced organisations to re-think their operating strategies about how to improve their position in the value-chain. This has shifted emphasis from a cost reduction focus to improving overall business performance through strategically outsourcing IT. To achieve such objectives, and as IT now increasingly "penetrates to the core of operations" (Lacity and Willcocks 2001, p. 248), many organisations have begun to realise that this strategic direction requires the need to co-operate with suppliers as well as aligning objectives and value-chains. In particular, as IT outsourcing has become increasingly value- and knowledge-based, it is crucial to integrate service providers into the overall corporate business plan and to build mutually beneficial partnerships. This not only requires an understanding of how

[6] Larry Ellison of Oracle, quoted in King 2004, p. 83.

IT is interconnected within the organisation, but also what the actual problems are, and how business processes work before they can be handed over to suppliers.

It has been mentioned that the management of such partnerships is still a main reason for failure of outsourcing arrangements. With the growing popularity of IT offshoring, it becomes even more important for outsourcing as well as for provider organisations to learn to establish and manage such partnerships, and to trust each other – even across national borders. Thus, further research in these areas is needed.

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