

# The trouble with outsourcing

*by*

Joshua Gans

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Consider a firm that has decided that major change in structure is in order and it will outsource one of its own functional divisions. In doing this, it faces a number of key choices; not the least of which is whether to outsource to an established firm or create a new entity.

Consider General Electric. Faced with a declining market share, in 1983, it considered outsourcing its production of microwave ovens. Having considered outsourcing to a competitor -- Matsushita -- it ended up outsourcing to a new entrant in microwaves -- Samsung. GE had decided that dealing with a competitor was too risk and so choose the independent firm. Ironically, Samsung is today itself a market leader in microwaves.

On the one hand, GE's choice appears to make lots of sense. After all, when it outsources, it becomes a consumer and consumers prefer competition. By giving a new entrant a leg up, GE appeared to minimise its costs over the long-term.

But there is another factor at work: GE did not just outsource but engaged in an asset sale. Its facilities, employees and capabilities in the production would all be traded to a new owner. One has to ask: would a new entrant pay more than an established firm for those assets?

As a basic matter of economics, the answer is no. A new entrant will pay an amount that reflects the profits it will earn as a competitor. An established firm will pay, not only to gain the assets, but also on the basis of the profits that come from a reduction in competition. As anyone (including the ACCC) will tell you, industry profits are higher when there is less competition, so an established firm will pay more.

So, firms like GE face a trade-off: sell to an established firm and maximise the value of the outsourced assets or create a new entrant and obtain lower input prices over the long-haul.

According to recent research by myself and a Melbourne Business School colleague -- Associate Professor Catherine de Fontenay -- how the trade-off resolves depends on what type of outsourcing contract will emerge following the sale. If it is one where you pay a simple per unit price on an equal basis to all of the outsourced firm's customers, then the reduction in competition will really raise your unit production costs. The costs of this are far worse than any gain that comes from higher asset valuation.

In contrast, if you can negotiate more elaborate pricing contracts, likely on a different basis than other firms, then the on-going costs of lower competition are higher payments for outsourcing but no increase in your unit production costs. That is a cheaper option and in that case, it is better to go with an established firm who will pay more for your assets.

Of course, I haven't mentioned issues regarding whether a new entrant has the capabilities to do the job or an established firm might relax in supplying a quality product if relieved of competitive pressure. Those will also play a role. But also important is the precise nature of the future

outsourcing contract. Short-term changes in firm structure, without regard to on-going management issues, are unlikely to be a good idea.

*Joshua Gans is Professor of Management (Information Economics) at Melbourne Business School, University of Melbourne, and an active researcher on competition and outsourcing issues using the tools of game theory. Details of his work are available at [www.economics.com.au](http://www.economics.com.au).*