

INTERNATIONAL OUTSOURCING: INCENTIVES, BENEFITS AND RISKS FOR THE COMPANIES IN SEE COUNTRIES

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Abstract:

Outsourcing is promoted as one of the most powerful trends in modern management. The rationale for outsourcing some functions and/or processes includes substantial financial economies, increased ability to focus on strategic issues, access to technology and specialized expertise, and an ability to demand measurable and improved service levels.

This paper considers a range of core issues related to the establishment of outsourcing partnerships with the participation of companies from South Eastern Europe. Special emphasis is put on the incentives, benefits and risks associated with the realization of outsourcing partnerships with vendor companies from SEE transition countries. Strategic outsourcing as a main type of such a partnership helps firms to align their competitiveness priorities, to focus management attention on long-term growth and innovation opportunities, and to target resources to those tasks firms do best. Some evidence is suggested implying that international outsourcing generally has a positive impact on the organizational performance and competitiveness enforcement in the companies within the region.

Keywords: outsourcing, strategic outsourcing, organizational performance, South East Europe.

Outsourcing is a particular type of international trade. We are used to trade in goods, but trade in services has expanded recently, made possible in large part by advances in telecommunications. Like all forms of international trade, outsourcing benefits an economy overall, though there are also short-term costs as workers are displaced.

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Council of Economic Advisors of the U.S. President

Introduction

Outsourcing has been growing both domestically and internationally during the recent years. Contemporary highly competitive environment in which today's businesses operate acts as a strong stimulus for firms to outsource. In addition, economic globalization facilitates the process of searching for opportunities on the open global market to outsource some of firms' activities instead of performing them on their own.

The role of outsourcing practices in the process of economic globalization is clearly outlined by the leading international consulting companies. Particular emphasis is put on the strengthening of the position of South East European countries as attractive sites for outsourcing of business processes. In fact, most of the new EU member states have already received investments for accomplishment of outsourcing projects. In the same time, there are still investors from large multinational companies that reveal serious interest in this respect.

It is commonly agreed in economic theory that when intermediate inputs are imported from foreign suppliers this is a form of international outsourcing, versus the national one if purchased from domestic suppliers (Egger & Falkinger, 2006). An outsourcing practice can be characterized as having high level of mobility – it can easily be attracted in a country but in the same time it can leave the country as much quickly. In a modern economy however

almost every investment is associated with risks. Currently, some reallocation of activities of large multinational companies is observed from Central to Eastern Europe (e.g. production lines are transferred from Hungary, Czech Republic, Poland to Slovakia, Romania, Bulgaria, Ukraine, including whole stream lines that were considered as much less mobile than activities in services). This process occurs in a highly competitive environment for foreign investments attraction and stimulation in the global economic environment. Thus, companies aiming in outsourcing of business processes and services are targeting in the most efficient alternatives for organizing their business activities. The transition countries in South East Europe /SEE/ definitely possess a substantial potential for high cost efficiency and development of such kind of international business cooperation.

The growth of outsourcing and its importance for SEE domestic economies development deserve some more comprehensive consideration. The expectation is that outsourcing leads to long-term benefits in respect of increasing competitiveness of subcontracting companies due to positive technological spillovers. It is particularly valid for business organizations in SEE countries regarding their attempt to rationalize their processes as well as their restructuring.

This paper considers some issues related to outsourcing partnerships between foreign companies (outsourcers) and companies from SEE transition countries (vendors) in relation with the typical ways they are conceived and implemented. Special emphasis is put on the incentives, benefits and risks associated with the realization of outsourcing partnerships in some vendor companies. The strategic dimension of outsourcing as a main feature of such a partnership helps firms to align their competitiveness priorities, to focus management attention on growth and innovation opportunities, and to target resources to those tasks that firms do best.

SEE transition countries have comparatively well-educated populations and in the same time low local wage level which provides them with a comparative advantage to attract outsourcing partners within enlarged Europe. However, these countries need more focused and effective public policies in order to utilize the most of these global market opportunities.

Literature review

Outsourcing is not a new phenomenon in the world managerial practice but still rapidly develops establishing the beginning of a new stage of international division of labor. Although there is no common agreement on the term, outsourcing generally refers to the procuring of material inputs or services by a firm from “sources outside the firm”. Outsourcing becomes a business practice through which the organization provides itself the possibility to mobilize its scarce time and financial resources and direct them to the development of *its core competitive characteristics*, in the same time achieving better results from its outsourced (secondary) business processes.

Outsourcing is promoted as one of the most powerful trends in modern management. The rationale for outsourcing some functions and/or processes includes substantial financial economies, increased ability to focus on strategic issues, access to technology and specialized expertise, and an ability to demand measurable and improved service levels. Outsourcing differs from alliances, partnerships or joint ventures in that the flow of resources is one-way, from the vendor to the outsourcer; typically, profit sharing or mutual contribution are not a common practice (Belcourt, 2006).

Production relocation and offshore outsourcing of jobs in manufacturing sectors have been occurring for decades in the world economy. Recently, along with the rapid technological development, investments in ICT infrastructure, ongoing trade liberalization in many service sectors and the availability of low-wage suppliers of skilled labor (like the new EU member states), outsourcing of services and particularly ICT-based business services (e.g.

customer relations, back-office, and other professional services) has substantially expanded (Bergen, 2004). In some sense, services outsourcing is qualitatively different from material outsourcing due to the easiness of border-crossing using new communication technologies such as the Internet.

In the international literature (both theoretical and empirical) numerous publications can be found on material inputs outsourcing, however, there is very little on the issues of services outsourcing. Mann (2004) focuses on the IT sector in the US arguing that the globalization, specifically international outsourcing of IT hardware, led to a fall of 10 to 30% in IT hardware prices which induced an increase in productivity in all sectors that use such hardware. International outsourcing of services had a positive impact on productivity in the electronics industry in Ireland between 1990 and 1995 (Gorg and Hanley, 2003); positive evidence of services outsourcing on labor productivity in the UK between 1980 and 1992 was also found (Girma and Gorg, 2003). Various studies on services outsourcing and employment effects have been conducted, e.g. McKinsey Global Institute's report (2003) – it attempts to predict job losses due to outsourcing for 2003-2015 evaluating the distribution of gains between the country that does the outsourcing and the one that receives the outsourcing.

Incentives, benefits, and risks of outsourcing

Various authors outline as a key drivers of international outsourcing the *cost savings incentive* and *globalization*. This process invokes a range of societal problems like job losses in the developed countries, although some authors consider also a variety of beneficial implications of outsourcing. For example, managerial analysis in large companies (like Procter & Gamble and General Motors) led to the decision to outsource substantial elements of their IT services (Beulen et.al., 2005). A variety of key reasons for an organization to outsource can be found in the literature, e.g. financial savings, strategic focus, access to advanced technology, improved service levels, access to specialized expertise, and organizational politics (Belcourt, 2006).

There is no doubt that the main reason for the outsourcing decision is *costs reduction*. Organizations find that costs can be cut down by outsourcing of one or more business processes. An additional motive is to provide for a more flexible cost control. Foreign companies – e.g. clients of an outsourced service – have an option to react more adequate in case that the vendor makes attempts to overcharge them.

A typical example for SEE countries is IT outsourcing targeted in cost reduction. It usually concerns software development operations performed by highly specialized personnel located in this low-cost environment. This efficiency effect implies a lower price of outsourcer's product which provides a better market positioning of the company.

Strategic dimension is however not less important in outsourcing decision making, since outsourcers acknowledge that they are not able to pursue supremacy in all internal business processes. On this basis, they strategically orient to focusing on the improvement of their core competences (e.g. customer service refinement and technological innovations) and transfer some of their secondary functions, such as back office, help desk, telemarketing, etc., to vendors who develop these functions *as their core competences*.

By outsourcing non-core processes the managers expect to provide conditions to focus on higher value-added functions. Finally, the essential sources of competitive advantages are not the products themselves but the managerial capabilities to strengthen and to combine skills and technology into competences for adaptation to changing business environment. For example, the core competence of companies like Nike and Benetton is the product design and they practice outsourcing in respect of most of the other business processes.

The improvement of service quality is identified to be another important benefit of international outsourcing. Contemporary product standards can be put in the outsourcing

contract in a more precise way. The managers of the outsourcer companies could search for the best quality vendors that show outstanding performance indicators, have higher flexibility in their business processes. For example, when using a service provider whose focus is service, outsourcers see substantial improvement in flexibility, response, and performance, especially when a competition between potential vendors occurs (Belcourt, 2006).

Ultimately, the price level and quality of service appear to be key factors in gaining competitive advantages, i.e. the main concern of outsourcing vendors in SEE is to meet as high as possible standards with the lowest possible prices achieving global competitiveness. In pursue of such a strategic goal, outsourcing activities are feasible when allocated in countries providing favorable economical and social conditions. In this respect, SEE countries are identified worldwide as attractive outsourcing destinations because of the effective combination of a cost-solution and high quality service.

The expansion of IT services outsourcing in SEE countries is enabled by the new information and communication technologies that allow effective operation of qualified international IT teams. The development of customers' web sites or overall information systems solutions is provided by high quality professional services at a reasonable price by SEE vendor companies quite lower than the costs in outsourcers' countries. For example, US companies hire foreign companies with IT expertise to execute labor-intensive software development projects gaining a possibility to focus the efforts of their own staff on the core competences and priorities, and in the same time to reduce the overall costs substantially.

The business model of international outsourcing however assumes also a range of **risks** which create some uncertainty in its operation. In most cases they are related to the potential problems in contracting that should reflect the possible changes in the partners' needs. But adequate changes in the contracts are not always feasible and the flexibility of altering the package of outsourced processes or their parameters might be quite low. Besides, in many cases it is likely that the vendor may become a competitor if acquired satisfactory managerial and technological know-how to enter the respective market.

A generalization of outsourcing risks leads to the overall process of its good management which assumes an initial comprehensive cost-benefit analysis. This analysis should provide decision-supporting information to justify the expectations that the vendor will perform satisfactory well and fast enough, and in the same time maintaining service quality levels and meeting legislative requirements. This makes the process of evaluating vendors critical regarding the selection of the most appropriate and potentially successful candidate.

Outsourcing of specific business processes, like IT services, reduces the organization's capability for creative organizational development. Thus, it might face a reduced competence to innovate through synergetic interactions. Besides, from its distance position the vendor could have a limited potential to acknowledge some specific needs of the outsourcer.

In order to protect their interests, each partner has to provide legal and technical experts to participate in the processes of contract negotiation. If there is a lack of enough expertise to guarantee performance standards, legal requirements, and payment terms, the contract provisions might favor one of the sides on the expense of the other. A risk emerges also in situations when the vendor (or the outsourcer) urges the execution of the service before the contract is signed under the promise for "taking care of the details later" – this allows for a possible deviation in the pricing that is initially not strictly negotiated (Belcourt, 2006).

Two other general types of risks originate from economic and political uncertainty in the vendor country. Economic risk reflects potential turbulence in inflation and exchange rates, a possibility of restriction in profits repatriation, taxation policy changes, etc. Political risk includes issues related to political instability, emergence of regional or international conflicts, a likelihood of changes in labor market regulations, environmental laws, regulation

of international business and trade, etc. In general, governments are capable to influence the extent and the form of foreign involvement through different forms of international outsourcing. They could impose various obstacles and barriers but in the same time could provide investment incentives by using a range of tax and fiscal instruments and subsidies (Graf & Mudabib, 2005).

Other two kinds of risks may arise in relation to business environmental reasons (e.g. changes in the broader business landscape) and behavioral reasons (e.g. unpredictable actions of the vendor). Any benefits derived from utilizing inexpensive but skilled labor of the vendors must outweigh the costs incurring with outsourcing transaction and sharing of control associated with such partnerships. In an extreme case, the realization of such risks can lead to ruining of the whole business agenda, substantial loss of control over important business processes, disruption of operations, and loss of functional focus (Kedia & Lahiri, 2007).

Having in mind the recent worldwide relocation of outsourcing processes it can be found that, along with the favorite outsourcing Asian destinations (e.g. India, China, the Philippines, Singapore and Malaysia), a range of Eastern European countries systematically improve their positions in the global outsourcing market. Countries like the Czech Republic, Slovakia, Bulgaria, and Romania are rapidly taking advance in respect of the escalation of „nearshoring” partnerships. This form expands mainly because of the relative proximity of CEEC to Western Europe and US business areas that are looking for a beneficial transfer of business processes to vendors from low labor cost countries that are closer than Asia. Particularly, SEE countries still offer low-cost and highly educated workforce combined with acceptable infrastructure, economic stability, geographic proximity and fewer security concerns.

The drivers in respect of risk sharing and flexibility have spurred the proliferation of strategic type of effective outsourcing partnerships. In the same time, it should be noted that a strict initial specification of the required performance level of the vendors in such partnerships is hardly achievable (Linder, 2004). Thus to achieve successful outsourcing partnership managers should go beyond the fragmentary negotiation and switch to long-term business models development.

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Evidence-based research in the field of international outsourcing involving SEE countries is still an under-explored area. It can provide potentially beneficial results oriented towards any flexible alternatives for solving intra-organizational problems (e.g. the improvement of internal business processes through acquisition of managerial know-how from developed business organizations having strategic interests in transferring their activities to vendor countries). Particularly, an assessment of the impact of outsourcing on the human resources development in both sides could be drawn in respect of the improvement of professional skills, labor specialization and business activities efficiency. This process assumes a stabilization of the tendency for the outsourcing to progress from *short-term managerial tactics* to *long-term strategic perspective*, on the basis of which strategic partnerships between domestic vendors and foreign outsourcers can be established.

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