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Article

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CESifo Forum

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Cronin, Bruce; Catchpowle, Lesley; Hall, David (2004) : Outsourcing, Offshoring - Outsourcing and Offshoring, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 05, Iss. 2, pp. 17-21

This Version is available at:

<https://hdl.handle.net/10419/166180>

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OUTSOURCING AND OFFSHORING

BRUCE CRONIN, LESLEY CATCHPOWLE
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The recent overseas outsourcing of a number of business services, such as call centres and accounts processing, has raised concerns about the future of an area of business activity in which the UK has been deemed to hold a competitive advantage. While the future direction of UK manufacturing may have been questionable, the abundance of skilled service workers has long been thought to provide the basis for a strong alternative range of businesses. But ICT developments have reduced the dependence of many tasks from any particular location and made possible the relocation of many service jobs from industrialized to developing countries that provide a suitable infrastructure, high skills labour market and labour cost benefits.

The great majority of work which is being offshored is in information technology (IT) and business process or call centre work (BPO). The providers of IT/BPO services include UK specialists, multinationals, and an emerging group of Indian companies. Interestingly, the Indian IT/BPO have not remained as local offshore providers but are becoming competitive multinationals in their own right, winning contracts directly in the UK and opening offices in the UK to supplement their Indian operations (Global News Wire 2002). Offshore capacity is also being developed in countries other than India, notably China, South Africa, Eastern Europe, Malaysia and the Philippines. IT/BPO service companies may rely on partnership arrangements, especially for BPO capacity in India (Air Transport Intelligence, 22 October 2003).

Nonetheless, the issues are not simply about saving costs. The emergence of the global knowledge company is said to have the potential to re-shape the relationship between the employer and employee in

the service sector in much the same way as manufacturing was altered in the mid-1980s (Sedley and White 2003). For developing countries, the benefits of accumulating competencies in relatively high-skilled work have been widely hailed, although a gender gap between male-dominated high-skill software jobs and female-dominated low-skill call centre work is evident and amidst rising wages for skilled work, India is being replaced by other third world countries as low cost destination (ILO 2001).

The promise

A useful starting point in discussing the potential of outsourcing and offshoring of business services is to consider why firms undertake activities locally and in-house at all. Nike epitomises such a standpoint, outsourcing its entire output to 900 contract manufacturers worldwide.¹ But even Nike still directly employs 23,000 staff and the case for directly administering core business activities is strong, centring on strategic and collaborative advantages.

The major motivation for in-house activities is to protect core product and process innovations. Locating core activities deep in-house can avoid encroachment from competitors, with proximity allowing for collaboration, closer monitoring and easy access to specialised resources and infrastructure (Marshall 1890, Richardson 1978, Krugman 1991, Saloner et al. 2002).

Against the benefits of in-housing, outsourcing offers the potential for reduced labour costs, efficiency through specialisation, and reduced agency costs:

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¹ Nike draws revenues of \$10.697 billion, directly employing 23,000 staff compared to an outsourced workforce of 660,000. Nike Inc., *Annual Report For the fiscal year ended May 31, 2003*.



- Because services are labour-intensive and staffing usually accounts for 65 percent of the cost of running IT departments and data centres (Simons 2003), the relocation of business processes to low labour cost centres is attractive. However, the interaction skills of providers are crucial to the quality of service provision.²
- Specialisation obtained through offshoring can increase efficiency beyond domestic outsourcing through economies of scale and learning gained from large volumes in international markets.³ However, the distinctiveness of each provision of a service reduces the scope for economies of scale and learning compared to those available in the more standardisable production of goods.
- Agency costs arise because it can be difficult to precisely identify the costs of activities carried out within the firm and to eliminate inefficiencies. Outsourcing can be attractive because the cost is clearly identified by the external contract (Besanko, Dranove, Shanley, and Schaefer 2004). However, it is difficult to measure the value of services in advance of provision and thus contract effectively for these.

Outsourcing offers the potential for reduced labour costs, efficiency through specialisation, and reduced agency costs

Each of these benefits is potentially enhanced by offshoring rather than domestic outsourcing. There are greater opportunities for lower-cost labour offshore, typically 20 percent of UK levels (Shennan and Bain 2003). The greater volumes in international markets increase the economies of scale of offshore providers. And the greater number of international competitors is likely to provide a greater variety of services available to be outsourced. Offshoring firms have cited total cost savings of as much as 65 percent (M2PressWire 2003).

Nevertheless, evidence shows that gains in enterprise performance only occur when new technology is combined with changes in work organisation – semi-autonomous, task-orientated teams with controls over quality and performance, plus greater flexibility

Table 1

Typology of offshoring and outsourcing

	UK	Abroad	Mixed
<i>Internal</i>	Insourcing	Inhouse ('Captive') offshoring	Locally Integrated Offshoring
<i>External</i>	Outsourcing	Outsourced offshoring	

in work patterns (World Employment Report, 2001). There are limitations here. Problems are encountered with flexibility and speed of delivery, due to practical implications of language, time difference, cultural subtleties, and the level of face to face interaction so often required to solve complex problems (Electronics Weekly, 17 September 2003).

Differing benefits

We found it useful to differentiate the potential benefits of outsourcing and offshoring in terms of the location and degree of control involved. Despite the often interchangeable usage of these terms, outsourcing and offshoring are two different dimensions. Firms may decide to offshore work that remains within the core company – this is sometimes known as “captive” offshoring. In other cases work is outsourced to a contractor and the contractor may carry out the work within the UK or offshore.

Some large companies have transferred business services from in-house UK operations to in-house operations offshore in India or elsewhere. GE Capital, part of the US multinational General Electric, set up its own in-house Business Process Outsourcing (BPO) division in India in 1993, which employs 12,000. In 1996, BA transferred 600 jobs from the UK to a newly created Indian subsidiary in India, World Network Services (WNS). HSBC is in the process of transferring 4,000 jobs from UK call centres to its Global Service Centres in India, China and Malaysia. In-house offshoring is likely to be more attractive where the issues of control and confidentiality matter and also where companies have existing operations in the chosen region, as is the case with HSBC.⁴ Most companies, however, use outsourced agents who then carry out all or part of the work offshore.

² Weak human resource management capabilities among out-sourcers has had a detrimental impact on service provision in NHS contracts. See Grinshaw, Vincent, and Wilmott (2002) pp. 475–502.

³ According to Adam Smith, the limit of specialisation is market demand. Firms will only develop specialist expertise and capacity when market demand for the specialist is sufficient to cover the cost of the investment. Thus, specialisation tends to deepen over time with market growth and as the cost of specialisation lowers, as with developments in information technology.

⁴ Even for companies setting up inhouse options, there are intermediate support agencies, such as venture capital firm Ariadne Capital which offers advice on “creating offshore subsidiaries”. http://www.ariadnecapital.com/journal/v3e1/portfolio_news_outsource.htm.

Yet UK companies are not faced with the simple alternatives of outsourcing to a purely Indian service company, or to a purely UK service company, what we call “locally integrated offshoring”. Most IT/BPO out-sourcers can offer a locational mix of capacity in both the UK and India (or elsewhere), which can combine the cost advantages of cheaper labour costs in India (or elsewhere) with the control advantages of a UK presence to interface with the client: “leveraging the cost effectiveness of our Indian delivery capability whilst providing clients with strong local support [in the UK]” (Xansa 2003). The mix offered on any specific contract is influenced or specified by the client. Three-quarters of the clients for IT services now request an offshore element, but public sector clients usually exclude any offshore component, considerations related to public concerns about the impact on employment and the role of public sector employment in regional development.

In these terms, different combinations of internal and external outsourcing and offshoring provide different sets of benefits. Firms seeking to enhance collaboration and customised offerings but still reduce costs are likely to retain much of their outsourcing and offshoring in-house. Firms more focused on general cost-cutting are likely to make more widespread use of external agents.

Our survey of 93 randomly selected large UK firms found 73 percent outsourcing significant components of their internal business services, and 20 percent offshoring these. Distinct results were found among outsourcers and offshorers. Offshoring is concentrated in precision manufacturing, computing, utilities and financial services. Research and Development and business research is a more frequent subject of offshoring than might be suggested from the business press. Further, this is often moved to high income, rather than low income locations, presumably in search of specific competences and productivity, rather than simply lowest cost.

While offshorers share with outsourcing firms an emphasis on price, innovation and investment in their business strategies, offshoring was more likely to emerge from established product and process offerings. Staff cost was a major motivator for offshoring but control, quality and efficiency are also significant considerations. Offshorers generally reported improvement in each area.

The costs of outsourcing and offshoring

Even with the major developments in ICT, coordinating geographically distributed activities is not without difficulty. Alongside more generalised concerns about job losses in developed countries, much of the controversy and uncertainty about current trends in offshoring concerns these coordination and related costs.

Drawing from established literature, our research identified five significant areas of cost in outsourcing and offshoring, including search costs, transition costs, coordination costs, exchange costs and capability losses.

- **Search costs** comprise the time and effort to discover the range of prices in the market. These costs are highest when price alone is insufficient to judge utility, as when product offerings are not standardised (Douma and Schreuder 1998). Since services cannot be standardised, only processes, they are particularly susceptible to these costs. Furthermore, the heterogeneous nature of service levels means transactions are uncertain. A rule of thumb for search costs in IT is between 1 and 10 percent of contract value (Overby 2003).⁵

Costs include those of search, transition, co-ordination, exchange, and strategic capabilities

⁵ Costs include documenting requirements, sending out RFPs and evaluating the responses, and negotiating a contract, and initial travel and hospitality. The process can take 6 months with due diligence.

Table 2

Differential benefits of outsourcing and offshoring

	<i>Local</i>	<i>Offshore</i>	<i>Local integrated offshore</i>
<i>Internal outsourcing</i>	Agency cost reduction Protection of proprietary information Collaboration Customised offering	Agency cost reduction Protection of proprietary information Labour cost reduction Customised offering	Agency cost reduction Protection of proprietary information Labour cost reduction Customised offering
<i>External outsourcing</i>	Agency cost reduction Specialisation efficiency	Agency cost reduction Specialisation efficiency	Agency cost reduction Specialisation efficiency Labour cost reduction Customised offering

Table 3

Differential costs of outsourcing and offshoring

	<i>Local</i>	<i>Offshore</i>	<i>Local integrated offshore</i>
<i>In-sourcing</i>	Option Loss +	Search Costs Transition Costs Coordination Costs Exchange Costs Proprietary Information Risk Reputation Risk Specific Asset Risk Infrastructure Loss Option Loss +	Search Costs Transition Costs Coordination Costs Exchange Costs Proprietary Information Risk Reputation Risk Specific Asset Risk Infrastructure Loss Option Loss +
<i>Out-sourcing</i>	Search Costs + Transition Costs + Coordination Costs + Exchange Costs + Proprietary Information Risk + Reputation Risk + Specific Asset Risk + Infrastructure Loss + Option Loss +	Search Costs ++ Transition Costs ++ Coordination Costs ++ Exchange Costs ++ Proprietary Information Risk ++ Reputation Risk ++ Specific Asset Risk ++ Infrastructure Loss + Option Loss +	Search Costs + Transition Costs Coordination Costs + Exchange Costs + Proprietary Information Risk + reputation risk Specific Asset Risk + Infrastructure Loss + Option Loss +

+ represent greater cost.

- **Transition** can also incur costs. Because the quality of service is important, the training and integration of the new providers is crucial, especially as costs are likely to be greater when encompassing different national business environments and national cultures. Furthermore, redundancy, reorganisation, retraining may have detrimental impacts on the remaining capabilities of the firm (Overby 2003). A rule of thumb in IT is that the costs of familiarising outsourcers with existing operations can cost 2 to 3 percent of contract costs, while redundancies and associated costs can add another 3 to 5 percent. Additionally, initial productivity shortfalls of 20 percent in the first two years of contracts have been experienced in IT (Overby 2003).
- **Co-ordinating** and integrating outsourced activities is also a cost, although the risk of disruption can be reduced by insuring against interruptions in supply, but this too is a cost. One Indian specialist offshore provider, Wipro Technologies, cites the cost of a sufficient telecommunications link for effective communication between a UK firm and an Indian operation at £70,000 per year (The Guardian, 25 September 2003, p. 18). Ongoing costs in specifying operational requirements of projects for IT outsourcers can account for 1 to 10 percent of contract price (Overby 2003).
- **Exchange** also poses a further cost. Enforcing the terms of exchange is particularly difficult in international transactions where international contract specifications are complex, or where the time between product despatch and delivery is long and the process often ambiguous (Hill 2003). In IT, ongoing contract management can account

for 6 to 10 percent of the total offshore contract price (Overby 2003).

- **Strategic capabilities** are the final set of costs. These include: the risk of *loss of proprietary information* to competitors – although the risk of loss can be reduced through detailed (and costly) contract specification; *dependence on specialised assets* specific to that transaction – there are costs or asset devaluation if these assets are used for other purposes (Williamson 1985), for example specific training and communication media associated with offshoring is not directly transferable to other processes; a *reduced infrastructural capacity* – for example once a business activity is outsourced, the technical expertise, infrastructure and knowledge to carry out that activity in house is eliminated or significantly reduced; and finally a firm has reduced options once having outsourced a business process. Retaining it in-house provides a degree of flexibility and protection in responding to future events (Johnstone 2002).

As with benefits, the impact of these costs will vary with location and degree of control involved. Many of these costs arise from the act of outsourcing, although search costs, transition costs and specific asset risk are likely to be particularly difficult for services because of ensuring quality of provision. Coordination costs are likely to be greatest for business processes that are more critical to other operations of the firm, whilst the options loss is universal.

Our survey found the management of offshoring involving a wider range of tasks than domestic outsourcing, with quite different priorities. For firms,

As with benefits, the effect of costs differ with location and degree of control

offshoring services, management of expatriate activities, infrastructure provision, transition and labour relations issues are of major concern. The costs of these management activities are significantly greater for firms offshoring than outsourcing services, particularly monitoring and transition costs. Offshoring firms encounter a much greater range of difficulties than outsourcing or in-housing firms, with government relations, contract negotiation and intellectual property rights being most problematic.

Conclusion

Our study of offshoring by UK firms found a much more limited and considered uptake of the practice than could be expected from media coverage of the issue.

This highlights the persistent theme evident in earlier work on ICT adoption in general. Only a small group of UK firms appear to have the capacity to tackle the potential of the new technologies to effectively utilise the creative competences of their workforce. Offshoring predominantly involves firms seeking to tap geographically distributed competences and are prepared to invest in the transition, monitoring and coordination necessary to do this.

Outside this group, few firms appear to have a vision of the strategic potential available from this route, with discussion focusing simply on the possibility to reduce operating costs. It is not surprising, then, that, when faced with some of the operating difficulties involved in offshoring, most firms are reluctant to explore this.

This underpins the emerging form of offshoring that we have labelled "locally integrated offshoring". Firms are able to vary the domestic/offshore mix through external agents according to short-term contingencies. While this is an ideal option for a cost-minimisation focus, it provides only limited ability to build internal synergies and develop distributed competencies. As with IT in general, UK firms are clearly still grappling with a limited understanding of the business potential of the new technologies.

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