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OUTSOURCING – A THEORETICAL VIEWPOINT

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ABSTRACT

Outsourcing or offshoring as it is now known has been around for many decades. In the beginning, it was only very peripheral activities that were outsourced, i.e. blue-collar (lower skilled) work but this is now all changing with the outsourcing of white-collar jobs. The digital revolution, the falling costs of transport and telecom costs and the opening up of the global economy helped the outsourcing market. For companies going down or contemplating the road of outsourcing there are both potential benefits and challenges, for example, the type of outsourcing they want to get involved in, and the country they want to outsource to.

Outsourcing can potentially happen anywhere in the world where the costs are lower and the quality higher. The main places that have been used for outsourcing have been India, China, Ireland, South-East Asia, Russia, Mexico and the Czech Republic.

The research currently underway is initially focusing on a literature review of current outsourcing applications in the market place. From this literature review, a questionnaire is being developed to assess the impact Outsourcing has on businesses. This research focuses on the Irish Market place.

KEYWORDS: Outsourcing, benefits, disadvantages

1. INTRODUCTION

In recent times, there has been a rapid increase in the international competition in almost all industries and markets. These changes have been brought about by a number of factors, including:

The rapidly changing differences between industrialised nations

New entrants have the skills to benefit from the experiences of others, and can adopt to the fast changing environments with little cost

Diminishing trade barriers, resulting in the free trade of goods and services from overseas being readily available

Ireland, as with other Western European manufacturing countries, is currently experiencing a change in the way that customers and suppliers relate. Manufacturing has becoming increasingly demand driven since the late 1970's, where the customer specifies their need and suppliers do their best to deliver a satisfactory solution. Increasingly firms that traditionally manufactured their own products are outsourcing production, and instead focusing on the companys' core competencies. Thus, the use of outsourcing is becoming more important, and is growing significantly in a range of industries, including electronics, pharmaceutical, medical devices, and automotive.

1.1 Evolution of Outsourcing

In the simplest of forms, outsourcing takes place when an organisation transfers the ownership of a service or function that used to be done in-house to a supplier. The degree of transfer of control is the defining characteristic of outsourcing.

Outsourcing or offshoring as it is now known has been around for many decades. In the beginning, it was only very peripheral activities mainly done by the blue-collar or lower skilled workers in the organisation. However, with the rising costs of wages and the increasing use of robots for automation purposes those jobs would have been lost anyway. Now, the fear of many skilled workers or managers is that their jobs are going to be outsourced as the global economy has opened up, and the cost of communication and transport is relatively cheap.

Historically outsourcing was used when organisations could not perform to world-class excellence in all sectors of the organisation due to many factors including: incompetence of staff and/or management, lack of capacity within the organisation, financial pressures, or technological pressures. However, nowadays, "adequate is no longer good enough, if a company cannot stand shoulder to should with the world's best in a competitive category, it has no place to stand at all."[1]

Outsourcing in its most basic of forms started from the basis of a single service such as canteen management, building management or computing. In the 1960's and 1970's, organisational diversification was "all the rage", organisations were trying to spread their options and hedge their bets against downturns in their core activities and also involved the "outsourcing" of slightly more complex functions like facilities management [2]. As this was dying out the "dominant force in the seller-customer relationship was changing forever, sellers no longer had the upper hand, and dictated to the customer, customers now told the supplier what they wanted, and when they wanted it. These and other changes created many problems within the organisation including: inflexibility, unresponsiveness, the absence of a customer focus, lack of innovativeness, and high overheads [1].

The recession in the 1980's did not help either and to overcome the recession organisations started to focus on core activities where they had long established experiences and had built up a body of expertise so they could reduce costs. It was also in the 1980's that the term "outsourcing" was coined as a function to describe the growing trend of large organisations transferring their IS systems to third party suppliers [2].

At the beginning of the 1990's, the market for outsourcing was developing at a very fast pace but was still immature. This was the time when many organisations were considering or entering into a significant degree of outsourcing for the first time. The outsourcing market has been growing rapidly since the early 1990's and experts [3] estimate that it will continue to grow by more than 15% per annum until the end of 2009.

Now, outsourcing is used to allow companies to build on core competencies and recognise that serving the customer is critical to the organisation "Anything that distracts us from this focus will be considered for outsourcing" [4].

2. TYPES OF OUTSOURCING

Outsourcing can be applied to most functions and services within the organisation, but what an individual company outsources depends on the core competencies, core activities, and critical functions within the organisation.

According to the literature [4], there are two main types of outsourcing. Total outsourcing is where companies outsource all the activities within the selected function or service within the company. The other type is selective outsourcing. This can be done in four separate and distinct levels; individual, functional, process and component levels.

Other types of outsourcing that are used but not as widely as the total outsourcing and selective outsourcing are co-sourcing where the client company keeps responsibility for the management and strategic aspects of the outsourced activity while the outsourced provider supplies consultancy service and often experienced personnel to help keep the business streamlined [2]. In other words, the responsibility of the outsourced service or function is held within the organisation. In addition, insourcing is the outsourcing of your work to other countries but instead of transferring all the responsibility to the outsourcing company your own company sets-up, staff and run the business there, except with much lower costs [5]. It can help overcome the problems of skill shortage particularly in the areas of project management and technical work. A major advantage of the Insourcing option is that because the suppliers are inside the organisation, they are living with their client and because they are attending company meetings, they understand the business inside and out. In addition, it is claimed that forty-one percent of ITO users intend to insource some components of their IT systems [6]. This is because they fear a loss of IT control.

3. OUTSOURCING COUNTRIES

Outsourcing can happen anywhere in the world where the costs maybe lower and the quality higher. The main places that have been used for outsourcing have been India, China, Ireland, South-East Asia, Russia, Mexico and the Czech Republic.

India is one of the most closed economies [18] but in saying that it has the second largest economy in Asia and the fifth largest economy in the world and is growing at a rate of seven percent per annum. Outsourcing is the “vanguard” that is helping turn India from a closed economy to an open one. India like China has a large educated population and graduates large numbers of science and engineering every year, which suits outsourcing, and English is widely spoken.

At present China has the sixth largest economy in the world and it is expected that in 2006 it will overtake the economies of the UK and France. China has been said to have labour costs from between $1/10^{th}$ to $1/30^{th}$ that of Ireland’s per capita ratio, with areas such as Shanghai and Shenzhen approximately five times that of the other areas [7]. However, even with the dramatic decrease in wages China still has a long way to come if it is to be really considered a safe place to outsource to. Problems in China range from IP, with an unreliable transport system that is expensive and often shipments “go missing”. Employers struggle to find and keep bilingual staff, and the ports and rail system are often clogged up by massive demands for imports. Traditional Chinese companies do not possess the depth of management capability that is required in this cutthroat environment. However, English is not widely spoken in China making communications very difficult. In addition, the Chinese culture is completely different to ours and Chinese companies take a long time to complete a deal and include excessive bureaucracy.

Ireland has been used for the last fifteen years as an outsourcing location for U.S. corporations. This is mainly because we are located relatively close to the U.S. (only a six hour plane journey from the East coast of America) and the language, infrastructure, and the culture, and the work ethic is quite similar [8]. In addition, there is plenty of overlap between the business hours of both countries. Ireland also has the lowest tax rate in Western Europe of only 12.5% (ref. Fig 1).

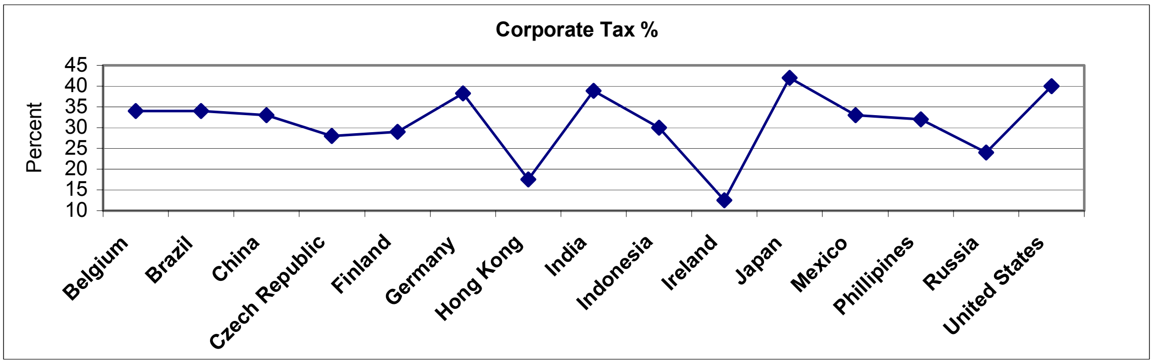

Fig 1: Corporate tax rates around the globe [9]

4. BENEFITS OF OUTSOURCING

There are many benefits that can be obtained to an organisation as a result of outsourcing, however, these depend on whether the company goes about the outsourcing project in the appropriate manner and if they are willing to put the time and effort into helping their staff overcome the problems they may encounter as their jobs change and evolve. Outsourcing has helped to open up the global market as outsourcing organisations take advantage of regional labour markets and reduce operating costs.

The benefits can be separated into two distinct areas obvious benefits and hidden benefits. The obvious ones are those that hit the bottom line of the company's financial sheet at the end of the month. These can include but are not limited to; lower prices, better quality goods and/or services, and a wider selection of products and services

Hidden benefits may include suppliers providing technical skills and ideas that might not have been able to develop in-house, and extending the scope of customer services. Probably the most important hidden benefit is that because as companies become more profitable and flexible "this protects many existing jobs and allows companies to invest additional money in the next-generation technologies and business ideas that will create the jobs of the future" [19]. It can also help to eliminate the barriers that were created between different departments within an organisation and allows for the merging of estranged departments.

With Europe suffering from a rapidly aging population, outsourcing can be used a way to make up for the dwindling workforce [18]. An inexpensive labour pool cuts the costs of application development, when outsourcing is relocated in a country where labour costs are lower and long-term development costs thus counteracting this problem.

In another vein, outsourcers claim that moving jobs overseas is good for the economy. They [15] base this revelation on the fact that they believe that when jobs are sent over to poorer countries like India or China, those countries become richer and more developed, and they in turn demand more of goods and services from countries in Western Europe and America, in other words an increase in purchases. This leads to better competition within organisations.

5. OUTSOURCING CHALLENGES

The main challenge for outsourcing is the fact that the starting point for every outsourcing project is different as are the offshore country, cultural, business, legal, and financial requirement.

Wages in some parts of the world have risen by up to fifteen percent and these increases have led to decreases in other sectors of the economy. In addition, the high growth rate in offshoring has created a shortage of highly skilled workers in Russia– predicted to be 20% excess demand over supply in 2008 [16]. Russia is failing to provide the high levels of skilled workers because of the gradual deterioration of their higher education due to insufficient funds and China an established powerhouse in the manufacturing sector, but has yet to replicate that success in the services sector [16].

Another problem is that outsourcing decisions are usually huge and affect the whole business organisation for a long time and thus need to be correct. The contracts tend to be between five and ten years in duration and to be successful, they requires the client to see the vendor's side of the equation. Problems with these include the fact that the contracts are impossible to describe, they change over time, and they need to be negotiated. Thus they may leave the organisation dependant on the supplier, and the termination of the contract may not be an option. Fixed service levels and incentives can become antiquated over time and the cost of an outsourcing mistake can be significant and almost impossible to reverse. Switching vendors can be complicated (if not impossible) and expensive.

Organisations sometimes do not take into account the hidden costs, such as the cost of vendor searching and contracting, and contract management and post outsourcing re-iteration. This can culminate in less than expected results leaving both sides disillusioned.

In Western Europe, rigid labour and product markets, coupled with persistent unemployment and anaemic job growth could deprive its economies much of the upside of outsourcing. These result in western European countries like Germany getting less indirect economic value from redeploying workers whose jobs are outsourced [19]. In Ireland, IT professionals are more expensive than in other nations.

In addition, companies can lose key members of staff leading to a loss of knowledge, loss of experience and exposure as the company may not know the answers as key personnel are no longer there. They may lose the responsiveness or flexibility within the organisation and lower the morale in an already "jittery" and mistrusting workforce [17].

Companies may inadvertently outsource a core competency of a company and hence, the company can surrender future opportunities for competitive advantage and the related profit, without recognising its loss, from which the company will struggle to recover [4].

Even if a company overcomes the problems that can arise it may not be able to overcome the risks. These can involve issues with staff in terms of loyalty, rewards and overall costs.

The risks can be categorised into three main categories [4]: 1. Risks inherent in any project (Lack of management commitment, Employee's reacting negatively to the initiative, Employees resistant to change, IP and Security.) 2. General risks that would be present in most outsourcing projects (Project managers and members that are inappropriately chosen, the outsourcing initiative's scope not clearly articulated, the appropriate methodology not chosen or followed, poorly constructed RFP so that responses are not responsive or comparable and the level of dependence on the supplier). And finally, 3. Specific risks that would confront the specific organisation, people, resources, and providers involved.

6. REASONS FOR FAILURE

According to the literature, failure of an outsourcing project is usually due to performance issues or financial issues that were not dealt with in the contract [20]. The outsourcing contract can fail for numerous reasons. The main one of these is contract failure, organisations underbidding for the project and the outsourcer expecting over and above what they have paid for. Moreover, the organisations definition to failure in the outsourcing project can mean many things. These include the failure of the outsourcing project to satisfy all of the tasks that were outlined in the proposal, the lack of clear performance measures before and after the outsourcing project takes place so the organisation cannot accurately gauge what benefits the project has accrued. [20]

Failure can relate to management taking a short term focus with no focus on the long term success of the project or the business, poor communication including the failure to keep staff and the other relevant people fully informed about what's going on, inadequate service levels, no benchmarking, the failure to recognise risk, and insufficient resources, frequently companies do not make plans or budget for sufficient resources to manage their outsourcing deals. In addition, lack of management discipline focus on both sides of the outsourcing deal and with the business changes and the scope of the services becoming greyer this culminates in chaos. [21], [22]

Lack of measurable goals can lead to organisations believing that they are on the correct track but they maybe losing money. In older companies, proper metrics were often lacking. Because the duration of the project is quite long term there is always the fear that the supplier will be taken over by another company and although the company must continue to provide the service, their style may not suit your organisation and it is only if the supplier fail to deliver under the terms of the contract is one able to terminate the contract. [20], [21]

7. NEXT STEPS

The methodology used was quantitative survey to gather the practical reality of what happens in companies and following these three case studies in order to get an in-depth insight into the benefits/challenges of outsourcing. In order to carry out the survey a research question and research hypothesis were formed. The research question is: What are the critical success/failure factors in relation to outsourcing from an Irish Perspective and what impact do they have on Business Performance? And, from this the overall hypothesis to be tested was formed which is: "Outsourcing has a positive affect on the overall business performance in an Irish context" with the following objectives:

1. To find out the types of outsourcing Irish companies are involved in.
2. Is there a correlation between what medium to large sized companies are outsourcing as compared to SME's?
3. What were the benefits companies experienced as a result of outsourcing? Were they the same as the benefits companies expected?
4. Were the problems experienced by companies more pronounced for SME's than medium to large sized enterprises?

8. CONCLUSIONS

In order to decide what to outsource the company should decide what they “absolutely” should keep in-house if they were to start from scratch and outsource, in other words to, “identify which parts of the company constitute the corporate crown jewels” [3]. In general for a company to be successful with outsourcing, the outsourcing function or service should have no face-to-face customer servicing requirements, high information contact, a work process that is telecommutable and Internet enabled, and finally have (if possible) a high wage differential with a similar occupation with the offshore company.

For companies to overcome the challenges associated with outsourcing they must go about the process in the correct manner. Most experts say that a company should spend 80% of their time planning the project and the other 20% executing the plan if it is to be a success.

If gone about in the correct manner with the right planning and execution, the company can reap the benefits of lower wages, higher quality, and access to new markets, which in turn will improve profitability, and as a result can only be good for the finances of the company.

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