

Service Offshoring – Concepts, Benefits and Risks

CLAUDIA SIMONE VIEIRA
PUC-SP

LEONARDO LOPES
PUC-SP

Abstract: Offshoring has two different concepts that one of them is part of an outsourcing and another that independently of the services to be supplied by the own company or external provider what is important to highlight is that services will be provided from a foreign country. In this paper we present a theoretical review on the concepts of offshoring and its implications, benefits and issues for the parties involved in the process. In other words, the key elements that should be analyzed when making the decision to offshore considering the location, benefits and risks.

Key-words: Offshoring. Benefits. Risks. Concepts.

Serviços de Offshoring – Conceitos, Benefícios e Riscos

Resumo: Offshoring tem dois conceitos diferentes: um deles é a parte de terceirização, e outro é independente dos serviços a serem fornecidos pela própria empresa ou por provedor externo, sendo importante destacar que esses serviços serão prestados a partir de um país estrangeiro. Neste artigo, apresentamos uma revisão teórica sobre os conceitos de offshoring e suas implicações, benefícios e problemas para as partes envolvidas no processo. Em outras palavras, os elementos-chave que devem ser analisados quando tomar uma decisão considerando a localização, os benefícios e os riscos para uma offshore.

Palavras-chave: Offshoring. Benefícios. Riscos. Conceitos.

INTRODUCTION

The main aim of this paper is to analyze the service offshoring from the business perspective. To achieve this aim, the paper will be based on theoretical models emphasizing the scope of the service to be provided outside the home country and the factors a company needs to consider when making a decision to offshore. The article will follow the structure review of theoretical concepts about offshoring and its lines of thought. Then it will look at the pros and cons of offshoring by analyzing the drivers, the selection of the location and the benefits for both parties (the company deciding to offshore and the country or the subsidiary providing the service) involved in the process.

The concept of offshoring is contradictory when we turn to the literature review, where there are two lines of thought. One defines offshoring as a service being provided from the foreign country in order to attend the service demand. According to Murtha, Kenney, and Massini (2009), “[o]ffshoring refers to the process by which companies undertake activities at some offshore locations instead of their countries of origin”. Besides that, “offshoring” encompasses activities both internal and external to the firm for the purpose of serving home country or global markets. Therefore, services are provided from another country, that is, vendor or subsidiary may provide services to the original country.

The other line of thought, classifies offshoring as being a part of an outsourcing. In this case, it is necessary to define outsourcing as that it involves contracting with an external provider for the provision of a service which may have been provided using in-house staff. According to Sangeeta and Bhushan (2010), “[t]his shift in Information Technology Outsourcing (ITO) to overseas locations began to be called ‘offshore outsourcing’ or simply ‘offshoring’”. After analyzing the information about services and international trading it was realized that World Trading Organization (WTO, 2008) considers “offshoring” as a subcategory of “outsourcing”, as included in its reports. That’s why, as mentioned above, outsourcing is an essential element when offshoring.

One of the purposes of offshoring is to transfer services from one country to another country and that implies an analysis of what the cons and pros for that are. Therefore, an analysis should be done in order to review the potential savings, benefits and risks which are part of the process of maintaining the services in country or transferring them to another foreign location (GUPTA, 2008). The cost of a transaction is associated with the selected foreign country, plus monitoring the work of this providing country.

THEORETICAL CONCEPTS

The term offshoring according to this theory includes international activities that can be an outsourcing or an

insourcing (foreign affiliates) since the activities are performed abroad as in figure 1.

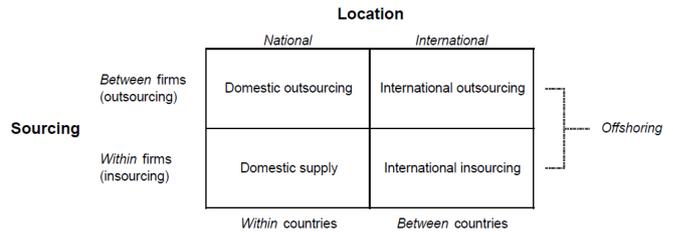


Figure 1: Offshoring, Outsourcing and Insourcing
 Source: Olsen (2006)

As observed in figure 1, the offshoring does not need to be part of a process of outsourcing but activities that are performed by a foreign country either by an external provider or subsidiaries (OLSEN, 2006). The term outsourcing refers to services that can be provided by external suppliers establishing a business relationship between the contractor and the supplier company. In other words, outsourcing involves contracting with an external provider for the provision of a service which may have been provided using in-house staff and insourcing refers to activities executed by the firm or its affiliates.

On the other hand, there is another theory that mentions that offshoring is part of the outsourcing process (WTO, 2008) as seen in the figure 2.

		Located in home economy	Located abroad
Shifting Intra-firm inputs/suppliers to	Non-affiliated firm	local/domestic/ Onshore outsourcing	offshore outsourcing = offshoring
	Affiliated firm	captive onshore outsourcing	captive offshore outsourcing = captive offshoring

Figure 2: Type of Outsourcing
 Source: WTO (2008) adapted from OECD (2007)

In this article, as a common definition, it is considered that offshoring is to provide a service abroad either by the firm or by affiliates (also known as captive centers) or by an external provider. It is also interesting to analyze agency and transaction cost theories applied to offshoring as follows:

Agency theory: is based on the tradeoff between company’s objectives and individual’s interests.

Bounded rationality and self-serving behavior or opportunism of a firm’s employees can imply productivity losses. As such, conflicting goals and interests between the firm and its employees may pose a problem to the firm. To reduce inefficiencies stemming from this source the firm can outsource its activities to an external provider and control the output or effort of the provider through an outcome based contract (OLSEN, 2006).

Transaction theory: according to Zhonghua and Brocklehurst, the major question is the ‘make-or-buy’ decision, which means, should a firm carry out an activity in-house be outsourced? and is based on that companies are profitable when there is a cost minimization.

However, is also to keep in mind that “the decision to distribute and locate an offshored task also depends on the differences in production costs at various sites, as well as a variety of social, political, and regulatory contingencies” (KUMAR; FENEMA; GLINOW, 2009).

DRIVERS

Reasons for the offshoring: according to Di Gregorio, Musteen and Thomas (2009), there are some reasons for offshore outsourcing for small and medium enterprises such as: a) efficiency and cost reduction (labor, transport, travel, others); b) availability and flexibility resources; c) access and capabilities from abroad; d) relationship with strategic partner; e) knowledge transfer to and from foreign country (subsidiary or other provider). There are also other points to consider as economic factors; quality of professionals; payment due to demand; mitigate technological obsolescence in-house and following the sun which means work period 24 hours per day.

Another point is that the companies are looking for locations that could provide the services globally in centralized way, that is, they could do standard services for any country. Furthermore, the “IT offshoring has been driven primarily by the executives’ desire to lower operational costs” (CARMEL; TIJA, 2005). The “pricing pressure for basic IT services and call centers maintenance pushed the industry into low wage countries” (LANGERLING; ROMAN, 2005).

LOCATION

The choice of the location that should provide services is an important element in the offshoring process. It should involve an analysis of the infrastructure (for example telecommunication and power supplier), labor, education, quality, language, multi cultures, legal conditions, political and government regulations, socio-economic aspects as an attraction factor for offshoring (JOSHI; MUDIGONDA, 2008). Moreover, for cases that a new delivery center shall be built from scratch, the initial setup costs such as infrastructure setup, trips, knowledge transfer, transition period (from the in house the country abroad), wages, and government regulation should be seriously evaluated.

Dunning mentions that it is needed to explore the location advantages for low wage labor, for instance. On the other hand, Berry (2009) suggests analyzing different aspects of the location such as labor (cost, availability and quality). It means, to verify not only the cost of maintaining the professionals

with salary, benefits, government regulation and other taxes and fees but also the availability and quality of the resources. Moreover, how much the offshoring is possible to increase in synchronism with the demand and obtain skilled labor in a timely manner. He also alerts to the fact that business analysis that covers economy, regulatory environment and how much a location is opened to new requirements and flexible in order to attend the customer from other parties of the world.

It is important to take into account that a site location for the offshoring is crucial for making the right decision in that direction. When selecting a country to provide the services, it demands effort from many people that are abroad: supplier, skill transfer, languages, time zone, different cultures and so on and so forth. If there is a wrong decision, probably there will be an extra cost in order to solve the problem and may jeopardize the business. It should consider investments in that initiative and to do a deep study for that location. According to Joshi and Mudigonda, “the issue of selection of a target country for offshoring services is critical for the success of an organization’s offshoring initiative”.

In figure 3, we propose a pyramid with the main reasons to evaluate a location. On the bottom of it, as most of the studies show, the primary reason for offshoring is a cost reduction (ABRAHAM; TAYLOR, 1996; CARMEL; TIJA, 2005). This should include the overall costs incurred (labor, infrastructure, overhead, and so on). The next item to be evaluated is whether the aimed country has the required language skills. This evaluation should take into consideration whether there is a pool of available resources with this capability. An example is that, the major differential of India is the domain of English language in providing services to English-spoken countries.

The next level to be analyzed is the quality of the infrastructure (telecommunication, Information Technology, facilities, energy and transportation). These three reasons are the most important in the analysis when deciding a location. Issues in any of them may exclude the aimed location as a potential site. Finally, at the top of the pyramid, there is “Other Factors” such as different cultures and government regulations. As seen in figure 3, on the bottom of the pyramid the decision is made based on low cost, and up to the top it there is an evolution in line language skills, infrastructure and others (education, culture, legal regulations, government, etc).

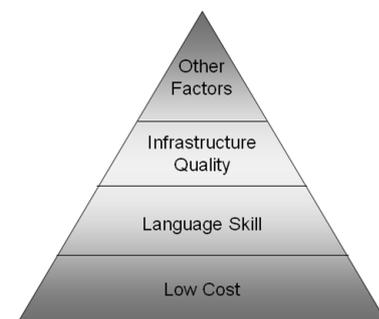


Figure 3 – Location Evaluation

Source: Authors

BENEFITS

Offshoring can be a way to review the organization's processes and procedures, to make adjustments on those and to attend the demand faster in line with the business growth. Also, to maintain or acquire competitive advantage against competitors from any place in the world is another worth of it.

a) Saving Costs - it implies to have a cost reduction for the services that are provided from a different country instead of the home country that demands the business process or function. One of the elements that compose the cost is the labor. There are cases that the migration of the services from home country to another is the cost of the labor. For instance, Call Centers have been migrated from the USA to India because the labor is cheaper. IT professionals outside the USA and other developed countries usually receive less salary for the same job (GUPTA, 2008).

In line with this thought, these savings improve the domestic company's competitiveness and reduce the costs for their products and consequently for their customer. There are indirect costs that can be realized in the savings for example social security, medical, government taxes and fees, reduce inflation rates, new source of knowledge (OVUM, 2007).

However, it implies that there could be a loss of jobs in the country that is buying services from foreign country (WTO, 2008). In the other hand, there is a benefit for the country that is providing the services because their employment rate increases.

In figure 4, as observed the savings when comparing offshoring against onshore and the elements that take part in the process such labor, legal, travel and telecommunication.

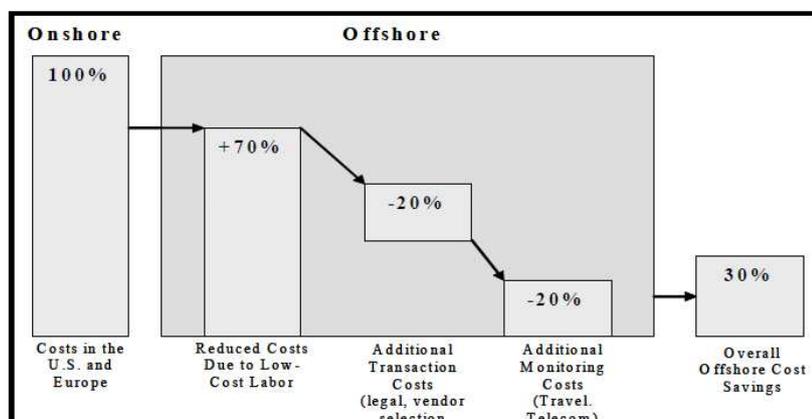


Figure 4: Offshoring operations savings

Source: (Robinson and Kalakota, 2004, apud Gião; Oliveira, 2009)

b) International Experience - it has been demonstrated that international background and language capabilities are important resources for enhancing the competitiveness (DI

GREGORIO; MUSTEEN; THOMAS, 2009). Companies shall find easier to offshore part or the entire process and operations, rather than develop them at home (KENNEY; MASSINI; MURTHA, 2009).

c) Economies of Scale - when comparing the unit price, the provider that has a large number of units, usually it has a unit price lower than other provider. When consolidating the services in a hub, in this case, out of home country it is possible to have this benefit. Further, according to Abraham and Taylor (1996), "a decision to contract out may not reflect labor market or industrial relations considerations at all, but rather the existence of scale economies accruing to specialized providers of particular services". This is applicable for offshore outsourcing.

RISKS

The most important of the offshore risks is the country risk. Offshoring is about working in developing or emerging countries, which have historically been more volatile, less stable, less predictable, and less transparent. Offshoring work exposes the company to a myriad of issues in the host country.

One of the concerns of a company that makes offshoring outsourcing is the loss of control and ownership of intellectual capital, also known as "the transfer of knowledge that exists in the form of 'know-how'" (GUPTA; GOVINDARAJAN, 2000). Additionally, loss of knowledge over time by the provider or even by the company may happen. There is more division and transfer of knowledge between the company and its affiliate or other providers.

There are few legal concerns that should be considered in the analysis such as employment rights, export services, data transfer, infrastructure, culture, government regulations, taxes and fees, intellectual property and currency conversion.

Misunderstanding or miscommunication between the customer and the remote provider causes frustration, mistakes, confusion or even though dissatisfaction (AVISON; BANKS, 2008). According to Krishna (2004), the challenges are of different nature such as cultural, behavior and language.

Another point that should be taken into account is regarding to interdependence among activities that involves much communication, control and effort in order to keep in touch every stakeholder of the process. In this case, there is a possibility of breakdown or lack of communication between the major parties when the activities are located around the world in long distances and additionally depends

on the differences among the parties when transferring and sharing information and activities. In this case, offshoring that involves different cultures and technical background is

really a challenge to build trust among the people (KELLY; NOONAN, 2008). It implies that it should have a mutual respect and confidence between the services receiver and provider and it usually takes time.

Many of the advantages of the offshoring could be lost due to cultural differences or misinterpretations and misperceptions among customers, providers, interlocutors and others (KOTLARSKY; OSHRI, 2008). Additionally, offshoring eliminates jobs in the home country what may cause social issues for the local community and affect the local companies (OVUM, 2007).

There are local risks such as political, natural disaster, operational, currency, infrastructure availability and skills (BERRY, 2006). In this case, it is necessary to consider political stability if the country has wars, terrorist attacks, political system (democracy, dictatorship, etc) that could interfere in the business, also natural disaster that jeopardizes the services, instable currency that affects the cash flow and the availability of technical resources based on the demand.

Moreover, there are myths and insights about offshoring as showed in table 1 as follows:

Table 1: Offshoring Myth and Insight

MYTH	INSIGHT
At the end of the day, outsourcing is all about cost reduction.	Labor arbitrage is giving way to talent access as the primary driver of next-generation offshoring.
Offshoring inevitably leads to large scale job loss in the originating country	Offshoring high-skilled functions create – rather than replace – jobs.
Offshore “hot spots” can’t stay competitive as wages climb.	The competitiveness of traditional offshoring markets is strong and sustainable.
Companies don’t offshore because political and other external risks are too high.	The obstacles to offshoring are increasingly internal.

Source: NASSCOM (2007)

In order to keep under control a service and mitigate many of the risks related to offshoring (mainly offshore outsourcing), the company - acquiring the service - must focus on its responsibility for the network and in a rigorous process of auditing, prevention, inspection and training as a way to keep the accountability of a service that is not part of the organization (FUNG; FUNG; WIND, 2008).

CALL CENTER

A very common example of offshoring is what has been done with Call Centers. Mainly in USA, there is a demand

for offshoring to other low cost countries because cost taking out. An example is the call center that is migrating from the USA to India, where the call takers speak English and the salaries are lower than the USA. Consequently, offshoring is presenting growth in various foreign countries and representing significant parcel of employment rate in those countries. The location of a call center could be said as virtual because it does not matter where it is and the customer has no idea from where the attendance is, what is important is the answer and the support.

Besides, India is known as having a large pool of English-speaking people coming from the universities and every year thousands of students are available to work with low salaries (SOOD, 2005).

According to Hall, everything you do, every word you say, every expression you make— whether painting a portrait, building your first house, or even making a facial expression—is a reflection of your culture, your values, and beliefs as molded by your surroundings.

FINAL CONSIDERATIONS

There are key success factors for offshoring such as understanding the company’s needs and business, partnership between the teams (in house, supplier or subsidiary), effective communication, overcome the challenges of cultural barriers, oversight control, strategy and development of synergy. Offshoring is an advantage for companies that work overseas because they can research low cost, buy services according to their demands, engagement remotely teams around the world and when necessary to reduce the services. Further, it is important to analyze the foreign country (subsidiaries or external providers) from different aspects such as culture, natural disaster, language, labor cost, government regulation and infrastructure. Finally, the tradeoff between benefits and risks should be taken into account when choosing the location.

REFERENCES

ABRAHAM, K. G.; TAYLOR, S. K. **Firms’ Use of Outside Contractors: Theory and Evidence.** Journal of Labor Economics, v. 14, n. 3, p. 394-424, 1996.

AVISON, D.; BANKS, P. **Cross-cultural (mis)communication in IS offshoring: understanding through conversation analysis.** Journal of Information Technology, v. 23, n. 1, p. 249-268, 2008.

BERRY, J. **Offshoring and Its Discontents Offshoring Opportunities: Strategies and Tactics for Global Competitiveness.** John Wiley & Sons Inc., 2006.

BOWERS, J.A., MOULD, G.I. **Weather Risk in Offshore Projects.** Journal of the Operational Research Society, v. 45, n. 4, p. 409-418, 1994.

- CARMEL, E., TIJA, P. **Offshoring Information Technology: Sourcing and Outsourcing to a Global Workforce**. Cambridge University Press, 2005.
- DI GREGORIO, D., MUSTEEN, M.; THOMAS, D. E. **Offshore outsourcing as a source of international competitiveness for SMEs**. *Journal of International Business Studies*, v. 40, n. 6, p. 969-988, 2009.
- FUNG, V. K.; FUNG, W. K.; WIND, J. Y. **Competing in a Flat World: Building Enterprises for a Borderless World**. New Jersey: Wharton School Publishing, 2008.
- GIAO, P. R.; OLIVEIRA, M.M. **A Study on the Potential of Brazil as a Hub for Offshoring of Services**. *Future Studies Research Journal: Trends and Strategy* ISSN 2175-5825 São Paulo, v. 1, n. 1, p. 100 - 122, Jan./Jun. 2009.
- GUPTA, A. **Outsourcing and Offshoring of Professional Services: Business Optimization in a Global Economy**. IGI Global, 2008
- GUPTA, A.; GOVINDARAJAN. **Knowledge Flows within Multinational Corporations**. *Strategic Management Journal*, v. 21, p. 473-496, 2000.
- KELLY, S.; NOONAN, C. **Anxiety and psychological security in offshoring relationships: the role and development of trust as emotional commitment**. *Journal of Information Technology*, v. 23, p. 232-248, 2008.
- KENNEY, M.; MASSINI, S.; MURTHA, T. **Offshoring administrative and technical work: New fields for understanding the global enterprise**. *Journal of International Business Studies*, v. 40, p. 887-900, 2009.
- KOTABE, M. **The Relationship Between Offshore Sourcing and Innovativeness of U.S. Multinational Firms: an Empirical Investigation**. *Journal of International Business Studies*, 1990.
- KOTABE, M.; SWAN, S. **Offshore Sourcing: Reaction, Maturation, and Consolidation of U.S. Multinationals**. *Journal of International Business Studies*, 1994.
- KOTLARSKY, J.; OSHRI, I. **Country attractiveness for offshoring and offshore outsourcing: additional considerations**. *Journal of Information Technology*, v. 23, p. 228-231, 2008.
- KUMAR, K., FENEMA, P. C.; GLINOW, M. A. **Offshoring and the global distribution of work: Implications for task interdependence theory and practice**. *Journal of International Business Studies*, v. 40, p. 642-667, 2009.
- JOSHI, K.; MUDIGONDA, S. **An analysis of India's future attractiveness as an offshore destination for IT and IT-enabled services**. *Journal of Information Technology*, v. 23, p. 215-227, 2008.
- MAHNKE, V.; WAREHAM, J.; BJORN-ANDERSEN, N. **Offshore middlemen: transnational intermediation in technology sourcing**. *Journal of Information Technology*, v. 23, p. 18-30, 2008.
- MAZZAFERRO, F.; THIMANN, C.; WINKLER, A. **On the Sustainability of Euroisation/Dollarisation Regimes: How Important are Fiscal Transfers, Offshore Finance and Tourism Receipts?** *Comparative Economic Studies*, v. 45, p. 421-436, 2003.
- OECD (Organization for Economic Co-operation and Development). **Offshoring and Employment: Trends and Impacts** - ISBN-978-92-64-03092-3 . Available in: <http://www.oecd.org/dataoecd/30/39/38819650.pdf>. Accessed on: 15/04/2011.
- OLSEN, K. B. **Productivity Impacts of Offshoring and Outsourcing: A Review STI Working Paper - OECD**, 2006.
- OSHRI, I.; KOTLARSKY, J. **Special Issue on Global Sourcing: IT Services, Knowledge and Social Capital**. *Journal of Information Technology*, v. 23, p. 1-2, 2008.
- OVUM, T. K. **Managing The Double-Edged Outsourcing/Offshoring Sword** (A Report), 2007.
- RANGANATHAN, C.; KRISHNAN, P.; GLICKMAN, R. **Crafting and executing an offshore IT sourcing strategy: GlobShop's experience**. *Journal of Information Technology*, v. 22, p. 440-450, 2007.
- ROTTMAN, J. W. **Successful knowledge transfer within offshore supplier networks: a case study exploring social capital in strategic alliances**. *Journal of Information Technology*, v. 23, p. 31-43, 2008.
- SANGEETA, S. B.; KUL, B. C. S.; HALEMANE, M. **Building a successful relationship in business process outsourcing: an exploratory study**. *European Journal of Information Systems*, v. 19, p. 168-180, 2010.
- SOOD, R. **IT, Software and Services: Outsourcing and Offshoring - The Strategic Plan with a Practical Viewpoint**. AiAiYo Books, 2005.
- ZHONGHUA, Q.; BROCKLEHURST, M. **What will it take for China to become a competitive force in offshore outsourcing? An analysis of the role of transaction costs in supplier selection**. *Journal of Information Technology*, v. 18, p. 53-67, 2008.
- WELSUM, D.; REIF, X. **The share of employment potentially affected by offshoring – an empirical investigation**. OECD, 2006.
- World Trade Organization (WTO). **Offshoring Services: Recent Developments and Prospects**. *World Trade Report*, 2008. Available in: http://www.wto.org/english/news_e/pres08_e/pr534_e.htm. Accessed on: 10/01/2011.

Artigo recebido em 21/05/2011.

Aceito para publicação em 27/07/2011.