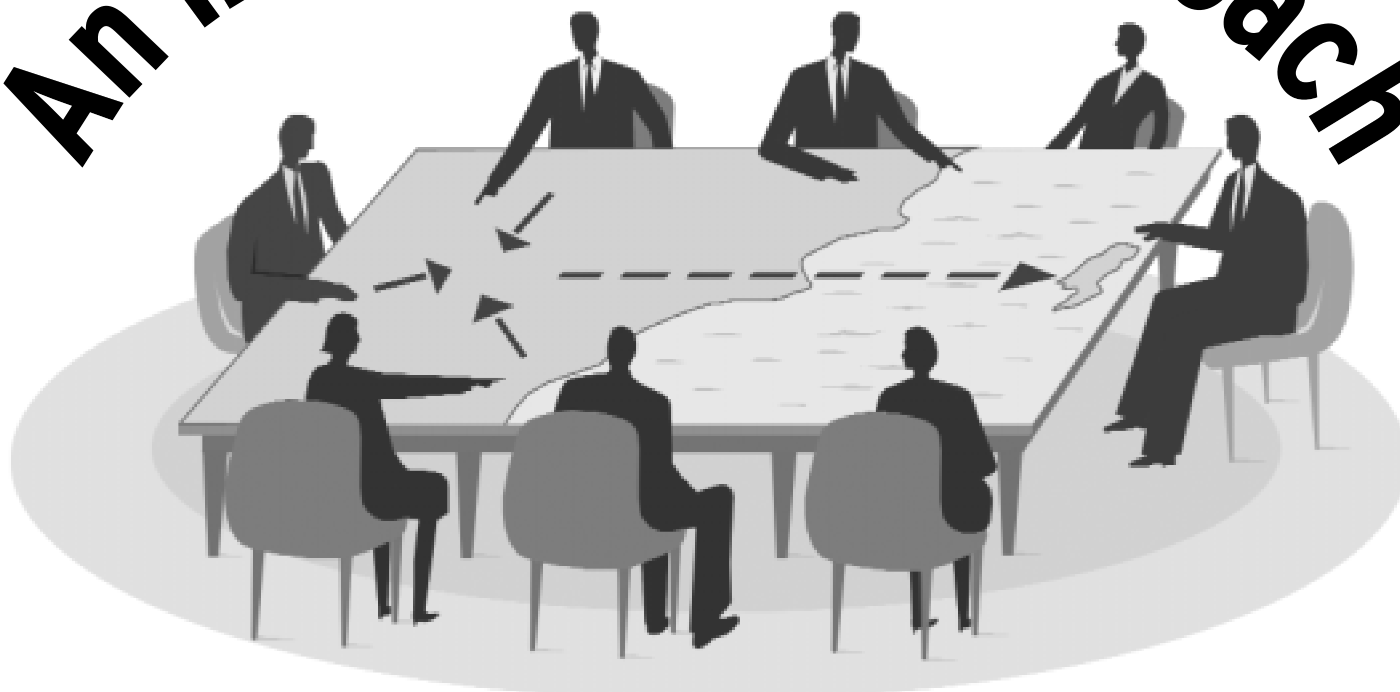
by Michael Mol



# An international approach



## Theories about offshoring do not always reflect the way real-life management decisions are made

Current views on offshoring tend towards one of two extremes. One position is that offshoring is bad business, undermining not only national employment but also long-term business competitiveness. Therefore, all available political and economic means should be used to prevent or reduce this practice. The alternative view is that offshoring helps companies to maintain and improve their efficiency by tapping into the worldwide pool of suppliers who can execute activities that are not part of a company's core business. Additionally, offshoring forces countries to keep upgrading their own skills bases. Therefore, the market should be allowed to rule and managers ought to be encouraged to engage in offshoring. Those two points of view pretty much sum up the current debate on offshoring on both sides of the Atlantic. But is there perhaps something more to be said?

This article will highlight some of the things we now know about outsourcing – international outsourcing in particular. We will consider some ideas that should appear on the agenda of any manager, consultant or politician concerned with the current trend towards offshoring. First, however, what is causing this trend?

### Key messages

- The polarised debate over the rights and wrongs of offshoring ignores the real issues faced by managers.
- Offshoring is often seen as inherently good, but many offshoring decisions are simply wrong.
- External influences and pressures, rather than cost-benefit analyses, drive many offshoring decisions.
- Size and international focus are key factors in successful offshoring.
- There is no generic right way of offshoring business activities, only the way that makes most sense for the company.

## Causes

Many forms of international outsourcing that we observe today have only become possible as a consequence of technological change, geopolitical change or a combination of the two. The use of information and communication technology enables the physical decoupling of many – though crucially, not all – business activities. This makes it possible to use external suppliers who are often geographically very distant. At the same time, the opening of previously closed economies (China, India, Central and Eastern Europe) not only allows access to an enormous pool of well-trained workers but also creates new competitors. Meanwhile, trade barriers continue to be reduced. Technology and international relations are combining to form a powerful force.

Another often overlooked change that has also allowed international outsourcing to become so buoyant lies within managers' mental maps. No longer do managers believe that integrating as many activities as possible will provide them with maximum bargaining power *vis-à-vis* customers, suppliers and other stakeholders. In fact, vertical integration is seen as a thing of the past, something with which few managers want to be associated. In addition, many managers have becomes less fearful of the unknown, and are much more willing to look at suppliers in other countries as potentially beneficial trading partners, not mere headaches. The growth in inter-cultural communications training, increased international travel and institutions such as global MBA programmes have all played their part in the development. Outsourcing, and international outsourcing in particular, are now the default option for many managers.

At the same time, there is now a much greater willingness on the part of managers to invest in outsourcing. Where outsourcing used to mean something like 'throw it over the wall and your supplier will take care of it', the post-outsourcing trajectory is now usually much longer. Much closer relations with suppliers are an expression of this. There is a generally shared belief that these relationships can deliver benefits, many of them intangible, which make it worthwhile to invest time, money and other assets in them.

## Academia versus reality

It is doubtful whether our academic models tell us the whole picture, or even most of it. The main reason for this is that they start out by modelling the behaviour of managers as if these managers follow one pre-defined logic, such as the logic of economic rationality. The truth is that managers follow different logics simultaneously, and sometimes what they do is not necessarily logical at all. In our research, we have observed how in outsourcing periods of inertia are followed by periods of over-shooting. For a long period of time, until the early 1990s, companies remained more vertically integrated than they should have been. Vertical integration had long been thought of as a successful recipe. The world, however, had moved on, and the technological and geopolitical changes mentioned began to facilitate more outsourcing. Then, in the late 1990s, events occurred that triggered a period of excessive outsourcing, where companies overshot their optimal degree of outsourcing and suddenly began outsourcing too much.

When we looked more closely at the decision-making processes involved, it turned out that these 'events' in many cases were not cost-benefit analyses, but rather the influences of outsiders on internal decision making or other forms of heuristic decision making. An amazing number of outsourcing deals are actually instigated by suppliers contacting their customers and then convincing them they can take over responsibility for a given activity. Such sales pitches seem to work quite well, even in industrial markets. In other cases, companies are on some 'neighbourhood watch' scheme. They observe what they think is successful decision making by competitors and subsequently mimic that behaviour, although the companies in question operate under quite different circumstances. In still other instances, companies get talked into outsourcing by consultants or business school professors. Such behaviour is known as 'bandwagonning', and includes both 'competitive bandwagonning', where industry competitors are observed, and 'institutional bandwagonning', where the views of other outside parties are reflected in decisions. In short, decisions about international outsourcing seem to follow various heuristics, rather than some pre-designed analysis scheme.

From a manager's point of view, this

## PRODUCTION VS TRANSACTION COSTS

**Our academic models tell us that international outsourcing is influenced by two factors: production costs and transaction costs. Production costs, for most companies in OECD economies, will tend to be lower abroad, while transaction costs are invariably higher. When the sum of production costs and transaction costs is lower for foreign suppliers than for local suppliers, then international outsourcing becomes an option. The make-or-buy choice is governed by a similar mechanism: in-house production costs are usually higher, but this is offset by lower transaction costs. Transaction costs can be seen as the 'costs of running the economy'. According to these models, companies should find a balance between make and buy as well as a balance between domestic and international sourcing.**

**Our research shows that the long-run performance of the company is an arc-shaped function of how much the company has decided to outsource. The company's performance moves on an inverted parabola, or what is known in academic terms as a 'negative curvilinear relationship. In other words, there is an optimal degree of outsourcing (the top of the curve) where some activities are performed in-house while others have been outsourced. Deviating from the optimum, either to greater outsourcing or greater in-house activity, is costly. Where the optimum actually is located is context dependent. For international outsourcing a similar principle applies: some activities are best performed at home, while others can be offshored.**

**Following from this observation, it is important to recognise that if outsourcing does not work, this is not necessarily an 'implementation' issue. Disturbingly, the changed mental maps of managers as well as the entrenched beliefs of academics and consultants, especially IT consultants, have led us to a situation where outsourcing is not only the default option, but has become something of a religious conviction. In fact, there are times when outsourcing is simply the wrong solution altogether. Any subsequent implementation problems are a consequence of the wrong initial decision. International outsourcing can have negative side effects, such as the risk of forward integration by suppliers, as many Chinese suppliers are about to demonstrate to their North American and European customers. Other problems can include less consistent or lower quality, the need to manage long-distance relationships more actively than expected, an ever-smaller basis for distinguishing the company from its competitors, and the lack of incentives for foreign suppliers to innovate.**

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actually makes a lot of sense. International outsourcing decisions are surrounded by many uncertainties. There is uncertainty about the reliability of the specific partner chosen, future developments in production and information technology, changing international trade rules and demand in the marketplace. Therefore, there is also much uncertainty about the effects of outsourcing on the company's performance. Our research into manufacturers of complex products shows that it can easily take three years for all the performance effects of outsourcing, both good and bad, to become visible. Some of these effects include learning and innovation, and it can take up to the full length of the product life cycle for these effects to be felt. There is substantial causal ambiguity: managers do not have a clear idea of the effects of their decisions at the time they take them. Phrased more boldly, it is simply not possible to do a reliable cost-benefit analysis of international outsourcing. Under these circumstances, heuristic decision-making involving outside advisers is a natural and in many ways a proper response.

Does this mean that managers making international outsourcing decisions can do little to improve the effectiveness of their decisions? Obviously not. To the extent that the real costs and benefits can be estimated, it is also useful to introduce formal decision-making procedures. For non-cyclical products such as food, for instance, this is more feasible because there is less uncertainty. Where such procedures cannot be introduced, there is often the possibility of learning about the effectiveness of international outsourcing decisions over time. By following a trial-and-error approach and making mistakes, companies can improve their heuristics. This form of learning, however, is extremely difficult given that most companies have not even developed good routines for dealing with domestic outsourcing. In addition, learning by making mistakes is a painful route. Few managers are willing to admit they make mistakes, let alone correct them. Finally, many outsourcing decisions are hard to reverse because internal competencies have been destroyed over time.

Our research also found that some companies are better at dealing with international outsourcing than others. The capability to outsource internationally is determined by (a) the size of the company, with larger companies generally being more competent; (b) whether the company is a multinational, with multinationals being better international outsourcers; (c) the extent of cross-border communication within the company, with more communication leading to more international outsourcing; and (d) the extent of integration between decision making on outsourcing and other areas of the company. The more integrated the company, the better it is likely to be at outsourcing.

In addition, it appears to be less profitable to outsource internationally under conditions of substantial volume fluctuations. Finally, companies that operate under conditions of great technological change and substantial product innovation tend to outsource internationally in a different way: they use a wider range of highly specialised sources, rather than maximising scale by outsourcing in one place. In sum, international outsourcing makes more sense for some companies than for others, and the way to do it will depend on the type of products a company produces.

## Parallel debates

So what are we to make of the current offshoring of business processes? At the moment, there are two parallel debates on offshoring, one considering it as a business phenomenon and the other as a political phenomenon. These two debates are only remotely connected. Offshoring as a business phenomenon is in many ways a relabelling of existing practices. The outsourcing of software programming to India, for instance, has been going for some time now. The development of call centres is not much of a next step. The skill level required for some offshored activities is gradually becoming higher, but on the other hand the skill levels necessary for all kinds of office work in OECD countries have also risen sharply over the past 10-15 years.

The discussion of offshoring as a political phenomenon is much more cyclical in nature, and assumes greatest importance before elections. Politicians seek to promote themselves based on the extent to which they can prevent offshoring from happening, arguing that it is a zero-sum game where any job created in another part of the world implies a job lost at home. Leaving aside the thorny question of whether 'simple' jobs lost are replaced by more skilled jobs in other industries, it should be noted the whole idea of one-for-one replacement is factually incorrect. Given existing productivity differences, it is more likely that one job transferred from the US or Europe leads to the creation of two or three new jobs in India. Politicians are often driven by inward-looking arguments that fail to understand international development as a driver of social progress.

## Future directions

International outsourcing is a much more gradual process than much of the current press coverage suggests. Nor is there as much global outsourcing as is often claimed. Stories about offshoring and international outsourcing are making headlines today only because much of the discussion of the topic is highly polarised, seeing the issue in black and white. If current technological and geopolitical conditions and developments continue as they have in recent years, then we may expect international outsourcing to become prominent over time. How big an 'if' is that? Perhaps not worryingly big now, but there are already concerns about the security of both the internet technologies underlying most of today's international communications, and the international political and economic stability required to accommodate international outsourcing.

For a manager involved in making decisions about international outsourcing, there are several recommendations. First, the degree of international outsourcing should always be a consequence of the circumstances under which the company operates. Second, decision-making about outsourcing is not perfect, so there appears to be little reason to pretend that it will be. Instead, evaluation and feedback processes should be in place that will help a company learn from its mistakes. Third, larger companies in particular can benefit from bringing together knowledge on international outsourcing in a centralised store or database that other decision makers can tap into. Fourth, while international outsourcing is likely to remain a trend for some time to come, this is not guaranteed. And finally, never follow one heuristic too much, whether it comes from your neighbour or your supplier or your management guru.

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