5. Outsourcing

In business, outsourcing is the contracting out of a business process to a third-party. The term "outsourcing" became popular in the United States near the turn of the 21st century. Outsourcing sometimes involves transferring employees and assets from one firm to another, but not always. Outsourcing is also used to describe the practice of handing over control of public services to for-profit corporations.

Outsourcing includes both foreign and domestic contracting, and sometimes includes offshoring or relocating a business function to another country. Financial savings from lower international labor rates is a big motivation for outsourcing/offshoring.

The opposite of outsourcing is called insourcing, which entails bringing processes handled by third-party firms in-house, and is sometimes accomplished via vertical integration. However, a business can provide a contract service to another business without necessarily insourcing that business process.

5.1 Overview

Two organizations may enter into a contractual agreement involving an exchange of services and payments. Outsourcing is said to help firms to perform well in their core competencies and mitigate shortage of skill or expertise in the areas where they want to outsource.

In the early 21st century, businesses increasingly outsourced to suppliers outside their own country, sometimes referred to as offshoring or offshore outsourcing. Several related terms have emerged to refer to various aspects of the complex relationship between economic organizations or networks, such as nearshoring, crowdsourcing, multisourcing and strategic outsourcing.

Outsourcing can offer greater budget flexibility and control. Outsourcing lets organizations pay for only the services they need, when they need them. It also reduces the need to hire and train specialized staff, brings in fresh engineering expertise, and reduces capital and operating expenses.

One of the biggest changes in the early 21st century came from the growth of groups of people using online technologies to use outsourcing as a way to build a viable service delivery business that can be run from virtually anywhere in the world. The preferential contract rates that can be obtained by temporarily employing experts in specific areas to deliver elements of a project purely online means that there is a growing number of small businesses that operate entirely online using offshore contractors to deliver the work before repackaging it to deliver to the end user. One common area where this business model thrives is in providing website creation, analysis and marketing services. All elements can be done remotely and delivered digitally, and service providers can leverage the scale and economy of outsourcing to deliver high-value services at reduced end-customer prices.

Reasons for outsourcing

Companies primarily outsource to avoid certain costs - such as peripheral or "non-core" business expenses, high taxes, high energy costs, excessive government regulation/mandates, and production and/or labor costs. The incentive to outsource may be greater for U.S. companies due to unusually high corporate taxes and mandated benefits, like social security, Medicare, safety protection (OSHA regulations) and FICA. At the same time, it appears U.S. companies do not outsource to reduce executive or managerial costs. For instance, executive pay in the United States in 2007 was more than 400 times more than average workers—a gap 20 times bigger than it was in 1965. In 2011, twenty-six of the largest US corporations paid more to CEO's than they paid in federal taxes. Such statistics imply that the reason companies outsource is not to avoid costs in general but to avoid specific types of costs.

Implications

For Business

Management processes

Greater physical distance between higher management and the production-floor employees often requires a change in management methodologies, as inspection and feedback may not be as direct and frequent as in internal processes. This often requires the assimilation of new communication methods such as Voice over ip, instant messaging, and Issue Tracking Systems, new Time management methods such as Time Tracking Software, and new cost- and schedule-assessment tools such as Cost Estimation Software.

Communications & Customer Service

In the area of call centers end-user-experience is deemed to be of lower quality when a service is outsourced. This is exacerbated when outsourcing is combined with offshoring to regions where the first language and culture are different.

Foreign call center agents may speak with different linguistic features such as accents, word use and phraseology, which may impede comprehension. The visual cues that are missing in a telephone call may lead to misunderstandings and difficulties.

Security

Before outsourcing, an organization is responsible for the actions of their entire staff, sometimes a substantial liability. When these same people are transferred to an outsourcer, they may not even change desks. But their legal status changes. They are no longer directly employed by (and responsible to) the organization. This creates legal, security and compliance issues that are often addressed through the contract between the client and the suppliers. This is one of the most complex areas of outsourcing and sometimes involves a specialist third-party adviser.

Fraud is a specific security issue as well as criminal activity, whether it is by employees or the supplier staff. However, it can be disputed that fraud is more likely when outsourcers are involved, for example credit-card theft when there is the opportunity for fraud by credit-card cloning. In April 2005, a high-profile case involving the theft of $350,000 from four Citibank customers occurred when call-center workers acquired the passwords to customer accounts and transferred the money to their own accounts opened under fictitious names. Citibank did not find out about the problem until the American customers noticed discrepancies with their accounts and notified the bank.

Insourcing

Outsourcing has gone through many iterations and reinventions. Some outsourcing contracts have been partially or fully reversed, citing an inability to execute strategy, lost transparency & control, onerous contractual models, a lack of competition, recurring costs, hidden costs, and so on. Many companies are now moving to more tailored models where along with outsource vendor diversification, key parts of what was previously outsourced has been insourced. Insourcing has been identified as a means to ensure control, compliance and to gain competitive differentiation through vertical integration or the development of shared services [commonly called a 'center of excellence']. Insourcing at some level also tends to be leveraged to enable organizations to undergo significant transformational change.[citation needed]

Further, the label outsourcing has been found to be used for too many different kinds of exchange in confusing ways. For example, global software development, which often involves people working in different countries, cannot simply be called outsourcing. The outsourcing-based market model fails to explain why these development projects are jointly developed, and not simply bought and sold in the marketplace. Recently, a study has identified an additional system of governance, termed algocracy, that appears to govern global software projects alongside bureaucratic and market-based mechanisms. The study[17] distinguishes code-based governance system from bureaucracy and the market, and underscores the prominent features of each organizational form in terms of its ruling mechanism: bureaucracy (legal-rational), the market (price), and algocracy (programming or algorithm). So, global software development projects, though not insourced, are not outsourced either. They are in-between, in a process that is sometimes termed Remote In-Sourcing. Projects are developed together where a common software platform allows different teams around the world to work on the same project together..

Standpoint of labor

From the standpoint of labor, outsourcing may represent a new threat, contributing to worker insecurity, and is reflective of the general process of globalization and economic polarization (economics).

On June 26, 2009, Jeff Immelt, the CEO of General Electric, called for the United States to increase its manufacturing base employment to 20% of the workforce, commenting that the U.S. has outsourced too much and can no longer rely on consumer spending to drive demand.

Standpoint of government

Western governments may attempt to compensate workers affected by outsourcing through various forms of legislation. In Europe, the Acquired Rights Directive attempts to address the issue. The Directive is implemented differently in different nations. In the United States, the Trade Adjustment Assistance Act is meant to provide compensation for workers directly affected by international trade agreements. Whether or not these policies provide the security and fair compensation they promise is debatable.

5.2 Strategies

Policy-Making Strategy

A main feature of outsourcing influencing policy-making is the unpredictability it generates regarding the future of any particular sector or skill-group. The uncertainty of future conditions influences governance approaches to different aspects of long-term policies.

Competitiveness Strategy

Economic growth requires change, therefore a governance disposed to helping social and economic structures adapt to the changing environment will facilitate growth and a stable transition to new economic structures, until the economic structures become detrimental to the social, political and cultural structures. In less economically developed countries, policies which embrace the global phenomenon of outsourcing are a logical response to the ongoing movement towards "open markets" and "trade liberalization." Outsourcing, when interpreted as a trade phenomenon, complements trade liberalization strategies not only by promoting technological spillovers and capital inflows but also by offsetting the increasing levels of unemployment which result from opening up domestic markets. As prices adjust to those in the global market they no longer reflect domestic productivity, driving lower-productivity firms in the previously protected sectors out of business. Economic theorists argue that the resulting unemployment is only temporary as workers readjust and are eventually incorporated into the country's most productive sectors, namely those which enjoy a competitive edge over other players in the international market. Nonetheless, rapid liberalization of markets in developing nations has not maximized the productivity potential of the region. In the Global South, where technological development is drastically lower than in the North, the redeployment of human and capital resources into new export markets has not come at the cost of necessarily low-productivity sectors but rather underdeveloped ones. In other words, many of the previously protected sectors were not competitive yet on a global scale, not because they naturally lacked the comparative advantage, but because industry efficiency had not yet been reached. In such cases where liberalization stunts the growth of potential industries, unemployment is a reflection of many underemployed resources. Outsourcing fills in the gap of receding protected national industries, improving employment and living standards. Among other economic externalities, outsourcing promotes capital inflows and infrastructure. In Mexico, wage convergence was faster in cities where outsourcing first took hold through maquiladoras, along the US-Mexican border. Studies suggest that for every 10% increase in US wages, northern cities in Mexico which are most influenced by outsourcing would experience wage rises of 2.5%, about 0.69% higher than in inner cities. Corruption and reduced tax revenues after signing the NAFTA Treaty have limited the economic resources available to the Mexican government, thus explaining the difference in investment policies between Mexico and China.Conversely, one of the successes of Asian countries in the twentieth century has been their promotion of higher rates of saving and investment. Studies suggest that the increase in capital input fueled the 'Asian miracle' rather than improvements in productivity and industrial efficiency. Though the previous conclusion suggests production conditions in the region remained static, the situation in East Asia experienced rapid transformations. Not only were national educational rates raised drastically, but there was also an increase in patenting and research and development expenditures. Rising levels of education, urbanization and even of patenting illustrate the active role of the government in advancing education as well as encouraging research and development.

Education Strategy

Jobs become outsourced not based on the skill-level group it represents, but rather based on a variety of other factors including transportation cost of ideas, wage and labour productivity edge. Because of the overall uncertainty regarding the future dynamics of outsourcing it is not possible to predict the nature of labour demand in different regions. To better prepare the domestic workforce to future industry demands, therefore, national education programs ought to focus on flexibility and diversity of skills rather than on any specific task-oriented skills. Emphasis should go on preparing students both to succeed in non-habitual tasks and to adapt to changes in labour demands in the market. A specific goal that ought to be adopted is teaching students how to learn rather than teach them particular skills. This strategy would help students adapt to changing skill requirements in the future thus reducing friction from structural unemployment.

Welfare State Strategy

The uncertainty regarding the domestic productivity edge renders caution a key element of governance to ensure a sustainable regional development. Together with helping the unemployed re-enter the work force and smoothly transition into high-demand labor opportunities – potentially through re-training programs –, the government should also address the socioeconomic struggle and other welfare concerns of displaced employees. Negative welfare effects of outsourcing have gathered substantial public attention. The possibility of outsourcing has internationalized labor markets which used to be local, opening up jobs which were traditionally non-traded to international competition. The resulting combination of lower wages and unemployment for certain jobs has driven the perceived ‘losers’ to engage in heated political debate. Labor unions in the European Union have succeeded in pushing through protectionist policies in favor or lower-skilled groups throughout the 1970s and 1980s, including the Common Agricultural Policy on farming. Interest groups opposing outsourcing have been more active to voice their disapproval because the negative outcomes of the phenomenon are more concentrated on specific groups of people, namely those losing jobs to external competition, whereas the benefits from it become dissipated among the population at large. Overall lower prices and greater quality and variety of goods in domestic markets are some of the benefits of exploiting a country’s comparative advantage through outsourcing. Unlike the alleged ‘losers’ from outsourcing, those affected positively by it lack the motivation to organize to voice their support. There has been a wave of protectionism concerned with deep changes in the social structure allegedly imposed on the global system through globalization and outsourcing. The activists see a readjustment of class systems and highlight an increased fracture in societies between the ‘haves’ and the ‘have-nots’ as different groups adjust to increasingly or decreasingly advantageous positions in the system of outsourcing. Opponents of outsourcing have also denounced it as a threat to local cultural integrity. The argument on cultural disintegration points to the standardization of practices and norms as multinational corporations become involved with industries in regions culturally different from those in the country of origin. The alleged diffusion of culture has raised concern over the endurance of cultural norms and values, sociopolitical institutions and frameworks, or even cultural preferences and traditions in a context of increasing foreign presence. Increased uncertainty regarding future socioeconomic security ought to be met with policies promoting equality and a fair redistribution of economic gains for a government to maintain its voters’ favour. Because of overall unpredictability, governments will likely need to reassure civilians that the burden of employment jobs resulting from outsourcing will be shared among taxpayers. The fluctuations in employment levels are determined by the types of jobs which can be profitably outsourced or offshored. Domestic jobs become offshored or outsourced when lower productivity in other regions is compensated by lower wages, making outsourcing profitable even despite the added costs of transportation. The overall cost-effectiveness of the spatial unbundling of the industrial process thus depends on the cost of transporting specific services or ideas given the available technology. Because of this reason technological advancements such as the telecommunications revolution, air shipping or the Internet have deeply accelerated outsourcing and may continue to boost this process. The future results of technological ingenuity and innovation are unknown, as are its potential impacts employment levels on any given task or job across regions. In the Global South, policies attracting multinational corporations can help increase employment levels and promote growth. Governments which pursue such strategies facilitate welfare protection given the context of increased unemployment in industries which cannot compete with the international market due to trade liberalization policies.

Industrial Policy

Outsourcing results from an internationalization of labour markets as more tasks become tradable. According to leading economist Greg Mankiw, the labour market functions under the same forces as the market of goods, with the underlying implication that the greater the number of tasks available to being moved, the better for efficiency under the gains from trade. With technological progress, more tasks can be offshored at different stages of the overall corporate process.

Environmental Policy

There are widespread claims that outsourcing has pushed environmental standards down in developing regions as countries compete to attract foreign projects and investment. Similar to lower wages, lower health and environmental regulations contribute to giving a country a comparative advantage over another due to lower production costs. The controversy this raises, however, is that unlike wages, lower health or environmental standards does benefit the new employees joining the workforce. Import competition has caused a de facto 'race-to-the-bottom' where countries lower environmental regulations to secure a competitive edge for their industries relative to other countries. As Mexico competes with China over Canadian and American markets, its national Commission for Environmental Cooperation has not been active in enacting or enforcing regulations to prevent environmental damage from increasingly industrialized Export Processing Zones. Similarly, since the signing of NAFTA heavy industries have increasingly moved to the US which has a comparative advantage due to its abundant presence capital and well-developed technology. A further example of environmental de-regulation with the objective of protecting trade incentives have been the numerous exemptions to carbon taxes in European countries during the 1990s. The evidence suggests that even if outsourcing has promoted lower environmental protection, there are no intrinsic geographic implications that the Global South has been more negatively affected than the North. O Although outsourcing can influence environmental de-regulatory trends, the added cost of preventing pollution does not majorly determine trade flows or industrialization.

5.3 Globalization and Socio-Economic Implications

Global Inequality and Development

Industrialization

Outsourcing has contributed to further levelling of global inequalities as it has led to general trends of industrialization in the Global South and deindustrialization in the Global North.

Even though outsourcing has promoted a movement of industrial sites from the Global North to Global South regions, it has not been the only reason for the concurrent deindustrialization and industrialization of the North and South respectively. Deindustrialization in more economically and technologically developed regions has also been affected by increased industrial productivity.

The rise in industrial efficiency which characterized development in developed countries has occurred as a result of labor-saving technological improvements. Although these improvements do not directly reduce employment levels but rather increase output per unit of work, they can indirectly diminish the amount of labor required for fixed levels of output. Likewise, a trending shift in demand towards non-tradable services such as those in the health-care or government sectors has further accelerated deindustrialization in the Global North. Since these tasks cannot be outsourced, the demand for them needs to be met domestically abiding by the local market price. Consequently, a shift in the labor force towards fulfilling these profitable services has mostly taken place at the expense of industry since the agricultural sector in the early industrializing Global North had already been maximizing its labor capacity.

Despite the variety of domestic and international factors affecting deindustrialization in the Global North, those concerning the external influence of the global market have been the most influential ones since 1994.

The recent industrialization process outsourcing has encouraged in the Global South has taken place at a much faster pace than it did during its beginnings in the North, given that the well-developed technology was already developed, and merely spread to further regions.

Growth and Income

The almost simultaneous industrialization of the developing Global South and deindustrialization of the more developed Global North resulted in an international convergence of incomes.

Outsourcing has been characterized by rapid rates of growth and industrialization in the Global South. Conversely, the Global North has experienced a moderate slowdown in growth. Patterns of global industrialization and deindustrialization are explained by a combination of models in economic geography and economic growth. Models in economic geography illustrate that decreasing communication costs reduce the spatial clustering of industrial development. The lower cost to the spread of ideas improved coordination and communication within corporations across greater geographic distances. This process originated roughly after the international chaos of the World Wars, as a consequence of advancements in information technology during the 1960s. Further adaptations to technological progress, particularly the spread of the internet and liberalization of the telecommunications industry, permitted an acceleration of the movement of ideas and consequently of outsourcing since about the 1980s.

Urbanization

The pace of urbanization in the Global North decreased considerably relative to its high levels following the Industrial Revolution. Rates of urban growth have been higher in the Global South.

Trade

Outsourcing emerged with a new wave of globalization marked by high volumes of trade and capital flows. The increased movement of capital and goods contrasted starkly with the barriers and protectionism prevalent throughout the World Wars and the Great Depression during the Interwar Years.

Migration

The level of migration has remained relatively low, particularly compared to the mass migratory trends which characterized the Industrial Revolution roughly between 1850 and 1914., probably because labor markets are not free now. Countries now have discrimination labor laws, only allow people with citizenship cards live and work free in their territories, even getting a citizenship card is difficult for some one not born in their territory. Free labor markets, discrimination based with a person skills would help reduce outsourcing problems, letting people freely follow their jobs in other countries.

Domestic Inequality

Outsourcing in the Global North led to a rising divergence in domestic employment levels in different tasks within a given industry, making tackling unemployment more difficult for governments as job losses ceased to be primarily sectorial.

5.4 By country

United States

"Outsourcing" became a popular political issue in the United States, having been conflated with offshoring, during the 2004 U.S. presidential election. The political debate centered on outsourcing's consequences for the domestic U.S. workforce. Democratic U.S. presidential candidate John Kerry criticized U.S. firms that outsource jobs abroad or that incorporate overseas in tax havens to avoid paying their "fair share" of U.S. taxes during his 2004 campaign, calling such firms "Benedict Arnold corporations".

Criticism of outsourcing, from the perspective of U.S. citizens, generally revolves around the costs associated with transferring control of the labor process to an external entity in another country. A Zogby International poll conducted in August 2004 found that 71% of American voters believed that “outsourcing jobs overseas” hurt the economy while another 62% believed that the U.S. government should impose some legislative action against companies that transfer domestic jobs overseas, possibly in the form of increased taxes on companies that outsource. One prediction (from 2010) claims that, by 2014, more than 1.3 million positions will disappear because of "the accelerated movement of work to India ..." and some other countries willing to accept outsourced jobs. President Obama promoted an act titled 'Bring Jobs Home Act' that would help restore jobs by giving incentives such as a tax cut or a 20 percent tax credit for moving operations back to the USA.

Union busting is one possible cause of outsourcing. As unions are disadvantaged by union busting legislation, workers lose bargaining power and it becomes easier for corporations to fire them and ship their job overseas.

Another given rationale is the high corporate income tax rate in the U.S. relative to other OECD nations, and the practice of taxing revenues earned outside of U.S. jurisdiction, a very uncommon practice. However, outsourcing is not solely a U.S. phenomenon as corporations in various nations with low tax rates outsource as well, which means that high taxation can only partially, if at all, explain US outsourcing. For example, the amount of corporate outsourcing in 1950 would be considerably lower than today, yet the tax rate was actually higher in 1950.

It is argued that lowering the corporate income tax and ending the double-taxation of foreign-derived revenue (taxed once in the nation where the revenue was raised, and once from the U.S.) will alleviate corporate outsourcing and make the U.S. more attractive to foreign companies. However, while the US has a high official tax rate, the actual taxes paid by US corporations may be considerably lower due to the use of tax loopholes, tax havens, and "gaming the system". Rather than avoiding taxes, outsourcing may be mostly driven by the desire to lower labor costs (see standpoint of labor above). Sarbanes-Oxley has also been cited as a factor for corporate flight from U.S. jurisdiction.

European Union

Where outsourcing involves the transfer of an undertaking, it is subject to Council Directive 77/187 of 14 February 1977, on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of businesses (as amended by Directive 98/50/EC of 29 June 1998; consolidated in Directive 2001/23 of 12 March 2001). Under that directive, rights acquired by employees with the former employer are to be safeguarded when they, together with the undertaking in which they are employed, are transferred to another employer, i.e. the contractor. An example of a case involving such contracting-out was the decision of the European Court of Justice in Christel Schmidt v. Spar- und Leihkasse der früheren Ämter Bordesholm, Kiel und Cronshagen, Case C-392/92 [1994]. Although subsequent decisions have disputed whether a particular contracting-out exercise constituted a transfer of an undertaking (see, for example, Ayse Süzen v. Zehnacker Gebäudereinigung GmbH Krankenhausservice, Case C-13/95 [1997]), in principle, employees of an enterprise outsourcing part of its activities in which they are employed may benefit from the protection offered by the directive.

Seeking to implement the cost-cutting solutions, many Western European firms have been transferring tech projects eastward. For example, Deutsche Bank has some of its software developed in Ukraine, Siemens possess R&D center in Romania. Europe Outsourcing has produced outstanding results and henceforward they are increasing them in numbers.

Despite unfavorable economic conditions from 2007 to 2009, the outsourcing services market continued to flourish in Central and Eastern European. In 2008 when the inflow of investment in Western Europe was down by 48%, it fell by only 9% in Central and Eastern Europe. In Poland alone, during 2009, the year following the global economic downturn, approximately 10,000 jobs were created in business process outsourcing (BPO).

Co-sourcing

Co-sourcing is a business practice where a service is performed by staff from inside an organization and also by an external service provider. It can be a service performed in concert with a client's existing internal audit department. The scope of work may focus on one or more aspects of the internal audit function. Co-sourcing can serve to minimize sourcing risks, increase transparency, clarity and lend toward better control over the processes outsourced.

Examples of co-sourcing services are supplementing the in-house internal audit staff with specialized skills such as information risk management or integrity services, providing routine assistance to in-house auditing for operations and control evaluations in peak period activity and conducting special projects such as fraud investigation or plant investment appraisals. Another example of co-sourcing is outsourcing part of software development or software maintenance activities to an external organization, while keeping part of the development in-house. Other internal business activities such as HR and administrative tasks can also be co-sourced by employee leasing companies.

Identity management co-sourcing

It is an approach to enterprise identity management in which the identity service interacts directly or through some technical footprint with an organization's Information Technology (IT) identity backend infrastructure (directories, databases, and other identity repositories). The organization and the external service provider typically have a shared responsibility for building, hosting and operating the identity service. The balance of this responsibility can vary depending on the service levels required, and span from an all on-premise deployment, where the identity service is built, hosted and operated within the organization's IT infrastructure and managed on-premise by the external service provider. This contrasts with an "all in-the-cloud" service scenario, where the identity service is built, hosted and operated by the service provider in an externally hosted, cloud computing infrastructure.

Counterwave outsourcing

There has been a recent overturn of the tendency to outsource. The most recent trends in outsourcing and offshoring have been precisely the opposite force as companies are drifting back to perform tasks themselves and develop facilities back in their home Western locations.

Many firms are undoing their steps in outsourcing because the consequences were not entirely as expected. The circumstances which allow firms to unbundle the different tasks or stages of its manufacturing process into different locations have not been fully determined. Though the nature of the tasks plays a role determining their interconnectedness, other factors such as innovation in the manufacturing process or advances in transport and communication technology also affect the need for direct contact among employees. As the process which ties tasks together within firms remains unclear, there is a degree of uncertainty about which tasks need to remain geographically clustered together. In many cases firms took risks experimenting with outsourcing while lacking a firm understanding of the relationship among internal tasks and its spatial implications.

Despite saving money, companies have often faced unexpected drawbacks from outsourcing, such as miscommunication or lower quality of intermediate products, which end up delaying the overall production process. According to a Deloitte Consulting survey carried out in 2005, a quarter of the companies which had outsourced tasks had to reverse their strategy. Many big companies like Lenovo are increasingly considering turning around strategies of outsourcing.

Another reason for a decrease in outsourcing is that many jobs that were subcontracted abroad have been replaced by technological advances.

Public opinion in the US and other Western powers opposing outsourcing was particularly strengthened by the drastic increase in unemployment as a result of the 2007-2008 financial crisis. In the first decade from 2000 to 2010, the US experienced a net loss of 687,000 jobs due to outsourcing, primarily in the computers and electronics sector. Public disenchantment with outsourcing has not only stirred political responses, as seen in the 2012 US Presidential campaigns, but it has also made companies more reluctant to outsource or offshore jobs.