

## REVIEW OF OFFSHORE OUTSOURCING

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### ABSTRACT

*The aim of this paper is to review the earlier studies on offshore outsourcing. Based on the review, the paper put forward the importance of widening the range of earlier studies. Studies are required from service receiver's point of view incorporating their benefits and risks, which are often ignored. The paper also highlighted the scope for further research as offshore outsourcing of services is not limited to a few operational areas. There is a need for empirical studies based on qualitative as well as quantitative measures for a better understanding on the issues related to offshore outsourcing business because of the continuous demand of these services in current global competitive environment. The paper provides synthesis of viewpoints on various dimensions such as reasons behind offshore outsourcing, theoretical justification, and future expectations from the service provider firms.*

**Keywords:** *Outsourcing, Offshoring, Profitability, BPO, and KPO.*

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### I. INTRODUCTION

Present study attempts to review in brief the concept, reasons, and benefits of offshore outsourcing and tries to find out a few research gaps in the literature to derive not only a better understanding of the issue but future direction also. Outsourcing is the delegation of non-core operations or jobs from internal production within a business to an external specialized entity (Gibson, 1996). When a service or a product is taken or delegated to a firm based on a location beyond the shore of the receiver firm then it is called offshoring or offshore outsourcing. There is a fundamental difference between these two terms although used simultaneously. In offshore outsourcing, there has to be a simultaneous transfer of ownership and control, which means that the activity is carried out by an external supplier (externalized), rather than an in-house unit (internalized) through a wholly owned unit or a specialized service provider. On the other hand, offshoring covers multiple modes of foreign involvement located on a market-hierarchy continuum (Pyndt and Pedersen, 2006). Offshore outsourcing allows firms to address deficiencies in their own resources and

capabilities. This is done for vertical integration (a type of management control that tries to unite through a hierarchy with a common owner, and when a firm wants to use the system to promote better financial growth and efficiency in

their firms and business), reduction in capital expenditure, offloading of non-core functions, access to value added services, and for improving proficiency, speed and services, minimization of risks for increasing consumer satisfaction, etc (Gilley and Rasheed, 2000).

Firms in the developed countries such as U.S.A., U.K., etc., are characterized with higher wages. With the economic liberalization, many firms in these countries started offshoring services from low wage locations to avail lower labour cost. India, China, Philippines, Malaysia, etc., are some of the low wage countries. These services are provided with the help of Information Technology (IT) called as Information Technology Enabled Services (ITES). ITES offshoring to India grew because of reliable communication and availability of services with relatively lower cost. Liberalization of the telecom sector in India during 1994 encouraged private participation. The new telecom policy of 1999 introduced IP telephony and ended state monopoly on international calling facilities. This brought a drastic reduction in the international calling rates and served as vanguard for the emergence of ITES industry in India (Evalueserve, 2007). This started with IT services and changed drastically after Y2K.

Earlier, only low end services were offshore outsourced. Over time, more specialized services like engineering, research and development (R&D), manufacturing and marketing functions or even entire business lines are being outsourced to have a competitive advantage. Manufacturing has also been benefited with considerable outsourcing, initiated in the electronics and pharmaceutical industries (Ghodeswar and Vaidyanathan, 2005). Competitive pressures and the need for enhanced financial performance are driving firms to use strategic and transformational outsourcing to improve business focus, mitigate risks, build sustainable competitive advantage, and better utilize technical capabilities and resources for core business purposes (Bartell, 1998). Firms like GM, IBM, Ericsson, Sony, Allstate Insurance, and American Express have been outsourcing services, especially marketing activities (McGovern and Quelch, 2005). This shows how wide spread the process of offshore outsourcing and how important economically the process is across firms. Therefore, present paper attempts to review the concept, reasons, and benefits of offshore outsourcing for better understanding of the process.

## II. CONCEPTUAL BACKGROUND

In traditional theories of firm, it is assumed that once a firm grows beyond a certain size, it experiences rising long-run average costs because of diseconomies of scale. As growth leads to profitability and vice-versa, in the pursuit of growth, a firm may seek to increase its market share through alternative growth strategies such as internal and external expansion by differentiation (horizontal expansion), vertical integration, conglomerate diversification, etc (Koutsoyiannis, 1982). This may be the strategy of the top management of a firm to choose the option which generates competitive advantage.

With technological revolution and easy accessibility of services through IT, offshore outsourcing is gaining popularity. There are several approaches suggested by academicians that explain the basic motive of offshore outsourcing. Most of the researchers agree on cost effective access to specialized skills and savings on overheads through short-term cost savings (Finlay and King, 1999; Klein and Prusak, 1994). Another perspective is that an offshore outsourcing firm should work towards building mutually beneficial long-term relationships with the suppliers. Effective management of such relationships can create new competencies to the outsourcer (DiRomualdo and Gurbaxani, 1998). Though economies of scale is still a major motivation for offshore outsourcing (Kakabadse and Kakabadse, 2005), firms may outsource to improve responsiveness to the dynamic market conditions (D'Aveni and David, 1994), to concentrate on core activities or to achieve a combination of both.

Bhagwati et al. (2004) discussed ways of providing offshore outsourcing services and distinguished between "long-distance" arm's length service providers and others, requiring the provider and user to work together. World Trade Organization (WTO), under its General Agreement on Tariffs and Trade in Services (GATS), indicated four different ways in which services can be traded. In Mode 1 of WTO terminology, trade in services involves arm's length supply of services with the supplier and buyer remaining in their respective locations. In Mode 2, services are provided by moving the service recipients to the location of the service providers. In Mode 3, service providers establish a commercial presence in another country, requiring an element of direct foreign investment. In Mode 4, service sellers move to the location of the service buyer. Construction and consulting services are often provided through Mode 4.

There are some theories such as transaction cost, resource based, neoclassical, and theory of firm boundaries that define the possibilities of outsourcing. In

contrast, contractual theory, partnership and alliance theory, relational exchange theory, social exchange theory, agency theory, institutional theory, etc., define limitation of outsourcing. Core competency theory assumes three main key criteria to be fulfilled such as consumers should be benefited, should not be easily imitable by the competitors, and can be leveraged widely in many products and markets. The transaction cost theory (TCT) was introduced by Coase in 1937. Williamson (1975) assumed that transactions are determined by production economics, and organizations are economic actors using the most efficient mechanism for transactions (Williamson, 1981). In brief, from the TCT perspective, the primary objective of a firm is to economize on the transaction costs through the selection of appropriate governance structures for handling its transactions. It over-emphasizes on cost minimization and neglects the value creation aspect of a transaction (Tsang, 2000). There are number of risks associated with this theory such as potential loss of control, uncertainty in supplier behaviour and performance, particularly in services (Bouquet et al., 2009). According to TCT, the attractiveness of offshore country is generally decided on the lower wage level, although this is not the only factor (Contractor and Mudambi, 2008). TCT addresses the conditions under which particular exchanges might be affected through the market rather than within a vertically integrated firm. However, it does not explain why an outsourcing relationship might be chosen by the lead firm.

According to resource based view (RBV) firms outsource to develop resources for competitive advantage as well as long term profits. Resources are physical capital that includes technology, plant and equipment, location, access to raw materials, and other related physical resources (Williamson, 1975). Other recourses may be human capital where training, expertise, judgment, intelligence, relationships, insights, and knowledge of the members of the workforce plays important role. Social resources include reporting structures, formal and informal planning processes, administrative and management systems, and informal relationships among groups within the firm and between a firm and its environment (Tomer, 1987). Financial capital resources include firm's debt and equity structures and cost of capital that can provide advantages as well. RBV identifies the requirements for sustained rent generation from scarce resources (Rumelt, 1991).

Resource dependence theory (RDT) is based on the organizational necessity of adapting to environmental uncertainty and actively managing or controlling resources for survival in the competitive environment (Pfeffer and Salancik, 1978) and for increasing speed to market (Lewin et al., 2008). RDT emphasizes

that power underpins the outsourcing relationship but does not say much about the sources of that power.

Agency theory (AT) presupposes a relationship between a principal (shareholder) and an agent of the principal (company's managers) generally for maximizing their mutual benefits (Boheren, 1998). The relationships in business are between stockholders and managers or between debt holders and stockholders.

Social exchange theory (SET) explains social change and stability as a process of negotiated exchanges between parties for subjective cost-benefit analysis and the comparison of alternatives for rewards as individuals seek rewards and avoid punishments. Best alternatives are searched before acting. Generally, in outsourcing, standards that individuals use to evaluate for rewards and costs differ from person to person and can vary over time (Sabatelli and Shehan, 1993).

Neoclassical economic theory focuses on the determination of prices, outputs, and income distributions in markets through supply and demand. It is often mediated through a hypothesized maximization of income-constrained utility by individuals. In accordance with rational choice theory, cost-constrained profits of firms are maintained, employing available information and factors of production (Antonietta, 1987).

The institutional theory argues that competition in the market as well as external support such as Government and social support leads to take a decision (Hätönen and Eriksson, 2009). The theoretical perspective behind outsourcing may be economic and cost saving. There are lots of debates behind these issues. Is outsourcing really beneficial to a firm, a country, or both or none? Under this, we can argue that offshore outsourcing should not be viewed as a simple example of a 'make or buy' decision, but it is also necessary to take into account the power asymmetries between the parties within the production chain. On the continuous debate as what to outsource and what should be kept inside, several researchers said that only peripheral works should be outsourced and core competencies of firms should be kept inside. On the other hand, according to the RBT, anything that is important for the growth of a firm can be outsourced if not available inside. Although all the theories try to find out the reason and justification, the real benefit to a firm is still a point of debate. Over time, the exchange relationship tends towards balance unless the firm counteracts this

tendency by only forming short-term contractual relations. The very process of outsourcing undermines the power asymmetries that enable the lead firm to appropriate the rents from the production chain. This is what Williamson (1975)

refers to as the fundamental transformation 'of what had been a large numbers bidding competition at the outset'.

Drawing on these theoretical perspectives, it can be concluded that there are many reasons to outsource. The theoretical approach to outsourcing, as discussed above, concludes that the practice of offshore outsourcing has evolved over the years. It started with an aim based on transaction cost economics, as the reason earlier was to save cost as well as externalization. However, with the success of time, this grew with resource based view and moving from low value service outsourcing to high value service outsourcing depending upon the need as well as availability of resources. Furthermore, it seems likely that institutional theory, agency theory, social exchange, and partnership theory are becoming important as the diversity is increasing. Again, introducing new theoretical approaches need to be applied to the examination of the outsourcing phenomenon (Hätönen and Eriksson, 2009). Different theories are dealing with different prospects for outsourcing and success of service provider firms depend on those factors that, if available with the firm, can lead towards success.

### **III. REVIEW ON OFFSHORE OUTSOURCING**

Large number of studies dealing with different issues of outsourcing analyzed drivers of offshore outsourcing from both theoretical perspective (Quinn and Hilmer, 1994; Razzaque and Sheng, 1998; Lankford and Parsa, 1999; Jennings, 2002) and from practical point of view using case studies and surveys in countries like USA, UK, Australia, and New Zealand (Corbett, 1996; Bolumole, 2001; Mclvor, 2003). Lau and Zhang (2006) found drivers for offshore outsourcing such as cost control and reduction, access to new expertise, technologies, improved flexibility, etc. A few other studies identifies key drivers such as advantages of early entry into market due to reduced time cycle and access to highly skilled professionals (Sobol and Apte, 1995; Apte et al., 1997). Rajkumar and Dawley (1997) found that firms in weak positions, struggling with high costs and poor performance tend to outsource IT-operations to regain a better position in the market. However, Fritsch and Wüllenweber (2007) concluded that offshore outsourcing is used as a strategic element. Willcocks and Hindle (2004), and Aron et al. (2005) stressed upon knowledge potential of it as the processes are often close to the outsourcer's core business. Throwing some light on strategic intent for IT outsourcing, DiRomualdo and Gurbaxani (1998)

concluded that, by leveraging core capabilities of both the service provider and the receiver, offshore outsourcing can even be a source of competitive advantage. The success of offshore outsourcing projects depend on many issues such as relational factor, organizational and interpersonal cultural differences as critical success factors in this context. Under this, information exchange, joint problem solving, and trust to reduce project cost overruns and improve client satisfaction can be beneficial. Apart from that, relationship between organizational and team level to point out cultural differences can lead to offshore Information System (IS) project success (Rai et al., 2009). Winkler and Dibbern (2008) also emphasized that cultural differences in terms of power distance, IS designer values, and an active versus passive working attitude critically affect several dimensions of relationship quality, thereby influencing offshore outsourcing success. The study of Zhan and Luo (2008) indicated that in offshore outsourcing, cross-cultural conflicts in shared management joint ventures sometimes has a negative impact on knowledge acquisition and ultimately affects the aim of knowledge acquisition. Some of the common problems defined were infrastructure problems, cultural barriers, language barriers, and differences in cross-national laws and regulations.

Amoribieta and Bhaumik (2001) argued about the choice of partner while going offshore as well as their interaction with the factors important for choosing a location. Results indicated that strategic learning toward internationalization, prior experience of offshore outsourcing and the extent to which firms are able to be benefited play vital role as offshore outsourcing involves not only risks but hidden costs too (Barthélemy, 2001).

According to Mouhalis (2007), one of the important factors in offshore partner selection is service provider firm's experience level in managing offshore outsourcing engagements. Specifically the processes, tasks, and the vertical quality of the product seeking to outsource should meet client's Service Level Agreement (SLA) requirements. Quality of work can be as much a qualitative issue as it is a quantitative one. Service providers should be financially stable and should have training, resources, and processes to cover possible errors. They are to be in place to support the needs of vertical functional experience with the leadership team for independent auditors. Depending on the level of security that is required for the engagement and depending on the sensitivity of the associated data, clients may review service provider's documented data security plan to understand the policies and procedures. In this way they control either directly or in the specific area for fulfilment of the liabilities.

Khan et al. (2011) identified service providers' cost-saving measures, skilled human resource, appropriate infrastructure, quality of product and services, efficient outsourcing relationship management, and track record of successful projects implementation as important aspects for the outsourcing clients. Apart from that, service provider should attempt to curb the sources of concerns relating to high levels of manpower turnover, insufficient generation of middle level managers, and inadequate data security measures (Lahiri and Kedia, 2011). Thus service providers have incentive to quote high provider prices to ward off future competitors, driving the latter to source outside (Chen & Perry, 2003). Service providers are needed to adequately assess different changes taking place in the clients' institutional environment, regularly monitor clients' specific requirements and changes, if any, and improve internal resources and capabilities at the individual, team and organizational levels based on feedback obtained from clients. Further, they need to absorb, learn, and take corrective actions from the knowledge transferred through client interactions, and constantly strive to become clients' dependable business partners by providing service improvements year-on-year (Budhwar et al., 2006).

Goles (2001) proposed that service providers must possess some qualities such as technical competence, understanding of the customer's business and relationship management. Claver et al. (2002) said that a service provider's success depends on resources, quality standards, competitive pricing models, cultural proximity, and trust with clients. Sullivan (1999) also emphasized on Intellectual Capital (IC) of a firm to get success. However, Currie (1998) emphasized on previous performance of the firms. In contrast, Claver et al. (2002), Han et al. (2008), and Levina and Ross (2003) emphasized on quality standards of the firms. Han et al. (2008) studied on firm's resources, capabilities, and interaction processes on the success of IT outsourcing. Kim et al. (2003) found strategic, technological, and economic effects were strongly related to tangibles. However, strategic effect was only positively related to reliability/responsiveness and empathy. Findings of Barge-Gil and Modrego (2009) also suggested that firms are able to recognize the influence of relationships on different technical, economic, investment, and intangible impacts. The economic impact and characteristics of these relationships affect the impact of research and technology organizations.

On the other hand, service receivers should also need to actively assess various changes taking place in the providers' business environment. Service receivers should constantly monitor enhancement of providers' resources and capabilities at the individual, team, and organizational levels, and engage in explicit knowledge transfer to allow them maintain understanding of their (clients')

business operations, specific requirements, and end customers. In particular, service receivers need to assist the providers in the latter's efforts to co-evolve as long-term business partners (Kedia & Lahiri, 2007).

Enlow and Irtel (2006) found that majority of the service receivers in both the public and private sectors and majority of the service providers (at least 30 per cent of the annual contract value of their deals) value the way the relationship is been managed. Bandyopadhyay and Pathak (2007) also found that the involvement of the top management in negotiating the contract and complementarily of knowledge among the employees results in better payoffs.

Lee et al. (2007) showed that certain factors related to organizational learning and knowledge management capabilities are important antecedents of e-business value. Here, knowledge is a rare and inimitable to become a source of competitive advantage. The magnitude of change introduced by IT service offshoring gave a significant positive economic effect on nation, firm, and employees of both the provider and receiver firms (Jain et al., 2008). Offshoring of product development are partially explained by the emerging shortage of high skilled technical talent in the US (Lewin et al., 2008).

Some other evidences such as loss of control (Razzaque and Sheng, 1998; Lankford and Parsa, 1999; Claver et al., 2002; Lynch, 2004) and loss of critical skills (Quinn and Hilmer, 1994) were also found as a driver of offshore outsourcing. According to DiRomualdo and Gurbaxani (1998), Willcocks and Kern (1998), and Gottfredson et al. (2005) research has started to focus on BPO and postulated that BPO bears unique potential along with several risks. Apte et al. (1997), Kumar and Willcocks (1996), Loh and Venkatraman (1992), and Ravichandran and Ahmed (1993) have concluded that little emphasis has been given to the underlying risks and ways of overcoming such risks. In offshore model identification for underlying risk assessment, the value and risks of the different offshore outsourcing business models helps organisations to make better choices during the decision making process when selecting vendors (Weerakkody and Irani, 2010). Chaudhry et al. (1995) discussed aspects uncertainties regarding fluctuations in earnings and suggested about the ability to manage growth intense competition in IT services, including those factors which may affect cost advantage with the increment in wage.

Examining outsourcing, Windrum et al. (2009) concluded that outsourcing is not good in the long run, as the benefits which are available in the short run are not consistent in long run. The relationship between multinational and downside risk is curvilinear. Risk first declines and then increases as a firm's portfolio of

international investments becomes extensive. In addition, downside risk is an increasing function of the average cultural distance between a firm's home base and the host countries in which its foreign subsidiaries operate (Tong and Reur, 2007). Herath and Kishore (2009) gave systematic solution of different risks and challenges such as on strategic decision of what to outsource and in what proportion, on vertical and horizontal chunkification on service provider selection, on service provider management, on project and process management with portfolio of controls, and on technology related issues.

#### **IV. RESEARCH GAP AND FUTURE DIRECTIONS**

Outsourcing is an emerging phenomenon and every second firm is going to offshore to have the advantage as claimed by different researchers. However, there is a need to systematically analyze the results. Most of the academic studies in last decade have focused on understanding the outsourcing decision, its determinants, and outsourcing process control (Gilley et al., 2004). There are very few studies on financial data analysis of outsourcing and effects of outsourcing on firm's performance and value. Thus, for filling these gaps, future research should consider financial based metrics to provide more objective evaluations of firms' outsourcing impact. Although some pioneer studies in financial data analyses such as Hayes et al. (2000), Barrar et al. (2002), etc., provided useful information for understanding of outsourcing results, their contributions are limited to a few areas. Since outsourcing is not always motivated for reasons of cost reduction, good information on cost reductions is sometimes simply not compiled. So there is also a need to know the motive behind outsourcing and its performance using influencing factors.

Different studies on outsourcing used case study method to derive their conclusions (Levina and Ross, 2003; Currie et al., 2008; Winkler and Dibbern, 2008). Respondents in case studies and surveys are middle-level managers, who usually talk about their own fields or departments rather than the whole picture of their firms. Managers as well as researchers may not direct their attention towards the ultimate value of the firm. This does not make clear of how well the evidence correlates to actual performance. However, using some quantitative methodology, one can expect some empirical results. In addition, a structured approach for evaluating the offshore outsourcing can also be taken. A long term strategy can be used to avoid long learning curves and to minimize redundant efforts in the development of high-quality services.

We find several studies with one or two factors measuring the impact of outsourcing on a firm. This does not give the holistic picture of IS outsourcing

and the factors behind success of a firm. The studies in other areas of outsourcing are also required to know the holistic picture and the overall affect of various factors. In addition, many studies are based on client's perspective as what they seek from outsourcing. Clients go for outsourcing decision for cost reduction, productivity growth, to increase profitability, to improve value of the firm, and to control or limit controls. However, in many studies, a small number of firms are used as their sample (Gonzalez et al., 2005) and this cannot be a representative of the whole industry.

Risk control is a necessary component in outsourcing contract. A well considered risk management document that measures the probability of each type of risk and its impact on an enterprise may determine the ultimate success of offshore initiative. There are needs to analyze and derive better decisions between short-term or long-term contracts as well as future opportunities on outsourcing results.

There is numerous policy issues related to the gainers and losers from the process of offshore outsourcing. However, the appropriate strategies of firms for entering international production chains should be analyzed properly (Coffee and Tomlinson, 2004). Questions such as what extent do lead firms, which have outsourced activities, are responsible for human welfare throughout production chains under their effective control (Kolk and van Tulder, 2002; Adams, 2002), to what extent does outsourcing involve the transfer of environmental problems (e.g., pollution, carbon emissions) to other (often overseas) members of the production chain need careful analysis for success of the process.

The literature established that there are outsourcing projects in many services. BPO projects are different in nature from KPO projects. We find studies focusing on BPO separately. However, studies are limited on KPO services. The reason might be that KPO is an emerging area. In most of the studies outsourcing contract is studied well. However, the kind of process or service outsourced is given a very less emphasis. In a few studies both BPO and KPO are studied together (Sen and Shiel, 2006; Currie et al., 2008, etc). It was estimated that KPO world-wide will grow to US \$16.7 billion by 2010-2011, implying an annual growth rate of 39 per cent and creation of approximately 350,000 professionals by 2011 (Evalueserve, 2007). KPO industry employed 34,000 and 106,000 professionals in 2003-04 and 2006-07 respectively. These estimations are needed to be tested. There lies an opportunity for pursuing many directions, and challenges that develop a more focused research agenda for better understanding

to add value to those engaged in the practice of service offshoring. There is also a need to identify future skill requirements for service providers. Researches on

the current challenges for KPO service provider firms should also be addressed, so that service providers, after improving their services, are benefited.

Similarly, in the context of global economic slowdown, earlier estimates may not come true. There is a backlash situation against offshoring in certain developed countries. On the other hand firms, because of economic slowdown or recession, may be compelled for offshoring to save cost as well as to be competitive in the market (BPOIndia, 2008). These estimations need to be tested on these factors.

## V. CONCLUSIONS

In the context of both developed and developing countries, present study tried to understand offshore outsourcing as well as related issues that are emerging with the changed world economic order. The development of offshore outsourcing is spreading towards various services. Earlier a few theories such as transaction cost and resource based theories were influencing outsourcing. However, with maturity, researchers are arguing the influence of other theories too. Offshore outsourcing of services is a strategic decision of a firm. Earlier, motive behind offshore outsourcing was mostly cost reduction, benefiting from labour cost arbitrage. With the development and maturity of offshoring contracts and good results, client firms are also encouraged to go for outsourcing. It is also found that Agency theory, contractual and alliance theory, neoclassical theory, social and exchange theory, etc., are tested in different research articles with the kind of work being offshore outsourced.

Offshore outsourcing is continuously growing over the years, as various studies tried to analyze the different aspects. These are mostly what, why, where, and how to outsource as well as what are benefits firms are getting, the requirements from the service providers as well as what precautions should be taken before going offshore outsourcing. Apart from that some gaps or paucity in research is also established in the process of offshore outsourcing.

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