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Issues and Concerns in Overseas Outsourcing from a Human Resource Perspective

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Abstract

Outsourcing is promoted as one of the most powerful trends in modern management. Outsourcing functions or processes include substantial financial economies, increased ability to focus on strategic issues, access to technology and specialized expertise, and an ability to demand measurable and improved service levels. This paper considers a range of core issues related to the establishment of outsourcing partnerships with the participation of companies. Special emphasis is put on the incentives, benefits and risks associated with the realization of outsourcing partnerships with vendor companies. Strategic outsourcing as a main type of such a partnership helps firms to align their competitive priorities, to focus management attention on long-term growth and innovation opportunities, and to target resources to those tasks firms do best. International outsourcing generally has a positive impact on the organizational performance and competitiveness enforcement in the companies within a region. This research aims to assess the issues and concerns of overseas outsourcing from a human resource perspective.

Key Words: outsourcing, strategic outsourcing, organizational performance, offshore outsourcing

Introduction

Outsourcing is a common practice among both private and public organizations and is a major element in business strategy. Perhaps most organizations now outsource some of the functions they used to perform themselves.

Throughout the 1990s a remarkable increase of outsourcing activities by firms has been observed. It has been hypothesized that this increase results from the decline in transaction costs in connection with the intensified use of information technology (Abraham and Taylor, 1996; Groot, 2001). It has also been argued that part of the process of deindustrialization is associated with outsourcing. Today, activities that used to be performed in-house (e.g. auditing, maintenance, repair, transportation, janitorial and legal services) are usually outsourced to firms in the business service sector. Consequently, outsourcing has contributed significantly to the growth of business-related services during the last decade (Fixler & Siegel, 1999). Moreover, manufacturing firms are outsourcing not only services but also internal production. One prominent example is the automotive industry, where some large car manufacturers only perform the final assemblage of major parts whose production is outsourced to external suppliers. Since this type of outsourcing quite often occurs at an international level, it is also closely entwined with the globalization process (Feenstra & Hanson, 1996).

This study is an empirical contribution to the literature on factors that determine firm performance. In particular, we test whether outsourcing is an important determinant for a firm's profitability. In addition, our paper also provides estimates on the relative importance of firm-, market- (i.e. industry-) and location - specific effects, as well as on the impact of organizational structure and human capital input on firm performance.

In general, outsourcing can be related to make-or-buy decisions on intermediate goods, to the hiring of temporary labour, and to the use of external services. The term outsourcing is used here to describe all the subcontracting relationships between firms, and the hiring of external workers. We presume that firms engage in outsourcing activities because they expect a positive impact on firm performance by saving resources in terms of both labour and capital. If, for instance, intermediate goods are no longer internally produced but purchased from an external supplier, this leads to a reduction of both labour costs and capital investments. In the absence of transaction costs, a firm will decide to outsource when the market price for an outsourced activity is lower than internal marginal cost for that activity (Fixler & Siegel, 1999).

However, it is an unresolved empirical issue whether outsourcing actually has a positive influence on a firm's performance as is expected a priori. Some case studies have reported that firms tend to underestimate the transaction costs associated with outsourcing. For instance, it has been documented that some firms have again 'insourced' activities that were previously performed by external firms, because they were dissatisfied with the quality or because they had underestimated the amount of asset specific investments (Benson, 1999; Gornig & Ring, 2000; Young & Macneil, 2000). A few studies have analysed the impact of outsourcing on firm efficiency (for an overview see Heshmati, 2002). Although efficiency is certainly an important aspect of firm performance, it neglects the product market performance of firms. Taking this into account, our study is a novelty to the literature. For instance, even if efficiency of firms remains unchanged after outsourcing of internal production, higher quality of intermediate inputs might result in higher quality of final products and hence higher sales and higher margins. The lack of empirical studies on the link between outsourcing and firm performance might be also due to a limited availability of suitable micro data for analysing this subject. Our study is based on a representative panel data set of about 43,000 German manufacturing firms from the German cost structure survey over the period 1992 to 2000. As an indicator for firm performance we use Gross Operating

Surplus (GOS). We employ several measures for outsourcing activities of firms. We found that in particular outsourcing of internal production had a significant positive impact on firm performance in both the short and the long run, whereas outsourcing of services appeared to have a negative impact in the short run but a positive impact in the long run. Besides this, our findings emphasize the importance of firm-specific characteristics for explaining differences in firm performance

Why do we outsource?

Outsourcing is a complicated decision rooted in the strategic plans of a company. Some of the reasons that companies decide to outsource includes: Mitigate risk, improve quality, faster time to market, obtain new ideas/thinking, rapid expansion of capacity, focus on core competencies, growth with less investment, infuse the company with new technology, leverage the company's assets and capabilities, improved return on investment, better cast flow, reduced cost.

At this point, a reader's response might be, "Hey, I thought this paper is opposed to outsourcing. You just made a compelling case to move my factory offshore."

On the contrary, we are in favour of sustainable strategies that ensure the long-term viability of a company, no matter its location. Economic stability in all countries promotes an environment in which peace is more likely to flourish. Our intention is to examine the rationale for outsourcing and to identify the real-world challenges in obtaining these benefits.

"You outsource because you can get the best talent in a highly specialized area and not have to carry them on your payroll," he said. "If you're installing a new computer system, you might have one IT person and outsource beyond that. The big benefit is it's a contracted price and a predictable cost (Simon, 2010)."

Companies outsource for a reduction in labour costs or efficiency. It may be more efficient to have a valet company who is experienced and knows the business. Valet managers need to know many statistics in order to make this operation successful. They need to be able to price appropriately and know what kinds of discounts to give on groups contracting with the company for events. They need to know the mix of attendees.

If a convention is paying for their attendees to park as a perk for coming to the conference what is a good rate to give them? If they have 500 attendees come to park for the day what kind of a discount can be given without the hotel losing too much revenue on the deal? Is it a perk the hotel may want to give away if the conference promises to spend a certain amount of money on other services? In this case, it may be beneficial for the hotel to give the parking away for free and pay out the valet company so that they don't lose out on too much revenue.

Functions like this would need to be negotiated in contracts in order for a mutually beneficial business deal to work for both parties. There are so many different mixes of business that many bookings have to be dealt with on a group-by-group basis.

A company may decide to offshore outsource for labour reductions. It can be financially beneficial for a company to have a service offered to the public where they are paying some a fraction of the wages they would if the job were located in the U.S. Many companies do not have the financial backing to run their operations fully onshore in the U.S. With minimum wage increases and labour unions it can be hard for a company to face the realization of inflation and competing wages. Some companies have been saved because they were able to produce their goods or services offshore where the wages are cheap. The cost of supplies can also provide significant savings.

Payroll is the largest cost for companies. The average wage of outsourcing someone in India is $11 versus $30 in the U.S (Customer Inter@ction Solutions, 2004). This saves companies a lot of money. Large corporations with thousands of employees can save millions with hourly rate differences of $11 versus $30. This may help businesses keep their doors open in order to keep the jobs of the onshore employees.

Why Companies Do Not Outsource

"For those that outsourced to an offshore provider to realize even further cost reductions, they have in many cases found that the degradation in quality of service—language, accent, cultural, etc.—has been a proven cause of loss of business, and therefore the original outsourcing return on investment has been completely overturned," as -Simon (2010) notes. Quality of service is something that the hospitality industry thrives on. A loss in the quality of service could severely hurt a hotel and its reputation. "When should hotels not outsource? When a function involves direct guest contact at the property, such as bell staff, housekeeping and front desk employees, according to Morone (citied in Simon, 2010).

Some companies do not outsource because they like to have full control over their own operation. Having limited control can cause many problems for a company and result in court proceedings. Many companies do not want issues with another company and possible issues with customer service.

Some companies have had negative experiences with outsourcing and decided to run that portion of their company internally after the contracts had expired. The company hiring needs to have strong backing because there are many companies out there that just want to make a quick buck.

Hotels create so much revenue that a company can make a lot of money for not doing a good job. Some outsourced companies care about the dollar and not the customer service. This may make the hotel lose guests, which can be a major loss of revenue in the long term.

What Areas are Beneficial to Outsource Onshore

Face-to-face **-** Areas of a business that require face to-face contact are more beneficial to outsource on American soil as well as areas that have a little bit less to do with the expertise of the main operation. A company should perform their own particular expertise internally. It is good for the employees that deal with the guests to be hired internally. Companies train their own employees and it is good to have full control over training for associates who will be interacting with guests. This helps with on the spot coaching, constructive criticism, and progressive discipline.

Local needs - It would be wise to keep services involving local needs onshore. If a guest calls for concierge services, for example, it would be wise to have someone there who knows the area. The guest may want to attend a local church, buy tickets to a ballgame, ask about current exhibits at the museums, or the best restaurants in town. Someone who lives overseas can only give so much information on these services. It would be possible to train them but it would not be the same. It is better when your concierge has experienced the local cuisines, museums, sporting events, etc. It is always nice to hear directly from the source. Someone overseas could only recommend through speaking with others or Internet reviews.

What Areas are Beneficial to Outsource Offshore

Phone related services **-** Areas that should be outsourced offshore would be call related services. If service takes someone sitting at a desk to help, then offshore outsourcing could be beneficial for a company. Reservations would be a good area to outsource offshore because most people do not meet their reservations agents. Reservation emails are usually sent to confirm the information discussed over the telephone. This is good because if there are accent barriers the customer will still receive confirmation on everything. A lot of the information is standard and specific, which results in less confusion than from outsourcing other types of services.

Production - It may be beneficial to run production offshore in a country where the cost of production is cheaper. For example, other countries may not have the corporate taxes that the U.S. has. This can help a company save very large sums of money. Maybe a company would want to offshore outsource in an area where the materials they need are cheaper. If a country has a particular abundance of a natural resource it may be cheaper to buy that resource due to readily available quantity.

Advantages of Outsourcing

Swiftness and Expertise: Most of the times tasks are outsourced to vendors who specialize in their field. The outsourced vendors also have specific equipment and technical expertise, most of the times better than the ones at the outsourcing organization. Effectively the tasks can be completed faster and with better quality output.

Concentrating on core process rather than the supporting ones: Outsourcing the supporting processes gives the organization more time to strengthen their core business process.

Risk-sharing: One of the most crucial factors determining the outcome of a campaign is risk-analysis. Outsourcing certain components of your business process helps the organization to shift certain responsibilities to the outsourced vendor. Since the outsourced vendor is a specialist, they plan your risk-mitigating factors better.

Reduced Operational and Recruitment costs: Outsourcing eludes the need to hire individuals in-house; hence recruitment and operational costs can be minimized to a great extent. This is one of the prime advantages of offshore outsourcing.

Disadvantages of Outsourcing

Risk of exposing confidential data: When an organization outsources HR, Payroll and Recruitment services, it involves a risk if exposing confidential company information to a third-party

Synchronizing the deliverables: In case you do not choose a right partner for outsourcing, some of the common problem areas include stretched delivery time frames, sub-standard quality and inappropriate categorization of responsibilities. At times it is easier to regulate these factors inside an organization rather than with an outsourced partner.

Hidden costs: Although outsourcing most of the times is cost-effective at time the hidden costs involved in signing a contract across international boundaries may pose a serious threat.

Lack of customer focus: An outsourced vendor may be catering to the expertise-needs of multiple organizations at a time. In such situations vendors may lack complete focus on your organization’s tasks.

Issues in Human Resource Outsourcing

Drawbacks or problems of HRO:

One of the problems with HRO is difficulty in accepting the change by the employees of the organization. There is also anxiety about losing control over the process.

Outsourced employees' reactions generally create difficulty in outsourcing. This resistance will be higher when more scope is added later. Effective communications and change management programs (OD initiatives) are especially crucial at this stage when the new scope involves implementing a self-service platform. Actually such systems are not intuitively obvious. Employees need to be helped to adapt to this new system.

In addition, there are various risks associated with HRO. One of such risk is the business risk which may arise due to cheap outsourcing contracts. There is also spill over risk, i.e. exposing of confidential matters to competitors. A political risk is another issue in outsourcing. One example of this is the controversial issue in the US during the time of elections when the opposition blamed outsourcing for unemployment and wanted it to be banned. Another problem in HRO is that sometimes it brings a threat to the organizational culture and it can get totally out of control in the hands of unsympathetic outsourcers. Also vendor organizations should be well aware of the laws and should act in compliance with laws of their client's country otherwise legal issues may crop up and may adversely affect the organization.

One more problem that arises is the loss of personal touch with the employees. Because an in-house HR person interacts daily with their employees, they will likely have more of an interest in their employees. This is the reason why Morgan and Stanley decided to provide retirement planning services in-house. The loss of talent generated internally, potential redundancies, fear of service providers ceasing to trade, loss of concentration on customers and less focus on the product are other drawbacks or challenges of HRO.

Also, when an organization is using a Professional Employment Organization (PEOs), giving up the right to hire and fire their employees, may not be desirable for their particular business. Mostly, PEOs insist that they should have the final right to hire, fire, and to discipline employees. This may not be healthy for an organization in the long run. If an organization decides to use an E-service, the same issues would remain with any active server pages (ASP). When everything is stored and handled online, there might be concerns about security as well as potential crashes, both of which can be detrimental to any business organization. Common complaints about HR outsourcing range from payroll mix-ups, to payroll not being deposited on time, to denied medical claims. (www.entrepreneur.com/humanresources/employmentlaw/article58222.html). Vendor selection is another major issue in outsourcing HR. If we select the wrong vendor, then we won't be able to enjoy the fruits as expected from HRO. Companies say that one of the important requirements while selecting vendors for outsourcing HR is the vendor's demonstrated HR process expertise, which was the response of 95% of respondents as mentioned in the survey conducted by Hewitt associates in the year 2005. (www.Hewitt .com).

Outsourcing and organizational Performance

First, reduced secondary activities allow organizations to focus on other major activities. This heightened focus on core competencies may greatly enhance organizational performance by allowing the organization to become more innovative and agile in its core domain.

Secondly, outsourcing secondary activities may greatly improve the quality of activities being outsourced. Specialist organizations (service providers), by focusing their attention on a narrow set of functions; perform them much more successfully than outsourcing organizations. This greatly influences the organizational performance of the organization.

Finally, outsourcing peripheral activities to the lowest cost supplier may lead to incremental improvements in an organization's overall cost position.

Conclusions

There are many reasons that a company should not outsource their employees. There can be legal ramifications and bad public relations due to outsourcing on or off American soil. Many companies feel that the cons outweigh the pros and that this type of business practice should not be considered anymore. Many hotels do not like how it impacts on their customer service scores. It also can give the impression that a company is trying to cut corners and costs, which in turn, can look cheap. It can take away from the essence of the feel of a company.

When someone walks into a 'mom and pop' style business, they enjoy seeing similar faces and making relationships with the team. They like knowing they will be helped by someone who works there. Many people want Corporate America to go back to the 'mom and pop' style.

People want the special touch and do not want to be another face in the crowd. Outsourcing adds more distance between the guest and the company.

The early 1990s have witnessed a remarkable increase in outsourcing activities. The starting hypothesis of this study was that firms pursue an outsourcing strategy in order to improve their performance. From the perspective of the firm, the rationale for outsourcing is to save internal resources either in terms of labour costs or capital investments or both. Outsourcing activities have many facets, e.g. cleaning, janitorial, transportation services or intermediate production. Our study provides estimates of the importance of three different types of outsourcing activities.

The first type is increasing intermediate material inputs relative to internal labour costs, which reflects the make-or-buy decision of firms. The second type is farming out production, which subsumes subcontracting between firms. The third type is external services, e.g. consultancy or auditing. The general result is that in the long run, all three types of outsourcing activities have a positive impact on return per employee (RPE), which we interpret as a measure of firm efficiency. Conversely, this does not necessarily imply higher profit margins for firms either in the short run or in the long run. Twelve firms that have increased their material inputs relative to labor costs performed better than firms that did not. Firms that have farmed out internal production or used external services are more efficient but have lower profit margins as a result of outsourcing.

These findings suggest that firms have over-engaged in these two latter types of outsourcing, and thus on average these types of outsourcing are above the optimal level. In sum, our analysis supports the view that firms tend to overestimate the benefits accruing from outsourcing of external services and/or underestimate the associated transaction costs. A prerequisite for successful outsourcing activities is that markets for intermediate inputs really function. Our results suggest that this is the case for material inputs, but not for external services. One reason could be that it is easier for firms to monitor quality of intermediate products than to monitor the quality of services. As noted by Williamson (1971), if market do not function, then vertical integration will be used by firms as a substitute for market organization. Also, firms might not fully anticipate the search costs of finding a suitable partner that can provide the service functions required.

We have also analyzed other factors that determine firm performance. For instance, we find that the wage level, which we interpret as human capital intensity of production, has a positive impact on efficiency particularly in the long run, but has a negative impact on the mark-up of a firm. This is not unexpected, since the mark-up corresponds to the difference between output and input prices, such that any increase in input prices will lower the mark-up. Another central conclusion of our study is that unobserved firm-specific characteristics, which presumably comprise technological knowledge, marketing or managerial abilities, are very important factors for explaining firm performance. These firm-specific factors turn out to be much more important than industry and location effects together. This finding also suggests that firm performance is quite persistent. Finally, firm size is not a particularly relevant variable for explaining differences in performance. The estimates suggest, however, that small firms tend to perform better than large firms.

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