

Outsourcing wave

Expansion of the market at the expense of enterprise hierarchies

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We have seen giants of American industry, such as General Motors and IBM, shaken to their cores. Their competitive advantages, once considered unassailable, have been ripped and torn in the fierce winds of competition. Technological wonders appear overnight. Aggressive global competitors arrive on the scene. Organizations are restructured. Markets appear and fade. The weathered rule books and generic strategies once used to plot our strategies no longer work as well in this environment."

Richard *D' Aveni*¹

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The paper discusses the outsourcing wave that started in the developed economies, and in whose current firms entrust tasks and functions earlier solved within the enterprise to outside entrepreneurs, frequently ceding their resources, equipment and sometimes even employees. Phenomena similar to outsourcing could be experienced even earlier. But the novelty is the intensity of the outsourcing process and that not merely peripheral functions are contracted out but also such departments, constituting the core of enterprise management. The big firms – becoming freed from ever more functions – turn into particular intellectual holdings which, retaining the management, regulation and marketing tasks, outsource almost their entire production process. As a consequence, the big firms get ordered into network-like formations, and their earlier employees become “nomads galloping with hired guns”. The analysis of these correlations is particularly interesting in less developed market conditions, in an economy of transition. Beside the advantages, characteristics and driving forces of the process, the author also mentioned its constraints. Yet her final conclusion is that, because behind outsourcing epochal economics and technological powers are moving, a further strengthening of the trend of outsourcing may be expected.

"AT ITS HUGE manufacturing complex in Rochester, New York, Eastman Kodak operates its own steam, electricity, and water purification plants. Kodak firefighters stand on call at Kodak firehouses. Bright yellow-and-red striped Kodak locomotives chug back and forth over

¹ *D' Aveni* [1995] p.45.

17 miles of Kodak tracks. But the company's self-sufficiency stops at its computers. In 1989, Kodak sold off its mainframes to IBM and hired Big Blue to do its data processing for the next ten years. The move startled computer managers across corporate America. No company of Kodak's size and prominence had ever turned over its computers to an outsider -- a practice called outsourcing. Kathy Hudson, Kodak's director of information systems, explains why the company did it: "IBM is in the data-processing business, and Kodak isn't. IBM runs our computer center as it supposed to be run -- as a profit center rather than a cost center." "(Kirkpatrick [1991] p. 103.) Kodak is plainly onto something. Now, two years later, information systems consultants say that about half the major U.S. corporations they work with makes sense for them.. Says security analyst *Stephen McClellan*, who follows computer services and software for Merrill Lynch: "Outsourcing is by far the biggest trend in computing since the development of the PC ten (more accurately: twenty) years ago."². (inserted words between brackets from me - K. Sz.)

The phenomenon of outsourcing

Outsourcing, although it most characteristic of the field of information processing, can by no means be restricted to the world of electronic information. Suppliers obtain a larger and larger portion of productions processes from large companies, and it is established practice to place production processes in far recesses of the world. Processes that were previously the task of employees are often given out to contractors and independent entrepreneurs.(*Franchi* [1990]) If there is an engineering task³ to be done at the company, the management does not consider employing an engineer, but gives the job to an external professional. If a hostess or designer is needed, the company does not expand their staff with hostesses or designers, but refers to the magic solution: outsourcing.

As it is the case with many other new phenomena, outsourcing does not have a *universal definition*, not even in professional circles. In the narrowest sense, the term is applied to cases where existing tasks and functions previously located within the company or institution are entrusted to outside entrepreneurs and suppliers along with

² The case is taken from the paper of *David Kirkpatrick* cikkében (*Kirkpatrick* [1991] p. 103.)

³ About the so called contract engineering see *Ashbrand* [1992]

the related instruments, appliances and capacities.⁴ The Eastman-Kodak case mentioned in the Introduction is outsourcing in the narrower sense. The wider sense of outsourcing is defined as having functions (mostly background tasks or the production of parts and units) originally within the production processes of the company performed by outsiders. The renting of human resources from HR companies is also considered outsourcing.⁵ The concept of outsourcing embraces more and more. The definition is very vague, and it's becoming broader all the time,... When business owners use the term "outsourcing," they now mean everything from what traditionally would have been known as simple vendor relationships to the dramatic reshaping of an entire company. (Buss [1995] p.19.) „Five years ago, outsourcing was a brand new, innovative way of operating internal mailrooms. Now outsourcing services *are available for any function*, whether it be the management of information networks, administrative services and data processing, legal management, informational tasks, telecommunication, or *even hired manpower.*” (Frost [1993] p.40.) (Italics by me - Sz. K.)

Outsourcing is *vertical disintegration*, i.e. the reversal of vertical integration processes. Companies participating in the outsourcing wave dismantle parts production and secondary services, producing a much “flatter” company structure by cutting off some of the many levels dependent on each other. *Bob Shelley*, manager of Octet Consulting uses the striking metaphor to define outsourcing: the *flattening of organisation charts* (Sharp [1993] p. 75.). This metaphor is also adequate in indicating that companies through outsourcing and relying on given resources background, can spread its influence in a much wider circle and go through *low-cost corporate growth*. the title of Dale D. Buss’s article also indicates this in a very expressive form: "*Growing More by Doing Less.*" Outsourcing as market revitalisation as opposed to hierarchies. The tasks that could only be safely performed within company walls before, are now “run through” the market and externalised. The realm of the market

⁴ Capacities are sometimes outsourced through being sold, but it is also possible for the outside entrepreneur to rent the facilities and instruments from the outsourcer. The third variation is when the outsourcer simply gives the outsider the appliances, and lets it deal with creating an instrumental background or infrastructure for these functions

⁵ A different categorisation also allows for narrower and wider interpretations of outsourcing. Many only see the relocation of parts or unit production as outsourcing, while others consider contracting out or renting workforce as outsourcing as well. We will accept the wider definition (for more on the definition dilemma, see *Feenstra - Hanson* [1996]).

and competition increases through outsourcing, while that of corporate hierarchies and long-term employment decreases.

Outsourcing allows companies to concentrate on their strengths and deploy everything else outside. In the age of *hyper-competition*, company management cannot afford to divide its attention between various partial functions and background activities while the smallest lapse in the main profile is instantaneously taken advantage of by competition. This factor is increasingly influential in decisions regarding outsourcing.

Although outsourcing only became *dominant trend in the 90s*, it is not an entirely new phenomenon. IT development projects, for example, have been relying on outside sources since the 80s. "Large facilities management contracts in the late 1980s signaled a timely convergence of supply and demand. On the other hand major vendors (like the Arthur Andersen, the IBM, the A.T.&T, the Computer Science, the EDS [Electronic Data Systems], the Sabre Group Holding) offered facilities management and other services" (*Earl* [1996] p. 26.) (Inserted words between brackets from me - K. Sz.) Outsourcing is growing at an extraordinary dynamism in the 90s. "Multibillion-dollar deals no longer raise eyebrows the way they once did." (*Ferranti* [1997] p. 101.) The development of the Internet is the prerequisite condition, mediator and motivator of outsourcing-transactions all over the world. Companies are increasingly relocating functions to countries such as India, South Africa, the Philippines, Singapore and Ireland, where IT knowledge is cheap and plentiful. "Access to training and skills for new networking technology and programming techniques are key for outsourcing contracts, because in many parts of the United States and throughout the world, trained IT staff is getting hard to find." (*Ferranti* [1997] p. 102.)

Statistical surveys about outsourcing are few in number, estimates are the main source of information. However, it cannot be doubted that the process is accelerating. *Yuji Furukawa* of Tokyo Metropolitan University estimates that subcontracting now accounts for over a third of Japanese firms' total manufacturing costs, up from less than 20% in the 1960s. He reckons the proportion will rise to 40% by the turn of the

century.⁶ James Savage, electronics industry analyst for *Gerard Klauer Mattison*, an investment firm said: "We expect the contract manufacturing industry to increase revenues at a compound annual rate exceeding *20 percent* through the end of the decade." (*Guinther* [1996] p.3.) Outsourcing is strongly linked to another global trend: globalisation. Outsourcing, especially in cases of physical production, often denotes relocation outside the country. This type of outsourcing is also developing dynamically. Between 1972 and 1990 imported intermediate inputs increased from 5.3 percent of material purchases to 11.6 percent of material purchases. (*Feenstra-Hanson* [1996] p. 242.)

Deployment instead of employment: Intellectual holdings

One of the most significant trends today is outsourcing in direct production. While organising, strategic planning and marketing, the dominant functions within the company that require high qualifications and innovativity are retained in the inner structure, material capital and manufacture processes are increasingly located outside. Satellite companies, contractor-supplier companies did of course exist in the 70s as well. The novelty of it is actually *the degree of outsourcing* and that it is not only minor, secondary processes that are relocated, but the production of *key elements* and even the *assembly of the final product*. There is also a strong wave of outsourcing within smaller companies of simpler structure.⁷ It should also be noted that some branches of industry show more intense outsourcing activity than others.

We can also detect a similar tendency of "immaterialisation" in the movement of risk capital. However, it is not alone with this attitude. More and more financiers comprehend that freezing capital into bricks and pipes is too risky in uncertain and turbulent times. Production companies, which have made an attempt at making themselves intelligent holdings, have already realised that *profit is not made in the bits and parts of the product, but in the "soft" factor of production*, the intelligent

⁶ The estimation can be found in the article of Economist (The ins and out..[1991] p.54)

⁷ In fact, small firms that do a lot of outsourcing tend to be more robust than their counterparts that do everything in-house, according to a survey of fast-growing small firms by Coopers & Lybrand, a national accounting and professional-services provider. Of the nearly 400 small companies surveyed--with median revenues of \$6.5 million and median employment of 66 people--two-thirds used outsourcing. (*Buss* [1995] p.18.)

services integrating production. It seems that all of the physical production processes - the „hardware” of production - will gradually be relegated outside. While at the same time, the „software” of production, the *intellectual processes* of management and planning for the future i.e. research and development⁸ *remain within internal structures*. In large companies, the significance of material capital has greatly diminished and *virtual capital*, which manifests itself in network connections, establishing, managing networks, and regulating global economic processes, is becoming predominant.

Novellus Systems Inc., the most profitable and fastest growing company in the semiconductor production equipment field, provides an interesting example. With only twelve shop floor personnel, *Novellus* concentrates on design and engineering of advanced chemical deposition equipment. It disdains internal "metal bending" activities in favor of long term strategic relations with a few trusted and specialized parts and subsystem producers. In addition to design, *Novellus* controls all assembly, test, customer contact, and post-sales service work and uses partners and suppliers to leverage its inhouse capital and design resources. In a notoriously cyclical industry, *Novellus'* profits grew twenty percent during the 1991-92 recession on sales of \$350,000 per employee-almost double the industry's average. (Business Week, January 27,1992).⁹

The leasing of the whole employees circle especially opens up new horizons in the development of intellectual holdings and the reorganisation of employment conditions of corporations and institutions. In several branches of industry in addition to information technology, it has become a practice for comfortable employees to turn into “wandering nomads with rented guns” (*Foster* [1997]).

These organisations do not invest into material capital that quickly becomes obsolescent, instead, as a leader of *TA Associates* an American company put it, „We don’t want to invest in hard assets. They are short lived and risky. We certainly don’t want to invest in bureaucracies. We want to invest in people who have a clear viable

⁸ Actually, this is not completely true. There is an emerging tendency to outsource sub-elements of research and development like the conducting of surveys and dealing with mechanical or dangerous tasks. Strategically crucial processes nonetheless remain internal.

⁹ Cited by Quinn [1992] p. 49.

concept...who can concentrate their internal energies on that small core of activities which creates the real uniqueness and value-added for the company” (Quinn [1992] p. 49.).

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Many businesses are redefining the structure of their firm. In these firms, persons who formerly were hired directly are being replaced with purchases of services. Such market mediated arrangement could include outsourcing or contracting out of various functions, utilizing temporary workers or even leasing an entire work force to meet labor needs. (Clinton [1997] p. 3) The leasing of a full employment circle especially opens up new horizons in the development of intellectual holdings and the reorganisation of employment conditions of corporations and institutions. In several branches of industry in addition to information technology, it has become a practice for comfortable employees to turn into “*wandering nomads with hired guns*” (Foster [1997]).

The motivations of outsourcing

It can be seen in the above that several factors can stimulate a company to replace an inner service or production by outsourcing. The causes can extend from avoiding taxation and having to let go of employees, or rather the discomfort of having to, to short-term cost-cutting, evading the employees’ difficulties in learning new technologies and dodging inherent risks. If we would try to categorise these causes, cost cutting would probably be at the top of the list. Companies specialising in outsourcing have various sources for decreasing costs. The outstandingly important one is scale returns. If it lends its services to many clients, the costs of an individual unit are consequently lower. In addition, these outsourcers will find it profitable to

install expensive technologies that further decrease their costs. IT, printing or legal outsourcing is also less expensive if their capacities are all utilised.

Most outsourced information technologies are used in a time share system, i.e. their clients share a capacity that they use one at a time. Legal consulting and representation are also essentially time-share forms of outsourcing. Since cases at a given company never appear continuously but with periods of too much or too little work, an outsourcer legal company can equalise oscillations because none of its client legal firms will be having over- or under-supplied periods at the same time. Thus, it can continuously employ its full capacity and decrease costs by getting rid of inactive stretches of time.

Another cost-cutting factor, also liked *return to scale*, is that outsourcers serving a larger number of clients generally buy inputs for their services in larger quantities and therefore cheaper.¹⁰ Cost-cutting possibilities are also important as regards employment. The most significant of these is probably saving on the notable secondary expenses of "inside employment."¹¹ "Faced with the high cost of payrolls and payroll taxes, health-care cost and other expenses associated with full-time workers, businesses increasingly will look to get work done through outside sources."¹²

The immeasurable benefit of outsourcing is that *it makes the adjustment of employment to tasks* continuous. It is widely known that employment is an extremely rigid factor of company functions. If they have employed and trained a team, it is difficult to cut them loose even if their job has become redundant. "Flexible work arrangements have been used as a means to meet fluctuations in demand for the firm's product, to supplement staff due to absences from work, and to reduce labor cost." (Clinton [1997]p.3.) While it is relatively easier to reduce or geographically relocate workforce in the USA than in Europe, where social partners often block doing so, the

¹⁰ Economies of scale also work to the benefit of the private company. A private company managing several treatment plants has more buying power which, in turn, means better pricing on treatment chemicals, capital equipment and supplies. (Lindow-Essel - Manuel [1997] p. 70)

¹¹ In Hungary, this cost-cutting feature is probably the most important motivation of the expansion of outsourcing. .

¹² The forecast of "Trend Journal" is cited by Jennifer J.Laabs (Laabs . ([1993] p. 93.)

danger of the decrease of production or of employees that have become redundant due to the restructuring of task remaining in the company is still great. The reverse, when the expansion of a company is brought to a halt because of the lack of specialised workforce, is of course no better. In the uncertain circumstances caused by fast shifts, task-oriented employment is a necessity. "Outsourcing is a natural outgrowth of the temporary-services concept of balanced staffing, whereby a flexible ring of temps is added to a basic core of permanent employees on an as-needed basis...Outsourcing is proving to be an effective cost saver in helping companies climb out of this recession." (*Laabs* [1993] p.93.)

Outsourcing also *solves the problem of the mutual defenselessness* of companies and employees in some cases. This mutual defenselessness stems from the fact that companies cannot easily replace employees with specialised local knowledge (i.e. valid only in that specific company), not even if it would like to find someone else for some reason. Meanwhile, the employee is also restricted in action as he/she probably will not be able to utilise the specialised knowledge gained in the company elsewhere. If he/she leaves the company, he/she might have to do everything all over again, and start at the new company as a beginner. According to *Williamson*, positions that require such specialised knowledge are also open to opportunists who might exploit the fact that they are almost indispensable. Through outsourcing, a business owner can gain access to highly specialized, sophisticated services without having to add to the payroll or be obligated to use the specialist for a long time. (*Buss* [1995] p.20.) If the company rents out such company-specialised tasks as developing the company's information technology system or attending to its legal affairs, not only the function but also the risk of opportunism is placed outside. Simultaneously, the employees at outsourcers also escape the trap of specialised activities, which is highly beneficial to them, since the employer cannot make ridiculous demands of the employee in the knowledge that he/she will think twice before leaving. The fact that they do not actually work for the company they are working for makes them less exposed. After all, they are outsiders, and their data or lives are no business of the company that gives them work. (*Gibson* [1993]) The separation of employment and supplying work is advantageous in many cases.

Lastly, but importantly, the fact that the *learning processes* demanded by new technologies and facilities are tiresome and expensive for companies is a principal motivation for outsourcing in the world of fast-changing technology. Most companies are simply unable to keep pace with technologies that change from day to day. The employees' drive to insist on using known methods and solutions as opposed to new ones is also very strong. In the case of smaller-sized companies, constantly changing the technologies of its secondary or background functions might not even be worth it. Of course, for companies specialising in this as their main profile, new developments of technology must be synthesised. "Those who sing outsourcing's praises point to many good reasons to outsource. But not many ponder the implications of widespread outsourcing" (*Withington* [1993]. There is no place here give full detail about the critical points of the phenomenon, but there is no question about it, that in the garden of outsourcer and their partners d not grow exclusively flowers, but we can detect some weeds as well.

Despite all counter-trends, predicting that outsourcing will continue its expansion is not difficult, because various tectonic economic and technological forces - what the motto of the paper is about - moving in the background propel the outsourcing wave. The *redefined space and time* that stems from the condensed pattern of the "global net," the appearance of "simultaneousness" and "space without space" in various segments of the economy virtually annihilate the transaction costs that made entrepreneurs rely on hierarchies. Hierarchies are loosened and a new light is shed on the economy regulating power of the market. "This phenomenon has just begun" as *D. Quinn Mills*, professor at Harvard Business School said about information services discharged by the Internet. "You will see many of a similar sort...And there are very few real restraints as to where it will end." (*Kroenke* [1991] p.514.)

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