Offshore Outsourcing – Models Assessing Destination Countries in the 3rd Decade of 21st Century

Armela Anamali¹  Bitila Shosha²

Keywords: Offshore outsourcing; Destination countries; Assessing models; 3rd decade

Abstract: The new decade began with an alarming health crisis (Covid-19), which countries will probably have to deal with for a long time. The war in Ukraine started in February 2022, agitated and raised the alarm regarding geopolitical and economic security for many countries directly or indirectly affected by it. Changing conditions have prompted firms to look at their operating strategies. Recent studies show how important it is to review the determinants of offshore outsourcing in reallocating activities according to the industries. This paper reviews the models for evaluating destination countries and analysing those considering new circumstances.

1. INTRODUCTION

Global value chains mark an important role in the industrialization process of a developing country, also reducing the costs of the developed ones. Low entry barriers, low capital demand, labour-intensive production, and low levels of skills serve as the primary motivation for developing countries to be immediately involved in low-added value chains (Gereffi & Memedovic, 2003). Global value chains have expanded thanks to trade liberalization and advances in communication and information technology. Foreign companies choose to grow by doing less and outsourcing more. Outsourcing (contracting third parties) is not a phenomenon of the modern economy. Successful theorists such as Coase (1937), Smith (1776), Williamson (1985), and others have proposed outsourcing to reduce costs and stimulate specialization. The outsourcing strategy is profitable for all sizes of firms. Large companies can reduce their costs of contracting a third party in the implementation of non-core activities. Small and medium enterprises have the opportunity to specialize in certain activities and increase their productivity.

Outsourcing dates back as early as the tax collection system on behalf of the Roman Kingdom. Even older professions, such as explorers, traders, or mercenaries, are considered examples of outsourcing (Corbett, 2004). In the 1970s, outsourcing gained increased attention due to the low efficiency of large firms. In the early 80s, many American, European, and Japanese firms built the first offshore factories. Their production was performed in other countries at lower costs and was then exported to the countries of origin (Farrell, 2004). Gradually, they started performing changes in their modus operandi in business by pursuing the strategy of reducing activities performed internally and contracting third parties to carry them out (Kakabadse & Kakabadse, 2005). Although the new century started rapidly through a combination of products and production factors in markets, new situations have once again returned to attention the factors that influence their choice and pick to the attention of the proposed models in the last 2 decades.

¹ University Aleksandër Moisiu Durrës, Street “Miqësia” University Campus, Durrës, Albania
² University Aleksandër Moisiu Durrës, Street "Miqësia" University Campus, Durrës, Albania
1.1. Lessons from Covid-19 and the Russia-Ukraine War

Over the past few decades, production processes have become increasingly more complex in the world economy. Any finished good now typically embodies added value from multiple countries of origin, often crossing multiple borders en route to its point of consumption, in production arrangements referred to as "global value chains" (Antràs, 2020). Covid-19 is considered a trigger (Barbieri et al. 2020) for many firms in the reframing of their functioning and distribution chains. Recent studies advocate many solutions to supply chain resilience and this should be awareness for the destination countries. How they should develop to respond to the changes in supply chains. Maina & Wambugu (2021) suggest as a strategy supplier diversification, and in the meantime, Valero et al. (2021) find the use of productivity-enhancing technologies as a solution to overpass the Covid restraints. Kumar et al. (2020) suggest developing a flexible and resilient manufacturing system to maintain the economic and social sustainability of the production process. The value chains, still shaken by Covid-19, suffered even greater shock from the war of February 2022. Exactly two years after the outbreak of the pandemic, which limited activity and transport side by side, the war struck a very stimulating factor, until before the pandemic, costs. In an uncontrollable situation of high costs, the firms of developed countries are reconsidering the strategy for going back or reviewing destination countries, while developing countries have strategies and industries that must be kept on their feet for survival.

2. METHODOLOGY

The research on the existing literature had the purpose of determining the aim of this study. The literature review helped identify what has been achieved and what can be achieved by going more in-depth into the knowledge in this field of study. The materials selected during the literature review are very diverse. They include books, online literature, reports, journals, scientific articles, etc. The revised literature is of value not only as a reference source but also as a sound basis for addressing the issues of our study.

3. OFFSHORE OUTSOURCING – THEORETICAL APPROACH

3.1. Offshoring – direct investing versus outsourcing

A value chain is a range of activities involving the design, production, and marketing of a product. Activities in value chains can be carried out in combination within and/or outside the firms of one or more countries. Companies tend to outsource activities for product value chains that require a low level of technology. The opposite is true for industries that require advanced technology (Gereffi & Memedovic, 2003).

Transfer strategies to another country may take the form of direct investments, such as setting up subsidiaries or establishing joint ventures. Another strategy is outsourcing local providers (local firms) to conduct the planned activities (Oshri et al., 2011).

Offshore outsourcing is a strategy for balancing the advantages of domestic costs with the costs of international transactions (Mol et al., 2005). Trade liberalisation and a decline in transaction costs have unlocked a massive supply of labour from developing countries (Geis, 2006). Table 2 presents the strategies that foreign companies can follow along with the motives of transferring offshore one or several activities from value chains.
Table 1. Make-or-buy decisions, according to the motive for transferring abroad

<table>
<thead>
<tr>
<th>Motive strategy</th>
<th>Search for markets</th>
<th>Search for efficiency</th>
<th>Search for resources</th>
<th>Search for specific assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct investment</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Outsourcing</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

Source: Authors

The earliest reason for outsourcing activities are the costs they bear to carry them out within companies. Transaction cost theory is used to address internal costs and compare transaction costs in the market. These contracts are not a simple customer-buyer relationship, where the cost is the market price. The execution of orders requires a two-way exchange of information and coordination of work for both companies and outsourced firms. The theory that deals with the evaluation of organisational boundaries and the determination of activities that should or should not be outsourced is the resource-based view theory. Resource Value Base (RVB) theory provides suggestions for contracts that companies can enter into by assessing activities within the business. Outsourcing is the best strategy for low-added-value activities, although today there are no restrictions on outsourced activities. An important aspect is opportunistic behaviour that outsourced firms may exhibit (addressed by agency theory). To avoid such behaviour of providers, one should choose outcome-based contracts. Contracts for the implementation of tailor-made activities (outsourcing) are issues of interest and are the subject of research in any field of economic sciences.

3.2. Offshore outsourcing – Models assessing destination countries in the last two decades

Transferring a business function overseas is directly related to the priorities of the destination countries (Oshri et al., 2015). Important factors include natural reserves, business environment, socio-cultural factors, political force, and legal environment, etc. The successful coordination of these factors indicates the level of readiness to be involved in the world economy and global value chains. In the academic and professional literature, several conceptual schemes (models) have been set up to help assess the advantages enjoyed by countries/regions as potential countries to be destinations of foreign firms in the transfer of activities. In addressing this subject matter, they have in common the following: costs, business environment, workforce availability and specific skills. Economic, technological and geopolitical developments have been accompanied by an expansion of these conceptual schemes. Although the vast majority of research has covered the analysis of foreign direct investment, international production has increased thanks to other forms, including joint ventures and outsourcing (Dunning, 1988). Firms undertake international business to obtain stocks not sufficiently available or too expensive in their countries of origin. They can buy these stocks from another organisation or make direct investments in their acquisition. In either case, they should prioritise where they can best get what they need.

At the beginning of the 21st century, many researchers were encouraged to build models for assessing destination countries as markets for factors and products (Anamali, 2015). According to Kajumba et al. (2020), the world is already a global village with companies established in different countries to be competitive and grow, but the border closure and other restrictions due to Covid-19 hint at the necessity to summarise the costs/benefits of indoor-outdoor tasks. Antrás (2020) goes further with a darkened perspective of globalisation as a cause of the pandemic.

The Heeks and Nicholson model (2002), otherwise known as the model of successful exports, is a successful tool to be acquainted with the experience of developing countries. Their paper focuses on the role of government as a catalyst for developing a certain industry. The authors distinguish the market of products and services, stating that products should have a strong internal market to precede them and be related to exports, while services can grow with little connection to the domestic market. According to them, strategies for being competitive in a certain industry are related to experience. Countries that have entered international markets at an early stage can only compete through added value growth, research development, and diversification. Countries with less experience need to be careful about cost strategy.

Table 2. Strategies for boosting exports

<table>
<thead>
<tr>
<th>Strategies of developing countries, to boost the exports of a certain industry.</th>
<th>Countries involved Early</th>
<th>Countries involved Late</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switching to higher added value activities (products or services) – on the grounds of competition emerging from new firms and countries offering the same quality at a lower cost. <strong>Diversification</strong> – into new segments within the market or into new markets. <strong>Innovation</strong> – launching new products in the same &quot;nodes&quot; of the market</td>
<td><strong>Low-cost</strong> – is a very popular version, although the authors do not regard it as very effective for 2 reasons: – it is not the key factor in customer requirements – all new competitors may enter the &quot;game&quot; following the same strategy. <strong>Market nodes</strong> – the study of market gaps, where competition is low, combined with the right factors for production, has proven to be a successful strategy for developing countries.</td>
<td></td>
</tr>
</tbody>
</table>


The following are some factors affecting the success of exports in a given industry: industry demand, national vision and strategy, international connections and strategy; industry characteristics, and the infrastructure in place. By the infrastructure in place, the authors encompass the following: cost, human resources (size, knowledge of English, level of qualification); information technology infrastructure; transport infrastructure, and public administration (level of bureaucracy). An important suggestion is to strengthen existing clusters in the industry rather than create new (artificial) clusters, some of which have a history of costly failure.

The Oval model (2003)

The Oval model, as illustrated in Figure 1, evaluates a particular industry and uses it as a conceptual scheme for policies and strategies that countries should undertake to improve their national well-being.

In this model, Carmel (2003) included eight factors that, in his view, affect the success of an industry's exports. The government's vision and policies, including tax and financing facilities, lie at the heart of the model. The author has divided the social environment in the country into three important components: a) human resources including national orientation and traditions, size, composition, language skills, and leadership skills, b) salaries and c) quality of life, arguing that talented professionals are inclined to focus on desired locations. The business
environment encompasses the industry and its characteristics, including the effects of clusters, the number of firms, their size, the associations organised by firms in the industry, the level of vision and common brand, and the standards that firms aspire to achieve. The Other two factors are capital (size and resources) and the relationships that arise between individuals, groups, firms, and countries, due to the geographical, cultural, linguistic, or ethnic proximity.

**Figure 1. The Oval model**

*Source: Carmel, 2003*

_Government's vision and policy:_ The government can play an active and facilitating role in every factor of the model. It can influence/facilitate the development of telecommunications, infrastructure, and capital availability, including venture capital, the revitalisation of industry, human capital (through investment in education), quality of life, and wage levels. The success of many countries in certain industries also comes from active policies in their stimulation and development. In national politics, however, a distinction must be made between the start-up strategy and the follow-up strategy (Heeks & Nicholson, 2002).

_Human capital:_ Human capital capabilities are the product of a tradition developed over many generations. Providing competitive human capital is directly related to the development of the education system, universities, vocational schools, etc. This factor, unlike others, emerges as a competitive one after several years of national investment (Carmel, 2003). The size of the human capital reserve is also important. To be competitive, a country must offer educated talents and absorb locals who graduated from other countries. Proficiency in English to integrate easily into the international market and leadership skills for successful management of the firms are two important requirements.

_Quality of life:_ Many companies tend to establish their activity in countries with high quality of life. The main reason is the high concentration of qualified human capital. Educated people prefer cities, or countries with a moral standard of living. When choosing where they will work and live, they must strike a balance between economic opportunities and lifestyle (Florida, 2001). This is one of the main reasons why talented individuals leave developing countries.
**Salaries:** The goal of any firm is to look for human resources and capital where they are cheaper and sell where profitability is higher.

**Industry:** Some characteristics that a successful industry should have are: the existence of clusters\(^3\), the number of firms in the industry, their size, business associations, the level of development of a common vision, the standards that firms seek to achieve these, or cases of entering the market with their brands. The firms' clusters simultaneously enhance competition and cooperation within a common environment. A positive effect of clusters is the dissemination of information from experts in professional networks. Obtaining such information externally is very costly. Success in an industry's exports is directly related to the number of firms in the industry or their size (Carmel, 2003). Firms must specialise in the same area/part of the value chain: in specific services or products. The specialisation helps disseminate information within the cluster and makes it easier to identify the industry. The primary function of business associations is to promote the industry, disseminate information, and set up internal production networks. Finally, achieving international quality standards is a critical element for the growth of the industry.

**Capital:** (Financial) Capital is vital for the growth of an industry in the international market. The government is central to stimulating an industry through subsidies, various facilities, improving support infrastructure, etc. The primary source of capital from abroad comes in the form of foreign direct investment.

**Technology infrastructure:** Technology infrastructure is the level of development of communication and information technology. In the absence of developed technology, the option of joint business clusters in industrial parks facilitates connectivity with the outside world.

**Linkages:** Linkages between people, working groups, firms or countries arise because of geographical, cultural, linguistic or ethnic proximity. The underlying reasons for linkages among businesses in different countries are their common features. The success of an industry can also be the product of connections with the Diaspora. Incentive policies "from flow to absorb the mind" may serve to develop certain industries and cooperation with foreign companies where they are applied.

**The Graf and Mudambi model (2005)**

The model proposed by Graf and Mudambi (2005) serves to assess the competitive advantages of a country as a destination for offshore outsourcing. According to them, the four key factors are information and communication technology (ICT), infrastructure, country risk, government policy, and human capital.

**Infrastructure:** Infrastructure relates to the specific production requirements of an industry. The service industry and the outsourcing business processes require destinations with secure, qualitative, and low-cost ICT infrastructure. In the absence of studies regarding the effect of geographical distance on the outsourcing of activities, such distance is still assessed as an obstacle to the marketing of activities.

---

3 Cluster represents a critical mass of firms in geographical proximity to each other, such as firms located close to metropolises or industrial areas (Carmel, 2003).
Country risk: A country's risk may be economic or political. Economic risk comprises the following indicators: economic openness, inflation rate, exchange rate fluctuations, and the possibility of repatriation of profits, etc. Economic risk increases when these indicators change frequently. Political risk is related to political stability in the country, the intensity of conflicts with other countries, and legal amendments and rules of work and business climate.

Government Policy: Governments may influence the size or form of involvement of foreigners in the industry through barriers or investment incentives. The two key factors in the flourishing of trade activities in a destination are fiscal policy and the clarity of the scheme that the government intends to use in boosting investment.

Human capital: Studies on the importance of human capital date back to the 1990s with the role of human resources in absorbing foreign direct investment. Recently, this resource has become a special asset for specific industries. The authors identify five aspects of human capital: availability, experience, quality, level of payment, and cultural differences. An important condition for transferring to a given country is the size of the human capital reserve with proper experience. International companies may look for countries that offer such reserves. Simultaneously, they offer the opportunity to acquire new knowledge and transfer knowledge to the environments where they operate. The quality of human capital is a determinant in some industries. It includes elements such as technical expertise, knowledge of foreign languages, and managerial skills, etc. Job compensation is one of the main motives for offshore outsourcing (Abraham & Taylor, 1996; Fenstra & Hanson, 2001), but if there are significant cultural differences between countries, transaction management becomes very costly (Pinto et al., 2013). Culture is central to the employee's approach to new technologies and relationships with others.

Graf and Mudambi (2005) also included moderating factors in their model. Moderating factors play an important role in the perception of foreign companies regarding infrastructure, country risk, government policies, and human capital in the priorities as advantages of a certain country. They are classified into specific factors of the firm factors in a given context. Specific factors are related to the main reasons that impel firms to outsource activities such as cost reduction, improving business processes, improving skills, etc. Situational factors refer to business processes, standardisation, and strategic importance, etc. State risk is critical for strategic processes, whereas the standardisation of the activities is impactful on human capital importance. The experience of foreign companies in the global value chain moderates the intensity of outsourcing (Graf & Mudambi, 2005).

The Farrell Model (2006)

The Farrell model (2006) is amongst the most detailed models in terms of selecting the destination country (Oshri et al., 2011). The model scrutinises six factors: costs, availability of skills, risk profile, environment, market potential, and infrastructure.

The major costs of a country comprise those of labour, IT infrastructure, real estate, and business taxes.

The availability of skills is analysed in three aspects: the size and training of the workforce, sector size, and landscape of local firms. According to Oshri et al. (2011), a proportional increase in labour force pools is important for long-term decisions. This proportional increase in human
resource pools keeps salaries low. The size and strength of a sector are measured through the monetary volume, the number of qualified personnel in conducting activities, and the share of exports of this sector concerning total exports. Assessing the skills and capacities of a supply firm serves to test its aptitude in meeting the further needs of the client, continuous improvement and readiness to coordinate the business according to the client's request.

![Figure 2. The Farrell model](image)

**Source:** Authors based on Oshri et al., 2011

The environment includes government support, business environment, living environment, and openness in the region. Government support is related to FDI policy, the level of bureaucracy, legislation on employment, and the level of corruption. The business environment comprises cultural differences and business ethics. The living environment refers to the quality of life, the spread of HIV/AIDS, and the per capita report of serious crimes.

The quality of infrastructure is the combination of the quality of the ICT network, real estate, and electricity supply.

The risk profile encompasses opportunities for devastating events, security in the country, and strict laws on the protection of intellectual property. The devastating events are workers' revolts, political instability, and natural disasters. The security variable is related to the risk of fraud and terrorist crimes. Regulatory risks are measured through the stability, fairness, and efficiency of the legal framework. Moreover, inflation risks, currency fluctuations, and freedom of capital are considered in the context of macroeconomic risks.

Market potential is calculated according to gross domestic product (GDP), GDP growth rate, and opening in nearby markets. According to Oshri et al. (2011), enlargement in the region may occur in the following forms:
Offshore Outsourcing – Models Assessing Destination Countries in the 3rd Decade of 21st Century

- Subsidiary, where the firm controls and manages the activity using the labour force, infrastructure, and reserves of the other country;
- Offshore outsourcing;
- Distributors in the region on behalf of foreign firms.

**The A.T. Kearney model (2011)**

In 2003, the A.T. Kearney Company published the first model for assessing destinations, starting with 11 countries. The aim was to provide an instrument that would serve to assess 3 factors: cost (40%), environment (30%), and human capital (30%). Cost carries a higher percentage, as it is the primary motive for transferring abroad.

*Financial attractiveness:* The financial advantages of a country are divided into three major categories: labour costs, infrastructure costs, tax, and regulatory costs.

*Availability and skills of labour force:* The categories of the labour force are: experience and quality in the offshore services sector, workforce availability, education and language, and the risk of withdrawal.

*Business environment:* The business environment consists of four major categories: country risk, existing infrastructure, cultural exposure, and intellectual property security.

**3.3. Models Summary**

Offshore outsourcing, designated as the contemporary trade of activities, is studied for the motives that urged companies to outsource, the criteria they evaluate for selecting the firm inside/outside the country, and the performance of this strategy. The choice of a foreign supplier goes hand in hand with the requirements (criteria) that the destination country must meet. Among the theories that study the factors influencing the increase in the advantage of one country over another are the eclectic theory (OLI paradigm), the theory of location, and the theory of internationalisation. The country's selection is directly related to the motives of international companies in transferring activities abroad. The government of the destination country is central to boosting investment, outsourcing domestic suppliers, and increasing exports. The two major factors in promoting the outsourcing of domestic firms by foreign companies are fiscal policy and the clarity of the scheme that the government intends to use to boost investment (Carmel, 2003). The models proposed by Dunning (1988) and other authors, presented in Table 2, have three factors in common: costs in the destination country, environment, and infrastructure. Each model proposed by the authors is within a certain context of motives, strategies, and the industry in which firms operate. When foreign companies decide to outsource value-chain activities, they are driven by different motives. The most often encountered motive is cost reduction. In all models presented in Table 2, the costs of the destination country are important in the decision-making of the companies for transferring abroad. Companies aiming to improve business processes and enhance skills within the value chain are looking for countries with developed industries for the required activities. The concentration of industries and the geographical clustering of firms tend to maximize the advantages of one country compared to other countries. If countries (or cities) manage to be affirmed as attractive destinations for certain industries, then the goal is achieved (Birkinshaw, 2000). Coombs & Battaglia (1998) describe the trade of activities as trade in services. The primary requirement in transferring activities to a
destination country is the size of the human resource pool, readiness to work 24/7/365, and the required level of qualification. This qualification is the determining factor for some industries. The quality of human capital includes technical expertise, interpersonal relationships, knowledge of foreign languages and the ability to apply new technologies (Graf & Mudambi, 2005). The environment of the destination country includes socio-economic development factors such as gross domestic product per capita, domestic and foreign trade, traditions, economic freedom, the level of corruption, etc. The development of international trade in intermediate, final products, and services has intensified thanks to trade liberalization and improvements to transport and ICT infrastructure in destination countries.

4. CONCLUSION

All the summarised models have costs, infrastructure, and the environment as important factors in choosing the allocation of their activities. Offshore outsourcing as one of the integration strategies in global value chains brings to light some important requirements for firms and destination countries, which wish to remain competitive in this global market.

First, the service industry dependent on information technology is challenged by updated programs that require not only an elevated information technology infrastructure but also a skilled workforce. Online services are a trend that has grown in particular because of the isolation and distancing due to Covid-19.

Second, business costs that have a significant weight on business performance have undergone significant growth. If outsourcing is considered a strategy that minimises costs, transforming them into fixed (as contract costs), offshoring in the literature of the Last 2 years has focused on the phenomena of reshoring and near shoring. Transportation costs have become a challenging cost in affected industries, and the rising cost of living has demotivated many female workers in labour-intensive industries. Costs as a driving factor for many destination countries must be reviewed in the long term, as it is a strategy that seems to leave behind remote countries and those with a small local market.

References


