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# Legal Services as Commodity: Reinventing the Lawyers' Services

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## Abstract

Business service is a very broad, highly fragmented, highly labor-intensive, and capital-adverse industry that provides nonfinancial business-related services to other firms. Due to the broad nature of the industry, the definition of business service includes various services. Recently, powerful forces have reshaped the market for legal advice delivered to corporations. The “new normal” is characterized by a higher price pressure (clients demanding another megatrend, transforming workflows and business models. The volume of data used in legal advice has increased exponentially—a pattern seen in many other industries as well. Legal industry (as a part of business services) has experienced a global paradigm shift in the delivery model for legal services, known as legal process outsourcing, which transfers the work of attorneys, paralegals, and other legal professionals to external vendors located domestically and overseas. Legal outsourcing (both onshore and offshore) is transforming more for less) the deconstruction of formerly homogeneous legal services into different activities and the rise of legal process outsourcing. The digitization of legal data constitutes law practice as law firms and corporate legal departments seek to minimize costs, increase flexibility, and expand their in-house capabilities. With the emergence of legal services outsourcing, the future generation will lead a more sophisticated life, with a higher value of legal work, at a higher level of quality and speed, and dramatically at a lower cost. In this chapter, the author deals with the process of the transformation of legal service into a legal product and points to some dilemmas during that process. This chapter argues that outsourcing ultimately will have a positive effect on the legal profession and development of the quality of legal services. In the second part of this chapter, the author also stresses out some information about different possibilities, how to organize virtual law firms (with legal tech) for low-budget legal services into the Slovenian case.

**Keywords:** LPO (legal process outsourcing), LSO (legal service outsourcing), virtual law firms, new business model, legal tech, corporate secretary, corporate governance

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## 1. Introduction

Recent reports and research studies in the legal services area predicted a significant change in the practice of the legal services industry. This covers 10 key legal trends including outsourcing, globalization, deregulation, virtual law firms, legal search engines and other web-based legal services, commoditization, multichannel communications, a growing number of lawsuits in every nation, a reduced state funding for those on low incomes in court cases, and rapid growth in the complexity of legislation and regulations [1].

The meaning of law is changing drastically due to a process where law is becoming more a good and less a service that is provided by legal professionals and law firms. The purpose of this chapter is to define and critically evaluate the challenges that such transformation is causing and to offer possible solutions and explanations for this global occurrence. As a product, law is rapidly entering the field of economics; in this newly shaped world, those lawyers who will find a way to adapt will be more successful. The fact of the matter is that powerful forces are reshaping the corporate legal-advice market, including price pressure from clients and the digitization of legal data. The chapter represents the objective on how legal-technology solutions can help law firms succeed in this new era, but this can be achieved only if they understand the tech landscape and redefine key elements of their business model.

In the era of tight economic conditions, the view on the legal profession and legal services has changed radically. The prevailing practice of accessing clients individually and offering them “universal” legal expertise has been superseded by providing knowledge belonging to narrow, specialized legal fields. Yet, it is not only specialization that has affected the way legal services are offered, the process of evolution of legal services has also been stimulated by the involvement of new technology. The ultimate objective of the emerging process was decreasing the costs of legal services; however, this was initially in total contradiction with the efforts to acquire high-quality expert legal knowledge and to ensure a 24/7 availability of lawyers to their clients. A combination of all these circumstances and goals, along with the technical advancement and easy access to Internet, has led to the occurrence of legal service outsourcing (hereafter referred to as “LSO”). Now, the process is slowly moving from the common law states to the states of the continental law system (the so-called transatlantic bridge).

Offering legal services to “larger” demanders in a technologically sophisticated manner has risen significantly, which has sparked the idea of offering “everyday” legal services to the legally illiterate in return of small fees, most effectively through the so-called virtual law firms. With the occurrence of LSO and legal process outsourcing (hereafter referred to as “LPO”), legal service became a good and is thus subject to all the rules of business. It is safe to say that it is well past time to face the fact that law is a business—and we better start acting like businesses, or soon, we will all be out of business. The exceptional growth of this new industry’s market is yet another proof of its ascent. Namely, the market of outsourced legal services jumped from 554 million USD in the year 2011 to 1109 million USD in the year 2014, which presents a 26% increase (“Legal Process Outsourcing: Crisis Creates New Opportunities for

LPOs," 2009).<sup>1</sup> It was estimated that outsourcing of legal services to evolving markets would be worth more than \$4 billion by the end of 2015 [2].

Key questions regarding the development of LPO are the following: what are the business risks related to the preparation and review of contracts worth millions of EUR? Will the quality of services be affected? What is the damage that could be caused by bad (unclear) contract clauses, bad managerial contracts, concluded employment relationships, cartels, violation of rules on competition, etc.? How much money can LPO really save? What about the risk of sharing sensitive legal information? How legal technology will change the business of law? Questions like these appear to the firms that do not have their own in-house legal departments on a daily basis. It is therefore even more important that the legal services offered on the market be of high quality, preventing any damage that could possibly be caused to the companies and individuals. Answers to those questions lead to the main objective—the process of changing the law from the offering of services to the offering of goods.

## 2. Characteristics of LSO/LPO

The basic characteristics of LSO are savings in the view of lower costs of legal services, possibility of acquiring expert knowledge from different fields of law, better and more effective exploitation of existing legal knowledge capacities (i.e., in-house lawyers), easier hiring and better availability of personnel and resources in case of larger unexpected projects, permanent availability of services considering different time zones and temporal difference, higher flexibility, etc. [3].

The times of large law firms employing a large number of legal professionals are passing. This observation is easily demonstrated with the fact that large law firms (employing more than 250 lawyers) are hiring as much as 67.5% of (external) contractual lawyers, while this number in smaller law firms amounts only to 38.4% [4]. Individuals in charge of law firms are evolving from being strictly lawyers to acting more as managers, marketing their products and conducting law business.<sup>2</sup> Consequently, an increased number of lawyers from large US firms are considering establishing or have already established smaller law firms, where they are hiring cheaper legal services from abroad (mainly from India) by using modern technology (e-business) [6]. Online providers of legal services are on the rise, since their number grew from 15 in the year 2005 to more than 200 in the year 2011 ([6], p. 9).

Constant pressure to lower the prices has triggered intense competition among providers of legal services, leading to an eventual lowering of prices and to a corresponding demand for higher effectiveness, with zero tolerance for any possible decrease in quality. Consequently, a conclusion can be made that from the users' viewpoint, there is a permanent race to the

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<sup>1</sup>For example, the top three firms for business services (by the Revenue—Global 100): Latham and Watkins LLP: Headquartered in Los Angeles with offices in 14 countries, generating a revenue of \$2.82 billion, Baker and McKenzie had a revenue of \$2.62 billion, and DLA Piper earned \$2.47 billion. Nadimpalli [1].

<sup>2</sup>Important information from the year 2010 indicates that 43% of corporations and 73% of law firms use legal outsourcing [5].

top, while the providers of services compete among themselves in a race to the bottom. At the same time, LPO is recognized as a positive trend in the global economy ([6], p. 6; “ABA Formal Opinion 08-451,” 2008). It should not be overlooked that LPO enables smaller law firms and individual lawyers to also run for larger deals, with no fear of being “undernourished” in terms of knowledge or staff. Thus, LPO will clearly blossom also in the future, in relation to not only large law firms connecting with other large firms but primarily among smaller law firms and individual lawyers who will be able to accomplish their goal of offering a high-quality and affordable legal service by connecting with smaller providers of legal outsourcing.<sup>3</sup>

Law firms from USA and UK consider India<sup>4</sup> as their first-choice country for obtaining LPO (lately, India is followed by the Philippines and South Africa), taking all the characteristics of LPO into account. Generally, it is not the quality of legal services of Indian lawyers that is decisive (they are not recognized as better or superior), but the fact that an equally good service costs significantly less than a service rendered by a US or a UK law firm (Law Without Borders, 2011: pp. 8, 10). It should be pointed out that India earned such a position also due to historic facts and the official use of English language. The country is a real superpower on the legal market, having more than a million lawyers and more than 128 providers of legal outsourcing, who, in the year 2010, exported more than 640 million USD worth of legal services ([10]).

LPO has important effects also from the viewpoint of global (macro) economics, since the rise of LPO is increasing the welfare and corresponding consumerism.

When considering LPO, the well-known saying “small is beautiful” is very eloquent. Namely, the focus of legal business has switched from large law firms to boutique law firms, that is, providers of a smaller spectrum of legal services. Such firms are proving to be more responsive, the threat of possible conflict of interests is lower, they are more specialized in specific legal areas, and are, finally yet very importantly, cheaper ([6], p. 9).

LPO has also caused a change in the orientation of legal service providers and lawyers using LSO in their everyday work—law firms and lawyers are increasingly concentrating on the management and brokerage of legal services. They are thus expected to execute only the final transactions and deals, to negotiate, appear in court, supervise external consultants, and offer legal advice, while all the other work is done by external consultants and collaborators. As a consequence, a new branch is emerging, redirecting the lawyer from being a provider of basic legal services to being an organizer of providers of those services [11].

Due to the increasing presence of the LPO process, certain warnings and concerns are coming to light, particularly regarding (“The resurgence of corporate legal process outsourcing,” 2011) the following:

<sup>3</sup>A similar viewpoint also shares [7–9].

<sup>4</sup>As a result of this outsourcing, tens of thousands of legal jobs have moved offshore between nations. The majority of legal services outsourcing was moved to India due to the low hourly cost (80–90% less) of legal services, as compared to USA and Europe (Nadimpalli [1]).

1. **Security and confidentiality:** legal work is confidential by its very nature. Many general counsels worry about transferring data to outside parties, especially if the data are being sent across oceans.
2. **Quality:** corporate legal departments are accustomed to face-to-face interaction with the people performing legal tasks. Legal executives may fear that work performed remotely will not meet the department's quality standards. In addition, legal executives may be unwilling to support the cost of deploying internal resources to provide quality control over LPO-provided services.
3. **Ethical implications:** risks related to the unauthorized practice of law made many general counsels uneasy about using LPO providers.
4. **Client/outside counsel relationship:** whether due to the perceived threat of an LPO provider's impact on the bottom line or a lack of trust in the quality of outsourced work, legal departments had a difficult time obtaining outside counsel's buy-in for the use of LPO.

Users of LPO are overcoming these flaws principally by increasing the transparency in hiring external experts and by acquiring their clients' consent or at least approval for the work on their case to be partially executed by outside counsels. In addition, all providers of outsourcing have to be regularly monitored and supervised and be subject to valid certification, performed by independent institutions. Moreover, LPO users themselves are responsible for verification and supervision of the providers' competences and abilities in order to ensure the best education processes, knowledge transfer, and selection. On the other side, it is of the essence for the providers of outsourcing to avoid any possible conflicts of interests or inappropriate backgrounds and to assure psychological stability, adequate infrastructure, and protection of data transfer and storing.

### 3. LPO models

LPO, as a result of technological influences, can be observed in different (technical) forms ([12], pp. 1, 4–6):

1. as external (foreign) LPO (mainly across-ocean outsourcing, generally from related legal systems, leading to huge savings in terms of time and money due to obtaining cheaper services of the same quality);
2. as near LPO (nearsourcing) (meaning chiefly special knowledge gained through the division of work principle, where in-house lawyers retain enough time to work on special matters while the specialists in particular fields of law are hired);
3. as LPO executed by non-lawyers, which can be established as external LPO or nearsourcing (in these cases, LPO providers are performing especially the tasks of technical assistance and general legal work that can also be performed by non-lawyers).

Each of the listed technical forms can be implemented in several different manners, while certain aspects are explicitly underlined, measuring from strategic legal advice (reserved generally for law firms) through technical legal advice and general legal work to repeatable legal work. The latter is mostly attributed to external operators (outsourcing). In this way, law firms and outsourcing are approaching each other, each from its own side. As we move on the measuring rod from law firms' services to LSO providers, we can clearly identify a transformation from art into craft.

In addition, specific characteristics of different providers of legal services need to be noted. As regards law firms, a high-level complexity of their work is especially in the forefront, which is often judgment-based with a priority focus on legal substance. On the contrary, legal outsourcing services are based mainly on high volume with a priority focus on procedural issues.

On the grounds of such evaluation, it is achievable to indicate typical forms of outsourced legal tasks that include document review, contract and template drafting, contract review and analysis, pre-deal and post-deal due diligence, case law research, legal research, drafting of legal papers, legislative tracking and analysis, documents redaction, M&A preparation, witness interviews, medical summaries, etc.<sup>5</sup> According to a recent study by Thomson Reuters and the Georgetown University Law Center, 51% of law firms and 60% of corporate legal departments use at least one outsourced service provider—but almost exclusively for document review [14].

In the future, such a legal-tech approach will determine the changes, namely [15]

1. stronger competition from boutique firms in respect of bespoke work and from legal process outsourcing providers and legal-tech vendors in respect of standardized work; and
2. evolving client expectations, which are becoming more sharply focused on efficiency (quicker, more tailored advice), along with a call for a greater transparency on fees and a more seamless collaboration between internal and external lawyers.

#### 4. Legal process outsourcing in EU

The European Union (EU) countries have long been resisting the LPO process originally introduced in the English-speaking common law jurisdictions, including USA, UK, and Australia. Yet, regardless of the opposition, globalization and multinational corporations have inevitably brought this process also to EU.<sup>6</sup>

<sup>5</sup>Services of legal outsourcing consist of 26% documentation review, 22% work with contracts, 16% support in court proceedings, 15% legal research, 8% financial reviews, the residual part belongs to other services [13].

<sup>6</sup>For example, USA is home to several hundred legal-tech start-ups and established software providers. According to *TechCrunch*, such start-ups attracted more than \$150 million in total venture capital investment during 2013. The considerable investment has led to the development of more solution offerings available for adoption. By contrast, Germany has far fewer legal-tech providers (only about 10), and adoption rates among law firms and corporate legal departments are lower than in the USA (Veith et al. [16]).

Expansion of LPO has hit a number of obstacles, including different historical reasons, which is why the number of European providers of legal services remains scarce ([17], p. 4). Among the inhibitors of LPO in the European Union, language barriers are especially pointed out, since the significant multilingualism effectively shields EU from the invasion of foreign service providers. A further problem is also the continental law system as such, which is neither unified nor harmonized in the field of procedural issues and enforcement, where *lex nationalis* has retained a complete dominance. Ultimately, LPO in the EU is hindered also by the conservative mentality of continental lawyers, following predominantly the “wait-and-see” approach ([17], p. 4).

Notwithstanding the negative presumptions, an increased activity in using LPO can be observed in the EU, especially as regards international business of banks and technology companies. European LPO is oriented mainly toward offering help regarding the elements of common law system and contains notably less litigation support, while the development is primarily concentrated on LPO that ensures EU privacy standards and meets quality expectations, specific to the European area. A vast majority of LPO process are related to the civil relationships, especially in the department of corporate law.

A conclusion can be made that the progression of LPO in the EU is not thoroughly following the path the common law states have taken. Yet, due to the unstoppable globalization and international corporations that have essentially forced EU into adoption of LPO, a slightly modified LPO model has been shaped, used especially in the civil law sphere regarding contracts, representation, corporate compliance, due diligence, etc.

Unlike the autonomous US regime that leans on the American Bar Association Rules, the LPO system in Europe is subject to statutory norms on data protection and quality of services. The (rare) providers of LPO are thus obliged to obtain certain certificates in order to be allowed to pursue their activities,<sup>7</sup> whereas the area of data protection is governed also by the Directive EU 95/46/EC.<sup>8</sup> Autonomous arrangements can also be governed by master service agreements (MSAs), taking European *ius cogens* into consideration.

In EU, an internal LPO process can also be observed, introducing cooperation between different member states (where LPO providers primarily originate from the UK). The LPO process is thus steadily expanding and paving the way for the lower costs of legal services. EU and its member states will have the privilege of being able to follow the example of the evolution of LPO in the USA and use the American model to properly regulate the area of LPO in terms of quality control and data protection.

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<sup>7</sup>For example, ISO 27001 (business continuity) and ISO 9001 (quality management) ([17], p. 6).

<sup>8</sup>Directive 95/46/EC of the European Parliament and of the Council of October 24, 1995, on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

## 5. Potential business models: case Slovenia

### 5.1. One-stop business model

In Slovenia, one of the EU member states, the LPO process has become apparent as well, seeing that an increasing number of law firms are using the opportunity to hire legal services from various external providers. Among the latter, especially noticeable are specialized institutions possessing expert legal knowledge in different areas of law and law firms and offices that are not necessarily employing only lawyers but are still capable of executing different legal tasks and services for their customers. Many non-lawyers can be found among such providers, resulting in a questionable level of quality of their services. The core of the arrangement between the user and the provider is governed by a master service agreement (MSA).

The LPO process in Slovenia is heading in two directions. Firstly, adopting the so-called division of work, Slovenian lawyers and law firms are utilizing high-quality expert legal opinions regarding their clients' matters to either eliminate the causes for potential court proceedings or substantiate and prove a certain legal position. Acquisition of expert legal opinions often benefits the clients, especially in terms of preventing the case to appear on court and thus removing possible risks of unpredictable judicial ruling, while also saving time that would eventually be spent before the court proceedings are wrapped up. On the other hand, when the court proceedings are already in place, these expert opinions help both the clients and the court to draw necessary objective and unbiased conclusions. In these cases, clients and law firms primarily order legal opinions from renowned top experts, generally employed at universities or institutes, specialized in a narrow scope of legal matters.

The other LPO model stems from the practical need to offer the clients different kinds of solutions in one place. Here, legal services present only one part of the provider's portfolio. The majority of clients using such services do not have their own legal departments, making their demand for legal services the number one reason for hiring an external provider. Afterwards, they become familiar also to other services offered by the same provider and, in accordance with the "phone booth" principle (if there is no phone booth, a wish to make a phone call cannot arise), start feeling the need to use those other services as well. The client is therefore offered a complete "service" in one place (one-stop business model, hereafter referred to as "OSBM") and given a possibility to use a full spectrum of services from the areas of law, economics, accounting, business, revision, company evaluation, taxes, marketing, PR, compliance, corporate governance, etc.

The described model has gained in relevance with the surfacing of the economic crisis, when a need emerged to shape a model for business and legal restructuring of corporations. OSBM has proven to be a suitable solution especially in the field of small and medium enterprises that lack the knowledge necessary to perform restructuring on their own. However, the purpose of OSBM is not only to restructure the clients and leave them to the unknown fate but also to help the clients raise their operation to a higher level and to keep offering them the services they require. These services can be executed either by a single entity or by a number of providers associated in a consortium. In the phase of realization, teams of people with

different skills are often formed, approaching the restructuring by (1) offering advice or (2) by taking over the functions in the corporation or taking over corporation's obligations.

Recently, Slovenia is witnessing an increased demand for simple legal services, including drafting of formal letters, complaints, objections, contracts, etc. When the need for such services appears, clients are afraid of hiring lawyers and law firms due to their high rates. This outlook gave rise to the idea of a low-budget lawyering that would enable customers to access simple legal services using modern technology. The first step was identifying a service provider that is close to the customers (e.g., banks, post offices, insurance companies), which was followed by establishing a pilot action, where the reception office acts as a vendor of legal services, offering low-cost answers to simple questions in the time frame of 48 h.

## **5.2. LPO and corporate governance: idea of business model with corporate secretary**

Corporate secretaries have a central role among the corporation's employees in the Anglo-American legal system (Jovanovič, 2000). Perhaps, in the future, we should give a thought to introduction of such a position also in Slovenia, even though direct parallels between the two legal systems are not possible. In certain Slovenian companies, corporate secretaries can already be noticed; however, their roles and tasks are not clearly defined and generally gravitate more toward the questions of compliance and security of the corporation, while having less emphasis on the development and monitoring of the company's corporate governance (hereafter referred to as "CG"). In certain cases, an interference between the competences of compliance officers and internal revenue officers can also be observed, the latter even appropriating the concern for the homogeneous CG. Such situation is especially visible in relation to the groups of companies.

In Slovenia, an additional variant of the corporate secretary has been established, namely the supervisory board secretary, introduced by the CG Code of 2009 under Principle 11. The function of the supervisory board secretary is offering special help to the supervisory board, much more than taking care of homogeneous CG and its development within the corporation. The main duties of the supervisory board secretaries are writing minutes of the meetings, maintaining the archive of the supervisory board, and supporting the board on the organizational and managerial matters. In addition, members of the supervisory board should be able to cooperate with the secretary also outside the supervisory board meetings, making the supervisory board secretary a permanent bridge between the supervisory board, its members, and the company. This would also ensure a proper flow of information between the members of the supervisory board, the supervisory board as such, and the company.

The role of the supervisory board secretary also includes organizational and expert support to the supervisory board and, especially, to its president. In addition, the secretary of the supervisory board should be responsible for facilitating the training and acquiring external support for supervisory board's operation. The supervisory board secretary's function is thus very demanding and carries high responsibility with it, which calls for a special arrangement regarding safeguarding of confidential information to which the secretary of the supervisory board gains access during execution of the duties.

It can thus be observed that various types of secretaries have evolved in Slovenia, representing different interests as they are named by different bodies. It can also be seen that all these types of secretaries can act as in-house representatives, outsourced professionals, or a combination of both.

The function of the supervisory board secretary can therefore also be conceived in the form of outsourcing (basically as the nearsource model LPO), especially due to the reason that a single person could professionally execute its duties for more than one supervisory board. Such solution would be specifically reasonable for smaller companies that have a two-tier management system. In Slovenia, into such positions are generally named employees of the company; yet, we believe that in accordance with the proper understanding of the supervisory board secretary's duties and responsibilities, these positions should be occupied by highly qualified professionals who could, as experienced corporate lawyers or CG experts, valuably contribute to the work and decision making of the supervisory board. In most cases, companies lack such personnel, which is why hiring external professionals (individuals or institutions) who could provide supervisory board with quality services and support regarding CG questions seems a sensible move. This would also decrease the need to engage different external experts to support the supervisory board, while adding to a good corporate governance and good practice. In group companies, such function, spanning over supervisory boards of a number of subsidiary companies, could importantly contribute to a more homogeneous management.

The introduction of corporate or supervisory board secretaries in the form of LSO would materially contribute to a more professional and unified practice and the development of CG in Slovenia and elsewhere. In this sense, one could also interpret the new discussions and recommendations of the European Commission, relating to the quality of reporting on corporate management (Recommendation 2014/208/EU). Even though the recommendations explicitly apply only to the public limited companies with shares dealt in on a stock exchange, they can prove useful also to smaller companies. Namely, CG statements certainly contribute to a better CG, while a key role in their preparation and monitoring could be assigned to company's corporate or supervisory board secretaries.

## 6. Conclusion

Recent studies revealed that the legal market is a dynamic, fast-changing, environment due to a combination of technology and globalization. Cybersecurity and data privacy and media and technology are the two red-hot practices in the legal market [1]. Technology and international participation in the legal process has not only allowed workers to work from lower-cost locales but has allowed skilled domestic attorneys to provide services easily to the world. Outsourcing is a positive development, because it not only increases client access to legal services by allowing traditional clients to meet their needs on a smaller budget but also helps reach a new category of clients who could not afford legal services previously ([12], pp. 18, 11–12).

It is anticipated that changes in this industry will force lawyers to offer a fixed price deals, rather than an hourly-based billing system. In particular, it will motivate lawyers to be also more efficient [16]. Furthermore, law firms will need to implement more sophisticated, customer-focused, services that aim to overdeliver and exceed expectations. Reports and research studies in the legal services area predicted a significant change in the practice of the legal services industry, which covers 10 key legal trends including outsourcing, globalization, deregulation, virtual law firms, legal search engines and other web-based legal services, commoditization, multichannel communications, a growing number of lawsuits in every nation, a reduced state funding for those on low incomes in court cases, and a rapid growth in the complexity of legislation and regulations [1]. A direct influence of LPO can be seen in the form of lower costs for clients, specialization of legal work, standardization of the questionnaire for legal outsourcing, easy legal access for all consumers, and, last but not least, also less litigations, due to a better legal environment and knowledge. The legal tech will also have the impact on individual roles and legal education to supply the legal market with lawyers who have the knowledge and skills essential for success in a landscape reshaped by legal tech.

It is safe to state that technology has opened the door for outsourcing in the legal profession and that outsourcing has changed the territorial and professional limits of the legal profession. Yet, the amount of questions and challenges regarding the mechanism indicates a live process that will keep evolving in order to assure that all the requirements concerning security, confidentiality, quality, ethics, and client relationships are met. The service providers who will be able to provide the best service at the lowest rates will ultimately succeed. In the end, cost-efficient lawyers will be able to serve clients better in the new reality of small legal budgets.

Since legal service outsourcing is increasingly gaining attention and importance in relation to offering specific (narrowly professional) legal services, the role of corporate and/or supervisory board secretaries could also be pointed out, due to their ability to use their expert knowledge in order to contribute to the use and implementation of good corporate practice in companies. This could also affect preparing and monitoring CG statements using the “comply or explain” principle, as recommended by the EU.

To sum up, Slovenia has clearly joined the global race to the top in offering outsourced legal services.

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# Not Yet Modern? Longitudinal Organizing Capabilities of Offshoring Enterprises

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## Abstract

While offshoring is well covered in literature, its organizational aspect and long-term development are not known. This chapter seeks to remedy this. Reviewing longitudinal offshoring studies discloses diverging findings. A range of activities has been offshored. The framework for organizing capabilities includes functions, tools, management/leadership and boundary spanners. A four-phase linear model of long-term offshoring is proposed, encompassing transfer, resource searches, transformation and development. Four case studies of offshoring organization were made: one longitudinal process is described. Their development paths differ, they do not go beyond transformation; two revert to backshoring; three do captive arrangements. Two employ project organization. They do not follow a modern pattern of linear progression.

**Keywords:** offshoring, longitudinal, organizing, capabilities

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## 1. Introduction

Offshoring and outsourcing are becoming central strategies in the management repertoire [1]. Pushed further by contemporary crises in Western economies, Western enterprises are forced to think in new and innovative ways and to use all their resources to develop new organizational forms. In this development, offshoring and outsourcing become more important for a range of business research strands.

It is argued that offshoring involves long-term relations [2] and goes beyond contracting. Hätönen and Eriksson [2] even claim that the transactional view is obsolete. At least harvesting benefits from offshoring should be viewed in a long-time perspective. Long-term offshoring involves establishing organizations and reorganizing them at appropriate times. Thus, offshore organizing is a combination of structured, more stable organization and processes of (re)organizing.

Against this background, the aim of this chapter is threefold:

- to develop a concept for organizing capabilities in emerging long-term offshoring setups.
- to assess existing literature, including empirical findings of long-term offshoring and their organization.
- to describe and analyze organizing capabilities in four cases of mature offshoring outsourcing setups, focusing on more recent developments.

Offshoring organization is therefore viewed as a process. Pettigrew [3] makes the case for processual longitudinal studies, claiming and demonstrating that they better account for organizational journeys of advance, success, retreat, barriers and missed opportunities. They avoid the ex-post rationalization of snapshot studies, where enterprise players (perhaps unwittingly) arrange their narratives according to success and failure, heroes and scapegoats [3].

Our case enterprises have limited resources; they are family-owned, with a family member as CEO. They cannot be understood simply as SMEs, but in two cases, central elements are legally SMEs (less than 250 employees) combined with contracts, strategic partnering and other arrangements. The other two cases are among the 500–1000 largest companies in Denmark. The companies have long been engaged in offshoring, enabling study of longer term organizing capabilities. Our focus, however, is on a more recent period (2007–2012).

The theoretical frame is multidisciplinary, combining enterprise internal and external theories [1, 4, 5] but with a basis in the resource-based and knowledge-based views of the firm (RBV and KBV [6, 7]). Capability is here viewed as the ability to perform actions. Teece et al. [8] try to understand how enterprises develop and sustain competitive advantage and suggest that this ability can be thought of as dynamic capabilities. This idea has been criticized [9], but we argue that in the context of conceptualizing organizational capabilities in long-term emergent (often rapidly changing) offshoring companies, it makes sense to think of these capabilities as dynamic (see also [10]). Organizational capabilities consist of two main components: relational capabilities [5] and knowledge-handling capabilities. Knowledge is important here, but the ability to execute is equally important. Therefore, ability to integrate knowledge and govern knowledge processes and interactions are of particular importance.

This chapter contributes by assessing the existing literature's longitudinal studies of offshoring presenting a concept of organizing capabilities that merges relational and knowledge-handling capabilities. It presents one case description among four cases of offshoring manufacturing companies analyzed in a long-term perspective, including organizing capabilities. The literature review is also a contribution in itself, as other recent reviews [5, 11] do not cover long-term development (Hätönen and Ericsson [2] is an important exception).

The chapter is structured as follows: first, a section describing the literature review method, the cases and the empirical method employed; then, the literature review and the conceptualization of organizing capabilities is developed. The empirical section describes one longitudinal case, followed by an analytical discussion and comparison of the four cases. The chapter ends with a conclusion.

## 2. Method

As advocated by Bunyaratavej et al. [11], the overall approach is multidisciplinary, but with a basis in the resource-based and knowledge-based views of the firm (RBV and KBV [6, 7]). We use an interpretivist and abductive epistemology [12]. Both theoretically and empirically, the chapter builds on one author's PhD project, which adopted a longitudinal approach to offshoring.

An initial literature review was carried out in 2007, which inspired the initial orientation of the research, providing concepts for transfer of knowledge, management and organization. A second literature review was carried out in summer 2012, following Hart [13] and Webster and Watson [14]. The second search's aim was to assess the knowledge accumulated in leading journals on offshoring companies' longer term development and their internal and external organization.

The delimitation of the search—following Hart [13]—was aided by relying on several previous literature reviews of the area [2, 5, 11, 15, 16]. These reviews suggest that international business, strategic management, operation management (supply chain management), (industrial) marketing and purchasing would be important research strands to pursue. It was decided to combine breadth with depth by using three search engines, and also investigate selected journals believed to be strong on offshoring. The three search engines were primarily Science Direct, and secondarily ABI/Informs and Business Source Complete (EBSCO). The time scope selected was 2007 on, since our focus is on the most mature offshoring setups. Articles and journals oriented toward IT technology were disregarded (but not business studies of IT sector firms).

Several consecutive searches, control searches and supplementary searches focused on management and organization journals, were made, giving a seven-article sample with longitudinal studies of offshoring. This focused sample includes four articles from *Journal of World Business* [4, 7, 17, 18], one article from *Journal of International Management* [1], two from *European Management Journal* [19, 20], none from *Journal of Operations Management* and many other journals. The manual review of hits from the two latter search engines added a range of relevant journals (e.g. *International Journal of Operations and Production Management*, *Academy of Marketing Science*, *Strategic Outsourcing*, an international journal) without longitudinal offshoring studies.

The manual in-depth analysis of the sample involved searches for understanding of offshoring, functions offshored, longitudinal, longer term, theories, research aims and results [13].

Supplementary search in 16 leading organization and management journals (using Web of Knowledge, Thomson plus broader reputation) gave no longitudinal studies but some useful contributions to our argument [10, 11, 21–23].

The *longitudinal empirical investigation* was part of the PhD and comprised four qualitative case studies following the companies over a longer time span [3]. The selection criteria for the PhD's four case companies—at the outset—were globally operating SMEs in the textile and furniture industry with considerable experience in offshore sourcing. The PhD study's field methods were on-site observations, semi-structured and unstructured interviews, and review of secondary materials. Respondents from each company were involved in commenting

on case summaries, including revisions. Secondary materials from each company included annual reports, press releases, customer presentation material and stakeholder and media material. The method was based on focusing on a few events in the four cases as a process research design [3]. After the first visit, the companies were revisited the following 3 years. The first interviews of key informants were based on a semi-structured questionnaire; the follow-up interviews the next 3 years were unstructured. Sixteen interviews were conducted. Interviews were partly transcribed (first 3 years of study) and coded in NVivo (QSR International software).

The PhD project focused on the knowledge element of offshoring, initially relying on an open understanding of knowledge, relating it to a broad range of enterprise activities including production facilities, product development and material flows. This chapter’s analysis of longitudinal offshoring organizing relies on the topical and theoretical similarity and openness of the doctoral work. The analytical design can be seen as a further iteration of the PhD study’s abductive approach, where the initial interviews and data gathering were influenced by a broad understanding of knowledge and offshoring, which involved more and more elements after the companies’ first steps toward offshoring manufacturing activities. This material is used here to analyze offshoring organizing and knowledge handling. Additional data were collected to enable this, but only a few subjects missing in the first material gathered were needed. Some details were changed due to anonymity concerns. The time range of the case study is indicated in **Table 1**:

Each case contributes important and potentially unique learning about offshoring [24], but the assumption is that variations between the four case studies will provide insight that will allow us to examine the complexity of the offshoring process and the emergent organizing capabilities. Therefore, we compare the cases, although we do not claim generalizability. Not having more than four cases as basis for analysis can be viewed as a limitation, another could be not having made an ethnographic research design to provide a more in-depth understanding of organization, organizing, knowledge handling and management.

Case	Retrospective scope phases	Study period	Organization scope	Number of interviews
FURNICO	Transaction and resource seeking	2007–2012	HQ	7
DRESSCO	Transaction and resource seeking	2007–2012	HQ and captive offshore unit	9 (3 in captive unit)
TEXCO	2001–2007 Captive production unit	2007–2012	HQ and captive offshore unit	13 (5 in captive unit)
KNITCO	2001–2007 Transaction and resource seeking Outsourcing	2007–2012	HQ	6

**Table 1.** Longitudinal case studies.

### 3. Literature review

The longitudinal studies review establishes the gap we can try to fill with our contribution, and also delivers elements to the subsequent theoretical frame for understanding offshore organizing capabilities. We commence by defining the central elements, and then proceed by reviewing contributions on longitudinal development of offshoring and offshore organization. Note that some contributions are used in Section 3.2 [5, 25], as they provide important input to the concepts but not to the review.

We define offshoring as a strategy of transferring activities across national borders, which may occur through using external resources (outsourcing) or through relocating internal production activities (direct foreign investment, captive arrangement) [2, 11]. It follows that outsourcing and offshoring overlap and are related, as shown in **Table 2**.

Offshoring and captive setup refers to the situation where the firm owns and runs offshored units in another country [11], whereas offshore outsourcing refers to the situation with simultaneous transfer of ownership and location of an activity ([2]: 147). As we see later, this definitional model is challenged by a practice that involves a range of hybrids, in-betweens, intermediaries, etc.

#### 3.1. Longitudinal studies of offshoring

Longitudinal studies of offshoring are scarce. To place our review in a context, we use former and more broadly focused reviews on outsourcing [2], offshoring [5, 11] and global purchasing [16]. These reviews point to the following relevant research strands: international business (IB), strategic management, operation management (supply chain management) and (industrial) marketing and purchasing.

Hätönen and Eriksson [2], Bunyaratavej et al. [11] and others point to present theories used (with the longitudinal studies in parenthesis): transaction cost economics (TCE) [7, 18] and the resource-based view (RBV) of the firm [4, 7, 18]. One longitudinal study draws on the framework of Christensen et al. [26] regarding the tensions between integration and disintegration [19].

Several papers do not directly use organization theory ([7], use grounded theory). The organization theories actually used are configuration theory ([17]—strategy and organization) and organizational learning [1]. These theories date some 10–30 years back. Contributions from contemporary organization theory (such as institutional sociology) are lacking. Several contributions suggest combinations of theories to cover internal and external aspects of the phenomena [4, 11]. Jensen [4] uses RBV, activity-based and international business network theories to obtain this combination of internal and external aspects. Hätönen and Eriksson [2] analyze

	Insourcing	Outsourcing
Onshore	1. Internal domestic provision	3. Domestic outsourcing
Offshore	2. Captive/foreign subsidiary offshoring	4. Offshore outsourcing

**Table 2.** The four main strategic options of offshoring/outsourcing (Adapted from [11]).

the practical and theoretical development of outsourcing in a systematic manner that would cover offshoring as well. Although this framework is tentative and ex-post, it can be used as a systematic attempt to conceptualize longer term offshoring developments. The framework consists of four phases:

- Transactional
- Resource seeking
- Transformational
- Developmental

The first phase is transaction. Hätönen and Ericsson [2] characterize it as a “big bang”, where the make or buy dilemma seriously tilts toward buy. Activities are turned over to outside vendors in the belief that market mechanisms of distant markets result in lower transactions costs. TCE is the main theory. The second phase is resource seeking. Here, companies rely on external sources to provide production components and services. The main theory becomes RBV ([2]: 152).

The third phase is transformational. The main theory is RBV, in combination with organization theory. In this phase, all parts of an organization can in principle be turned over to outside vendors ([2]: 152). And as offshoring and outsourcing become integrated legitimate tools in the management repertoire, the concerns turn to the timing of offshoring.

The fourth phase is developmental. Here, the organization becomes increasingly boundary-less and managing business development and continuous improvement of internal activities can even become part of offshoring/outsourcing arrangements ([2]: 152). Management takes the form of portfolio management, as many internal activities are project-oriented. Yet, longer term perspectives of external sourcing are employed, even a “lifecycle” perspective. This implies that the main theory applicable is RBV according to Hätönen and Eriksson [2].

Hätönen and Ericsson’s [2] time scale, 1980–2007, broadly matches that of Hutzschenreuter et al. [20], but while Hätönen and Ericsson [2] understand the phases to be characterized by relations between the involved companies, Hutzschenreuter et al. [20] view the changes as waves of offshored functions; first, support functions within R&D, then, technology-based support functions, and finally, interaction-based functions. This analysis is based on a comprehensive dataset, but some longitudinal studies contradict the pattern—Lampel and Bhalla [17] find a call center to be the first offshoring (relation-based) emerging into R&D offshoring; and Jensen [1, 4] finds continued and increasingly more strategically important R&D offshoring. Hätönen and Eriksson [2] refer to portfolio management as part of the fourth phase. This reference points back to Kraljić’s matrix of supplier segmentation [27] and to project organizing with management of multiple parallel projects [28].

The studies reviewed show that, by 2012, almost any part of a classical hierarchical organization can be subjected to offshoring and provide a range of examples. Most longitudinal studies occur in the service sectors (Finance, IT and engineering; [20]). They cover R&D, IT development, HR support functions and more [1, 4, 17]. Fewer studies focus on manufacturing. Bengtsson and Berggren [19], in their longitudinal study of telecom giant Ericsson, show a radical shift from

production disintegration to partial reintegration. This occurs as production is mobilized into the company's innovation activities—for example, standardizing components.

The longitudinal studies do not equivocally comply with Hätönen and Eriksson's [2] framework. Firms offering low-cost products continually use offshoring with a strong cost focus [17]. Even when the companies achieve high-value core activities, they may be forced to continue outsourcing and offshoring to stay in their market segment and keep their overall costs low. Lampel and Bhalla [17] offer this type of case in telecommunications. Over a 6-year study period, the company offshored more and more and struggles with increasing coordination (employees traveling back and forth) to handle this. Activities offshored include customer services, development of an internet order portal, billing system and triple-play system (offering customers TV, broadband and telephone). Offshored core value-creating activities have to be tightly coupled to the main firm. Lampel and Bhalla [17] use configuration theory, combining strategic positioning and organizational design elements; however, their analytical result remains close to the rich longitudinal case, which is thus implicitly viewed as unique.

Also within Human Resources processes, longer term development might differ from Hätönen and Eriksson [2]. Pereira and Anderson [18] focus on business process offshoring within HR. Theories are the resource-based view (RBV) of the firm and transaction cost economics (TCE). They make a qualitative case study with a 2-year time scope. The longitudinal analysis "...indicates an increase in the transactional and extrinsic basis for HR practices" ([18]: 230). And the "promise" of long-term partnering between HRO organizations and their clients "...may be viewed as little more than an empty shell" ([18]: 230). Activities offshored are transactional HR and recruitment processes. There is little direct dealing with organizational issues.

Vivek et al. [7] carry out six longitudinal studies with a short 1-year time scope. They show shifts in focus from an all-dominant transactional view to differentiating between cases where relations between partners are developed. Increased focus on knowledge is part of this development. There is little conceptualization of organization nor any empirical results on organization.

Jensen [1, 4] raises the question of what impact offshoring professional services will have on the core company's resources, referring to the risk of "hollowing out" the core company. He combines RBV, activity-based and international business network to cover internal and external elements of offshoring outsourcing. In two of his three cases, the longitudinal scope is 3 and 5 years [4], while the third covers 1 year [1]. All three longitudinal cases show a high level of interconnectedness between the Danish firms and their Indian offshoring partners. They use project organization as the first organizational instrument, in the collaboration with the Indian software providers. Jensen [4] finds surfacing of new opportunities rather than hollowing out. One firm realizes a quick expansion of the first offshored project, and soon several hundred Indian consultants are involved, 30% of them at the Danish site. After the transfer of a first project, another firm even experiences a rather quick development through project expansion (resource seeking) to a transformation of strategy [1], due to the Indian partner's European customer portfolio, which provides a strategic expansion option for the Danish firm to the European market. Both the two longer term cases establish IT development centers at their Indian partners' facilities and station expatriate managers at these centers. These expatriate managers facilitate coordination and communication between the Danish and Indian parts of the cooperation.

### 3.1.1. Summing up

The literature study conducted reveals varying responses to the long-term pattern. Bengtsson and Berggren [19], Hätonen and Eriksson [2] and Vivek et al. [7] find a shift from transactional relations to relation-based approach and complementarity. Lampel and Bhalla [17] and Periera and Anderson [18] find continued focus on transactions and low cost. On this basis, it is not possible to follow Hätonen and Ericsson [2] and Vivek et al. [7] in their claim that transaction cost economics is becoming obsolete to the benefit of the resource-based view and other complementary resource-oriented theories.

The longitudinal studies conducted show that by 2012 any part of a classical hierarchical organization can be subjected to offshoring and provide a range of examples: software development [1, 4], call center services [17], recruitment [7] and production [19]. Several studies point to different types of project organization as the first organizational building block of the offshoring process [1, 4, 5]. The longitudinal studies reviewed here remain highly descriptive and exploratory, which can be understood as expressing appreciation that the empirical basis is rich in cases of practical offshoring.

The main contributors are strands of international business, strategic management, purchasing and supply chain management. Organizational theory and management studies lag behind, both internally by lacking studies of offshoring based on organization or management theory, and in the others strands' conceptualization of organization (and partly management) when conducting offshoring studies using organization theory. This stands in sharp contrast to the present importance and centrality of the trend toward offshoring, and thus the need to include organization theory.

## 3.2. Conceptualizing organizing capabilities

The above conclusion of the literature study identifies a gap of longitudinal studies of organization and organizing in offshoring companies and their sourcing setup. Therefore, this section and the following two develop our concept for organizing capabilities in such a setting, first by extending the concept of alliance capability [5], and then adding organizing and knowledge-handling capabilities [29, 30].

As offshoring enterprises develop their organizations and supplier base, their setup becomes increasingly disperse and delocalized [2]. Moreover, the strategic challenges continue to be highly dynamic, forcing the companies into recurrent changes. This leads to a stronger emphasis on relations between elements of the organization, in contrast to classical co-located organizations. Pagano's review [5] of relational capabilities, drawing on Heimeriks [31], Heimeriks and Duysters [23], sets out to link internal organizational mechanisms with external relations. The aim is to disentangle specific components of relational capabilities at the micro-level, moving beyond the setting up of organizational units ([5]: 906). Pushing Pagano's [5] definition further, we define organizing capability as *the capability to develop and run mechanisms in a firm that can manage and develop its external performance*.

We suggest the mechanisms should be understood as four main elements (drawing on [5, 23, 31]: 906):

1. Organizational functions
2. Tools
3. Management and leadership
4. Boundary spanners

*Organizational functions* (extending Pagano's [5] "function") are both functions pooling necessary equipment and expertise and functions for external linking, such as an Alliance Department in charge of alliance-related tasks. Pagano [5] finds the following organizational functions such as Executive Steering Committee, international purchasing groups, global sourcing project teams, product teams for sourcing components and materials, lead buying systems and corporate contract coordinators.

*Tools* involve Human Resource management and information systems to support knowledge management flows. Pagano [5] finds first HR routines to be particularly important—for example, recruiting, training and retention of purchasing personnel, engineers [1, 32]. Second, information and communication technologies, such as intranet solutions, are important.

*Management and leadership* procedures (extending Pagano's [5] "Management and control procedures") include coordination mechanisms between multi national corporations' (MNCs) internal units, for example, incentives to promote learning processes. Leadership is of particular importance as the organization setup is under continual development [33]. Pagano claims that the management and control procedures discussed in the literature lack knowledge management. We suggest that this area can be covered by many contributions on knowledge integration and knowledge governance (see below). In our conceptualization of organizing capabilities, knowledge management is therefore included. Moreover, as the companies are under continual pressure to change, we include leadership, for example, in terms of giving direction, as an important capability.

*Boundary spanners* (extending Pagano's [5] "external actors"): Involving external actors, such as consultants, provides knowledge resources related to management of partnerships with suppliers. However, many other kinds of actors than consultants could link internal and external elements, crossing the core firm's organizational boundaries. They could include middlemen [34], expats and other human intermediaries. Pagano [5] finds very few studies of their role, but mentions intermediaries supporting the company in doing supplier search as well as insurance and customs management. Other types are trading companies, import promotion offices and external consultants.

### 3.2.1. Organization and organizing

Offshore organizing has a temporal character, but also involves stabilized structured elements. It is therefore a combination of stabilized organization and processes of (re)organizing, and spatially, a combination of inter- and intra-organizational elements, overcoming and exploiting differences [21, 22].

Some contributions cover the static elements of organizing. Hartmann et al. [25] present a snapshot of large multinationals, whose structure is divided into three types: multidomestic,

global and transnational. The multidomestic has a low need to process information across countries (pooled interdependence). Global multinationals are the “hub and spoke” type with extensive information processing. Transnational multinationals are integrated networks of equals, with business activities dispersed across countries. Global multinationals are the most centralized, although transnationals also exhibit quite centralization. IT systems are one of three central control mechanisms.

The industrial marketing and purchasing approach (IMP) has long discussed linkages between internal and external organizations [35]. Arnold [36] identifies three ideal types of combining purchasing organizations and internationalization: centralized purchasing, coordination model and outsourcing model (the highly internationalized firm). Arnold predicts that the SME development path would be from centralized purchasing to highly international outsourcing. Gadde et al. [35] discuss the combination of internal organizing, relationship organizing and supplier-base organizing. Relationship organizing can be understood by first looking at one-to-one relations between buyer and supplier, and then extending the understanding to the supplier base as such. The buyer-supplier dyads involve—almost by definition—closer interactions than market-based, buyer-supplier interactions. This interaction can be viewed as consisting of three dimensions: hierarchical level connections, broad interaction across various internal functions and frequent interpersonal contacts [35]. Inter-organizational arrangements can be characterized in terms of the degree of control, coordination and stratification [35]. The appropriate inter-organizational contact pattern is dependent on the maturity of the relationship, power distribution, economic importance of the other actor, product complexity and transaction complexity. The inter-organizational arrangements are also highly dependent on the internal organizing of buyer and suppliers—for example, when scarce internal coordination needs to be complemented with more interactive external coordination. Bocconcelli and Håkansson [37] present a case study of a company successfully restructuring and reducing its supplier base, and focusing on selected suppliers through massive mobilization of their resources and capabilities. This was supported by the establishment of cross-corporate teams, as well as internal reorganizing. Counter to this example, the IMP strand tends to exercise too much focus on the purchasing function. In our view, offshoring firms need to mobilize a range of organizational elements in their efforts at offshoring, not only the purchasing department.

### 3.2.2. Knowledge handling

Organizations’ knowledge handling becomes increasingly important as products’ and technologies’ stabilization processes seem to be increasingly shorter. Ability to integrate (new) knowledge should therefore be included in organizing capabilities. An early definition of knowledge integration is presented by Grant [6]:

*“Integration of specialist knowledge to perform a discrete productive task is the essence of organizational capability, defined as a firm’s capability to perform repeatedly a productive task which relates either directly or indirectly to a firm’s capacity for creating value through affecting the transformation of inputs to outputs.”*

The issue of handling knowledge in and across organizations involves an attempt to conceptualize the learning organization and continue into knowledge creation and management [38].

A number of different intra-organizational designs have been proposed to improve the creation of knowledge-intensive services and products, and there has been increasing appreciation of knowledge's informal nature and tacitness [39], also when attempting to transfer, translate or transform knowledge [40]. Knowledge management literature continues to differ on the issue of knowledge management [38], spanning from absolute belief in the capabilities of information systems (IT) to claiming that management should leave knowledge interaction alone in order to avoid distortion of knowledge interaction microprocesses. However, the claim that knowledge management needs to encompass several types of activities, hard and soft, is quite widespread [38, 41]. While explicit information can be handled with IT (hard), tacit knowledge is better handled through informal direct interaction (soft). Koch's [41] combination of hard and soft encompasses strategic management, organization, information systems, office design and human resource activities.

This disagreement is repeated in the more recent knowledge governance literature [30]. This view of knowledge governance coordination mechanisms encompasses a broad set of means, divided into hard and soft dimensions, where the hard dimensions are contracts, directives, incentives and rewards and the soft dimensions encompass communication, trust, management styles and organizational culture. Knowledge governance thus addresses challenges on how to combine formal (mainly "hard") and informal (mainly "soft") coordination mechanisms to achieve a knowledge governance system that fits specific demands to maintain and develop the competences of the individual organizations. This approach can be characterized as echoing the more managerial version of knowledge management mentioned above, where contradiction and tension between management and knowledge are somewhat underestimated.

Even if global organizations and/or inter-organizational considerations are discussed to some extent in the knowledge management and knowledge governance literature, the primary focus is on co-location and singular types of organizations [30, 38]. Here, the newer knowledge integration strand differs [29] and departs from Grant's [6] definition of knowledge integration; and includes knowledge creation as a significant process in knowledge integration. The focus is on a process of cooperation of purposeful knowledge combinations (for new products, systems and solutions) in and across organizational boundaries.

**To summarize**, our theoretical frame consists of the elements offshoring; long-term organizing and organizing capabilities, including knowledge handling.

It is assumed that organizing capabilities follow the development of the offshoring arrangements. Hätönen and Eriksson's [2] four phases are therefore used to organize the case description and the subsequent analysis. Our focus is mainly on Hätönen and Eriksson's [2] fourth phase—the boundaryless organization.

We understand offshore organizing as a combination of stabilized organization and processes of (re)organizing. As suggested, we conceptualize organizing capabilities in a longer term development perspective as consisting of four elements (emphasizing initial relational capabilities): organizational functions, tools, leadership and management and involvement of boundary spanners. Knowledge is integrated in these four elements.

## 4. Case: FURNICO

FURNICO designs, sources, produces, distributes and sells quality furniture in the value-for-money segment. It has a complex supply chain setup with a global sourcing network, its own production, and a distribution system ending at more than 300 franchise-based stores in more than 50 countries. The number of employees at the Danish headquarters and the owned domestic factories is just over 500, while more than 2000 are involved in outsourced manufacturing and delivering activities. The company produces and sources upholstery and flat-pack furniture. Over the years, the ratio between internally controlled resources and externally managed resources has changed radically. Adopting the longitudinal scheme proposed by Hätönen and Eriksson [2], the evolution is described in three phases: first the transactional, then the resource seeking and third, the transformational and developmental phase.

### 4.1. Transactional phase

When FURNICO acquired two furniture manufacturers in the late 1980s, its transformation into an industrial enterprise was fulfilled. Then, FURNICO grew into an international corporation with production facilities at four locations in Denmark and one in the Baltic region. At this time, the products were launched on the global market; eight sales offices supported this internationalization process. The products were mainly sold to consumers through traditional retail shops. The logistics infrastructure was controlled from a central organizational unit, and FURNICO's downstream supply network had low vertical integration. FURNICO controlled the marketing function, eight sales office facilities/resources, and distribution of finished goods from a central warehouse. Retail facilities were owned by others but controlled through a contracting system. According to FURNICO, the consumers related to the retail brand and not to where the furniture was designed and produced, and the retail chains grew continuously during the period. As a result, the logistics infrastructure underwent radical strategic transformation, which started with the opening of a captive brand store.

At the turn of the millennium, FURNICO developed a new strategy for all downstream activities. This strategy's focal point was a franchising concept, and especially the marketing resources were tailored to improve branding of the company. Until now, FURNICO's marketing activities were allocated to two brands, but changing to the new franchising concept implied that all resources should focus on one brand name. Four years later, this strategic objective was achieved. By then, more than 150 franchise-based stores in 24 countries were established; FURNICO owned 12.

Another central part of the strategy was sourcing, also mirrored in the sourcing director's membership in top management. Some components—such as fittings and screws—were sourced from a European supplier. But the new strategy meant focusing on sourcing from the Far East. The simpler parts of the upholstery production were offshored to the Baltic and the Far East.

### 4.2. Resource seeking phase

It took some time for the organization to create the necessary organizational capabilities to handle the sourcing. The organizational capabilities and the potential for further cost savings

became a driver for changing the sourcing strategy; gradually, the scope for the sourcing network increased. In the beginning, the purchasers bought components; later, finished furniture. The quality of the products produced, especially at the Chinese facilities, was problematic. Although FURNICO exerted substantial effort to improve quality, it was not unusual to receive containers filled with useless furniture. Consequently, FURNICO established a sourcing office in China. According to the sourcing director, the achieved knowledge and organizational capabilities, as well as the established logistic infrastructure between the Danish facility and suppliers' facilities in China, were crucial for setting up the sourcing office in China.

*"We realized that it was necessary to create an organization and a base of suppliers before starting up; you have to build up a skeleton before constructing the sourcing office." (Sourcing Director, FURNICO)*

Concurrently with increasing sourcing activities, the company decided to divest a large part of the manufacturing facilities, selling one factory in the Baltic region and one in Denmark. The remaining upholstery production facility in Denmark was bought by a former management group and moved to the Baltic region to reduce labor costs. The flat-pack furniture production was not outsourced, due to high flexibility and quality demands in the production process and lack of identified competent and suitable suppliers in Eastern Europe/the Far East (especially since at that point the size should match the size of FURNICO as a large SME), as well as the company's historical path.

These changes, as well as changes in the manufacturing facilities, made it possible for FURNICO to transfer its managerial and organizational resources to the distribution and retail activities of the company, which gradually increased in importance.

#### **4.3. Transformational and developmental phase**

FURNICO changed its strategy from producing furniture to focusing on retailing. This was realized by FURNICO reducing its ownership of the production facilities. According to the CEO, the captive production setups in Denmark rank alongside the suppliers in the Baltic region as well as in China, when deciding upon the sourcing network for developing a new product. At the beginning of this phase, the sourcing director describes the organization like this:

*"In a few years, a dedicated distribution center, a development center, will synchronize between DK and the Far East; [it is a] success criteria to do it in the same manner following common rules."*

*"[We operate as a] matrix organization on quality, logistics, documentation and development, purchasing. Project managers are typically the bosses, a way to do things that are synchronized all the way round." (Sourcing Director, FURNICO)*

One of the company's main suppliers of upholstery furniture is located in China. FURNICO representatives initially found that the Chinese suppliers lacked understanding of the company's quality demands and possessed inadequate knowledge and organizational capabilities. However, tensions were also due to cultural differences. Therefore, the company decided to establish a control unit in China, hiring local employees to work as quality controllers in the suppliers' factories. This setup was extended at the end of the study period by establishing a second Chinese control unit far from the first in order to achieve physical proximity to other key suppliers as well as the recently outsourced warehouse activities (2011).

The product development capabilities among FURNICO's employees involve utilizing and combining the available technological resources, as well as the logistics infrastructure, to create value for the customers. As the CEO points out, all decisions start and end with the retail shops. The company cooperates closely with the upholstery supplier in the Baltic region on product development, as this facility is still managed by the former management group from Denmark. Past interactions between the two physically separated facilities have paved the way for creating knowledge and organizational capabilities. However,

*"...product development of upholstery furniture is rather dynamic. Actually, there are four players: our own product management, a group of designers, some of whom are sitting in Europe, a production, and finally the market." (Sourcing Director, FURNICO)*

Regarding the logistics infrastructure, a crucial issue is to ensure a short time-to-market and delivery lead-time; therefore, the geographic locations of production and warehouse facilities are a determinant when designing new products. As the Sourcing Director states:

*"We do not design our products; rather, we design our supply chain to handle the products we are going to sell in the shops." (Sourcing Director, FURNICO)*

The products developed for the European shops thus take into consideration the European and Chinese logistics infrastructure, while products for shops in China, Japan, USA and South America are developed to utilize mainly the Chinese logistics infrastructure.

The company uses their product managers, an external design company and key suppliers to develop new products. This entails physical relocation of designers and product managers, since they join the local manufacturing staff in the different production facilities (mainly in the Baltic region for upholstery products; from time to time, in China) to discuss new designs and how to produce them with the available production equipment. Physical movement of humans is preferred, due to the difficulties entailed in other interaction across organizational boundaries.

The company is continuously increasing its sourcing activities abroad, especially sourcing of products/components via its sourcing offices in China. In addition, the company has outsourced its warehouse to different geographical locations in an attempt to optimize the logistics infrastructure and thereby reduce time-to-market and delivery lead-time to the franchise-based shops. To enable this, the company transfers Danish employees to its own facilities (e.g. in China) for longer periods of time to train and work with local employees. Domestic employees in its captive quality control centers are sent to Denmark for short-term training and an attempt to translate the company's organizational culture into a Chinese context. The local expats, and to a certain extent the company's product managers, function as brokers in relation to the complex interactions between the Chinese suppliers and the Danish facility. This broker role is less important for the Baltic suppliers, due to their higher level of organizational knowledge and capabilities.

## 5. Discussion

FURNICO commenced its offshoring development, mostly in production, as a relatively vertically integrated organization. Its structural organizational capabilities were strong in

production, product development, sales, management and administration, and were developing in retailing. It employed standard tools such as enterprise resource planning (ERP), which provided the company with a host of administrative IT support tools. The ERP system was able to handle multi-location accounting, purchasing, production control and administration. Management consisted of different profiles for distribution, sourcing and production, although the CEO was oriented toward the distribution side.

In the transfer phase, FURNICO's organizing capabilities began to change from relying on internal production units and capabilities in relational/contractual relations to external offshored units of production. Offshoring production created quality problems, and FURNICO was forced to develop a quality control organizational function in the Far East. Manufacturing was divested and new relations were established with a Baltic unit owned by former employees. Communication technologies like Skype, e-mail and videoconferencing became important. ERP and sourcing management prevailed.

In the third phase, FURNICO transformed itself from a production based to include a distribution-based organizing capability. Growth from 8 to more than 300 outlets was realized. The enterprise's product development and sourcing processes are often carried out as projects in a matrix-like organization, where function managers also act as project leaders. On the sourcing side, personnel increasingly moved back and forth between Denmark, the Baltic region and China as the interaction became increasingly complex and also began to involve innovation activities. Expats were also placed in the control centers to act as knowledge translators and continuously help local suppliers build their manufacturing capabilities and quality understanding.

Although FURNICO is our most advanced case, it shows little sign of further dissolution of the organizational structure. The technology tools prevail; the family ownership and management of the core enterprise prevail (generation shift is under preparation) and there are no signs yet of dissolution in the developmental phase (**Table 3**).

### 5.1. Case comparison

In the following (**Table 4**), we juxtapose the four cases. Each case represents important and potentially unique insights on longer term offshoring. We discuss the elements of organizing capabilities in the four cases as an approach to using the variations between them to gain insight to understand offshoring's complexity. As an opening remark, it can be concluded that at the end of the study period, the companies are successful. Although company performance and offshoring and/or organizational capabilities are not one-to-one with financial results of the core group, it can be noted that during the study period, the four case companies with their setups have managed to navigate through the financial crises, and at the end of the study period, they are again picking up speed with regard to growth in sales and financial results.

*Function:* The long-term journeys of offshoring are nevertheless quite different for the four cases. FURNICO has transformed itself into a retail chain with an integrated supply setup. The three others have ventured into captive production setups, but in different ways. DRESSCO developed from a network-like enterprise to running an extensive captive offshore production, whereas TEXCO does captive production but has also backshored design after attempting to

FURNICO	Transfer	Resource seeking	Transformation	Developmental
Organizational functions	Vertical integration, distribution, first production elements offshored: the less complex upholstery production to the Baltic and China.	Establishment of first control center in China  Divesting production in Denmark	Distribution focus emerging; more and more retail outlets  Second control center in China  Matrix organization and projects	No signs of further dissolution of structure
Tools	ERP	ERP and Skype, e-mail and video conferencing	ERP and Skype, e-mail and video conferencing  Increasing physical movement of personnel back and forth between Denmark, the Baltic and China	IT technology prevails
Management/ leadership	CEO with distribution profile	Standardization Control via control centers  A physical link between headquarters and key suppliers	Function managers are also project leaders	Management and ownership of core enterprise remains stable
Boundary spanners			Strategic positioning of expats in control centers to act as knowledge translators and continuously help the local suppliers build their manufacturing capabilities and quality understanding	

**Table 3.** Changes in organizing capabilities in FURNICO.

offshore it. KNITCO backshored a complex part of the production activities to integrate product development, testing and the complex production activities in Denmark, thus obtaining greater control of flexibility and quality. The enterprises follow the transfer, resource seeking and transformation pattern suggested by Hätönen and Ericsson [2], but TEXCO and KNITCO depart from this pattern again by reverting to backshoring some activities. KNITCO's move can be seen as a buyer-seller failure to translate less transferable and robust organizational routines to the offshored unit. Moreover, neither FURNICO nor DRESSCO appear to enter a phase of developmental organization as expected by Hätönen and Eriksson [2]. The structural development of organizing capability therefore draws a "back and forth" pattern across the four enterprises.

FURNICO does exhibit elements of portfolio management, a project and matrix organization with function managers also acting as project managers. Also DRESSCO uses project organizing in combination with relatively strong function orientation. TEXCO and KNITCO have small organically organized headquarters as their approach.

*Tools:* In the transformation phase, DRESSCO established a captive offshore production unit. To create retention, the company implemented corporate social responsibility (CSR) directed toward

the production employees, also offering higher wages than local competitors. The three other cases do not exhibit CSR or other “exports” of the Scandinavian labor market model. All four cases employ IT: especially ERP and communication tools seem to act as backbone for interaction and as an enabler for standardization, which is recurrent in the cases, encompassing production routine descriptions, product data management such as bill of materials, design drawings, etc. The case companies’ moves do indicate, however, that modern communication and information handling tools applied to governing knowledge are still not sufficient to run a globalized value chain. Therefore, FURNICO, DRESSCO and TEXCO all move employees back and forth in the transformation and development phases, mainly to enable translation of less transferable and complex knowledge—initially in the product development process, and later within manufacturing, warehousing and logistics. FURNICO also includes a strategic positioning of expats in the control centers to act as knowledge translators who continuously help the local suppliers build their manufacturing capabilities and quality understanding. Identical moves of expats to their captive offshore manufacturing units are also seen in DRESSCO and TEXCO.

*Management/leadership:* The CEOs recurring in these enterprises can be seen as family members and globalists. They participate directly in offshore activities. Most of the case examples exhibit several managers—including production and sourcing managers—collaborating on realizing the offshoring setup, a type of multiple or dispersed leadership [33]. Where FURNICO exhibits a relatively flat organization, DRESSCO is managed in a top down manner.

Moreover, FURNICO, TEXCO and KNITCO all moved production units abroad with the local implication of redundancies. The three enterprises operate in local areas where such moves are rather visible. It required leadership, both internal and external, to carry out these moves.

Standardization is widely used to control processes in the four case companies. Knowledge governance structures were established as a necessary managerial tool in order to work with the continuous standardization of mainly processes in TEXCO and mainly products in DRESSCO. Both companies meant they needed their own captive entity in close physical proximity to their main supplier base in order to govern knowledge. DRESSCO uses very detailed documentation of their different products. In addition to several IT systems, it also involves standardization of quality (ISO 9001) at both ends. The CSR certification (SA 8000) was obtained late in the transformation phase. Similarly TEXCO is ISO 9001 and 14001 (environmental) certified.

*Boundary spanners:* Intermediaries of various kinds are used extensively in all four cases when the enterprises reach the transformation phase. FURNICO uses collaboration partners from Eastern Europe as flying controllers in Asia, while KNITCO’s production managers fly back and forth to Eastern Europe. The company also collaborates with a company with an Indian management team in Eastern Europe. TEXCO and DRESSCO place an external consultant at the offshore unit to develop knowledge and competences at the local offshored premises. The local general manager is a Dane in the DRESSCO case and has a hybrid of Scandinavian and Baltic work experience in the TEXCO case.

To summarize, the four cases show development of differentiated organizing capabilities. Contemporarily, several case companies possess both relational sourcing competencies and

	Transfer	Resource seeking	Transformation	Developmental
FURNICO	Production	Production innovation	From production to distribution ERP Moving people back and forth Expats	Distribution and integrated supply chain ERP Moving people back and forth Expats
DRESSCO	Network, no production unit	Supply from a range of offshore production units Quality issues	Captive network CSR at captive production unit Increasing movement back and forth of employees between DK and Far East captive unit	(Captive) more complex production integrated in the organization
TEXCO	Production	Captive production Expatriate managers	Own IT system Offshore captive part of design Manager with mixed background Long-term placement of consultant	Backshoring design
KNITCO	Production Production managers Boundary spanners	Production ERP Production managers Boundary spanners	ERP One-way movement of production managers	Backshoring complex knitting activities

**Table 4.** Four cases – overview.

transactional contract competencies as well as competencies to run a full-blown classical on-site manufacturing company with integrated supply and distribution. In this sense, the cases can be considered a progression of organizing capabilities. However, it is more relevant to think of the organizing capabilities as involving: flexibility, adaptability and global outlook, the ability to establish and run profitable global organizational setups in ever new forms and shapes. Now that product development and innovation activities have been mobilized across the setups, it is difficult to predict what the companies' next move would be and how their organizing capabilities will match it.

The four cases demonstrate the importance of relational capabilities (Heimerik's four dimensions, [31]) in combination with knowledge handling. So, in this sense the framework has proved useful. However a tendency exists for the four-dimensional framework of capabilities to take over in a too factor-oriented manner, actually risking losing the relations because they risk drowning in instrumentalization.

Moreover, we find the Hätönen and Eriksson [2] framework too optimistic on behalf of offshoring development. Its implicit progression along the four phases does not hold in the four cases; they develop differently, which is hardly in contradiction with the rather open framework of Hätönen and Eriksson but nevertheless tells us to be careful with generalizations. This criticism also applies to Hutzschenreuter et al.'s [20] claim of progression in outsourced functions, something our cases do not support either.

## 6. Conclusion

In studying long-term offshoring, this article's aim was threefold: to develop a concept for organizing capabilities; to assess existing literature, inclusive empirical longitudinal findings and to describe and analyze organizing capabilities in four cases, focusing on recent developments.

The literature study revealed varying responses to the long-term pattern of offshoring. Hätonen and Eriksson [2] and Vivek et al. [7] found a shift from transactional relations to relations based on complementarity. Lampel and Bhalla [17] and Periera and Anderson [18] found continued focus on transactions and lower cost. This implies continued relevance of transaction cost economics, the resource-based view and other complementary resource-oriented theories (i.e. resource combining in the IMP approach, [35]). Combining views of organizations through both internal and external theorizing perspectives is a future research agenda.

In practice, the longitudinal studies show that many activities can be subjected to offshoring. Several studies point to different types of project organization as an organizational setup for the offshoring process [1, 4, 17, 19]. Production functions are often offshored [19], but also software development [1, 4], call center services [17], recruitment procedures [7] and R&D [20].

The longitudinal studies reviewed here are faithful to their rich case material. This implies, however that they remain descriptive and exploratory. There is clearly a lack of longitudinal theory for conceptualizing offshoring journeys. The contributors' main strands are international business, strategic management, purchasing and supply chain management. Organizational theory lags behind, exhibited by the number of studies of offshoring using organization theory in the other strands' conceptualization of organization. This stands in sharp contrast to the present importance and centrality of the trend.

Empirically, our four longitudinal cases show that the longer term offshoring journey does not involve a single best practice. The cases show captive as well as outsourcing arrangements and even enterprise transformations. There is a common focus in the cases of finding and nurturing core suppliers and core business processes, which can be characterized as continual learning and developing of organizing capabilities.

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# Crowdsourcing: A Double-Edged Sword Outsourcing Strategy

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Additional information is available at the end of the chapter

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## Abstract

Nowadays, companies have to increasingly face a lack of internal creative ideas. This has led them to outsource their ideation process through crowdsourcing contests in order to benefit from the creativity of participants on the Internet. Crowdsourcing is a successful outsourcing strategy for companies but includes some limitations that the authors recall in this chapter. Since some authors tend to praise the merits of this new practice, others are suspicious regarding certain aspects of its application. It is in this context that the authors offer a synthetic view on the benefits and risks of creative crowdsourcing. They also offer an analysis of applicable strategies that are commonly used to circumvent major obstacles related to the organization of creative contests and to improve the success of a crowdsourcing campaign. Based on the literature and the results of two qualitative studies, the authors point out the main managerial implications of crowdsourcing initiatives in terms of implementation, benefits, limits and conditions of success.

**Keywords:** outsourcing, crowdsourcing, benefits, limits, conditions of success

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## 1. Introduction

Crowdsourcing is defined as “the act of taking a job done by the employees of a company or institution and outsourcing this task to a large and undefined group of Internet users in the form of an open call for contribution” [1, 2]. Crowdsourcing is implemented by companies to meet a variety of needs, ranging from simple or routine tasks (e.g., data collection, proposal of informational content) to creative or ideational such as artistic design [3, 4].

A company is invited to choose among two broad options when it comes to setting up crowdsourcing practices. The first is based on the creation of dedicated platforms allowing

them to permanently receive fresh ideas and suggestions (e.g., IdeaStorm of Dell, Cvous, Open Oxylane, MyStarbucks Idea). The second is to use specialized intermediation platforms (e.g., Mechanical Turk for simple crowdsourcing or routine activities; eYeka, Creads ou Studyka for creative crowdsourcing activities; and Innocentive for crowdsourcing of inventive activities) [5–7].

One of the most popular and promising crowdsourcing initiatives is crowdsourcing contests [8]. Companies are increasingly using crowdsourcing contests in different industries for both problem-solving and decision-making. They may take the form of idea competitions, design competitions, idea contests or innovation and research tournaments [9].

The increased use of crowdsourcing activities can be explained by the different benefits it provides for companies: the possibility of gathering new ideas to complement those of professionals [10, 11], accelerating innovation [12], reducing the launch failure rates of new products and services [13], low cost innovation [14, 15] or strengthening the customer relationship and improving the image of the company [10, 16].

While several researchers recommend the use of crowdsourcing for its multiple benefits [2, 3, 17], others agree on the difficulties encountered in setting up these campaigns. They allude the difficulty of finding potential participants or evaluating the large number of proposals received by the crowd [4, 11, 18]. Similarly, some authors argue about the risk of generating negative feelings, which is essentially linked to the perceived unfairness by participants (i.e., not all participants are equally rewarded at the height of their efforts) (Decoopman and Djelassi, 2009; [3, 19, 20]).

Based on the context provided earlier, this chapter seeks to provide a comprehensive overview on creative crowdsourcing strategies. Prominent authors have different opinions regarding crowdsourcing practices. Some authors tend to praise the merits of this new practice, while others are skeptical regarding certain aspects of its application. It is in this context that the authors offer a synthetic view on the benefits and risks of creative crowdsourcing. This chapter will also offer an analysis of applicable strategies that are commonly used to circumvent major obstacles related to the organization of creative contests, and to improve the success of a crowdsourcing campaign. The chapter is organized as follows. The authors begin with presenting the methodology employed to systematically provide an insightful synthetic framework. Then, based on the literature and the results of two qualitative studies, the authors point out the main managerial implication of crowdsourcing initiatives in terms of implementation, benefits, limits and conditions of success.

## 2. Research methodology

Using a qualitative approach by interviewing experts and participants in crowdsourcing contests, this chapter seeks to understand the main benefits and limits of this particular outsourcing strategy. The authors also aim to shed light on its conditions of success. Therefore, we collected insights from fifteen semi-structured interviews with participants in crowdsourcing contests (cf. **Table 1**), and ten interviews with managers in charge of crowdsourcing contests (cf. **Table 2**).

Interview	Interviewee	Occupation	Age	Recruited via	Interview duration
IN01	Sami	Designer	28	Eyeka.com	35'10
IN02	Coralie	Engineer	23	Studyka.com	23'
IN03	Terrence	Master's student	22	Studyka.com	22'
IN04	Freddy	Student	24	Studyka.com	20'
IN05	Paul	Consultant in big data	27	Studyka.com	32'
IN06	Julien	Student	22	Studyka.com	19'33
IN07	Maxence	Entrepreneur	25	Studyka.com	62'
IN08	Amine	Master's student	24	Studyka.com	43'
IN09	Jean-Louis	Financial project manager	26	Studyka.com	67''
IN10	Carine	Master's student	22	Studyka.com	35'32''
IN11	Florence	Developer-writer	57	Creads.fr	46'21''
IN12	Robert	Computer engineer	25	Studyka.com	33'
IN13	Nadine	Senior advertising manager	29	Eyeka.com	41'49''
IN14	Doriane	Artistic director	43	Creads.fr	20'
IN15	Amina	Educational specialist	29	Creads.fr	25'25''

**Table 1.** Sample of participants in crowdsourcing contests.

Company	Crowdsourcing initiative	Respondent's position	Interview duration
French multinational food-products corporation	Voting for the next version of a product	Product manager	31'
Intermediary platform organizing individual creative contests	Creative contests for well-known brands	Responsible marketing	55'
		Regional director	3'
French home-improvement and gardening retailer serving thirteen countries	Idea proposal and preference voting from DIY enthusiasts	Responsible for coordinating innovation projects	47'
Intermediary platform and French leader of student challenges	Student competitions focused on generating new ideas	Technical department manager	50'
		Marketing responsible	33'
		Commercial director	23'
Intermediary platform organizing individual creative contests for freelance designers	Creative contests about creating logos, slogans, etc. for companies	Associate director	21'
French multinational food-products corporation	Proposal and vote for the products to see shelves	Policy officer	60'
Intermediary platform organizing individual creative contests	Example contest: Submitting innovative ideas to reinvent the delivery and installation of kitchens and bathrooms	CEO	48'

**Table 2.** Profile of interviewed managers.

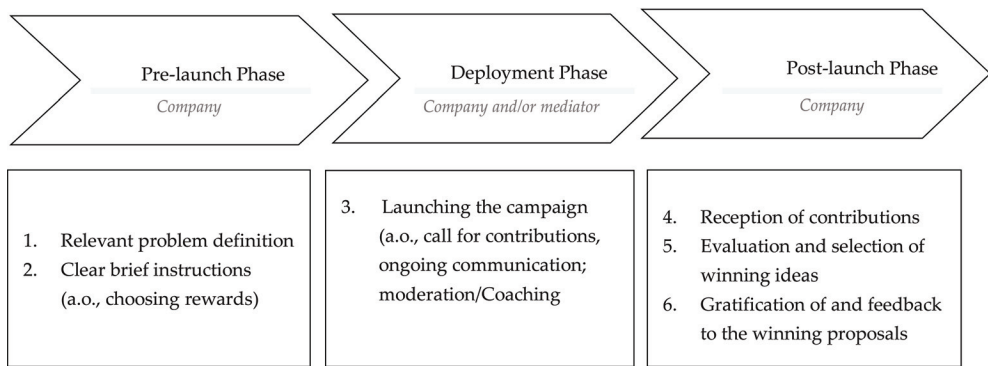
We ensured for information richness through sample diversity [21]. Both, participants and managers, were rigorously selected according to diversity criteria, i.e. age, gender, and profession [22]. Moreover, the authors ensured that participants varied in their amount of experience with crowdsourcing contests and the type of contests they participated in or managed.

All participants were recruited through three creative contest platforms namely Studyka, eYeka and Creads. The selected platforms were of different types: The first is the French leader of student innovation group challenges. The second platform offers individual challenges asking participants to submit ideas and original content. The last mediation platform is composed of a community of freelance graphic designers. Managers of these platforms were interviewed as well. The latter sample was completed by managers of international companies, which have launched creative contests on a national level.

### 3. Implementation of crowdsourcing contests

The results of the interviews with expert managers enabled us to identify six steps required to implement a crowdsourcing contest. Indeed, and far from being a simple promotional tool, crowdsourcing is a thoughtful strategy and a process structured around several steps. First (1) step is to define the problem. The question that arises is *"What is the problem to be solved?"*. It starts with how this problem can be communicated to the community. *"Identification of any problem could vary; from the search of new ideas, new concepts, products, packaging or advertising to new communication media or customer experience."* For Instance, a manager could pursue a goal of brand promotion to make it more visible and acceptable. *"I would like my brand to be better known."* Next comes (2) the formalization step and the declination of the problem in a brief (i.e., instructions). *"We will transform the problematic of the company in a brief to the creators, that directs the people towards the problem," "It has been formalized in our business brief, in a PDF document that is four pages long."* The next phase (3) refers to launching the contest online. This step is backed up by intensive communication efforts, which aim to maximize the number of participants *"We will put the operation online and we will try to set up a communication plan to ensure maximum participation."* This phase is followed by the reception of participants' contributions (4). In the next step (5), the authors observe a phase in which a jury chooses the best solution among the mass of received contributions. *"We make a first selection of about thirty files in general. This was followed by the request for further information and detailed input. Based on this, we select about five contributions. Then these five teams are invited to a ceremony to present their projects in front of the jury."* After going through several proposals, the companies could reward the winning proposals. In the sixth and step (6), the winners are offered a proper contract to ensure that they get the reward they deserve. At this step, the participants are also provided professional assistance to bring positive changes to their input.

By carefully studying different companies' approaches toward the organization of crowdsourcing campaigns, the authors have concluded that some companies prefer outsourcing the crowdsourcing procedure to specialized mediating platforms such as eYeka, Studyka or Creads. This is mainly due to a lack of internal resources or expertise *"Maybe because they lack in either the*



**Figure 1.** Implementation stages of creative crowdsourcing campaigns.

*required skills or the network of collaborators such as professional agencies. Lack of creativity could be another obstacle.*" Companies also choose mediating platforms to save time and improve reactivity.

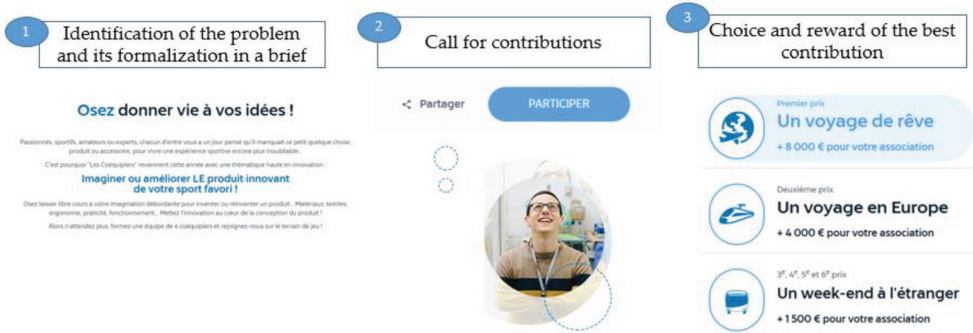
These mediating platforms position themselves as advisers and support companies by giving companies access to a community and to technical tools *"We accompany companies in carrying out these campaigns so that it takes them less time," "Because they cannot do it on their own, because they do not have the technical tools," "It's very difficult for a company to organize a crowdsourcing campaign on its own. It is very complicated so I see no reason for a company to take this step alone."*

While several experts agree on the benefits of outsourcing crowdsourcing competitions, others, on the contrary, do not share this opinion. They advise companies to be autonomous in the management of their call for contributions. They put forward arguments related to the lack of transparency toward participants *"It seems odd to me to subcontract this campaign because it is an activity which often means being transparent to consumers."* **Figure 1** summarizes the different stages of implementing a crowdsourcing initiative.

For instance, a recent contest launched by the French mediating platform "Studyka" (cf. **Figure 2**) illustrates the main steps described above.

#### 4. When crowdsourcing is profitable for companies

The first part of this chapter shows that organizing a crowdsourcing campaign requires considerable efforts and a careful consideration of the structure and the steps of such competitions. Whether these efforts are favorable or risky has been discussed in the scientific literature. It is a difficult task to provide a clear answer regarding the profitability of creative contests. In this chapter, the authors argue that creative crowdsourcing refers to a double-edged sword, which depends on the company's investment and involvement to a great extent. To illustrate this assumption, the authors first present the benefits that are commonly cited in the crowdsourcing literature, before addressing the risks that are generally associated with it.



**Figure 2.** Example of the main organizational stages of creative crowdsourcing.

While presenting the different benefits and risks, the authors include citations of interviewed managers and participants to face scientific arguments to real-life observations.

#### 4.1. Improving the commercial acceptability of products and services by the market

Even though many crowdsourcing benefits may be cited, previous research discusses the generation of new ideas tailored to the needs and expectations of consumers. It addresses the critical issue of launch failure rates of new products and services [13] and maximizing their commercial acceptance rate [20]. Crowdsourcing is here perceived as a pre-test of the product before it is launched on the market [23]. In addition, the crowd benefits through its participation from the opportunity to express its needs and to make proposals to improve existing products [24]. Companies can probe the need of the market by having access to customer and prospect preferences, which serve them in a useful way [25].

As a result, by using the wisdom of the crowd, companies benefit from a broad access to participants' skills. They thereby circumvent the limits of internal innovation [26]. Using the crowd also allows the company to access consumer ideas and resources if they cannot solve the problem internally [4]. Over the last years, the number of crowdsourcing initiatives, which seek to gather the freshness and diversified ideas and solutions has increased [3, 11].

In this context, Poetz and Shreirer [11] demonstrated that the crowdsourcing process makes it possible to produce attractive ideas whose score is significantly higher in terms of profit and novelty, and thus allows the company to gather new ideas to complement internal suggestions.

Interviewing experts shows that their sayings are in line with the scientific literature. They are unanimous in considering the need to innovate as one of the biggest priorities of crowdsourcing *"The first one will be of course to innovate, so to appeal to a community that helps to find ideas and which will provide potential solutions to problems."* Interviewed professionals consider crowdsourcing as an undeniable source of ideas, which allows companies to collect the preferences of current and potential customers more quickly compared to traditional means of co-determination of needs and expectations with customers *"The novelty first, other things second, like the speed with which they can harvest ideas compared to what is traditionally possible, such as focus groups. It is much faster."*

#### 4.2. Mass of proposals at a low cost

Proponents of crowdsourcing consider that the major advantage of this practice lies in its relatively low cost [3, 4, 12]. Crowdsourcing allows the company to access a large pool of individuals around the world [27] and to reduce the relative cost [28]. Several researchers point out the benefits of integrating non-experts into the innovation process, both in solving scientific problems and in the design of products and services. They offer better and less expensive solutions in comparison with traditional research development programs [8].

Lebraty [15] points out that the cost advantage is not always guaranteed because some crowdsourcing initiatives can have counterproductive effects, as the company must manage the risks of dissatisfaction. Similarly, Le Nagard and Reniou [29] consider that some companies perceive the cost of crowdsourcing as high (human and financial resources).

#### 4.3. Strengthening the customer relationship and the brand image of the company

Another benefit associated with crowdsourcing is of the strengthening of the customer relationship and the brand image of the company [10]. Crowdsourcing allows the company to improve its visibility through accessing a large group of users online [30].

Experts reveal that crowdsourcing allows firms to be present on the Internet and to speak about the brand, which generates positive word-of-mouth: *"We also try to create buzz, to improve our visibility on the web."* They evoke their desire to improve their brand image by using crowdsourcing. *"From an image point of view, it's important to say that we are customer-centric."*

Similarly, managers recognize the positive impact this proximity can have on the company's results. *"If we do well and we succeed in creating proximity and commitment to consumers, it will certainly be reflected in sales and in the market share."* For them, the relational objective manifested in the proximity complements the commercial objective of maximizing sales.

### 5. When crowdsourcing carries risks for companies

Besides the many benefits of crowdsourcing as an innovation strategy, the scientific literature warns about some side effects or risks that can appear if the campaign is not managed properly. In the following paragraphs, the authors present the main limits of creative contests and confront them to the interviewed managers' vision.

#### 5.1. Risk of loss of control by the company

Enkel et al. [31] identified a set of risks that companies must manage when investing in crowdsourcing projects. For these authors, when the company loses control over the crowdsourcing process, it also risks losing control over its long-term innovation strategy. The potential risk of losing control is associated with the potential impact on the image of the company. In this case, participants who do not win become hostile toward the company [32]. They generate negative word-of-mouth by sharing their negative experience online, which can

be detrimental to the company's brand image [33, 34]. Some researchers talk about "crowdslapping" to describe this phenomenon [2, 23].

Participants, who question the credibility of such competitions, often highlight the random and subjective nature of the gain. As a result, they do not feel rewarded for the effort they provide *"The gain is too random to settle on it, we are too disappointed if we focus on the gain"* (Paul, participant).

## 5.2. Risk of disclosure of key information

When it comes to discussing the potential risks of crowdsourcing, some researchers do not hold back to stress the risk of losing the confidentiality of certain strategic information. The open and visible nature of crowdsourcing is likely to divulge the company's strategy to competitors [32].

This risk makes the company lose the advantage of benefiting from relevant ideas and proposals of the crowd ([14]b). The risk is greater when the company engages in crowdsourcing initiatives to solve complex problems or develop new products. This finding explains why companies prefer to use traditional means of innovation and internal teams in the case of breakthrough innovations [29].

## 5.3. Risks related to ethical and legal issues

Consumer empowerment increases the complexity of managing crowdsourcing initiatives for businesses [35]. They face ethical issues related to the management of intellectual property rights. Indeed, some participants claim the total ownership of their ideas. The absence of a clear intellectual property policy can lead to a feeling of unfairness [10, 14]. Intellectual property is considered as a sensitive topic that companies must manage with great care [29]. Researchers insist on the need to clarify the rules related to intellectual property rights [3, 4] and on the use of ideas received by the crowd [29]. As a result, companies need to inform participants upstream on generating new ideas. They have to make clear if they remain owners of their ideas or not [36].

Another ethical point is what some authors call "free work" or "free exploitation" of participants [14, 37]. If crowdsourcing is based on the voluntary participation of individuals, few proposals are "paid." In this case, the authors talk about "over-exploitation" [23]. They compare the amount of work provided by the crowd and its real value on the market, with the remunerations paid by the companies. Participants fear being exploited by the company, which results in a feeling of mistrust and skepticism in the way of interacting with brands.

*"I had no knowledge of property rights, which troubled me, but it's true that my parents told me to not be exploited"* (Amina, participant). The mistrust refers to the feeling of participants of being manipulated by the company."

Participants mention the negative effects that crowdsourcing generates when it comes to the exploitation of their ideas *"I feel like companies only do this for their human resources department. So, they don't care for ideas"* (Caroline, participant) and the lack of transparency *"Often, even if we won the first place and when our recommendations were accepted, we received no return. We received*

*no acknowledgement regarding the confirmation that our strategies were accepted. There was lack of communication and that is very disappointing.” (Paul, participant).*

## 6. Crowdsourcing success determinants

To avoid any failure of crowdsourcing operations, we asked managers to decide on the possible determinants of success. According to them, the success of a crowdsourcing operation is often attributed by the experts to a good preparation by the company or the mediating platform “It is crucial for the company and the management to focus on preparation and clearly defining the objective of the whole exercise.” According to the managers, if the team is ready and well prepared, it is far easier to explain the objectives and to solve the problem. *“I think that what is needed is to have a clear brief that must be unambiguous, keep it simple and seek input for new idea generation only. The participants must not be involved beyond idea generation level. They should not be requested to take part in product positioning. It is necessary that the request is very clear and understandable. In short, it is mighty important to have a clear brief.”* The professionals managing the crowdsourcing process should also be prepared to face negative participants’ reactions. *“Because it takes great effort of preparation and framing, so you should anticipate the possible reactions of consumers.”*

The analysis of expert interviews shows that only a good preparation is not enough. It is pivotal to communicate the message effectively through the right media to encourage consumers to participate. *“Good communication before and after the event could make a big impact on the outcome.”* Managers also stress the need to provide feedback after the participation of consumers. By providing feedback to participants, companies show that they value their participation.

As far as the management of the reward system and intellectual property is concerned, professionals insist on the transparency and the clarity of the roles between the company and participants.” *That it has a fair remuneration system for participants and is clear about intellectual*

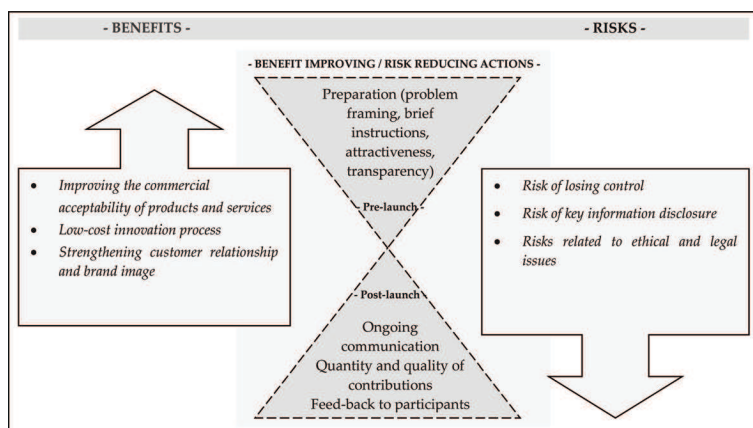


Figure 3. Benefits, risks and success determinants of creative crowdsourcing.

*property rights”, “It is therefore necessary that the rules are clear and transparent. “The company must communicate these rules upstream. Another factor of success of crowdsourcing initiatives is the nature of the problem companies need to solve. It must be interesting enough to attract the target audience. “This is an interesting topic for communities, so there is no crowdsourcing if the problem is not interesting. The second thing is that we need to have a community and third are the technical tools that bring companies and participants closer together.”*

Finally, managers consider that the success of any crowdsourcing initiative depends on the number of participants and the mass of contributions they are capable to submit. *“The number of ideas, the number of participants and on the other hand the quality of participation,” “First by looking at how many participants we had and second the quality of the contributions”* overall findings are summarized in **Figure 3**.

## 7. Conclusion

This chapter provides a synthetic overview on a relatively recent phenomenon from a scientific point of view. While some authors support crowdsourcing initiatives by focusing on the benefits of this practice, other researchers fear that the limits linked to this outsourcing strategy outweigh its benefits. In this chapter, the authors confronted both views and analyzed the conditions of success. The authors conclude that crowdsourcing presents clear benefits and helps circumventing companies’ major internal obstacles.

However, the financial aspects of running a crowdsourcing program need to be studied carefully. Moreover, the company and the concerned professionals should commit themselves fully to this program. Their level of commitment would determine the outcome. Therefore, it is important to engage themselves at every step of the crowdsourcing program. Crowdsourcing should not be considered as a low-cost strategy. This comprehensive approach requires time and investment to yield the benefits discussed in the literature.

Crowdsourcing campaigns, if managed effectively, can reap positive results such as the inclusion of fresh and innovative ideas. It can also maximize the commercial acceptance rate of new products or services. Therefore, the professionals must be very aware of the importance of managing this strategy with great care. The failure of crowdsourcing contests can be detrimental for firms as it influences the company’s innovation strategy over the long term and can strongly affect their brand image.

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# **Outsourcing and the Flexible Firm; The Financial Services Industry**

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Mammed Bagher and Grant MacKerron

Additional information is available at the end of the chapter

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## **Abstract**

This chapter investigates, through a literature review, the increasing use of outsourcing by organisations and why this has become so prevalent in recent years. The use of an effective performance management system for outsourcing projects in the financial services organisation is considered as a means of ensuring success, and how outsourcing can be sustainable through the use of appropriate KPI's. The research results give valuable information on the use of monitoring the performance of suppliers through the use of a clear framework for performance management, and how this will avoid the organisation of the many potential pitfalls which may be encountered with outsourcing. Further work is recommended in the area of outsourcing relating to the use of effective performance management and key performance indicators, which are carefully chosen to reflect the markets the organisation operates in, to reduce the risk of failure.

**Keywords:** outsourcing financial services performance management

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## **1. Introduction**

Many European governments have advocated both privatisation and outsourcing to further boost their companies and economies. This has motivated public and private organisations to enhance their core competencies by focussing on these first, whilst giving their other competencies to outside organisations, third-party providers, who in turn can provide focus and use their expertise in these areas. Due to this shift in how these organisations operate, a significant market has developed for companies who focus in the provision of enhanced support activities for other organisations [1].

Since the 1990s, service outsourcing became very popular [2]. Such a move has become prevalent in the service sector, notably in the financial services sector, where, for example, the back

office operations can be outsourced relatively easily. This in turn allows process efficiencies to be improved [3]. According to the technical committee of the International Organisation of Securities Commissions [4], outsourcing is defined as ‘an event in which a regulated outsourcing firm contracts with a service provider for the performance of any aspect of the outsourcing firm’s regulated or unregulated functions that could otherwise be undertaken by the entity itself’.

According to the survey published in 2017, the financial sector has been the main driver of UK outsourcing to date. The survey, according to Arvato, suggests that the UK market achieved the strongest half-year performance since 2012. This included outsourcing deals worth £5.2Bn from January to June 2017, up 23%, of which the private sector accounted for the majority, worth £4.5Bn. Of this, the financial services sector was 64%.

As with many new trends, there have been a number of outsourcing projects which have either not met their expectations, or have failed in their entirety. A German management consultancy, Steria Mummert, conducted an exercise in 2008, which confirmed this. Steria Mummert asked 512 managers about their experiences; 30% of the managers said that the implementation of their business process outsourcing has not met their expectations [5]. This raises the question of why some outsourcing projects fail quite spectacularly, whilst some do succeed. Post-outsourcing supplier management has been cited by many researchers regarding poor outcomes in contracting-out [6], especially with regards to ensuring ongoing sustainability of projects in the financial services industry.

This chapter considers different forms of supplier outsourcing, including the notion of the flexible firm. The chapter further considers different forms of managing them to help managers ensure they have a sustainable, successful outsourcing project. This includes the implications of performance management on the outsourcing process and the outsourcing contract. To ensure this, the key success factors are identified, together with alternative frameworks from literature which have been considered and developed by different authors to provide an approach to be adopted to ensure best practise for management of outsourcing.

## **2. Literature review**

### **2.1. Organisation**

Coase [7] defines the concept of an organisation: ‘in modern economic theory as an organisation which transforms inputs into outputs’.

Beardwell and Holden (1995) suggest that in order for an organisation to achieve its objectives, there is a need for the completion of a number of tasks. The complexity of the task determines the need for the availability of appropriate technology together with sufficient skills, of the human resources employed, to carry them out. As a result of this Beardwell and Holden (1995) explain ‘this division of labour constitutes the lateral dimension of the structure of the organisation’, and move on to explain the hierarchical relationships of power and authority between the owners and the employees who take on the responsibility for completion of the task(s). As a result of this, Beardwell and Holden (1995) suggest ‘some of the basic elements

of an organisation, then, are its ownership and source of authority'. Another basic element of an organisation is to help its employees to succeed.

One of the most important challenges an organisation faces is to make sure that there is a good match between an employee's skills and commitment and the tasks they are being asked to perform. In current rapidly moving work environments, the availability of time for new employees to adapt and develop is lessening. The organisational expectations are for the employees to become productive almost immediately, to perform the task(s) and move on.

As the quality and quantity of output is becoming more demanding, coupled with the unstable nature of work in recent years, more and more organisations are shifting to outsourcing. To this end, outsourcing can be seen as both a strategic and a pragmatic response to the demands and constraints of an organisation.

The selection of strategically relevant resources and capabilities is critical in determining an organisation's core competencies in order to promote ownership and employee success. A core competence is what an organisation prides itself in, what it is especially proficient at, and it is often invisible to the external customer.

This core competence has become more valuable over time and through continued use because, as is mostly the case, core competencies are primarily knowledge based and they become embedded into the culture of the organisation through the passage of time. As a result of this, organisations must continuously invest in their strategically chosen core competence to be able to adapt to the rapid changes in the global economy, if this is not the case, the organisation is clearly at a competitive disadvantage. According to Hitt et al. [8] 'a sustainable competitive advantage is achieved when organisations implement a value-creating strategy that is grounded in their own resources, capabilities and core competencies'. This viewpoint is based on the assumption that resources and capabilities are of primary importance to profitability and the emphasis is placed upon adapting the external environment to the organisation. The rationale for the resource-based approach to strategy states that the external environment in which an organisation operates is constantly subjected to uncertainty and rapid change. However, an internal focus upon resources and capabilities offer a more secure basis for strategy than a market focus. Thus, it is how the organisation, and not where the organisation, competes. The task of organisational management, therefore, is to decide which resources and capabilities are strategically relevant, and how best to improve them in order for the organisation to exploit all the opportunities in the external environment.

As stated by Hitt et al. [8] organisational resources can be defined as: 'inputs into an organisation's production process, such as capital equipment, the skills of individual employees, patents, finance, and talented managers'. Resources can be divided into tangible and intangible assets and their integration and combination is crucial to ensure an organisation's long-term competitiveness. Tangible resources can not only be easily identified and evaluated, but also imitated by an organisation's competitors. Perhaps the most important and strategically relevant intangible resource is the organisations knowledge, together with the organisations reputation for its products and service quality in being able to create value for its targeted customer.

Day [9] suggests that capabilities are: 'complex bundles of skills and collective learning, exercised through organisational processes, which ensure superior co-ordination of functional

activities'. The strategic integration of an organisation's tangible and intangible resources are its capabilities which must be developed and built upon over time for an organisation to compete in today's global economy.

However, organisations must be aware that core competencies should never be so rigid, so as not to allow the organisation to grow and develop in accordance with the demands both from the internal and external environment.

An organisation's resources, capabilities and core competencies provide the foundation for success; nevertheless they represent one piece of the organisational jigsaw. Resources alone are relatively unimportant; it is the ability of the organisation to use those resources effectively to create opportunities in the external environment which ensures an organisational success.

In addition to our earlier definition of outsourcing, the concept is often quoted in literature is that of Elfing and Baven [10], where the outsourcing concept is seen as, 'a contractual agreement between the customer and one or more suppliers to provide services or processes that the customer is currently producing internally'. Prior to starting the process of outsourcing its paramount to consider the key determining success factors and also the limitations of such direction. As suggested by the Technical Committee of the International Organisation of Securities Commissions [11], there is a need to be mindful of 'the potential that the inappropriate consequences for the outsourcing firm's customers and in certain instances, the potential for systemic risk to the market as a whole'.

Resource-based theory [12] identifies processes and services to be outsourced. Wernerfelt found that when analysing a firm for a future strategy, resources are more important rather than the products it sells or services it performs. He defined resources as tangible and intangible assets, which are tied semi-permanently to the firm. Research by Prahalad and Hamel in [13] found out that organisations' resources are the key in building competitive advantage; these in turn are noted as their core competencies. Core competencies are a starting point when deciding which parts of an organisation can potentially be outsourced. Outsourcing can be carried out both internally in the organisation and, more commonly, carried out externally. Internal outsourcing is noted as 'quasi-outsourcing' ([14], p. 533), where an organisation outsources a process to an entity which acts like an external vendor, but is still owned by the organisation. When an organisation uses external outsourcing, the business process is operated entirely independently by a third-party provider [15]. Further, there are other categories relating to where the outsourcing is located; service performance onsite, onshore-outsourcing, offshoring and nearshoring [16]. Why such alternatives are considered in the majority of cases, is due to costs of undertaking the process in-house against those to be incurred if the process is undertaken by a third-party. Lower costs by a third-party will give reason to consider outsourcing, although other significant issues need to be taken into account [17], including the use of clear performance metrics if the approach is to be used.

## 2.2. Flexible firm

The concept provides the organisation with the facility to be flexible enough to focus on the core business and sub-contract or alternatively outsource the remaining parts of the

organisation. For an organisation to be able to respond to such a business model it must be dynamic, flexible and efficient enough to cope with the demands of such an organisational form.

The first objective is to establish what is meant by the term flexible firm and how the concept can be applied to traditional organisations today.

Atkinson's model of flexibility which was developed during the 1980s, identifies four different forms of flexibility within an organisation and defines the ways they can be achieved. As a result of this Atkinson (1986) developed the model of 'The flexible firm', based on numerical, functional, distancing and pay flexibility.

*Numerical Flexibility:* According to Atkinson (1986), numerical flexibility can be achieved to meet the demands of human resources inputs by increasing or decreasing the number of working hours, or alternatively increasing or decreasing the number of human resources employed by the organisation.

*Functional Flexibility:* Functional flexibility can be achieved through multiskilling of employees, and the organisation's ability to alternate and utilise the skills of employees to meet the requirements of different tasks at various levels by changing the methods of production and workload.

*Distancing:* An organisation's numerical flexibility can be improved by replacing the organisation's employees by subcontractors, consultants, self-employed and agency temporaries. These services can be utilised as and when required by the organisation.

*Pay Flexibility:* Pay flexibility focuses on providing financial support for various functional and numerical flexibilities.

Atkinson's (1986) flexible firm's workers are divided into *core* and *peripheral* working groups, where the core group, i.e., 'the primary labour markets' is focused on running the organisation and securing contracts, whilst the remaining groups', i.e., 'secondary labour markets, stay flexible through quantitative adjustment' according to the organisational needs, followed by self-employed contract workers, subcontractors, outsourcing and agency temporaries all pooled together to complete the task (Atkinson and Gregory 1986) **Figure 1**.

### **2.3. Outsourcing in the financial services industry**

In the financial services sector, Tas and Sunder [3] identified major drivers for outsourcing as well as offshoring, where improvements in communications have made it possible for financial institutions to outsource processes with little loss of control. Globally accredited ISO systems have made it possible to outsource business processes utilising skilled labour.

### **2.4. Performance management of suppliers when outsourcing**

According to Neely et al. [18], performance measurement is defined as 'the process of quantifying the efficiency and effectiveness of action'. In other words, it helps an organisation assess the performance of its processes regarding effectiveness and efficiency.

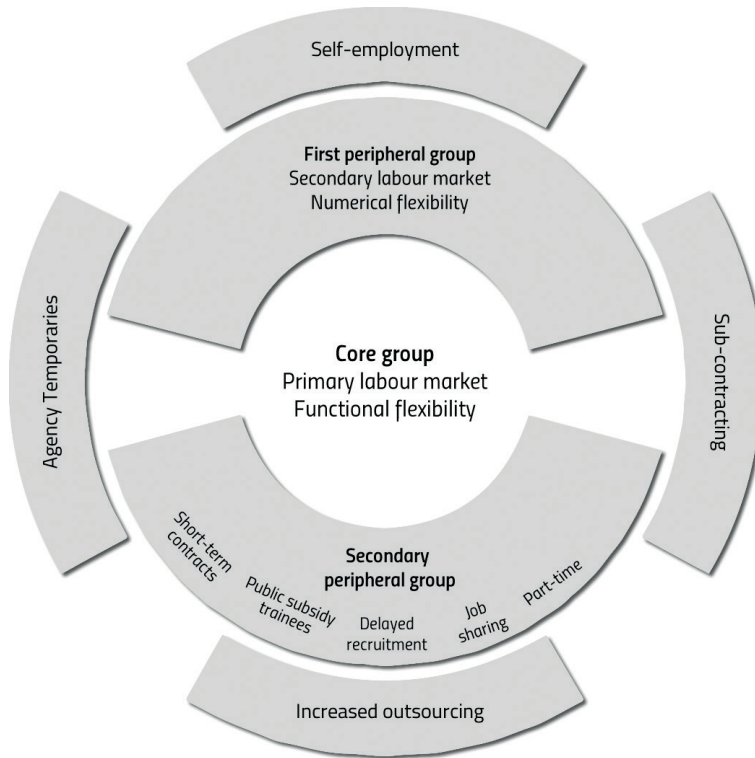


Figure 1. Atkinson's flexible firm.

Performance management has developed from performance measurement [19] in recent years. Literature on measurement has mostly focused on producing data, whereas performance management converts such information into means to improve performance. Folan and Browne [20] saw performance management as using information relating to performance measurement information provide enhanced organisational culture, systems and processes. This is done by using performance goals and prioritising resources, whilst ensuring managers effect and control policy bring about change and meet pre-defined goals by using performance management [20]. Performance management itself has been developed in the field of human resources with a special focus on human performance [19] as well as for managing corporate performance as well.

Notably, the literature exclusively reviews intra-organisational performance. However, performance management of suppliers requires an external view of performance to be adopted. This area has not been extensively investigated, and some authors [20] have suggested further research on performance management systems outside the organisation, including how to effectively assess the supplier. Little work has been done of developing frameworks, which include factors relating to the industry, economy, etc., which can affect the operation of the supplier significantly.

Weimer [17] outlined three major steps in the performance management process; engaging with objective setting, incorporating a performance measurement system able to assess the status of objectives and converting the gathered data into action to ensure performance improvement. To do this, account needs taken of the outsourcing lifecycle. During the different stages of the outsourcing process, account needs taken of the outsourcing lifecycle, which can in turn be sub-divided into phases. The number of the phases depends on what is being outsourced and its complexity, but usually noted as between two and four [17, 21, 22]. Usually, this includes an assessment phase, including a transition plan for when the process moves to the supplier organisation, to ensure the correct outsourcing strategy, the setting of clear objectives to the eventual signing of an outsourcing contract [23]. After selecting the most appropriate outsourcing organisations, a document outlining the service level agreements (SLA) will be required, from which a clear business case for the finally selected supplier organisation will emerge. The final document will be an outsourcing contract for the selected organisation. Outsourcing, for the majority of processes, is not always quick to bring to effect and needs careful planning, requiring a transition plan as processes are transferred to the selected outsourcing organisation. A prime objective at this stage is to move processes with no detrimental effect on the service previously provided by the organisation. There will be a transition phase, where processes or services are moved from the organisation to the supplier; according to the transition plan established in the assessment phase [23], the aim being to shift the outsourced operations efficiently to the service provider so that the agreed service levels are met after a short period of time [17].

Once service levels are met, through to when the contract terminates, it is expected that both parties work together to continually enhance the process in order to both reduce costs and to further the benefit of having the process outsourced, using measurement tools [24] as appropriate.

This is best attempted, where possible, as a partnership, although experience and research has pointed to this actually not being the case and often a reason for failure. This highlights the importance of the outsourcing contract [25], which needs to set out in unambiguous terms the scope of the work within the outsourcing being carried out, together with roles, responsibilities, liabilities and expectations of the parties managed by the contract ([15], p. 134).

Frameworks such as that of Platz and Temponi [26] identify the most important elements of the outsourcing contract, covering performance, financial, HR and legal functions to ensure the contract is fully covered and can be managed to the expectations of both parties. Other authors see the most important elements being specifications for service levels and quality to encourage vendor performance and discourage underperformance [26], whilst others include guidelines to ensure measures are taken where there are cases of poor performance by the supplier [15] as well as for over-performance [27].

## **2.5. Performance management systems in outsourcing projects**

Aron and Singh [28] stress the importance of using internal measurement before the outsourcing decision as a key factor in contributing to success. This is useful where a comparison is later made to ensure, or otherwise, that the outsourcing service provider is providing

a better service/process than would have been the case if this were still provided in-house better than this own organisation did when the process or service was still performed in-house. Further, noted that benchmarking of the service/process should also be carried out to ensure the appropriate levels of performance and cost expectations are realistic and likely to be met.

After the selection of the service/process to be outsourced, Gottschalk and Solli-Saether [29] describe stakeholder management as significant and a further important factor in ensuring that outsourcing is a success. They see the relationship between buyer and vendor needing effective and defined management to ensure success; these required efficient and effective approaches to ensure success. Weimer [17] contributed to this in pointing out that success of an outsourcing project solely depends on the professionalism in managing the outsourcing supplier's performance.

During the operations phase, performance management is critical to success. Measures used need mutual agreement at the start, but there must be the flexibility in contractual agreements to allow measures to be changed due to enhancements to the process or where factors impinge on the process provided. Amendments to pre-agreed contractual measures need to be considered, as many outsourcing projects fail where there is inflexibility in coping with changes to the changing environment [30]. There is agreement among research that changes to contracts needs careful regulation to cope with changing business conditions [31].

Basu [32] also points to the need for careful selection of the performance measurements to be utilised; too often there is failure in taking time to consider what is appropriate to the process being outsourced; taking time at this stage can save considerable discussion at later stages in the work. Dittrich and Braun [23] stress the need to consider both hard and soft measures at this stage. Later work by Pai and Basu [25] reviewed performance metrics and placed them into four categories; volume of work, quality of work, responsiveness and efficiency.

## **2.6. Tools for performance management**

The most commonly used tool in outsourcing projects is the Balanced Scorecard approach [31]. Devised by Kaplan and Norton [33], the Balanced Scorecard is a tool used by many organisations to provide a tool to translate objectives to performance measures and is appropriate to outsourcing projects.

Performance management of outsourcing is also only of relevance if the reasons for failure to meet measures is given careful consideration and the reasons for this poor performance [30]. Prior to suggesting improvements, the cause needs to be found and reviewed to find if the cause is temporary or a change to the work is required.

It is essential to find out the causes of poor service levels first before designing an improvement programme. It is also important to review what will be done where levels are exceeded; sharing the rewards of enhanced performance can be excellent for both parties and needs careful consideration as well as considerable encouragement. On the contrary, how to deal with poor performance needs careful consideration and managed in a way that ensures the contractor is encouraged and motivated to meet or exceed targets [34]. Pai and Basu [25] introduced the

concept of a service credit system; payments to the outsourcing service buyer, when the supplier does not meet the service levels. The main purpose of this is to provide the organisation providing the service with incentives to meet target performance and has proven to be very effective for supplier performance improvement [25]. Throughout the above approaches, the means of communication needs careful consideration, together with how this is managed, as part of the drive to improve the outsourcing relationship [35]. By building trust through communication, the post-contract transaction costs can be reduced [31]. Authors, such as Dzierzon [30] and Schoeningher, have recommended teams of staff dedicated to this task, where the scale of the project is large.

## **2.7. Financial services outsourcing: key factors for success**

The preceding paragraphs provide generic factors to be considered in ensuring success. For the financial Services industry, two further factors have been added. Authors writing about outsourcing in financial services point to the need to consider risk management. This requires [36] a risk analysis of the outsourced process. First, the process requires evaluation with regard to the internal business risk should the outsourcing process fail. Gewald und Dibbern [37] put forward four classifications for this; Performance risk, where the supplier does not deliver according to expectations leading to potential damage to reputation of the financial services institution; Financial risk, where the financial institution will be obliged to pay more for a service than initially planned; Strategic risk, where the organisation may lose resources that could contribute to competitive advantage; and finally, Psychological risk where managers' departments are outsourced. A second issue is where there may be legal restrictions imposed on financial services institutions with regard to them outsourcing distinct areas of their business. Governmental institutions, including the Basel Committee on Banking Supervision, the Committee of European Securities Regulators and in the UK, the Financial Services Authority (FSA), have stressed the necessity of legal regulations relating to the outsourcing of financial organisations. These relate to supplier dependence, legal risks, IT risks, to only name a few [36]. The UK Financial Services Authority's regulations were analysed by Evans [38], who found that the identification of potential risks and necessity of systems for management and control of these risks are a major issue within these regulations. This demands a secure supplier contract, employed within a relationship management system. There is a need for internal and external due diligence and the introduction of a well-managed performance measurement system are claimed by this legal body as well. Outsourcing within the financial sector in general, is seen [39] as increasing risks where outsourcing is used.

A further area of interest that is quoted in literature about performance management in financial services outsourcing is the statement of auditing standards (SAS) 70, originally developed by the American Institute of Certified Public Accountants as a communication tool for auditors to discuss the functionality of audit processes between outsourcing parties. This is an international standard for the evaluation of supplier's performance control systems [36]. This gives the outsourcing organisation an independent view on the processes and performance of the supplier. Reports are prepared by audit companies on a continuous basis to ensure that the outsourcing company can assure the supplier's capability for the delivery of the outsourced services [40]. This provides a valuable supplement for the supplier's performance assessment.

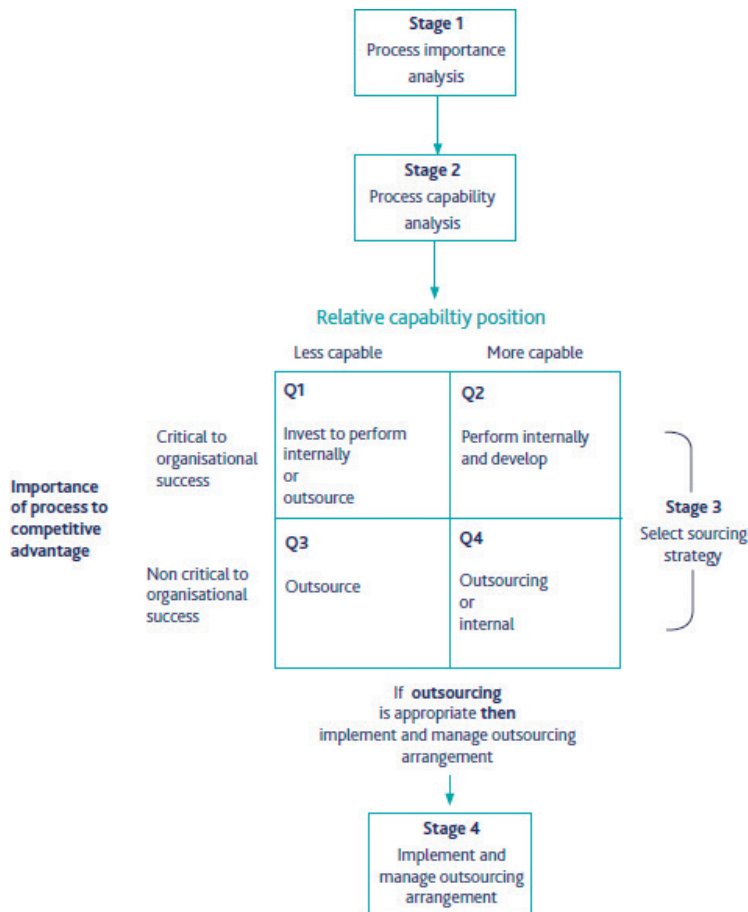


Figure 2. McIvor’s performance management framework [41].

2.8. Performance management frameworks for outsourcing projects

Figure 2 is an example of a Framework for managing outsourcing, developed by [41]. This provides an organisation with a guideline of how to implement performance management both prior to, and during an outsourcing project. McIvor split this into four stages:

1. Process importance analysis, identifies the process’s contribution to corporate success. Core competencies contributing to competitive advantage should remain in-house. Non-core competencies should be considered for outsourcing. This area of McIvor’s study uses the so called critical success factor (CSF)—method to identify critical and non-critical processes.
2. Process capability analysis, is used to determine whether the outsourcing organisation is capable of performing the process to the same or a higher level when it is compared to potential external suppliers. This stage will use both cost analysis and benchmarking.

3. Choosing the sourcing strategy based on the analysis results is then carried out by the organisation. There is then the decision of whether the organisation carries on, or whether it decides to outsource.
4. Finally in McIvor's framework, the further step relates to the implementation and management of the outsourcing arrangement if this is the chosen path, following the third stage. Here, a sub-classification into contract management, managing and evaluating the relationship is made. Although the study gives some indication on how to manage and evaluate the supplier, a clear tool or guideline for design and implementation that could be adapted to the majority of outsourcing projects is not given.

Further to the above, Weimer [17] has put forward an approach to transform the Balanced Scorecard, normally used for internal use, into a performance measurement tool for outsourcing projects. The work of Weimer concentrated on the need to identify the relevant information necessary for an organisation to effectively manage the outsourcing project (Hodel et al. [24]; Basu [32]; Würz and Blankenhorn [31]), are also noted authors relating to using the balanced Scorecard.

In identifying relevant information for performance management in outsourcing, Weimer used the Delphi technique to organise and share opinion through feedback. Service reporting and performance management were the two areas, where he found a distinctive need for good information, together with measurement and reporting tools that produce information regarding service levels, quality and customer satisfaction to ensure success of the outsourcing contract. Weimer found the balanced scorecard to be of benefit in undertaking this task.

### 3. Conclusion

Limited work has been undertaken in the development and use of effective performance management in outsourcing projects, beyond the work of McIvor and Weimer. However, the frameworks shown, do provide a model for organisations to follow to ensure they consider appropriate stages, which if done in detail and managed appropriately, should lead to success.

In addition to the main areas addressed in this chapter, there is a requirement for further research into the relationship between performance management and the notion of outsourcing, using data from organisations who have undertaken such a move in recent years. There are many real, potential challenges to outsourcing as has been the case in recent, turbulent international markets. There has been a notable amount of literature on successful outsourcing within the financial services sector, but there further research work is required to ensure organisations use carefully selected KPI's relevant to their particular situation, whilst ensuring they are aware of the use of these.

Further recommendations relating to the above [42] are that organisations, in order to reduce the risk of failure when outsourcing, they need to consider a number of key factors prior to embarking such a strategic move. Bateman suggested that they also take account of 'realistic expectations; sufficient in-house expertise to enable effective contract management and have a contingency plan so that you can, if necessary, take the service back in-house'.

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# Outsourcing of Services: Case of the Czech Republic

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Radka Vaníčková and Gabriela Gabrhelová

Additional information is available at the end of the chapter

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## Abstract

The chapter deals with an analysis, assessment, and use of the outsourcing in a public institution that employs an external firm to service office and common office cleaning. Based on the methodology and objective were information established by personal interviews and monitoring, the calculation of the cost of individual employees was designed for all forms of employment, i.e., both the full-time and part-time employment, the work and job agreements and related number of cleaning staff, gross wage, health and social insurance payments, super gross wage, income tax, tax allowance, and net wage of the cleaning worker. Transferring the competence of an ancillary activity to an external company enables the public institution to have an advantage of focusing on the main activity, including the time advantage, as it can provide a higher quality of services to citizens (clients) with a lower administrative burden. The conclusion of the chapter assesses the advantages of outsourcing for the public sector including core business and risk transfer as a comprehensive solution of facility management with the emphasis on expanding and improving the portfolio of services in the future. Furthermore, the benefits of outsourcing in the context of the service sector, advantages and disadvantages of the client and outsourcing provider, current trends, development, innovations and changes in outsourcing in the context of services, the prediction of future development and the estimation of the use of outsourcing in services.

**Keywords:** outsourcing, services, public sector, forms of employment, core business, risk transfer, facility management

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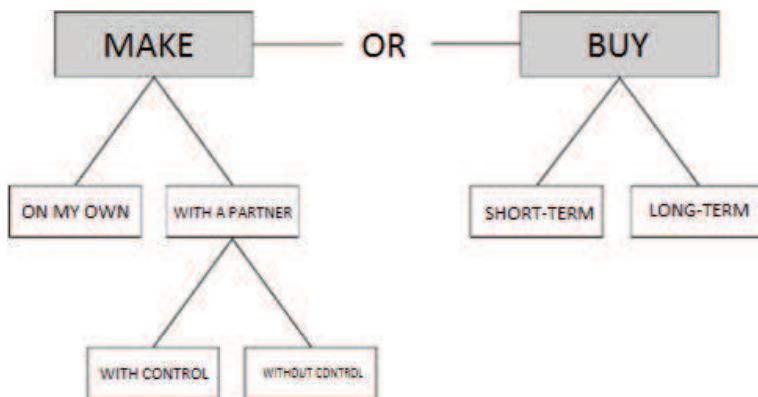
## 1. Introduction

In general, outsourcing is an opportunity to restructure an enterprise [1]. It is appropriate to use it for those activities that are not effective in their own way—for example, the full capacity of the technical equipment [2] or the selection of employees is not used completely [3].

Outsourcing as a short for Outside Resource Using is always a decision between two possibilities—Make or Buy as reported in **Figure 1** [4].

Kadefors [5] reports that each company may have its own requirement on outsourcing providers. Such service differs both by the main focus of the company [6] and the outsourcing plan [7]. A number of companies that choose a provider of company's processes by different needs and criteria have been growing. Assignment of the responsibilities to an outsourced supplier offers a stable service delivery of guaranteed quality [8] and usually at a pre-determined price that guarantees concentration on the main business plan and key processes [9]. It not only generates a competitive advantage and significant market position but also predictable revenue and increased production [10].

Regarding the type of transactions, there are [11] local and international outsourcing—near shore and offshore outsourcing. Local outsourcing is provided by firms within the same state [12]. International outsourcing is its contrary [13]. The most important difference between outsourcing and a purchase of goods and services is the long-term base of the relation of the client and the provider [14]. Nowadays, as companies are looking for a new outsourcing provider, they can not only consider the financial issue but also have to take many other conditions into account [15]. The choice of the definition of a particular outsourcing company's activity is subject to a decision for several years. In decision-making, the role of other competing companies with whom a potential outsourcing contractor already cooperates plays an important role [16]. The top managers should take into account what activities should be outsourced and what activities should they focused on in relation to their own type of business [17]. The first question employees discuss is whether it makes sense to outsource the particular activity [18]. In business practice, there are cases where the company is able to carry out the same activity of the same quality on its own [19]. In such case, a transfer of the activity to a supplier is more favorable for the company considering the longer term aspect of the activities such as the future development of the cooperation of the supplier [20]. In the latter case, the company is unable to produce the product or service in the required quality. If the



**Figure 1.** Make or buy. Source: [4].

company finds that it has limited capacities, it is more appropriate to outsource the activities [21]. The third alternative to outsourcing decisions is certain concerns about the emergence of risks that may threaten or restrict the company in the future, such as an employee who may have a long-term illness or they may damage a machine, a vehicle, and so on. In such case, a company should transfer the unpredictable risk to outsourcing supplier [22].

Outsourcing may also occur at the tactical level—the company has problems, and outsourcing offers a quick solution, such as addressing the shortage of workers [11]. Strategic outsourcing is successful if the organization realizes the added value [23], for example, the relationship between a supplier and a buyer is turning into partnership. Transformational outsourcing also serves to build a new face and structure [24].

The authors [25] described an outsourcing contract as a process of negotiation on outsourcing activities and its subsequent conclusion with an outsourcing contractor. Such contract provides long-term partnership, mostly for 3, 5, or 10 years. The company and the outsourcing supplier will be governed for several years under the agreement, and therefore the access to the contract from a senior management perspective must be as thorough as possible and satisfactory to both parties. The outsourcing contract is used and referred to as a means of reducing the risks related to business [4]. All requirements and obligations for both parties must be enshrined in the contract [16]. The main legal risks in the Czech Republic include the duration of the contract and the way in which the content is changed and the contract is terminated. The most common forms of outsourcing contracts include a contract for a work, a lease, or a mandate contract. If outsourcing is supposed to be successful, careful consideration should be given to the risks and possible impacts on the business [26]. It is clear from the various researches that approximately half of the contracts contracted did not meet the required expectations and results; however, providing outsourcing services both globally and locally is expected to further increase in the future.

## 2. Methodology and objective

The chapter deals with analyzing, evaluating, and using outsourcing services. A public institution from Prague with 562 employees was used in the research. The research took place from February to May 2016. The institution hires an external cleaning service company to clean offices and common parts. Outsourcing of services was analyzed to decrease possible financial, investment, and operating expenses. Studies and papers used as the secondary resources are listed in the references.

We stated the following research questions:

Research questions 1: The public institution has opted for outsourcing to reduce financial costs.

Research questions 2: Outsourcing is at an early stage of its life cycle.

Information necessary for the analysis was established by an interview with a governmental official and monitoring. The official answered the following questions:

Which company provides the cleaning service?

What is the cost of the institution for the service provided?

Have you ever thought about hiring your own workers to clean up the offices and common areas?

Do you have a sufficient number of cleaning staff?

For what period of time is a partnership contract signed with the external company?

How large rooms are cleaned by a worker?

What form of employment was signed with a cleaning company?

What is the net and gross wages of the cleaners?

What are the working time and the job of the cleaners?

What cleaning supplies do the cleaners have? Who provides the customer care for the cleaning supplies?

The above-mentioned questions were answered in order to prove or reject the hypotheses. Based on the information established by personal interviews and monitoring, the calculation of the cost of individual employees was designed for all forms of employment, i.e., both the full-time and part-time employment, the work and job agreements and related number of cleaning staff, gross wage, health and social insurance payments, super gross wage, income tax, tax allowance, and net wage of the cleaning worker.

The first type of employment analyzed was a full-time employment. The gross wage was calculated as follows: Employee's statutory payments + Health insurance =  $4.5\% \times \text{gross wage}$ , Social security =  $6.5\% \times \text{gross wage}$ . Employer's statutory payments paid by the employer: Health insurance =  $9\% \times \text{gross wage}$ , Social insurance =  $25\% \times \text{gross wage}$ .

Gross wages + Health insurance  $9\%$  + Social insurance  $25\%$  = Super gross wage (the amount is rounded up to hundred crowns).

Income tax = Tax rate  $15\% \times \text{Super-gross wage}$ .

Income tax allowance = Income tax–Discount (2070 CZK a taxpayer).

Gross wage–Health insurance  $4.5\%$ –Social insurance  $6.5\%$ –Income tax + Tax allowance (e.g., 2070 CZK a taxpayer) = Net wage.

The second type of employment analyzed was a part-time job. The calculation was the same as the full-time job but halved.

The third type of employment analyzed was an agreement to perform work. There were two possibilities. The first possibility was calculated as follows: The gross wage was up to CZK 2500. As set by law, if this amount is not exceeded, no social security and health insurance payments are required. The gross wage of the cleaner is taxed on income tax of  $15\%$ , and then the monetary claim for net wage/1 cleaner is calculated.

The second possibility was different: the gross wage was set at CZK 3000 (more than the statutory deduction amount) where the calculation procedure was the same as the full-time form of employment.

The last type of employment analyzed was an agreement to complete a job. The gross wage was less than 10,000 CZK and social security and health insurance payments were not required. The calculation was then the same as in case of work contracts up to 2500 CZK.

The agreement to perform a job and the agreement to perform work are special types of service contract agreements used in the Czech Republic. They both differ from standard employment by less strict rules and they are often used in case of part-time jobs.

The most important difference between these two types is as follows. The agreement to perform a job is a short-term contract—for one employer, it is possible to work under such agreement for a maximum of 300 h per calendar year.

The work is limited weekly. Usually, it is 20 h a week, i.e., a half of the average working hours for a full-time employment.

The investment costs included cleaning carts, industrial vacuum cleaners, and cleaning mops, where the selection criteria were price, quality, functionality, and usability. Based on the location, distance, availability, selection of services, and the relevant product range, a suitable supplier, a wholesale of Makro Cash & Carry ČR based in Prague, was chosen.

Based on the goal in line with financial savings, emphasis was placed on eliminating increased investment costs, minimizing own operating costs and lowering wage costs, transforming investment expenditures into operational tax optimization, more transparent cost planning by reducing or eliminating hidden costs, or sharing investment risk.

Transferring the competence of an ancillary activity to an external company will enable the public institution to focus on the main activity, including the time advantage, as it can provide a higher quality of services to citizens (clients) with lower administrative burden. Through an external firm, the public institution does not have to implement any operational processes because they are in the competence of an outsourcing company, such as the management of cleaning staff costs, wage and accounting agenda, controlling activities, the transfer of cleaners, recruitment of new cleaning staff and similar.

The conclusion of the chapter assessed the advantages of outsourcing for the public sector including core business and risk transfer as a comprehensive solution of facility management with the emphasis on expanding and improving the portfolio of services in the future.

### **3. Results and discussion**

A public institution decided to outsource cleaning service of offices and common parts. An external supplier was chosen by a completion based on Czech Act 134/2016, Coll., on Public Procurement [21]. The competition was entered by 22 companies; the most important criterion was the lowest price.

The costs for the public institution amounted to CZK 338,660 per year and CZK 28,221.60 per month (the contract price takes the sum of the necessary costs to fulfill the subject of the contract into account). An external firm is not a VAT payer; the price is not increased by the value

added tax of 21%, so it is the final price. The charged price is paid monthly by the customer based on the invoice issued by the contractor within 14 days after the end of the respective month with a maturity of 21 days from the date of delivery to the customer.

The obligations of the contractor-client are as follows: training of managers of the provider related to labor safety, provision of free electricity and water consumption for service providers, provision of comprehensive technical functionality, safe and hygienic storage of personal belongings in the premises, closed cleaning premises with the cleaning equipment and machines, and commissioning of responsible persons by operative contact with the operations manager [27].

Obligations of the provider are the following: providing work clothes, protective, cleansing, cleaning and disinfecting agents; preventing workers from other workplaces away from cleaning; training of employees in the field of general standards of hygiene and disinfection; and determination of responsibility for the allocated cleaning areas.

As reported in the contract, the provider's workers are allowed to clean the offices and common parts from certain time only. They are allowed to start working with the termination of official hours at a public institution. The contract also reports the schedule of cleaning divided into different groups: offices (daily, weekly, and monthly cleaning), halls (daily, weekly, and monthly cleaning), staircases (daily, weekly, and monthly cleaning), toilets (daily, weekly, and monthly cleaning), meeting rooms (weekly and monthly cleaning), and warehouses (cleaning only if agreed upon). The provider employs seven cleaners under the agreement to complete a job. The cost on workers for the provider consist of the monthly gross wage, social insurance payment (25%) and health insurance (9%) and insurance as required by law taken out the Kooperativa insurance company (9%).

**Table 1** reports the data necessary for the calculation of net wage. Gross wage is 10,255 CZK; health insurance payment amounted to 462 CZK, and social insurance 667 CZK (total deduction/one cleaner 1129 CZK). As the cleaners report their employment as the main employment in the Declaration of the taxpayer liable to personal income tax from dependent activity (employment) and office-holders' emoluments, the income tax is 15% of the gross wage and the tax allowance is 2070 CZK per a taxpayer; monthly deduction of the employer is the health insurance 923 CZK and the social insurance 2564 CZK.

The total monthly cost of the employer to seven cleaners is CZK 71,785, health insurance of 6461 CZK contributions and social insurance of 17,948 CZK. In total/ seven cleaners = 96,194 CZK/month + CZK 100 per quarter (Kooperativa insurance).

### **Annual cost of the employer**

(Deduction, gross wage) =  $96,194 \times 12 = 1,154,328$  CZK.

Kooperativa insurance (7 workers) =  $(100 \times 4) \times 7 = 2800$  CZK.

**Annual cost of the employer in total = 1,157,128 CZK.**

Number of workers	Gross wage	Employee		Employer		Super Gross wage	Income tax	Tax allowance	Net wage
		Health insurance	Social insurance	Health insurance	Social insurance				
1	10,255	462	667	923	2564	13,800	2070	2070	9126
2	10,255	462	667	923	2564	13,800	2070	2070	9126
3	10,255	462	667	923	2564	13,800	2070	2070	9126
4	10,255	462	667	923	2564	13,800	2070	2070	9126
5	10,255	462	667	923	2564	13,800	2070	2070	9126
6	10,255	462	667	923	2564	13,800	2070	2070	9126
7	10,255	462	667	923	2564	13,800	2070	2070	9126
<b>Total</b>	<b>71,785</b>	<b>3234</b>	<b>4669</b>	<b>6461</b>	<b>17,948</b>	<b>96,600</b>	<b>14,490</b>	<b>14,490</b>	<b>63,882</b>

Source: Authors.

**Table 1.** Net wage of cleaners in case of full-time employment.

As reported by the annual cost, such possibility is not economical as there is a high excess amount of 818,468 CZK for the service provided. Full-time employment contract sets the obligation to work 8 h a day. Due to time and capacity reasons (the shift has to start in the afternoon), it is not possible to decrease the number of workers. The possibility is not advantageous.

### 3.1. Part-time employment

Part-time employment is a second possibility of employment. Monthly gross wage amounts to 6000 CZK.

If the public institution decides to pay the workers a gross monthly wage of CZK 6000, the net wage is CZK 3915, health insurance of 270 CZK, and social insurance of 390 CZK, with 15% of the income tax (15%) and health insurance additional payment of 180 CZK. This was due to the employer's duty to pay for health insurance for the employees under the minimum gross wage of CZK 8000 and not from CZK 6000 as stated in **Table 2**. For this reason, an additional payment is paid, which the employee pays for himself/herself. A total deduction for a worker is 2085 CZK. The total monthly cost of an employer for a part-time employment is estimated at CZK 42,000 (Gross wage), health insurance of CZK 3780, and social insurance of 10,500CZK, a total of CZK 56,280.

#### Annual cost of the employer

(Deduction, gross wage) =  $56,280 \times 12 = 675,360$  CZK

Kooperativa insurance =  $(4 \times 100) \times 7 = 2800$  CZK

Number of workers	Gross wage	Employee		Employer				Super Gross wage	Income tax	Tax allowance	Net wage
		Health insurance	Social insurance	Health insurance	Health insurance additional payment	Social insurance					
1.	6000	270	390	540	180	1500	8300	1245	0		3915
2.	6000	270	390	540	180	1500	8300	1245	0		3915
3.	6000	270	390	540	180	1500	8300	1245	0		3915
4.	6000	270	390	540	180	1500	8300	1245	0		3915
5.	6000	270	390	540	180	1500	8300	1245	0		3915
6.	6000	270	390	540	180	1500	8300	1245	0		3915
7.	6000	270	390	540	180	1500	8300	1245	0		3915
<b>Total</b>	<b>42,000</b>	<b>1890</b>	<b>2730</b>	<b>3780</b>	<b>1260</b>	<b>10,500</b>	<b>58,100</b>	<b>8715</b>	<b>0</b>		<b>27,405</b>

Source: Authors.

**Table 2.** Net wage of cleaners of part-time employment.

### Annual cost of the employer in total = 678,160 CZK

Annual cost is calculated to be 678,160 CZK. Such amount is higher by 339,500 CZK compared to the amount paid by the public institution. It does not include the cleaning supplies costs such as the hygiene supplies, detergents, purchase of vacuum cleaners, etc. This possibility cannot be accepted.

### 3.2. Agreement to perform work

An agreement to perform work is another choice. A cleaner works 300 h a year as those are the working hours in the public institution in the afternoons. If the gross wage paid to the cleaners is up to 2500 CZK, it is not necessary to pay social and health insurance and income tax of 15% is only paid. The social and health insurance are obligatory if the gross wage is more than 2500 CZK, including the income tax.

See **Table 3** for the first possibility if the gross wage is up to 2500 CZK.

The cleaners are paid their gross wage of 2500 CZK. Social and health insurance are not paid and the income tax is 15% (375 CZK). The total monthly costs of the employer for the Work Agreement (1)/7 cleaners are CZK 17,500 for the gross wage, health, and social insurance payments of 0, i.e., the total amount of 17,500 CZK.

### Annual cost of the employer

(Deduction, gross wage) =  $17,500 \times 12 = 210,000$  CZK

Kooperativa insurance =  $(100 \times 4) \times 7 = 2800$  CZK

**Annual cost of the employer in total = 212,800 CZK**

Number of worker	Gross wage	Employee		Employer		Super Gross wage	Income tax	Tax allowance	Net wage
		Health insurance	Social insurance	Health insurance	Social insurance				
1.	2500	0	0	0	0	0	375	0	2125
2.	2500	0	0	0	0	0	375	0	2125
3.	2500	0	0	0	0	0	375	0	2125
4.	2500	0	0	0	0	0	375	0	2125
5.	2500	0	0	0	0	0	375	0	2125
6.	2500	0	0	0	0	0	375	0	2125
7.	2500	0	0	0	0	0	375	0	2125
<b>Total</b>	<b>17,500</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>2625</b>	<b>0</b>	<b>14,875</b>

Source: Authors.

**Table 3.** Net wage of cleaners of Agreement to perform work (1).

The above-mentioned cost is significantly lower compared to the amount paid by the public institution for the service. Although the total amount is lower by 125,860 CZK, it is not the really the total amount, as it does not include additional cost such as vacuum cleaners, cleaning carts, sanitary and cleaning products, detergents and so on. The option is not appropriate.

See **Table 4** for the second possibility if the gross wage is over 2500 CZK.

As reported in **Table 4**, if the public institution opts for this possibility, it pays the gross wage of more than 2500 CZK, and the social and health insurance payment is obligatory. In case of the gross wage of 3000 CZK, the payments are 135 CZK (health insurance) and 195 (social insurance). There is the income tax of 15% (615 CZK). The resulting net wage amounts to 2055 CZK.

Total cost for the agreement to perform work (2) is as follows: gross wage/1 cleaner (3000 CZK), charges—Health insurance/1 cleaner (270 CZK), social insurance payments/1 cleaner (750 CZK), i.e., a total of 4020 CZK per month/1 worker; in case of seven workers = 28,140 CZK.

#### **Annual cost of the employer**

(Deduction, gross wage) =  $28,140 \times 12 = 337,680$  CZK

Kooperativa insurance =  $(100 \times 4) \times 7 = 2800$  CZK

**Annual cost of the employer in total = 340,480 CZK**

Assuming this option is preferred by the public institution, the annual cost of the cleaning staff is CZK 340,480, which corresponds to real possibilities and willingness to pay for the services provided by an external firm (CZK 338,660). Unfortunately, the total amount of 340,480 CZK does not include additional cost such as vacuum cleaners, cleaning carts, sanitary and cleaning products, detergents, and so on. The option is not appropriate.

Number of workers	Gross wage	Employee		Employer		Super Gross wage	Income tax	Tax allowance	Net wage
		Health insurance	Social insurance	Health insurance	Social insurance				
1	3000	135	195	270	750	4100	615	0	2055
2	3000	135	195	270	750	4100	615	0	2055
3	3000	135	195	270	750	4100	615	0	2055
4	3000	135	195	270	750	4100	615	0	2055
5	3000	135	195	270	750	4100	615	0	2055
6	3000	135	195	270	750	4100	615	0	2055
7	3000	135	195	270	750	4100	615	0	2055
<b>Total</b>	<b>21,000</b>	<b>945</b>	<b>1365</b>	<b>1890</b>	<b>5250</b>	<b>28,700</b>	<b>4305</b>	<b>0</b>	<b>14,385</b>

Source: Authors.

**Table 4.** Net wage of cleaners of Agreement to perform work (2).

### 3.3. Agreement to perform a job

The public institution can also opt for an agreement to perform a job. If a cleaner works up to 300 h a year (a gross wage of less than 10,000 CZK), the income tax is of 15%. The total amount does not include additional cost such as vacuum cleaners, cleaning carts, sanitary and cleaning products, and detergents, and it is necessary to add them to the total amount paid for the service.

By a personal interview with a cleaner and the monitoring, trademarks of cleaning products, including suppliers, were found to calculate the operating costs of the service. Personal conversation could not be recorded because of privacy concerns about the person being addressed.

### 3.4. Choice of the cleaning cart

Assuming that a public institution decides not to hire an external company for the service (cleaning) and opts for hiring its own cleaning staff, it will be essential to equip the cleaning staff with the necessary sanitary and cleaning supplies designed to clean the offices and common parts. A personal interview with a worker showed that each cleaner has their own cleaning cart, including vacuum cleaners and detergents, which are located in the closed premises of a public institution attended by the cleaning staff in the afternoon.

**Figure 2** depicts a simple wheeled cleaning cart, which helps to be easily moved and manipulated both inside and outside. It is equipped with a plastic bucket and mop rigs [29]. The cost of one trolley is CZK 1597/1 cleaning staff (11,179 CZK/7 workers).

The above-mentioned cleaning cart (see **Figure 3**) is not plastic; its base is a chrome structure that allows you to handle two 17l plastic buckets. An advantage is the side baskets, which can

be purchased individually, including a mop-wringer [31]. The price of one cleaning trolley is 2650 CZK/1 cleaning worker (18,550 CZK/7 workers) (**Figure 4**).

The third type of the cart is a professional trolley. It has a chrome-plated construction, a waste bin, two smaller buckets, one big plastic bucket, part of which is a mop-wringer [33]. The cost of one cart is CZK 5977 per 1 cleaner (41,839 CZK/7 workers).

Although a large number of cleaning carts are available, the three we have selected are common, and perfectly suitable for cleaning work. In terms of price, functionality, and ease of use, the first cart was chosen.

### 3.5. Choice of the industrial vacuum cleaner

It is necessary to choose an industrial vacuum cleaner of higher performance can clean up a larger area of dirt on everyday use (**Figures 5 and 6**).

The above vacuum cleaner is capable of vacuuming dry and wet dirt on smaller surfaces [35], which are sufficient to clean the office and common areas. The product is made on the basis of interchangeable sachets that capture dirt [36]. The cost of one industrial vacuum cleaner is 5044 CZK/1 workers (35,308 CZK/7 workers).



**Figure 2.** Cleaning cart AMIGO 35 l. Source: [28].



**Figure 3.** Cleaning cart CLAROL. Source: [30].



**Figure 4.** Cleaning cart with one bucket. Source: [32].



**Figure 5.** Kärcher NT 27/1 vacuum cleaners. Source: [34].



**Figure 6.** PLAY 202 STEEL vacuum cleaners. Source: [29].

This vacuum cleaner is designed for everyday use, it is suitable for cleaning common areas, and however it cleans dry dirt only. The price of one industrial vacuum cleaner is 4538 CZK/1 cleaner (31,766 CZK/7 workers) (**Figure 7**).

Another possible vacuum cleaner is the Bolezzo 151 industrial vacuum cleaner, which is designed for daily vacuuming of dry and wet dirt that is captured by a long-life filter (7 years



**Figure 7.** BOLEZZO 15l vacuum cleaner. Source: [37].

warranty) [38] that is influenced by vacuum cleaner maintenance. The price of one industrial vacuum cleaner is CZK 3589 per 1 cleaning worker (25,123 CZK/7 workers).

**Table 5** revealed that the most advantageous candidate for quality purchase is the first Kärcher vacuum cleaner, however, with the highest price and no warranty period. The second Soteco vacuum cleaner is more affordable, the power consumption of the device is lower by 80 W compared to the previous, and the volume of the tank is sufficient (19l). The disadvantage is the use only for dry dirt, which is unacceptable for practical use in offices and common areas due to the winter season. The third Bolezzo vacuum cleaner is best priced. It is made for both dry and wet dirt, but the power and volume of the tank have the lowest values. As cleaning is done every day, the Bolezzo is the recommended type to be purchased [39].

The basic equipment also includes a cleaning trolley, a vacuum cleaner, a mop, detergents and supplies [40], such as a mop holder, an aluminum rod or a flat mop. A suitable option for is the 41.5 cm flat mop holder is made of high-quality hardened plastic; the rod for the mop holder is made of aluminum. The cleaning mop suitable for water washable floors with a length of 41.5 cm and a lifetime of 250 washing, corresponding to the area of the office and common areas.

Producer	Kärcher	Soteco	Bolezzo
Weight(kg)	7.5	10.64	—
Power input (W)	1380	1300	1000
Noise level (dB)	72	63	—
Tank volume (l)	27	19	15
Dry dirt	yes	Yes	yes
Wet dirt	yes	No	yes
Shipping cost	0 CZK	182 CZK	0 CZK
Guarantee (years)	—	1	7
Price (1pc)	5044 CZK	4538 CZK	3589 CZK
Price (7pcs)	35,308 CZK	31,766 CZK	25,123 CZK

Source: Authors.

**Table 5.** Industrial vacuum cleaner parameters.

Supplier	B2B partner	Habra	Simply clean
Holder type	Flat mop holder 40 cm	Flipper holder 40 cm	Flipper holder 40 cm
Holder material	plastic	plastic	plastic
Price 1pc	844.58 CZK	823.00 CZK	653.00 CZK
Price 7 pcs	5912.06 CZK	5761.00 CZK	4571.00 CZK
Shipping cost	0 CZK	0 CZK	157 CZK
Total price	5912.06 CZK	5761.00 CZK	4728.00 CZK

Source: Authors.

Table 6. Options for a supplier of a mop holder.

Supplier	B2B partner	Habra	Simply clean
Rod brand	Not known	Alu	Alu
Material	Aluminum rod	Aluminum rod	Aluminum rod
The length of the rod	140 cm	140 cm	140 cm
Rod diameter	2.35 cm	2.35 cm	2.35 cm
Price 1pc	204.49 CZK	163.00 CZK	109.00 CZK
Price 7 pcs	1431.43 CZK	1141.00 CZK	763.00 CZK
Shipping cost	0 CZK	0 CZK	157 CZK
Total price	1431.43 CZK	1141.00 CZK	920.00 CZK

Source: Authors.

Simply Clean is also a suitable supplier according to the price criterion with the same product quality.

Table 7. Options for a supplier of an aluminum rod.

Supplier	B2B partner	Habra	Simply clean
Mop brand	Flat mop-combin	Flipper	Flipper
Mop length	41.5 cm	40 cm	40 cm
Price 1pc	177.87 CZK	151.00 CZK	104.00 CZK
Price 7 pcs	1245.09 CZK	1057.00 CZK	728.00 CZK
Shipping cost	0 CZK	0 CZK	157 CZK
Total price	1245.09 CZK	1057.00 CZK	885.00 CZK

Source: Authors.

As it is the same product with a different price, Simply Clean is a suitable supplier due to the lowest price of 885 CZK.

Table 8. Options for a supplier of a mop.

	Cleaning cart	Industrial vacuum cleaner	Cleaning mop
Name	Eastmop AMIGO 35l	BOLEZZO 15l	FLIPPER
Price 1pc	1597 CZK	3589 CZK	866 CZK
Price 7 pcs	11,348 CZK	25,123 CZK	6062 CZK
<b>Total price</b>			<b>42,533 CZK</b>

Source: Authors.

Initial investment for clearing supplies amounted to 42,533 CZK (it does not include the cost of sanitary products, detergents, toilet hygiene, soaps, and similar).

**Table 9.** Initial investment for clearing supplies.

**Table 6** reports the suppliers of the same goods with a different price. From the point of view of the identity of the goods, a purchase is recommended with a Simple Clean supplier whose price is the lowest and is CZK 4728 (the quality of the product is the same) (**Tables 7–9**).

## 4. Conclusion

At first, the analysis was carried out to find if service outsourcing is profitable for the institution considering the financial cost per a cleaner.

As there are several forms of employment, the present chapter presents possible options, including the calculation of the total monthly and annual wage costs that the public institution would spend if it did not accept the possibility of using outsourcing services and chose the way of employing cleaning staff itself. In connection with the individual calculations, the cost of cleaning accessories, such as cleaning carts, industrial vacuum cleaners and mops, including the valuation of suppliers of external firms, was also calculated.

Based on the calculations, a suitable supplier, the wholesale of MAKRO CZ [41], was chosen due to its long tradition, the wide range of offered assortment, transport accessibility, the possibility of payment by cash payments, repayments or invoices, and various offers of sales representatives, the number of offered discounts, offers, sales support system, such as the core business focusing on the company's core business in terms of concentration on key business processes. After considering the variants submitted, the public institution decided to use outsourcing in order to reduce the financial costs, which confirms the research questions 1.

The financial saving was designed in order to eliminate increased investment costs [42], minimize the operating costs and reduce the wage costs, to transform investment spending into operational tax optimization, by more transparent cost planning and by reducing or eliminating hidden costs, and sharing investment risk. Transferring the competence of an ancillary activity to an external company enables the public institution to have an advantage of focusing on the main activity, including the time advantage, as it can provide a higher quality of services with a lower administrative burden. Through an external firm, the public institution can implement support processes as they are in the competence of an outsourcing company,

such as the management of cleaning staff costs, wage and accounting agenda, control activities, transfer of cleaning products, recruitment of new cleaning staff and similar. Other reasons for outsourcing include the transfer of risk to another business entity, for example, in case of damage, loss of property, electronics, written documentation or possible delay. In the case of a full-time worker employed in a public institution, the amount of compensation is 60,000 CZK.

It was found that in the event of dissatisfaction with an external firm, the public institution initiates an immediate working meeting with a view to the operational elimination of the problem, including the possibility of joining the sanctions stipulated in the contract or possibly bringing legal proceedings, for example due to failure to pay the invoice in time.

The geopolitical risks, which are often ignored, are a challenge for risk managers who need to take into account or set up defensive measures when defining business prospects. By [43], such risks include deflation in the euro area, i.e., the expected fall in prices in the euro area sector, which may start the deflation spiral to spin, stagnation of salaries due to a reduction in household spending and unfavorable geopolitical development in the world, for example in Ukraine. So, there has been evidence of global geopolitical risks in the world.

After considering all of the above-mentioned possibilities, the public institution has outsourced supporting subsidiary activities by addressing an external company providing cleaning service where the annual service cost is CZK 338,660 CZK. As research question 1 was confirmed, the institution did not use the possibility to employ the cleaners on its own due to too high financial cost, in particular the wage (annual payment of 1,157,128 CZK). Such amount is higher by 818,468 CZK, and it is not economical as it is not possible to employ the cleaners in a full-time employment as they can work in the afternoons only. A part-time job is a possible solution as the working time is shorter (the cost would be 678,160 CZK, compared to current 338,660 CZK).

Another possibility is the agreement to perform work, where the gross wage amounts up to 2500 CZK (the annual wage costs for the cleaning staff are 212,800 CZK). Such amount is lower by 125,860 CZK than the annual amount paid out to the outsourced company. If the monthly gross wage of the cleaning staff was set at 3000 CZK, the annual cost would be 340,480 CZK. Although the sum is very similar to the amount paid by a public institution to an external company for the services provided, it does not take into account the amount of operating costs (the outsourcing option is more favorable and economical). The outsourcing competition may also be an alternative to the agreement to perform a job. Although the calculated monetary amount is lower, it only takes into account the costs of the cleaning staff, not the operating costs.

Based on the results found and the confirmation/rejection of the research questions, it can be stated that for a public institution the variant of outsourcing of services as ancillary activity is advantageous due to the reduction of the financial costs especially the wages.

With regard to long-term partnerships, it is appropriate to conclude a contract with an external company, including description of the penalties, damages, default, and extraordinary events, which may result in litigation between the parties.

In the current contract, the maturity date is from January 1, 2016 to December 31, 2016, which implies that outsourcing is at the final stage of the life cycle. This rejects research questions 2.

The interview with a cleaning worker revealed that contracts with external companies were only concluded for a fixed period of 1 year, so it would be appropriate to confirm mutual cooperation by signing the contract in the long term for a minimum of 3 years or more with the possibility of further renewal in case of positive business partnerships. The advantage of concluding a longer-term contract is that the supplier can better plan the process of obtaining financial income, investment, or obtain better certainty of future income by obtaining a guaranteed customer/buyer, without the cost of maintaining a competitive advantage due to longer cooperation.

#### **4.1. Disadvantages of the outsourcing customer**

In case the outsourcing relation is not optimal, cost saving might not meet the expectation. There may be an increase in costs, in particular transaction costs, transport cost, and consultancy costs. The cost of changing the contract may be expensive for the outsourcing client, and at the same time very risky, because the supplier in most cases passes ownership of the property or infrastructure.

If the relationship with an external organization collapses, there is a risk of leakage of sensitive information due to the breakdown of the mutual intensive cooperation of the partners. A customer tends to withdraw from a contract with a supplier, bringing increased expense to change legal documents in the short term in order to reach out to new, suitable outsourcing providers who take responsibility for purchasing of equipment and technology.

As the companies also require references and experience in the area of their business, it is vitally important to choose a trustworthy outsourcer with a positive references who is able to guarantee the protection of intellectual property.

#### **4.2. Disadvantages of the outsourcing provider**

The outsourcing provider may deviate from the current business and business model by acquiring a new subscriber. Higher assets, and an increase in the capital and human capital requirements, increase the management requirements, such as increased number of non-productive jobs, the change in the organizational structure of the enterprise, the assumption of risk for changes of technology.

Business reasons for outsourcing and its possible benefits include competitive, strategic advantages taking future, long-term business advantages into account. Factual reasons develop core business and its improvement in the most important activities, accenting the support of tradition, reputation and image of an enterprise, in some unfortunate cases also the survival of the enterprise. Financial reasons for outsourcing include cost reductions and/or revenue increases, where the costs (finance) are the decisive and evaluating factor of outsourcing. Simplified management and downsized organizational structure known as restructuring is related to the specialization of an enterprise, its employees, but also the middle management.

Due to the long-term contract and the mutual knowledge of the partners, it is not necessary to invest high costs for advertising, marketing and direct sales (savings can be used in transaction costs). For example, an outsourcing client may leave the logistics center to an external company that obtains a convenient coverage of a particular location.

Short-term advantages generate the flow of funds and the release of capital and sources of use for other purposes; reduce operational costs, and share risk. Certain difficulties are related to the unpredictability of costs and transparency of expenditure in the area. An enterprise does not have sufficient human resources to manage functional areas; some resources are not internally available, when moving to another location. Some activities are difficult to control, such as inter-operational control.

Due to the strategic importance of the decision to implement the outsourcing process through the project, it is advisable for an enterprise to develop a detailed project and methodology for addressing service provider issues with regard to individual phases, strategic functional area analyses and their determination to be excluded in the context of risk analysis and identification, requirements and selection of outsourcing providers including managed contractual partnerships.

Improving the overall perception of the outsourcing contract in terms of overcoming some of the barriers in communication should include interactivity between the communicator and the recipient of the communication calling for a contact person, who can be addressed if necessary.

Pro-activity between managers/shareholders/employees is required to communicate information, support team cooperation, and understand the members of the team. It is important to spread messages by setting up communication channels at regular intervals and in a standardized format; together with pointing to cultural differences related to misunderstanding of the main principles of communication and misinterpretation of its importance.

In order for companies to be able to provide complex facility management services, it is appropriate, on the basis of a good contractual relationship, to conclude a long-term advantageous contractual contact with the external supplier in the agreed quality and service level with regard to the merger of the services. If possible a single supplier is required whose interconnection have and high degree of substitutability and reinsurance of stable levels of stability and delivery quality with an emphasis on human resources and labor safety management and guaranteed level of savings, higher labor productivity and an integrated management system with a contact person for the customer (the client of a public institution) that manages, delegates the services provided, eliminates possible duplicates and misunderstandings when entering work assignments. High emphasis is placed not only on the soft and hard skills of managers, especially on communication and bargaining skills, but also on the management of crisis situations and empathy, including professional expertise and practical experience of a complex service worker.

Regarding the location of service providers, most of them are located in Prague as it is a more attractive location compared to other regions of the Czech Republic. The second highest representation of enterprises in the field of outsourcing in the Czech Republic is in the

Moravian-Silesian Region, as reported by study [16]. There are 1/3 of small enterprises; middle-sized enterprises with more than 250 employees account for 2/3 only.

Regarding the service portfolio, personal outsourcing is popular in the Czech Republic such as occasional help, helpdesk and consultancy. In terms of trend and innovation in human resources, many HR managers are leaving the traditional pattern of employing workforce, transferring to the permanent hiring of a skilled, top worker who brings innovative experience, practical skills and quality information into the work process, having a long-term positive impact on the reduction of the total costs of the enterprise (operating, financial, and HR), which is a basic prerequisite for the success of each enterprise in a dynamic environment. By using outsourcing services, time savings can be achieved and also cost savings in particular the wages (variable fixed costs transfer), improved cash-flow, longer-term risk elimination, long-term efficiency of personnel processes with an emphasis on employee skills development, personnel audit and company-wide analysis, increased production volumes, including the handling of unpopular personnel steps by an independent external expert.

Efficient management through specialized tools, innovative management solutions, reduction of administrative burden using modern IT technologies and a single entry of inputs and outputs, checks, reports or invoicing of services increases the interest of clients in complex solution of facility management services with the emphasis on expanding and improving the portfolio of services.

The importance of system integration, streamlining the functionality of different departments with the support of strategic alliances working together with an outsourcing partner is also necessary to be taken into account. Investing in data center operations and security is one of the prerequisites for sustainability and strategic competitiveness with the synergies used by strategic alliances with outsourcing partners.

With the accession of the Czech Republic to the EU on 1st May, 2004, the Czech Republic has become a more attractive business environment for foreign, strategic, business partners, especially in the field of development of outsourcing. With the ability to transfer information and deliver real-time business results with the support of functional communication channels and resources and a low value for the workforce valuation, the Czech Republic continues to maintain one of the world's leading outsourcing markets.

In terms of expected future developments, the cost of service might be reduced again. The cost-cutting process might be caused by an increasing number of providers/competitors of both current and future. At the time of the economic recession, companies have a competitive advantage, above all, the price by which they reduce their own costs and change the terms of the outsourcing contract in relation to the volume of services, Service Level Agreement, etc., to reduce as spending much as possible and increase competitiveness in the global market.

The drop in prices can put pressure on Asian suppliers, whose competitive advantage is mostly the lowered price of products/services as the quality is low in most cases. This state may also decrease the final price for the product/service.

Based on the prediction of prices in North America and the EU, the analysts of Gartner Company [44] predicted by current trends and pressures of the economic crisis an average decrease of

outsourcing services by 5–15%, especially in the area of network services, data centers, and help-desk use. Developments in price decline will be further influenced by location of enterprises, by the size of clients and outsourcing contractors. It might be useful for all the stakeholders, to achieve good and sustainable partnership, contractual relationships beneficial to all involved, with the call for increased quality of service provided as a potential competitive advantage.

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# Outsourcing Rules in the Public and the Private Sector

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Mihaela Grubišić Šeba

Additional information is available at the end of the chapter

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## Abstract

There have been outsourcing and insourcing trends for decades. Most often benefits and costs of outsourcing are compared from the purely financial side. However, risks are those that eventually determine whether a particular product/service/asset should be outsourced or not. The aim of this chapter is to fill in the gap in the literature by analysing risk-reward or benefit-cost ratio in outsourcing decisions for services in the public and private sector. After comparing the process of strategic decision-making and pros and cons of outsourcing between the private and the public sector, a general rule of thumb is developed as a guideline for outsourcing decisions. The decision-making tree for outsourcing decisions is applicable to both typical outsourced services and outsourcing the implementation of complex projects. As a rule, the more complicated the service, the greater the chance of outsourcing. However, greater complexity of services is usually accompanied with higher risks, like in energy performance or public-private partnerships. Whenever the contract is not well prepared, outsourcing may not achieve the expected benefits and may enhance the costs and risks. Although some very specific cases cannot be generalised, the similarities in decision-making behaviour can be taken as guidance when opting for outsourcing possibilities.

**Keywords:** outsourcing decision, public procurement, public-private partnership, energy performance contracting

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## 1. Introduction

Outsourcing is defined as the procurement of products or services from sources that are external to the organisation [17]. It does not matter who owns the organisation or what is the size of the organisation. The organisations cannot do business alone, so each organisation uses outsourcing whenever contracting external parties to deliver a product or service. Companies have always tried to make up for the resources or references they do not have by engaging into

different types of arrangements with those private entities that could help them. Outsourcing is done even before a certain contract is awarded. The whole subcontracting procedure in (public) tenders can be considered as an outsourcing activity. Companies subcontract and engage into consortia to make up for the insufficient financial or operational capabilities (staff qualifications, technology and/or other physical resources). Outsourcing can also be done by creating equity partnerships like equity joint ventures or statutory public-private partnership agreements. Holweg and Pil [10] distinguish fee-for-service outsourcing and establishing a new, wholly or partially owned, enterprise, by outsourcing entity to take on the activities that are externalised (enterprise partnership).

The advantages of outsourcing can be operational, strategic or combined. It can be added that the advantage of outsourcing is ultimately financial. Expected cost savings arising from outsourcing tend to be mitigated by monitoring costs when the outsourced service is complex and requires constant quality control. The theory of outsourcing complex products is very well illustrated by Brown et al. [6]. Operational advantages usually provide for short-term trouble avoidance, while strategic advantages offer long-term contributions in maximising opportunities [17]. The prime reasons to outsource are lack of internal competencies, focus on core business, lower costs and greater flexibility. Outsourcing can also be interpreted as accelerating a business change (business restructuring). Outsourcing in general keeps fixed costs (of staff and/or technology) lower and controls the risks of goods or services availability on time and on budget. When considered from the point of flexibility (moving CAPEX into OPEX) and elasticity (capacity to expand or reduce the activities), outsourcing is all about the rental of technology (including leasing contracts) or external staff with certain competencies (contracted workforce). The portfolio of leased assets in Europe steadily grows each year and it reached 779.1 billion euro at the end of 2016 [16] which is a good guidance on outsourcing market growth. However, leasing contracts have traditionally been perceived as a financing option only. When the government wants to maintain public ownership of essential assets and transfers the responsibility for managing the assets to the private sector, it is called public sector outsourcing [11].

The goal of this chapter is to compare decision-making rules for contracting out services in the public and in the private sector, to compare the market size of outsourcing and to warn on proper preparation process before contracting out complex services. The chapter consists of five parts. After the introductory section, Section 2 deals with outsourcing market size development. In Section 3, a decision-making tree for contracting out in both the private and the public sectors has been developed. Section 4 deals with outsourcing complex contracts such as public-private partnerships and energy performance contracts and Section 5 concludes.

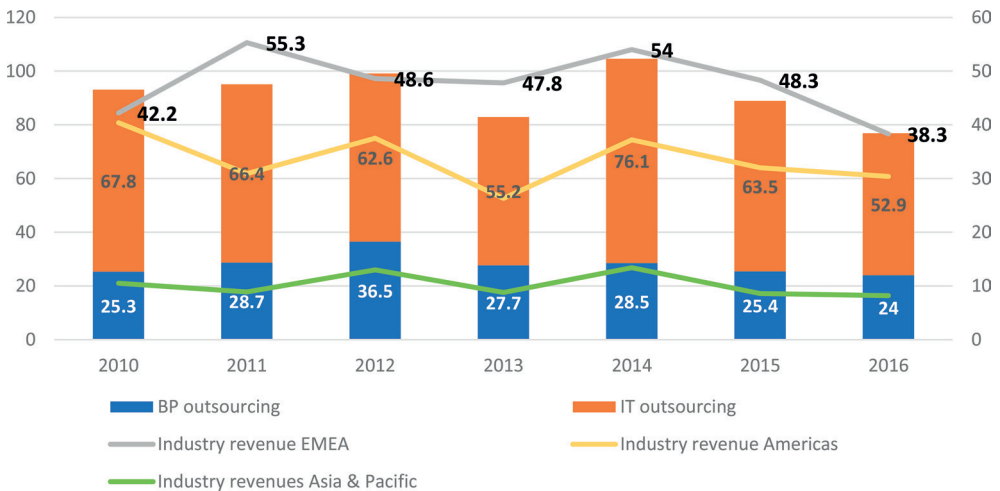
## 2. Outsourcing market size development

According to Statista [23], global market size of outsourcing steadily grows each year. It climbed from 45.6 billion USD to 88.9 billion USD from 2000 to 2017. Information technology (IT) and

business process (BP) outsourcing as well as outsourcing industry revenue estimates at the global level are shown in **Figure 1**. Although these data cannot be taken as accurate as there are different statistics related to outsourcing, they represent a rough indication of outsourcing market size and its development. IT outsourcing is twice as larger as other business processes outsourcing. Europe, the Middle East and Africa (EMEA) region has the largest share in outsourcing industry revenue that exceeds the combined outsourcing industry revenue in Americas, Asia and Pacific.

Outsourcing market can be considered from the private and from the public sector's stance. According to Kircher [13], outsourcing of production of goods or services by private companies within the EU is most frequent in Finland (53% of overall activities). Nordic countries take a lead together with Portugal whose companies contract out 41% of their production or services. EU-28 average of private sector outsourcing is 27%, whereas least outsourcing prone countries are Croatia (15%) and Ireland (16%).

Government to business market within the EU is huge, with Germany, France, UK, Italy, the Netherlands, Spain and Sweden at the lead. These seven countries account for more than 80% of total public procurement value in EU-28. **Table 1** shows the market size in absolute and relative numbers per member countries. While the EU average for public procurement share in GDP is 13.8%, in some countries, government consumption climbs over 15% of GDP (yellow shade in **Table 1**). Government consumption is in some countries bound to the pan-European institutions' presence (Luxembourg and Belgium) and to the overall size of the central and local government. In general, the larger the value of contracting between the government and the private sector, the higher the proportion of outsourcing public services to the private sector. Hence, the more efficient public administration should be if the public procurement contracts are structured the right way and awarded according to the prevailing qualitative criteria, and if government employment is under controllable levels.



**Figure 1.** Global outsourcing industry, 2010–2016, in billions USD. Source: Statista [23].

Country name	2012	2013	2014	2015	Mean market size 2012–2015	Mean % share in GDP 2012–2015	Expenditure on government outsourcing as % of GDP 2014*	
							Goods and services used	Goods and services financed
Germany	408.7	425.5	442.0	461.7	434.5	15.1	4+	8
France	313.5	318.6	317.0	317.2	316.6	14.9	5	6
UK	290.3	285.4	312.6	349.7	309.5	13.9	11	0
Italy	171.7	171.6	169.2	170.3	170.7	10.5	6	2
Netherlands	134.8	133.9	134.9	135.6	134.8	20.4	6+	10+
Spain	113.0	105.9	104.9	111.4	108.8	10.4	5+	2+
Sweden	69.3	71.8	70.8	72.1	71.0	16.3	8	2+
Belgium	56.8	57.1	58.7	59.5	58.0	14.6	4	8
Poland	48.4	47.4	51.5	52.1	49.9	12.3	6	2
Austria	41.1	42.5	43.4	45.2	43.1	13.2	7	4+
Denmark	37.6	37.3	38.3	38.7	38.0	14.7	9	1+
Finland	35.8	37.4	37.7	37.0	37.0	18.2	12	2+
Czechia	22.2	21.4	21.5	24.2	22.3	13.9	5	6
Greece	20.0	19.0	18.9	19.0	19.2	10.6	4+	3
Portugal	17.2	16.6	17.0	17.7	17.1	9.9	6	2
Ireland	17.0	16.5	18.0	18.3	17.5	8.8	4+	0
Romania	15.6	16.2	16.4	18.7	16.7	11.3		
Hungary	13.1	14.3	16.2	17.3	15.2	14.7	8	2
Slovakia	9.9	10.1	10.9	13.4	11.1	14.7	5+	5
Croatia	5.7	6.0	6.0	5.7	5.9	13.5		
Luxembourg	5.6	5.7	5.9	6.3	5.9	12.3	4	
Slovenia	4.7	4.8	5.1	5.2	5.0	13.5	7	2
Bulgaria	4.5	4.9	5.5	6.2	5.3	12.2		
Lithuania	3.6	3.6	3.7	3.9	3.7	10.4		
Latvia	2.7	2.7	2.7	2.9	2.8	11.9	6	1
Estonia	2.6	2.6	2.7	2.9	2.7	14.1	7	2
Cyprus	1.3	1.1	1.0	1.0	1.1	6.0		
Malta	0.7	0.7	0.9	1.0	0.8	10.6		
Total	1867.4	1880.6	1933.4	2014.2	1923.9	13.8		

\*Source: European Commission [15, 18].

**Table 1.** Government to business market (public procurement contracts value) in EU-28 in billion USD.

The value of public procurement is in general larger than the value of outsourcing of the public sector. Total outsourcing reached 8.7% of GDP in 2015 on average among the Organisation for Economic Cooperation and Development (OECD) countries. Therefore, governments provide outsourcing market value of at least 1.2 trillion USD each year that is considerably higher than business-to-business (B2B) outsourcing. In other words, governments create the largest outsourcing market in the world by public procurement of goods and services.

Outsourcing of public sector activities can take place in two ways. Governments can either purchase goods and services to be used as inputs, or they can pay a non-profit or private entity to provide the goods and services directly to the end user. Last two columns of **Table 1** represent outsourcing decisions of the governments of OECD countries only [5]. Complex projects such as bridges, highways and other major public works typically undergo many revisions and changes throughout the course of construction. One-third of the items experiences changes that alter the amount of work by more than 25% [19]. Contractual incompleteness lead to 15–27% subcontracting cost increase for the change in quantity of contracted works of up to 35% [19].

Complex outsourcing contracts, such as public-private partnerships, represent only a small part of the EU public budget. These financial instruments have been heavily promoted due to budgetary and efficiency reasons, but they require contracting capabilities of the public sector and well-defined public sector needs before entering into such contracts. Otherwise, public sector ends paying the assets/service it does not need for many years ahead.

Both the value and the number of public-private partnership (PPP) contracts are on decrease. Compared to the year 2000 when there were 306.5 billion USD public-private partnership contracts across the EU and 1563 of the projects, in 2015, the value of PPP contracts declined to only 27.6 billion USD, whereas the number of projects was only 118. **Figure 2** depicts an 11-fold decline in value and a 13-fold decrease in the number of projects. Interestingly, PPPs in the UK are not considered as PPPs in the European context as PPP contracts are considered as private finance initiative in this country.<sup>1</sup> The largest number of PPP projects in other EU states has been implemented in transport (more than 50% on average). Healthcare and education accounted together for about 25% stake in total value of the projects; environment protection stood in the fourth place with 6–8% stake in total project value. Despite most EU governments have deficits, only several countries engage into complex long-term contracts such as PPPs. They are primarily France, Spain, Portugal, Germany, Italy, the Netherlands, Belgium, Ireland and Greece. These data should be monitored combined with the data on concessions (which are not available at the pan-European level) and the data on energy performance contracts. The reason for inclusion of the latter is that there are no energy efficiency projects contracted as PPPs in EPEC's PPP statistics from 2000 to 2015. The adoption of the Directive on energy efficiency [7] that defined and encouraged energy performance contracting in EU member states to achieve Europe's 2020 goals, that is, 20% lower greenhouse gas (GHG) emissions than in 1990s, 20% electricity production from the renewables and energy efficiency increase by 20% until 2020 [8]. The total EU Energy Service Company (ESCO) market has been estimated at 2.4 billion euro revenue in 2015 [4]. Again, this is only an additional

<sup>1</sup>At the end of 2016, there have been 59.4 billion GBP operational PFI projects in the UK. <https://www.gov.uk/government/publications/private-finance-initiative-and-private-finance-2-projects-2016-summary-data>

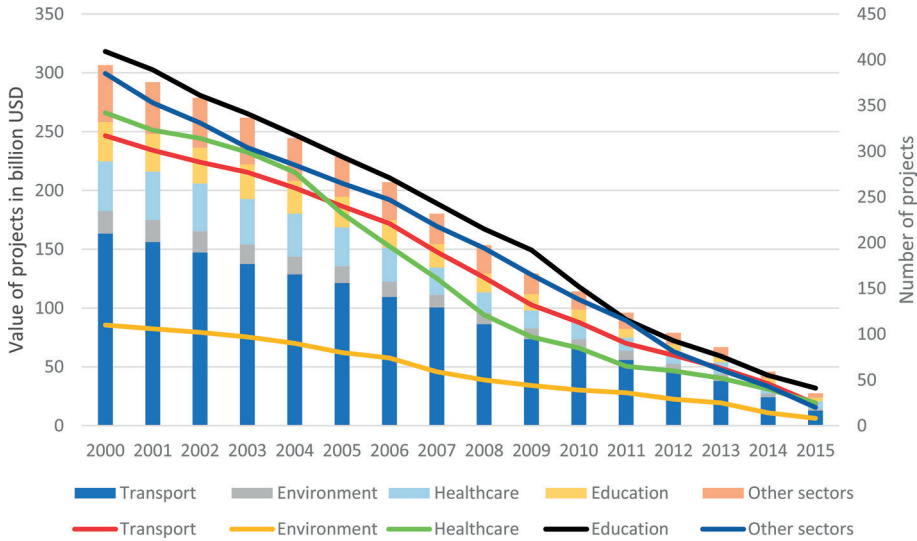


Figure 2. PPP contracts by value in billion USD and number of projects. Source: European PPP Expertise Centre (EPEC).

confirmation that the public sector keeps trying to avoid fiscal barriers in implementing capital infrastructural projects with shortened time horizons of repaying the capital and other costs of the investments during the contract term. Besides, contracting EPC contracts can include energy supply contracts, shared savings contracts and other variants that can encourage the participation of the private sector in delivering energy-efficient infrastructural solutions.

### 3. Making decisions on outsourcing

Most frequently outsourced services are IT, legal, tax, accounting, finance, (digital) marketing and sale, procurement, customer care and call centres, intellectual property protection, project management, research and development and other business processes. The decisions on outsourcing vary depending on the following factors:

- Size of the organisation (the greater the number of employees, the less likely outsourcing of some business processes such as human resources, accounting, legal advisory).
- Type of the organisation and the origin of its revenues and costs (public organisations have estimated budgetary revenues. The higher the revenues they get from the public budget, the more likely that they would constantly outsource all activities. In times of budgetary contraction, only necessary services and goods are contracted out to the private sector. If there are no funds and there is a clear responsibility towards the public to have an operational infrastructure, engagement into more complex outsourcing contracts is more likely. The private sector earns revenues in the market, and hence, its outsourcing decisions are

more dependent on the expectations of their end users and the moves of their competition. If the competition has a service that is difficult, costly or slow to develop, then it needs to be bought regardless of its costs to keep the company in the market play).

- Type of business (manufacturing organisations are more likely to outsource business processes related to product/goods transport or delivery, manufacturing of some parts that do not hide intellectual property secrets or some administrative functions. Some manufacturing companies may engage into collaborative projects with research institutions to develop prototypes of future products or services. Service companies do not require a large portion of capital employed, and hence, they are more flexible in outsourcing certain business processes. For trade or personal secret sensitive outsourcing, a background national regulation of the country in which outsourcing is to be placed is required. Globally present companies are more likely to outsource certain business processes as they never have all processes in one place and decide to outsource based on the lowest cost principle (including lower tax).
- Integration of to be outsourced activities with the core business (the greater the integration of the activity into business processes, the less likely is the decision on outsourcing. Even relative simple activities can be classified as complex if they influence health, safety, security or personal data or environment protection).
- Possibility to build inside competences versus buying them on contract (it is all about 'hire or fire' decision related to the employees and technology. Even if technology purchase can be afforded, are there sufficient competences to make use of it?
- Fixed versus variable costs and related flexibility (outsourcing gives flexibility to the organisations, enabling them better growth chance. Organisations that engage into loans to finance fixed costs are not prone to risk as they have fixed obligations to fulfil on a monthly basis. By moving CAPEX to OPEX, both financing and operational restructuring can be done. The service is there when needed and paid only when needed and used.
- Postponement of the obligations is like flexibility, but with different motive (even if outsourcing does not provide lower costs, time value of money often prevails in such decisions. If equipment is needed and it is too much to pay it at once, companies consider operational leasing that also enables them technology change after the end of the contract. In other words, the whole set of activities related to obsolete technology (whom to sell, at what price, how and where to decommission it are transferred to the lease companies).

**Figure 3** illustrates a decision-making tree in outsourcing. It starts with a dilemma on whether to outsource or not and what to outsource. After the identification of what to outsource, there is a set of check questions on the reason behind the outsourcing decision. The most frequent reasons to outsource are numbered, starting from the focus on core business over lower costs and higher efficiency, lack of internal competence and greater flexibility. If the reason behind the outsourcing decision is concentrating on core business, then the question is to what extent the business process to be outsourced overlaps with the core business. This question also considers intellectual property protection, if there is such. The more complex the process/activity to be outsourced, the higher the costs of outsourcing. Hence, outsourcing should not be done,

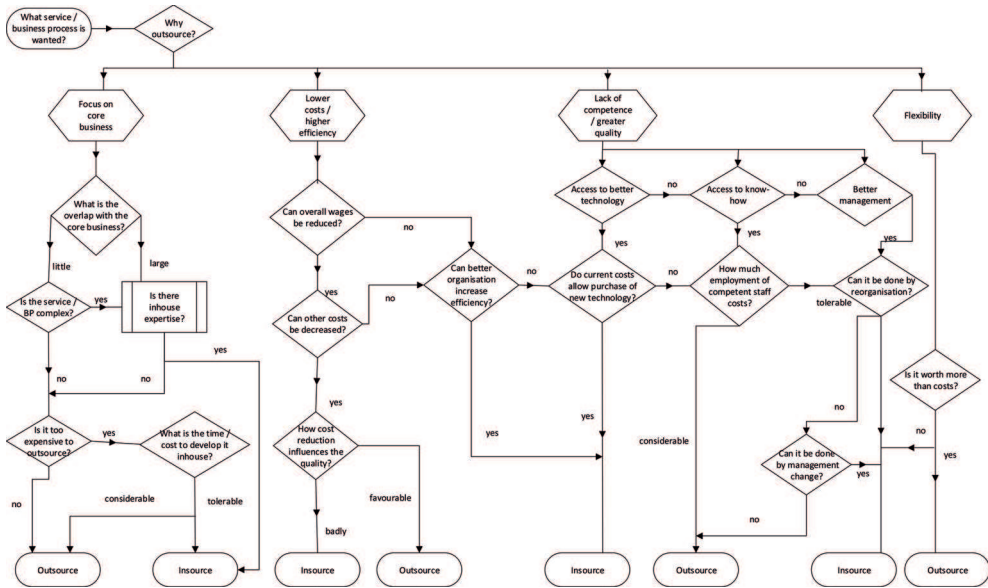


Figure 3. Decision-making tree in outsourcing. Source: Adapted according to Grubišić Šeba [9].

especially if there is an in-house workforce capacity to perform such business process. The questions on outsourcing encompass also the questions on financial capacity and operational/business restructuring. Probably, the simplest decision on outsourcing is flexibility as it requires answering only one question on whether greater flexibility is worth the costs.

The analysis conducted by Tadelis and Bajari [22] suggests that for long-term and steady provision, goods and services that are simple to contract should be outsourced with fixed-price contracts. Unlike them, complex goods and services should be internally produced as if they are procured with a cost-plus contract. In the latter case, the benefits of internal production are that the procurer retains the control over the process and flexibility. Kim and Brown [12] distinguish between simple and complex products. According to them, simple products encompass auditing, court reporting, janitorial service, landscaping, laundry and dry-cleaning, equipment maintenance and repair, security guard and patrol, solid waste collection and warehousing and storage. Complex products include advertising, computer systems development services, engineering, legal service, logistics support, professional and management training, programme management and support services and programme review and development services.

#### 4. Estimating risk: reward in outsourcing complex contracts

Public procurement or government to business (G2B) market has been considered the largest outsourcing market with between 15 and 20% of EU GDP or 1.3 trillion euro spent each year [14]. Effective contracting promises win-win exchanges, and markets are most likely to produce win-win outcomes when buyers and sellers can easily define and verify product

cost, quality and quantities. When markets fail, the win-win outcomes are replaced by lose-lose or win-lose outcomes where the winner's gains are greater than the loser's losses. Unlike simple products, the cost, quality and quantity parameters of complex products cannot be easily defined or verified, leaving buyers and sellers unable to clearly and completely define exchange terms [1]. Outsourcing complex assets or services delivery to the private sector has widely been known under different modalities of public-private initiative. While an extreme part of such outsourcing contracts is called sale or privatisation of once government assets or business, the mixed solutions that provide different ratios of public or private influence for a certain period are known as public-private partnership options, as illustrated in **Figure 4**. Contracting out needs to be considered whenever the government entity cannot take advantage of the economies of scale or scope, whereby it can be done either to the private or to the public sector. In other words, contracting out government services will neither reduce government outlays nor increase government efficiency unless decision makes economic sense [21]. Public-private partnership contracts outsource one or more of the following activities to the private sector: financing, design, construction, operation and maintenance. Such contracts are considered complex as each outsourced activity encompasses a few subactivities such as risk and responsibility transfer, employment of certain number of staff with designated competencies, avoidance of numerous public procurements for goods or service delivery and achievement of certain performance standards (quality of service). In other words, the entire set of the outsourced subactivities is known as know-how of the private partner which is expected to bring value for money to the public partner over the term of the contract.

Purely seen from the perspective of the traditional public procurement, complex outsourcing contracts such as public-private partnerships outsource public activities to the private partner for a certain period of time. The public partner in such contracts in fact combines a few usually separately publicly procured services into a single public procurement procedure. No wonder that such tenders are not governed under public procurement law, but under a more stringent law, that is, public-private partnership law. In addition, the project preparedness must be better, the procurement procedure is longer, often there are negotiations with interested prequalified private partners known as a competitive dialogue procedure in which prequalified bidders try to convince the public partner that they are the one to contract with, the contract must be approved and monitored by the governing institution such as the Ministry of finance or Public-private partnership agency. Public-private partnerships have been popularised within the new public management wave in the context of saving public budget, that is, achieving greater efficiency at lower costs [3].

It is often claimed that the project implementation is as good as its preparation. Hence, it is no wonder that complex projects are prepared years before public tenders are announced. Even though it is hard to calculate value for money in public-private partnership contracts as it not only consists of a financial part, more and more regulators require calculating public sector comparator before making decisions whether to perform a certain project via the traditional public procurement procedure or to engage into public-private partnership contract. The key is monetising some non-financial risks and benefits and comparing them with the calculations on the resources required to implement a project under the traditional public procurement procedure. The precondition for accurate calculations is setting good assumptions on traditional public procurement costs and time, as well as internal staff and resources necessary to implement

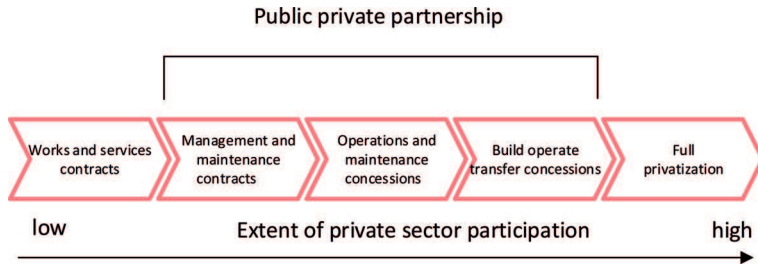


Figure 4. Illustration of the variety on public-private partnership contracts. Source: PPIAF [20].

a project in a quality way, on time and on budget. If there are internal resources to implement the project and financial capacity of the public authority is not sufficient, there are numerous variants of public-private partnerships to consider apart from the most often mentioned turn-key solution which includes design, build, finance, maintain and operate model. Public-private partnership contracts may not be signed for the maximum period of 30 or 40 years, they may be signed for some activities only such as design, financing and construction, or design, finance, construction and maintenance, while the operation of the asset can be entrusted to the public partner. Even in complex contracts, a public partner shall go through the decision-making tree and consider other options of asset or services delivery. The starting point in answering questions in the decision tree is defining a desired capacity of an infrastructural assets and quality of service, current and projected public budget, current and expected internal resources, the expected revenues and costs (not only from the budget) after the assets/service becomes operational. In other words, the public sector needs to determine what internal resources and budget they have, what and when they (the citizens) want to have, what is the quality of the asset or service the citizens want to have, to what extent the project can be completed with own resources and to what extent contracting out to the private sector would be most feasible.

Making decisions on energy performance contracts resembles engaging into public-private partnership contracts, even though the energy performance contracts are considered much simpler. Two paramount reasons are shorter duration of the contract and no impact on the public budget increase. Energy performance contracts contain guaranteed energy savings that oblige public partner to pay for them only after they are achieved, shifting the whole energy performance risk to the private partner. All the costs of the private partner are paid periodically, that is, over the time of the contract, if the contracted savings are accomplished, and the size of the monthly/annual bills has its cap in the size of the bills before project implementation. In other words, achieved savings after new project implementation should be sufficient to pay off the capital costs of the investment and other costs (fees) of the private partner without increasing the public budget over the contract term. No matter what a certain model of contracting is called, **Table 2** should help distinguish between complex and simple contracts. The more freedom is given to the parties in contracting, the more complex the contract. Good contracts require sound internal or external staff competencies to define risk-reward ratio acceptable to other parties. Otherwise, complex contracts become a subject of public critics and negative perceptions of the public.

While reward of the private partner in complex contracts relates to financial and reputational benefits, the risk-reward ratio of the public sector is not so simple. **Table 3** tries to

illustrate typical risks and rewards to which the public and the private partners are exposed to in complex outsourcing contracts, such as are public-private partnership contracts. Energy performance contracts are also considered as complex contracts, which, unlike public-private partnership contracts, do not require extra budget of the public partner.

Feature of the contract	Public-private partnership	Energy performance contracting
Long-term nature of the project	Yes	Yes
Risk-reward ratio	If contracted	Yes
Performance-based/quality of service contracting	If contracted	Yes
Different stages of project implementation included	Yes	Yes
Stakeholders presence	Yes	Yes
Occasional adjustment of the contract to market condition	If contracted	If contracted
Source: Author.		

**Table 2.** Common features of complex contracts.

Project phase	Private partner		Public partner	
	Risk	Reward	Risk	Reward
Design	No	Fee	Yes, it should define what is wanted	A well-designed object in accordance with public needs
Finance	No	Coverage of all the costs of borrowing plus guaranteed rate of return over the contract	Yes	Off-balance sheet accounting, no immediate financial outflow
Construction	Performance on time and on budget if defined so	Guaranteed fee/reputational benefit	No, apart from obtaining certain permits on time and risks related to location selection	Avoidance of multiple public procurement procedures for contacting works or services, no need to engage plenty of internal staff in preparing and monitoring certain project phases; know-how of the private partner
Maintenance	Fixed costs of staff and variable costs of replacement parts	A right to exploit an object on your own if contracted so with the public partner	No	The object in good condition is there when needed
Operation	Fixed costs of staff, electricity, water, heating, cleaning	Guaranteed fee/reputational benefit	No, if quality of service is contracted	No need for employment of extra staff; good reputation of the public partner among stakeholders
Transfer	Overhauls	Reputation	No, accepts the object if everything is functional	Can decide whether to continue operating it on its own or to outsource operation and maintenance, that is, should prepare exit strategy
Source: Author.				

**Table 3.** Risk-reward between public and private partners in complex outsourcing contracts.

**Table 3** also shows that the extent of reward to the public partner after engaging into complex contracts is mostly dependent on the public partner's capability to anticipate and balance between budgetary outlays, satisfaction of the end users and internal resources needed for contract implementation and monitoring.

The benefits of outsourcing complex contracts can be huge, but the huge can be the costs if the contracts are not balanced as well. In general, all the disadvantages of engaging into the complex contracts are the same as engaging into simple outsourcing contracts. They are nicely noted by Barthélemy [2] who called them seven sins of outsourcing: (1) outsource activities that should not be outsourced; (2) select the wrong vendor (private partner); (3) write a poor contract; (4) overlook personnel issues; (5) lose control over the outsourced activity; (6) overlook the hidden costs of outsourcing and (7) fail to plan an exit strategy. These can also be taken as precautionary measures before making outsourcing decisions and whenever evaluating whether outsourcing has been a good decision, regardless of the complexity of outsourcing contracts.

## 5. Conclusion

This chapter deals with outsourcing rules in the private and the public sectors as well as with the features of complex outsourcing contracts. Outsourcing activities are usually linked to the private sector organisations. Yet, contracting out is even more important within the public sector as the public procurement market represents the largest outsourcing market in the world. Making decisions on outsourcing can mostly follow the same path regardless of whether public or private organisation implements it. Hence, a decision-making tree on outsourcing is presented. It considers four most frequent reasons to outsource including: focus on core business, lower costs and higher efficiency, lack of internal competencies and greater quality of service and greater flexibility.

Complex activities (projects to be implemented) are usually outsourced to lesser or greater extent. However, engaging into complex contracts has often not been considered an outsourcing, but financing decision. However, such contracts should not be considered from the financial stance only, but from the stance of the quality of contract. Complex contracts should make up for the internal (not only financial) resources, simplify multiple public procurement procedures and achieve better quality of service provided to the end users (stakeholders).

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# The Dark Side of Outsourcing: The Case of Logistics

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Elisa Villani and Luciano Greco

Additional information is available at the end of the chapter

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## Abstract

Contemporary capitalism is characterized by the central role of global value chains (GVCs) that heavily rely on logistics and transport services. Thus, logistics services—and among them warehousing and handling of commodities and consumption goods—affect the competitiveness of companies and countries. In the last decades, firms have reacted to this new environment by outsourcing logistics services to specialized operators, from large multinational logistics companies to small worker cooperatives. In some cases, logistics cost efficiency has been reached by investments in new technologies and organizational arrangements, thus increasing workers' qualification. In other cases, labor cost-savings within GVCs have accompanied by heavy social costs, in terms of workers' wage and nonwage conditions often bordering full-fledged exploitation practices. In this chapter, we focus on the functioning of a "shadow management system" that has characterized part of logistics firms in Northeastern Italy.

**Keywords:** global value chains, warehousing, social dumping, workers' exploitation, organized crime

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## 1. Introduction

In the last decades, the evolution of capitalism and the emergence of a world economy have fostered competitive pressures on companies. This has been partly driven by customers' search for price-savings and improved quality of goods and services. In turn, industrial organization and international trade have changed dramatically to face new challenges deriving by the globalization of production and trade. In particular, multinational companies have deeply reshaped their core competencies to focus on the most value-added segments of the value chain and reduce direct control on secondary functions, such as the generic services requiring low skills that can be easily and cheaply bought on competitive markets.

In this framework, the role of logistics has become extremely relevant for two main reasons: (a) its concept has evolved to embrace global production and distribution networks that require an integrated management and (b) its role has changed according to the evolution of global value chains (GVCs). Logistics represents now one of the main functions that transnational and big firms outsource to other companies [1, 2].

The outsourcing of logistics services has largely contributed to the economic and business success of GVCs, by reducing prices and improving the quality of intermediate and final consumption of goods and services. There is a common agreement on the fact that enterprises look more and more to outsourcing in order to meet the value creation challenges for their businesses [3]. Organizations achieve many different benefits through successful outsourcing, such as the possibility to save costs related to some functions, the improvement of quality for the outsourced services, a better focus on core activities, and the access to greater knowledge and specialization [4]. However, this success has often been tarnished by associated negative social and environmental externalities.

Growing evidence shows that outsourcing involves not only benefits but also risks in terms of loss of competences and hidden costs. In particular, it has been said that changing market conditions and technological development can lead to a mismatch between short-term cost-savings and long-term perspectives, which can make outsourcing no longer the optimal choice for organizations [3]. Opportunistic behaviors in outsourcing relationships, for example, may put at risk the strategic objectives behind outsourcing [1]. Several potential risks associated to outsourcing have been acknowledged by the previous literature, such as the loss of skills and control, the loss of flexibility, and the reputation-related issues in case of bad relations and poor performance [4].

Even though some possible drawbacks of outsourcing have been analyzed in the literature, investigations about its (negative) social and environmental impacts are largely underdeveloped. In the last few decades, environmental, social, and governance (ESG) criteria, aiming at assessing nonfinancial impacts of economic activities and investments, have gathered momentum as driver of investment decisions within the global financial and business community. That is why, in this chapter, we want to shed new light on this important aspect. To do so, we focus on a (rather representative) case in which social sustainability criteria are systematically violated in the usual functioning of such a crucial function of GVCs that is logistics.

## 2. Global value chain and logistics

As an example of GVC, consider Nike. Nike is the world's largest supplier and manufacturer of athletic shoes and sport equipment. In 2017, Nike employs about 75,000 people worldwide and generates more than 34 billion of US dollars as global revenue. A comparable amount of people is employed in Asia in the production of clothing and shoes for Nike, although they are not employees of the company. Most of these people are employed in companies that have contractual agreements with Nike, usually run by the third Asian parties. The concept of GVC has emerged to take into account that activities that constitute a value chain are not contained anymore into a single firm or group; instead, they are carried out in interfirm networks on a global scale [5].

The management and coordination of GVC is extremely difficult for two main reasons: (a) the complexities associated with extended supply chains, namely, the interaction with multiple entities that are located in geographically distant areas and (b) the problems associated with the coordination of networks that are globally dispersed, usually across different supply chain entities [6]. These two issues lead to a series of additional problems—including the possible information distortion; the decision on optimal location of production, exchange, and distribution points; and the identification of cost structure and business opportunities according to supply chain configurations—in order to assure timely delivery and afford excellent quality to customers [7].

The rising *integration* of world markets and the *disintegration* of the production process [8] have made **logistics** the cornerstone of GVC and business strategy [6]. Logistics refers to “the wide set of activities dedicated to the transformation and circulation of goods, such as the material supply of production, the core distribution and transport function, wholesale and retail and also the provision of households with consumer goods as well as the related information flows” [9, p. 2]. Efficient logistics is the most important driver for competitive advantage in an economic setting characterized by intense global competition and diminishing profit margins. Accordingly, the benefits arising from GVCs and diffused networks cannot be exploited without paying attention to logistics capabilities and their impact on performance, efficiency, and competitiveness [10]. In other words, logistics services are crucial for the functioning of the contemporary world economy and strongly influence productivity (e.g., in terms of added value per worked hour). Indeed, although companies are particularly efficient in producing goods (i.e., production commodities and inputs), the cost and quality of business-related logistics services (i.e., handling, packaging, warehouse and distribution center management, transportation, etc.)—taking place in logistics areas—have a major impact on value creation and overall efficiency of production processes. Therefore, logistics has been described as the “next frontier of competition” [6, p. 204].

A new concept of logistics has emerged, most likely triggered by fast-changing technologies, specialized know-how, standardized delivery systems, and change in market preferences [11]. Companies are trying to consider logistics services as key part of their business models, but most of the times, they lack adequate competencies. Hence, there is a growing trend to *outsource* logistics activities to third-party logistics (3PL) providers, in order to focus on core expertise [2]. These operators become the coordinators and integrators of very different logistics tasks that may include manufacturing, handling, warehousing, packaging, national and international transportation, IT services, and customer services [12]. In a global economy resting on time-based competition mechanisms, the motivations leading companies to outsource logistics functions that have traditionally been performed in-house are the following: (a) reducing the enterprises’ own logistics costs by accessing specialized and innovative resources and competencies of 3PL; (b) improving the overall efficiency and the quality of customer services by making use of 3PL’s professional know-how; (c) specializing companies’ investments in core competencies by avoiding to employ resources on logistics establishment; and (d) increasing the enterprises’ flexibility in business and strategic action and creating economies of scale in the value chain by reducing fixed cost and improving efficiency [13]. Accordingly, logistics outsourcing allows companies to save “an average of 11.8% on logistics

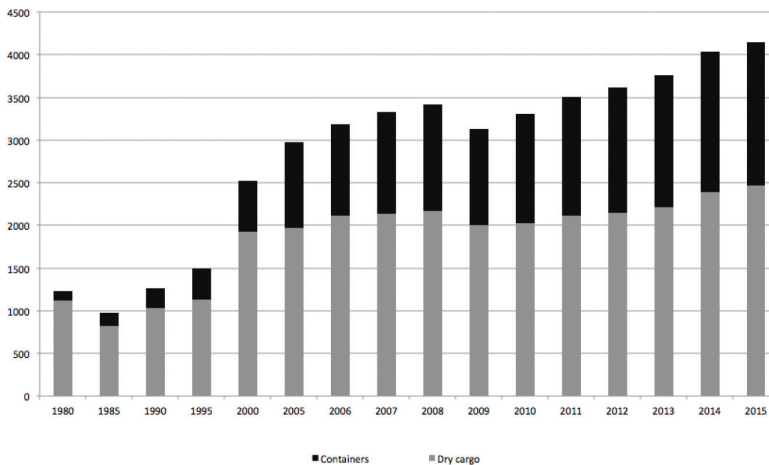
costs, 24.6% on logistics assets, and 8.2% on inventory costs, while shortening their average lead time from 7.1 days to 3.9 days. For example, in Europe, 76% of large enterprises use 3PL, and 70% of them have more than one 3PL partner” [14, p. 12].

Competition in specialized logistics services is intensifying, and global logistics markets are steadily growing. In the last 25 years, the logistics sector has grown by around 10% per year [12]. Notwithstanding the Great Recession started in 2008, containers’ seaborne transportation, that is intensive of logistics services, has doubled in the last 10 years (see **Figure 1**).

Logistics companies are constantly optimizing their skills and organizational and managerial capabilities in order to ensure the highest service levels at the lowest cost. Logistics industry is continuously adapting its distribution strategies to new economic trends, under constant pressure to develop innovative solutions, new technologies, and management approaches, as well as adequate physical facilities. In order to reach sustainable and superior performance, European ventures outsource a large share of their logistics activities to 3PL companies [2]. As a consequence, logistics market appears very much fragmented, going from multinational companies taking care of customers’ logistics strategy and encompassing the entire logistics process to small organizations specialized in selected activities within that process [13].

Although the fundamental role of logistics in GVCs and outsourcing of logistics functions have improved production efficiency for single firms, reduced prices, and increased quality for final customers, such trend has also created significant negative externalities in terms of GVC social sustainability. In particular, the quality of working conditions in logistics has progressively worsened, and the risks of workers’ exploitation and illegal practices have soared.

Environmental, social, and governance (ESG) dimensions have become tangible and competitive assets of business activity in almost all economic sectors. Companies have to be



**Figure 1.** Worldwide seaborne non-commodity cargo (millions of tons loaded) (Source: Adaptation from [15]).

sustainable with respect to these aspects to generate real economic and social value and, in turn, to attract financial investments. In this chapter, we focus on social sustainability, and we aim to address the following research questions: *does outsourcing in logistics services, which are pivotal for economic activity, commit to social sustainability? What are the risks associated to logistics outsourcing in terms of employment conditions?*

### 3. Warehousing and distribution center management

The logistics industry is very wide. In this chapter, we focus on logistics tasks dealing with warehousing and distribution center management. We have decided to focus on these specific logistics activities because they are pivotal to the whole GVC process. Even though its importance is often forgotten, warehousing is present in every business process included in the chain of value creation [16, p. 7]; in reporting a Motorola survey says that “fewer organizations continue to view warehouses simply as commoditized links between endpoints of the supply chain. Warehouses are no longer necessary evils that are fundamentally cost centres... Warehouses today can drive competitive differentiation and, by doing so, increase profitable growth.”

All companies, both commercial and industrial, are supposed to deal with a warehouse. They need space for keeping goods and managing shipments and orders coming from both production and sales processes. Warehousing refers to a logistics function that primarily consists in storing goods by a company and includes packaging, receiving, handling, and assembling goods, as well as shipping goods to clients. Warehouses are one of the most important places for economic operators, as they represent the center of the most relevant physical and informational flows. Following [17], the most important activities that characterize warehouse management can be described as follows:

- (a) *Entry of goods*, referring to the unloading of goods and the check of quantity and quality for their subsequent organization in the allocated spaces.
- (b) *Storage* and transfer of goods to dedicated boxes and areas, according to whether they have to stay or be shipped again. For this activity, space optimization plays a central role by reducing picking time and good searching.
- (c) *Picking goods*, including all the activities related to processing orders, packaging, and final controls.
- (d) *Sorting of goods*, taking into account clients, packaging, product characteristics, and type of transportation.
- (e) *Postponement*, referring to all the customizations that are made on standard goods before shipment. These processes allow product customization and differentiation.
- (f) *Exit of goods*, by preparing goods for shipment and loading vehicles for transportation according to a predefined agenda.

As all other logistics activities, warehousing services are characterized as follows:

- (A) From a *technological* point of view, by high-intensity capital invested in real estate facilities (i.e., storage and intermediate handling) and labor, which is usually low skilled
- (B) From an *economic and managerial* point of view, by the considerable dynamism of the sector which is led by subcontract service relationships among the different operators of the supply chains and by product and process innovation

The search for efficiency gains and profit margins has to deal with these two aspects. In order to reach these outcomes, many logistics companies try to cut labor costs. In some cases, this comes with violations of workers' protection standards. This phenomenon, together with the massive use of low-skilled workers, precarious legal protections, and widespread employment of migrant workers, makes logistics sector a typical target for the activities of criminal entities and organizations.

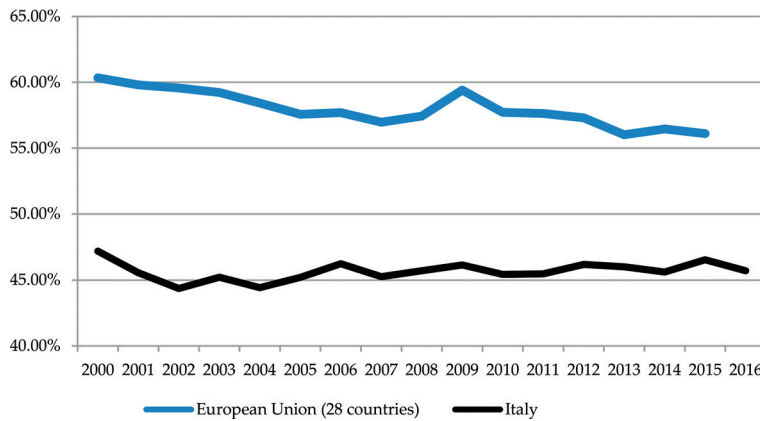
## 4. The case: methodological issues

### 4.1. Research setting

Even though the logistics industry in Italy shows structural delays as compared with the main developed countries, it has reached a value of 109 billion euros in 2016 and follows an upward trend. The basic feature characterizing this sector in Italy concerns the outsourcing of activities to both multinational companies and small, specialized firms—including, in particular, worker cooperatives. Outsourcing in logistics sector is steadily growing in Italy, reaching 80 billion euros of turnover in 2016, with an increase of 1.2%, which follows a growth of 2.6% in 2015 and 1.4% in 2014. 3PL firms have reached around 45 billion of turnover, which exceeds 40% of the entire market [18].

Taking into account the improvement of warehousing services in terms of automation and digital technologies, it is worth highlighting the peculiarity of the Italian logistics sector. Looking at the relationship between automation and workforce, a trade-off between productivity and flexibility exists in all logistics activities within warehouses. On one side, warehousing logistics can make business value chain more efficient and productive thanks to the implementation of IT services and advanced technological and organizational approaches; on the other side, the application of such innovations is highly dependent on the degree of flexibility and adaptability of manpower.

Most of the companies operating in the logistics sector in Italy have not really tried to balance these two aspects. They seem to have rather opted for labor-intensive business solutions, which resort to low-cost and low-skilled workforce and subsequent low investment in digital technologies (see **Figure 2**). According to the Italian Ministry of Infrastructure and Transport, the amount of manpower occupied in logistics activities in 2016 has reached its historical peak of about 1,200 million of units. Thirty percent of total manpower deals with warehousing tasks [20]. This highlights that Italian warehousing activities—and, more generally, logistics services—still base their competitive advantage on the ability to handle people. Therefore, human capital is the key resource, and labor conditions count.



**Figure 2.** Share of workers' compensation on value added in logistics activities (Source: Elaboration from [19]).

The Northeast of Italy represents one of the most important logistics areas in Europe. There were 2,800 active logistics enterprises in 2015, with a total turnover of 8 billion euros. The reason of the prominence of this geographical area is threefold:

- An important part of the Italian industrial production is clustered in the northeast, which, in turn, explains the large demand for logistics services and, in particular, warehousing activities.
- A large share of Italian manpower is located in the northeastern part of the country, and more specifically in the Veneto region, since most of the industrial activity is established there.
- Most of immigrant, low-skilled, and low-wage labor, which characterizes the logistics sector and warehousing in particular, is employed in the northeast where it is easier to find a job [21].

For all these reasons, we are very much interested in understanding the functioning of labor management in warehousing activities in Northeastern Italy. Accordingly, we base our study in the logistics area around Padua, in the Veneto region, and we focus our analysis on the specific dynamics occurring in warehousing operations.

Just to give an idea of the significance of the setting taken into account for our study, we report in the following table (**Table 1**) the main characteristics of Padua logistics area.

## 4.2. Data collection and analysis

Data collection followed common prescriptions for case study analysis [22] combining preliminary interviews with key informants, semi-structured interviews with key players, archival documents, and information from newspapers (see **Table 2**).

Logistics connected to warehousing activities is a very complex field, populated by many different actors. The main economic and social operators are described as follows:

Characteristics
Overall area of 2 million sq. meters, including freight rail terminal, courier areas, service areas for people and goods, and fruit and vegetable market
1.05 million sq. meters of urban area
270,000 sq. meters covered with logistics warehouses, of which 23,000 sq. meters of cells and rail junctions
240,000 sq. meters of intermodal rail terminals, with eight intermodal tracks of 700 mt
40,000 sq. meters of offices
Railroad “CORE” node, part of the European network
Source: our elaboration.

Table 1. Padua logistics area’s characteristics.

- The buyers of logistics services (e.g., multinational groups operating in commercial distribution, manufacturing companies, etc.)
- The suppliers of logistics services (i.e., public and private operators), managing warehouses and providing integrated services of storage and handling of goods and commodities
- The suppliers of workforce for logistics activities (e.g., worker cooperatives)
- Trade unions and associations

In addition to these formal players, we find two other important “operators” that are usually not considered by economic and managerial analyses, who play a crucial role in the logistics sector. They are the *informal (illegal) brokers of workforce*—or recruiters of day laborers, according to the terminology borrowed from the agricultural sector—and *nonprofit associations* taking care of logistics workers, who very often are immigrants and/or poor people. Considering the

Sources	Typology of data	Data use
<b>Interviews</b> 197 pages	<i>Preliminary interviews</i> (5) with trade union representatives and managers of companies that outsource warehousing services	Familiarization with the context and identification of key informants for the following focused interviews
	<i>Semi-structured interviews</i> (21) with representatives of logistics companies, employees of cooperatives, and representatives of trade unions	In-depth exploration of work processes and dynamics occurring in outsourced warehousing activities
<b>Other documents</b> 170 pages	<i>Archival documents</i> about activities carried out, website, and reports	Triangulate data and support information emerging from interviews
	<i>Newspaper information</i> related to the specific context and logistics companies taken into account	Triangulate data and support information emerging from interviews
Source: our elaboration.		

Table 2. Data collected and their use.

functioning of the subcontract relationships that actually regulate labor supply in logistics sector, the informal brokers of workforce afford substantial flexibility in terms of costs to the buyers of logistics services, to address variable volumes of activity and greater specialization of services.

Most of the key players interviewed were all employed in the logistics area around Padua but under different companies and cooperatives. The interviews lasted about 45 min and were all recorded and transcribed. Following common practice in qualitative management research [e.g., 23], we coded interviews and documents with the aim of identifying important dynamics and mechanisms in warehousing activities. We will see in the next section that the structure of the sector itself causes a series of problems, which dramatically affect its real functioning.

## 5. Findings

Competition in subcontract relationships between the suppliers of manpower for warehousing activities leads to a structural tendency to reduce the price applied for the service—which typically refers to transactions carried out or, more precisely, to packages turnover. In some cases, such a price war can determine a drop in the incidence of the cost of labor on the total value of logistics services. In particular, we have found that the suppliers of workforce can implement this competitive strategy in two different ways:

- (a) By introducing new technologies and organizational models aimed at increasing productivity, through the reduction of the number of workers and the simultaneous improvement of their expertise, skills, and wages.
- (b) By adopting organizational models based on the coexistence—in the same warehouse—of formal workers (i.e., employees that are apparently paid in compliance with the existing contractual, tax, and social insurance regulations) and illegal workers, thus affording an increase in formal productivity by squeezing the cost of labor below the minimum legal requirements and by evading taxes and social contributions.

Representatives of trade unions said that the suppliers of manpower and the buyers of logistics services could definitely benefit from the competitive strategy (a) in order to increase cost efficiency of logistics activities and technical and professional quality of workers (e.g., by reducing the demand for unskilled manpower). This strategy would allow reaching these goals without violating any rule in terms of labor legal and social protection. However, as our data demonstrate, the same result is actually achieved by adopting the competitive strategy (b). In what follows, we focus on the dynamics distinguishing this second approach.

The experience of warehousing activities in the logistics area around Padua shows that subcontract relationships for labor supply are very often characterized by the coexistence of legal procedures and systematic violation of rules. Accordingly, the mechanisms adopted in warehousing logistics frequently make the boundary between legality and illegality very blurred. As a representative of a trade union told us:

*This is a system intended to exploit workers, reduce costs, and make some people profit from it. Cooperatives are established, closed and re-established with the only intention to pursue fraudulent purposes. Of course, in such conditions, it becomes very difficult to run worker cooperatives in compliance with legal norms and remain competitive.*

These practices are made possible thanks to a *shadow management system*, which is based on two main mechanisms:

- (1) An *organizational* one, which relies on *atypical cooperatives*. The distinguishing features of atypical cooperatives (as compared to usual worker cooperatives) are described as follows: (a) they do not belong to any recognized national cooperation group, (b) pure capital shareholders (instead of worker-owners) have the control of the cooperative, (c) worker-owners are essentially excluded from the management, and (d) managerial control is entrusted to a third party, who usually acts as a dummy.
- (2) A *contractual* one, which relies on *social dumping contracts*. These contracts regulate the service and price conditions between atypical cooperatives and the buyers of warehousing services. They are characterized by very low prices that should bring the buyers of logistics services to suspect that the cooperative is violating of labor, tax, and social insurance rules. Indeed, worker cooperatives that do not invest in cost-efficient technological innovations are unable to offer low prices and comply with rules.

As regards the first, organizational mechanism, the fact that atypical cooperatives do not belong to national cooperation groups—with a central organization carrying out coordination activities and monitoring of associates' operations—reduces safeguards and supervisory activities against illicit behaviors. On top of this, the actual control over atypical cooperatives is exerted by external, shadow partners, who often do not play any formal role in their governance. For example, shareholders are often foreign-owned companies subject to loose financial and tax regulations. Accordingly, the chain of power can be very long and may easily hide illegal interests and criminal practices. An immigrant worker of an atypical cooperative said:

*I work in the warehouse until 73 hours per week, even though I should not exceed 36 hours. I perceive a very low salary, but this is ok because I have at least a job that allows me to survive and to have some others benefits. I just know what I have to do each day, but anything else about the others and the organization of work.*

In many cases, the buyers of logistics services are unable to detect or even suspect illegal practices because of the problem of multiple subcontract relationships. This situation arises when a single cooperative has several buyers as counterparts. In turn, the capacity of each single buyer of warehousing services to control the fulfillment of specific obligations by the concerned cooperative is seriously dampened. Even though, according to the Italian legislation, buyers are responsible also for the obligations and misbehaviors of subcontracting cooperatives toward their workers, the coexistence of multiple logistics operation platforms—possibly, within the same warehouse and corresponding to different buyers—makes it impossible, for each buyer, to check whether its platform regularly employs workers or, instead, uses illegal manpower.

Also, governmental authorities find it hard to supervise atypical cooperatives. In order to elude controls and subsequent sanctions, the life cycle of atypical cooperatives is very short, usually not longer than 2 or 3 years. A regular employee of an atypical cooperative told us:

*It's now five years that I work in this area and I have changed three different employers. Practically nothing has changed, but my contracts have been readapted to the new name of the company, even though the conditions are exactly the same as before.*

The use of illicit practices, for manpower exploitation and evasion of tax and social insurance obligations, is the central aspect of the functioning of atypical cooperatives. In this respect, a central role belongs to the *informal broker of workforce*. This is the pivotal player of the shadow management system, who makes possible the operationalization of the organizational and contractual arrangements reported above. The informal brokers do not appear in the governance structure of atypical cooperatives but actually have a real power over the management of their activities. With respect to the agricultural sector, where similar players operate, these intermediaries—who mainly operate in the suburbs of Italian major cities—are much more independent in their actions and perform a function similar to dealers in illegal drug markets. In other words, these are “workforce dealers” who employ their own economic resources and establish territorial networks that are usually connected to criminal organizations. A local newspaper reported:

*The boss managed five hundred people without having any direct role in the cooperative, where workers providing warehousing activities were exploited and oppressed. Workers tell—but they fear to report this information to the authorities—that at least 30% of the workers used in the warehouses are victims of threats by the side of the boss.*

An important reason why the informal brokers of workforce are key players of the shadow management system is their capacity to balance the presence of legal and illegal workers within warehouses and cooperatives. In other words, the informal brokers create a ring fence allowing illegal activities within workplaces and, at the same time, afford formal compliance to labor, tax, and social insurance rules.

Such fine-tuning of illegal and legal activities is particularly relevant in the treatment of formal workers. Although the presence of formal employees is a necessary condition to prevent government controls and preserve the exploitation mechanism, also formal workers are exploited under the shadow management system. In particular, they perceive a salary that is formally in line with the minimum allowed by the national labor regulations (sometimes even more than the minimum), but the *relational contract* they have to accept in order to work forces them to return back a substantial part of their salary. This mechanism has the dual function (a) of reducing the cost of formal manpower and (b) of collecting criminal money to fund illegal operations by the shadow management system.

These criminal funds are firstly used to place illegal workers in the organization of the atypical cooperatives providing warehouse activities. Accordingly, being illegal manpower employed in the logistics sites of the same cooperative, their very low remuneration contributes to drastically reduce the cost of labor and increase the margin of profit coming from labor exploitation. The illegal situation—which poor and migrant workers (e.g., usually without a valid residency permit) are subject to—strengthens the bargaining and coercion power of the

informal broker and, more generally, of the shadow management system. This power is used, of course, to squeeze wage and nonwage work conditions, with the only limit of the physical subsistence of manpower. A representative of one of the most influential trade unions in logistics reported:

*Warehouses are places where workers undergo terrible injustices. However, they remain silent fearing to lose their job, their residency permit, or both. This is not possible because these workers have to return to their family of origin the money they got on loan for sending them abroad in search of a better life.*

Criminal money is also used to finance several other illegal activities in different sectors (e.g., corruption of public officers). These findings highlight the intimate connection between labor exploitation in logistics outsourcing and the most widespread forms of corruption that are unfortunately very much diffused.

Finally, it is worth to provide additional details on the implementation of the *relational contracts* that are crucial to the very effectiveness of the shadow management system. In particular, we analyze the specific techniques that are employed by the informal brokers to control and constrain workers. These are the following ones:

- (a) The threat of job loss, which must be credible to be fully effective. Its credibility actually derives from the abundance of unemployed workforce. In this respect, it is worth highlighting that the inflow of new immigrants plays an essential role to keep the exploitation system effective. Indeed, it makes the threat of job loss credible and, by increasing competition among workers, also squeezes salaries toward the level of subsistence. An employee of a cooperative said:

It is not allowed to be sick and to be less productive because otherwise the –thousand of people from Bangladesh needing a job will replace you.

- (b) A welfare to exploited work, which relies on the provision of a wide range of social and assistance services by informal brokers to formal and illegal workers, such as legal and administrative assistance in immigration procedures, housing, health services, microcredit, etc. Such social service package creates an “exploitation trap” by increasing the opportunity cost of quitting the shadow management system for exploited workers, for example, by reporting it to governmental authorities. Indeed, leaving that system would mean to lose all the connected social services that would be impossible to obtain from someone else than the informal broker. This mechanism is even more effective in the case of illegal workers, who do not have any regular residency permit and, therefore, cannot access any public assistance scheme.

The “welfare-to-exploited-work” system is particularly effective in the Italian context where legal social services to poor and immigrant workers are underprovided. Public funding in Italy is clearly insufficient to provide effective social assistance services. On top of this, the Italian public social services are quite fragmented and, therefore, unable to secure effective social protection. The fragmentation of social service provision, as well as the ineffectiveness of public-private intervention in the social field, has been told by many interviewees to be the main limit for competing with the welfare system provided by the informal brokers of manpower. As a worker reported:

*I have to be thankful to my “boss” because he gave me a home to stay and medical assistance to my children when they needed it.*

The role of the informal brokers of labor has deleterious effects on trade unions functioning as well. The control over a huge amount of workers operating in warehousing activities puts brokers in the condition to influence the way trade unions operate. In some cases, brokers can even trigger trade union claims in order to extort “benefits” from the buyers of logistics services and logistics operators themselves. The real paradox of the logistics sector in Italy is that the very players that, in the conventional wisdom, should greatly benefit from workers’ exploitation—i.e., the buyers of logistics services—end up in being among the victims of the shadow management system, in the form of blackmails and extortions. Accordingly, the control power exerted by the informal intermediaries ends up emptying trade unions of their role of labor protection. This effect is, in particular, determined by the capacity of the informal broker to force workers under his control to quit a particular trade union and take the card of another, in order to pursue the broker’s agenda. A representative of a trade union noticed:

*The “boss” told some of the workers under his control to take the card of [Trade Union A] to rebalance the weight of that union with that of [Trade Union B]. He holds in his pocket the banking payment cards of formal workers, in order to have the maximum degree of flexibility in taking back the money paid to them.*

A general model summarizing our findings is reported below (Figure 3).

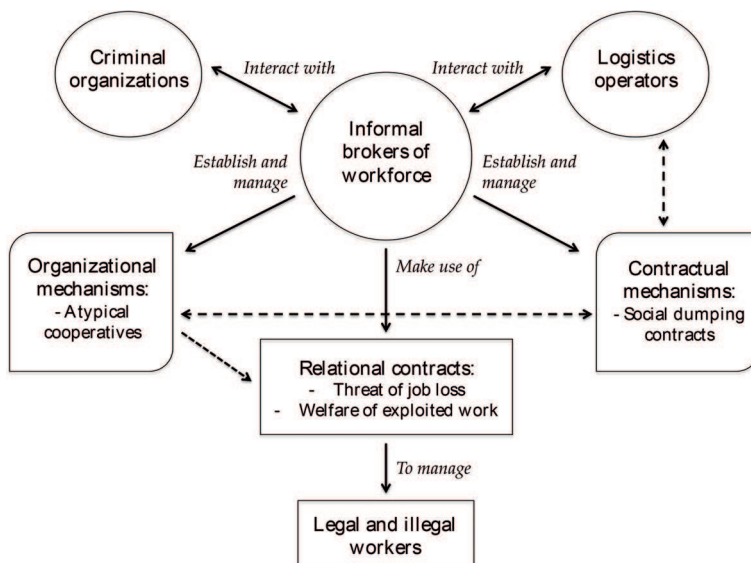


Figure 3. A model for the “shadow management system” in logistics (Source: our elaboration).

## 6. Conclusions and implications

As highlighted in this chapter, the outsourcing of logistics and, in particular, warehousing services in GVCs may involve relevant “unintended consequences” in terms of social sustainability of the business models on which contemporary capitalism rests. We saw that cooperatives providing these services may, quite easily, be part of a wider shadow management system that bases its business model on clever blend of legal and illegal activities aiming at labor exploitation, tax and social insurance evasion, and corruption.

Our analysis shed a new, dreadful light on the negative externalities of the twenty-first-century capitalism. To some extent, what we see now reproduces, at the heart of contemporary Europe, the typical working conditions of early stages of industrialization, featuring Europe between the end of the eighteenth and the end of the nineteenth centuries.

A number of research and policy questions arise from our analysis. The first crucial question is about the relationship between the shadow management system for workers’ exploitation in logistics, on one side, and organized crime and transnational illegal activities (e.g., money laundering, human trafficking), on the other. Though this is an interesting issue for future research and many important details are missing, we can draw here some educated guesses. As our analysis has pointed out, organized crime is likely to be the main provider of two crucial inputs of the shadow management system, namely, (illegal) financial capital and (illegal) workers. Criminal organizations have business motives, technical capacity, and global networks to play this role. It is quite likely that these organizations are crucial stakeholders of the shadow management system in connection with informal brokers of manpower.

Another issue is the (causal) relationship between the functioning of the shadow management system and the severity of social deviance phenomena and crime that feature big cities (e.g., prostitution, pimping, drug trafficking). Our analysis highlights the essential function of large unemployment of illegal and very poor workers to support the implementation of the “exploitation trap” by the shadow management system. Such extremely bad economic situation fosters petty crime and social deviance, as underlined in interviews by volunteers working in nonprofit associations that support poor and migrant people.

The natural policy question that arises by our analysis is what are the ways out? Our investigation provides some interesting clues in this respect. The first issue is the control of transnational illegal activities. Improving international cooperation to fight money laundering and human trafficking would also reinforce the capacity of governmental authorities to fight the implementation of the shadow management system, in particular through atypical cooperatives.

Another important tool is social policies. In the case of Padua, the shadow management system draws large part of its strength from the stark unbalance between the power of informal brokers of workforce and the weakness of civil society and government to address the social needs of poor and immigrant people. A key factor of this unbalance of powers is the capacity of the shadow management system to provide, on top of jobs, effective welfare services. A strategy pursuing a rebalance of powers in this field could be based on a wider and stronger “public-private social service network,” aiming at rationalization, coordination, and strengthening of

public and private resources and initiatives that already exist in many Italian cities. On top of such incentive effect, a functioning legal protection system against poverty and social disadvantage is, as workers told us, an effective social control mechanism to counter other social deviance phenomena that affect the weaker part of our society.

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