

Challenges Of Nearshoring Services Within The Enlarged EU

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Scopul lucrării este explorarea potențialului de delocalizare a activităților de servicii cu livrare electronică între țările dezvoltate membre UE și țările în curs de dezvoltare noi și viitoare membre UE, în special România. Pornind de la analiza comerțului și fluxurilor investiționale în domeniul serviciilor informaționale și de afaceri, dinspre țările dezvoltate membre UE spre cele central și est-europene, vom identifica factorii ce ar putea explica preferința statelor membre UE15 spre delocalizare a activităților de servicii către statele ECE (Europa Centrală și de Est), precum și provocările determinate de intensificarea acestui fenomen la nivelul pieței europene lărgite, pe fondul deficiențelor în ce privește piața internă a serviciilor.

Key words: *IT-enabled services, nearshoring, Central and Eastern European countries, services internal market*

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Cross-border trade in “IT-enabled services”¹ is today among the fastest growing areas of international trade. While industrial countries are the largest exporters of such services, with trade being still conducted predominantly among them, some of the most dynamic exporters are developing countries. At least three factors are responsible for this phenomenon:

1. advances in technology, that influenced the structure and organization of services sectors, determined changes in the way services are internationalized and dramatically improved the tradability of services through electronic transfer;
2. substantial investments in education in a number of developing countries, that resulted in the creation of a relative abundance of skilled labor available at fairly low wages, due to the absence of proportionate employment opportunities;
3. innovations in business practice that have led to the out-location of service activities or functions, by multinational enterprises in the manufacturing and services industries, to their own operational units located abroad or to independent service providers (Mattoo, 2004).

Companies in developed countries are increasingly outsourcing information technology services (ITS) and business process services (BPS) or are establishing their own subsidiaries in developing countries. Rapid technological progress has lowered the cost and increased the efficiency of communication and transfers of information.

¹ *IT-enabled or E-tradable services* are services provided from one country to another over telecommunication or data networks; include information technology services and business process (outsourcing) services

Companies have capitalized on the availability of information, communication and technology infrastructure (ICT) to fragment their value chain and carry out different parts of their operations via geographically dispersed subsidiaries and foreign third-party service providers. Standardization and service market liberalization, including increasing openness to foreign direct investment by developing countries (improving ICT infrastructure and permitting establishment by foreign subsidiaries) are other important enabling factors.

The aim of the paper is to explore the potential for nearshoring of e-tradable services among old (EU15) and some new and prospective Member States of the EU, including Romania. First, issues related to the theoretical background of the offshoring phenomenon are addressed. The central part of the paper focuses on the analysis of EU15 - CEECs (Central and Eastern European countries) trade and FDI in e-tradable services, to evaluate whether the statistical evidence supports nearshoring trends towards the CEECs and to determine the geographic orientation of this trend. In the final section, potential factors that could explain the preference of the EU15 to nearshore services to the CEECs, especially Romania, are considered, as well as the challenges of nearshoring for the enlarged EU, given the rigidities in European labor market and deficiencies in internal market for services.

1. Theoretical framework

The current trends on the global market, related to the international organization of services activities, namely (1) the redefinition of firms' core activities through stripping away services functions that no longer fit the firms' strategy, the emphasis being on "core competencies", resulting in a separation of peripheral activities, in order to improve the operational efficiency and the capacity to create value added; (2) the geographical reconfiguration of firms' value chain activities internationally, through redefining the roles and functions of individual corporate units; (3) the reconfiguration of firms' activities through redefining the boundaries between internalized and externalized transactions, led to the emergence of new models for the international expansion of corporate services activities and functions – offshoring models.

According to UNCTAD (2004) and BCG Consulting (2005), offshoring - shifting an activity abroad - can be undertaken through:

- (1) internalization or captive offshoring - continuing to produce the services in-house, by transferring the supply of those services to an affiliate set up in a location with a cost advantage – approximately 70-80% of the offshoring activity takes place this way. Captive offshoring allows the company to benefit from the scale and cost advantages, while maintaining operational control of the offshored activities
- (2) externalization or outsourcing - contracting the supply of services with a foreign independent service provider. Companies that choose this model aim at exploiting cost and specialization advantages of some locations or suppliers, while agreeing to give up operational control.

Hence, any offshoring decision requires a firm to choose to remove a service function previously undertaken in-house at home and entrust it to a provider – either its own foreign affiliate (internalization) or a third party (externalization) – located outside the home country.

Nearshoring, as a form of offshoring, entails the relocation of business processes to another country, located geographically near. For EU15 countries the nearshore locations are the new and prospective EU member states, especially the CEECs¹.

(1) In the internalization case, companies offshore one or more functional activities along the value chain of services to affiliates abroad and integrate them with activities elsewhere within their production systems, in order to better exploit different locational advantages.

The significance of offshoring through internalization for CEECs has increased in recent years, with the type and purpose of FDI (main vehicle for captive offshoring) differing largely across the European transition countries: while in countries like Russia, Ukraine, Poland and the Czech Republic FDI represents only a means to penetrate the market of the host country and the surrounding region and to produce goods for these markets within the region, to facilitate market access and avoid trade barriers (horizontal FDI), in countries like Estonia, Lithuania, the Slovak Republic, Romania, FDI is aimed at taking advantage of lower factor costs for parts of the services value chain and then at re-importing the service activities to the source country as an input for the final production (vertical FDI).

(2) The potential for externalization of services is partly gauged by the progress in outsourcing of services at the national level. Once a company has outsourced an activity to an independent supplier in its home market, a logical next step may be to explore similar arrangements in other locations. Moreover, as domestic suppliers of outsourced services expand internationally, the scope for offshoring also increases.

The most dynamic segments of the services market, with a high potential for offshoring and a significant contribution to the increase in developing countries' exports, as well as to their integration into the global trading system are e-tradable services, namely information technology services (software development and implementation services, data processing and database services, IT support services, application development & maintenance, enterprise security, enterprise application integration, total infrastructure outsourcing, web services etc.) and business process (outsourcing) services (customer interaction services, administrative services, sales-related services, operations, professional and other business services) (Mattoo, Wunsch-Vincent, 2004)².

2. Nearshoring patterns within the enlarged EU

Nearshoring practices within EU25

Compared to the USA, the EU15 is lagging substantially behind in regard of the offshoring of services. This might on one hand be explained by the fact that EU firms

¹ Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, Romania, Bulgaria.

² The list of activities is not exhaustive, nor are the categories mutually exclusive.

tend to externalize services to a much lesser extent than US firms and on the other hand by the lower extent of internationalization of EU firms in relation to their US counterparts. Market fragmentation due to natural or artificial barriers (e.g. regulations and lack of internal market) might hamper the capacity of these countries for offshoring.

The estimates of the size and likely effects of offshoring for the EU differ and rely primarily on evidence focusing on the number of jobs that could potentially be relocated (Schaaf, 2004)¹.

The analysis of the EU25 employment distribution shows that in 2003 13.7 million workers worked in the fields of “computer and related services” and “other business services”, the two service sectors that best approximate activities that can be offshored. While EU15 account for the majority of jobs in these two sectors, the strongest growth rates in employment in 2000-2003 period were experienced in the new Members States (NMS), partly due to the relocation of jobs from old to NMS (Huws, Dahmann, Flecker, 2004) and indicate the growing capacity of the NMS to provide IT-enabled services.

Because of the lack of reliable statistical indicators on the extent or the nature of offshoring (Van Welsum, Vickery, 2004) examined from the point of view of potential jobs that could be shifted abroad, this paper will follow a different approach and will attempt to provide complementary data on the potential extent of the nearshoring of services between EU15 and CEECs, based on data referring to trade and FDI in “other business services” and “computer and information services”, that will serve as proxy indicators. The main sources of data for the investigation are the balance of payments statistics on trade in computer services and in other business services and data on flows/stocks of foreign direct investment by activities.

Differences in the demand and supply of labor and wage levels in the recently enlarged EU have spurred intra-EU trade in IT and business process services. Western European companies are increasingly importing services from Eastern Europe, where salaries are modest and skilled labor abundant. Trade is further boosted by inflows of FDI from both EU and non-EU companies that locate regional headquarters and service centers in countries like Hungary and the Czech Republic to service customers in the European single market.

2.2. EU15-CEECs trade in IT-enabled services

Data on services trade reveal the existence of positive growth rates of the CEECs exports of e-tradable services to EU15. Exports from the new member states to EU15 grew in the period 2000-2003 by 7.2% in information and computer services and by 3.8% in business services. During 1997-2003 period the EU15 imports of services from the NMS grew faster than their total imports of services, and this in particular relates to information and computer services.

Trends in intra-EU15 trade are rarely similar to those in EU15 trade with the CEECs. EU15 imports of services from all CEECs, with the exception of the Czech Republic, recorded higher growth rates in 2000-2003 period than intra EU15 trade in services. When longer time period is considered (1997-2003) the CEEC performed

¹ It has been assessed that until 2009 a maximum of 2% of all jobs in the services sector will be lost due to outsourcing

better than EU15 as the growth rates of the EU15 imports of ICS and business services from the CEEC (22.7 % and 14.5 %) surpassed those of intra EU15 trade (21.0 % and 10.5 %).

The main competitors of the CEEC in supplying IT-enabled services to the EU15 are Asian countries, with India topping the list. Although the volume of the EU15 imports of e-tradable services from India is larger than from the CEECs and the imports of ITS from India experienced much faster growth than from the CEECs throughout the 1997-2003 period, the EU15 imports of business services from the CEECs during 1997-2003 grew faster than from India (11.4%), mainly due to the performance of Lithuania (28.1%), Estonia (19%), Hungary (14%) and Romania (12%). If we take into account more recent period (2000-2003) four CEECs (Estonia-16.1%, Lithuania-14.1%, Hungary-14.6% and Romania-11.6%) outperformed India (9.1%) in regard of the dynamics of IT-enabled services' exports to the EU15. Finally, it is worth noting that in the 1997-2003 period all CEECs with available data (except for the Czech Republic) show higher growth rates in exports of services, business services and ICS to the EU15 than Asian countries (Eurostat, 2005).

As for Romania, exports of IT and business process services grew by 32.3% in the period 2002-2003 and by 40% in 2004, with over \$250 million in exports in 2004. For the period 1995-2002, Romania witnessed an increase in these services of 28%, ranging 2nd in the world, after India. In addition, 70% of Romania's trade with the EU is derived from outsourced facilities.

Consequently, available empirical evidence tends to speak in favor of the CEECs potential to compete in the provision of information and computer services and other business services to the EU15.

2.3. EU15 – CEECs FDI in IT-enabled services

Inward FDI in business services in those CEECs countries with available data (Czech Republic, Estonia, Latvia, Poland, Hungary, Romania, Bulgaria), originating in EU15 countries have on average increased in the period 2000-2003 by 37%, with a stunning increase displayed by Latvia (77%), followed by Estonia (25%), Czech Republic (25%) and Poland (18%).

With respect to the distribution of FDI flows from EU15 to CEECs, Romania is on the 5th place, with 9%, Hungary, Czech Republic and Poland being on top of the list.

It is also worth highlighting that EU15 FDI in business services abroad have grown much faster than the intra EU investment (31.6% vs. 23% in 1997-2003 and 13.9% vs. 5.5% in 2000- 2002). Moreover, FDI growth rates in intra EU15 were much smaller (5.5%) than FDI growth rates to the CEECs in business services.

Even though empirical data regarding trade and FDI in information and computer services and other business services from EU15 to CEECs is limited, we could at least assert that CEECs are supplying a higher quantity of such services to the EU15 countries than are importing from them and are dynamically increasing their supply of services to EU15. In addition, other factors support this statement and illustrate that nearshoring of e-tradable services from EU15 to CEECs is already taking place:

the AT Kearney consulting company report from 2003 placed Hungary, Slovakia, Romania and Czech Republic among the top EU offshoring locations for information services, indicating a very high potential for CEECs (AT Kearney, 2003);

the McKinsey report from 2005 point to Hungary, Czech Republic, Poland and Romania as the most attractive locations for services offshoring (Farrel, 2005);

The Economist Intelligence Unit from 2005 places Romania on the 14th place worldwide as a services outsourcing destination, with a 7.08 score, as opposed to India, ranked the first, with a 7.76 score (The Economist Intelligence Unit, 2005).

Factors underlying the potential of CEECs to serve as nearshoring location

In the last fifteen years the CEECs have experienced a dynamic growth of the service sector that resulted in narrowing the gap in relation to the EU15. The most advanced CEECs have surpassed the performance of some EU15 member states regarding the service sector development, blurring the line between the old and the new EU members. The progress of the CEECs in services in terms of growth and improved range of services was enabled by privatization, regulatory and institutional reform, liberalization, technological and organizational change.

The level of labor costs in different locations plays a major role in offshoring and might also be a strong determinant of nearshoring from old to new and prospective Member States of the EU. Labor costs in the CEECs vary between 5.7% and 49.5% of the EU15 average in market services. In the case of Romania, labor costs represent only 7% of the EU15 average, while labor productivity is approximately 30% of the EU15 average. An index of productivity/labor costs points to countries like Romania, Bulgaria, Latvia and Slovakia that are more cost-attractive for nearshoring.

One of the obvious advantages for European companies of nearshoring to CEECs rather than offshoring to India or elsewhere is the issue of human capital, in terms of language skills, cultural affinity and education levels and qualifications. All CEECs achieve better result by education attainment than the EU15 average and four of the CEECs surpass the EU15 by the share of graduates from tertiary education per 1000 inhabitants (Estonia, Latvia, Lithuania and Poland). As for Romania, it ranks the 6th in the world by number of certified professionals (Brainbench, 2003) in the field of information technology and the 13th by the number of graduates in the field. Currently, about 25,000 software professionals work in the industry and almost 1/5 of them are involved in software export activities. Romania's density of software graduates per thousand inhabitants is significantly higher than in the USA, it is two times that of Russia and nearly seven times that of India. Romania is in fact seen as the most promising location for IT outsourcing worldwide due not only to low labor costs but also to well-educated and multilingual labor pool, competitive property costs and time zone (UNCTAD, 2004).

Another factor that influences the nearshoring of services from EU15 to CEECs is the existence of cultural similarities, historical ties, geographical proximity to operations and a familiarity with language. The Romanian work force has some fairly unique language skills. Pierre Audoin Consultants (2003) found that 80% of the IT work

force speaks English, 25% speaks French and 11-12% speaks German including native speakers, and many other western languages are present in smaller percentages. Also, some 60% of the Romanian population speaks a foreign language, mainly English.

Some additional reasons why EU15 companies may prefer to nearshore to the NMS, Romania and Bulgaria rather than to other low-wage locations relate to easier coordination of offshoring procedures, but also to harmonized standards and other regulations, easier alignment of prices in single currency.

The benefits of nearshoring business processes to CEECs for companies in Western Europe have attracted an increasing number of companies to various Central and Eastern European cities in the last three years. These companies have consistently been attracted by the same factors – the opportunity to minimize costs (especially labor costs), the availability and quality of human capital, locational advantage and the business environment. Although real estate issues are not usually the deciding factor in offshoring, as a company begins to examine a region more closely, real estate issues become an essential part of the offshoring decision.

Thus, an increasing number of companies are finding that nearshoring to CEECs is helping them to stay competitive in today's global market, even with competitive players from the US or Asia.

The available evidence presented above suggests that future developments may speak in favor of EU concentrating a large part of offshoring within its frontiers. This view is founded on the comprehension that differences in wages may not be sufficient condition for outsourcing to Asian locations with lower wages. The experience shows that offshoring is not an easy process for companies and that other costs may in the end surpass the differences in wages. These costs include direct and indirect costs that relate to business and legal framework, cultural barriers, etc. Hence, the harmonization of regulation among the EU member states, especially through the efficient implementation of the Directive on Internal Market for Services could help to alleviate rigidity in labor market within the EU and contribute to increased provision of services, thus favoring nearshoring of services within the enlarged EU. The European "proximity", in the wide sense of the term, i.e. cultural, historical and geographical becomes a major competitive advantage of CEECs as a nearshoring location. It should, however, be complemented by an "economic proximity", supported through the removal of obstacles to services trade and the creation of a pro-competitive regulatory environment required for improving service market competitiveness in Europe. An enhanced service economy throughout the enlarged Europe is the prerequisite to encourage an effective European integration.

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