

# 9. GLOBAL SOURCING OF SERVICES: HOW WELL ARE THE NEW EU MEMBER STATES COPING WITH THE CHALLENGES? (PART I)

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## Abstract

*In the current debate on services offshoring, the New EU member states (NMS) have increasingly drawn the attention of economists and politicians, as well as the public. Particularly in the light of the recent waves of EU enlargement these countries have been considered as highly attractive locations for offshored services both from a European and global perspective. While a fairly large amount of anecdotal evidence documents the NMS high potentialities in terms of service offshoring, academic research on this topic is limited. This paper aims to contribute to this discussion.*

*Drawing on recent literature on the complex issue of service globalisation, the paper investigates NMS trade and FDI flows in services over the period 1995-2007 to find evidence of enhanced offshoring-related activities in these countries. The focus is on NMS-10, i.e. NMS-12 excluding Cyprus and Malta. Given the shortcomings of available statistical data and instruments for gauging the scale and impact of services offshoring, the paper adopts a three-tier approach based on BoP trade and FDI statistics, complemented by alternative sources of information.*

*Notwithstanding the caveats associated with this kind of empirical exercise, the paper documents an accelerated pace of offshoring-related activities in the selected NMS, under both forms: international outsourcing and captive offshoring. Its findings show that the fast growing exports in some individual service categories in recent years, coupled with the favourable ongoing changes in the structure and performance of NMS services trade are largely driven by enhanced offshoring activities hosted by their economies. Further, the paper highlights the NMS capabilities to cope with the challenges raised by the increasingly competitive global offshoring landscape, as measured by competitiveness indicators. Finally, the findings of the paper confirm that current anecdotal information and consulting companies-based projections on NMS*

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*growing attractiveness as targets of offshoring decisions by TNC originating both inside and outside EU-15 are widely backed up by available statistical data. The paper is organised in two parts under the same title.*

**Keywords:** globalisation, services, international trade, FDI, New EU Member States

**JEL Classification:** F02, L80, O52, O57

## Introduction

In the last couple of years, service offshoring ranked among the most hotly debated topics in the context of international economics. The highly dynamic developments revolving around this relatively new and most visible form of globalisation focused widely the interest of economists and politicians, as well as the public.

In the absence of a commonly agreed definition in the public debate or in the economic literature, service offshoring has been frequently described as the process of relocation of service activities/functions to lower cost destinations outside national borders. By assuming the perspective of the country of origin, such a description contributed largely to portraying services offshoring as a one-way process typically from a high-wage location to a low-wage destination in developing and transition countries, by which the former would be greatly threatened. Especially its alleged negative effects on employment fuelled considerable concern in the home countries, mostly developed countries (Ghibuțiu, 2008, p. 43).

During the ongoing discussion on the phenomenon of services offshoring worldwide, Central and Eastern Europe (CEE), in general, and the new EU member states (NMS), in particular, has been assigned a prominent role as destinations of offshoring decisions by companies located both in the EU-15 and other parts of the world. Particularly the NMS high potentialities in terms of relatively low labour costs, vast talent pool and modern ITC frameworks are considered to make them leading players in Europe, but also globally. Moreover, countries like Romania and Estonia are now seen by some analysts as becoming “Europe’s India” and “Ireland”, respectively, in terms of providing offshoring solutions to the rest of Europe. At first sight, the analogy between the NMS and the Indian or Irish model might seem surprising, not least due to the relatively modest weight of NMS on the global offshoring market.<sup>1</sup> Nevertheless, a quite large amount of anecdotal information and projections put forward by various international consulting companies backs up NMS growing attractiveness as locations for offshored services.

Paradoxically, insights based on official sources into offshoring activities in the NMS are still a moot point. In part, this may be explained by the very limited knowledge about the complex issue of services offshoring, in general, despite its high ranking on the media and policy agendas worldwide. Research on this topic is greatly hampered

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<sup>1</sup> *The Czech Republic, Hungary, Poland and Romania, together with Russia and Ukraine, accounted for a tiny fraction, i.e. USD 0.9 billion, of the global market for offshored services estimated to be USD 30 billion in 2003. Comparatively, India and Ireland accounted for USD 12.2 billion and 8.6 billion, respectively, in the same year (McKinsey&Co, 2006, p.19).*

not only by lack of adequate official data and statistical instruments to quantify its real size and impact, but also by the absence of an international consensus on what offshoring actually means. Lack of progress in harmonising internationally the definitions, data classifications, as well as data collection itself, greatly restricts the scope for comparison of the various studies on the extent and effects of service offshoring and hence the formulation of sound and consistent policy recommendations (van Welsum and Reif, 2006, p. 22).

Nevertheless, the recent theoretical and empirical contributions have improved understanding of this multifaceted phenomenon by shedding more light on its nature, driving forces and impact. And most importantly, they have helped channeling the initially heated debate on a less emotional track and placing the expectations and fears of offshoring into a more balanced perspective (Ghibuțiu, 2008, p. 43).

On the other hand, due to the one-sidedness of approach prevailing in the current debate on service offshoring, the bulk of academic research has concentrated so far on its potential employment effects in developed countries. Far less attention has been devoted to investigating its scale and impact on the host countries, specifically the NMS. The scarcity of systematic academic research on this topic is in sharp contrast not only with the extensive amount of anecdotal evidence on the NMS attractiveness as offshoring locations, but also the widespread view both in the current literature and official EU papers, that European enlargement has rendered NMS increasingly desirable as targets of service offshoring.

The considerations above bring us to the following question: What are the facts behind the hype? This paper attempts to find the answer to this question. Its purpose is to investigate on the basis of available official statistics the dynamics, scale and potential impact of service offshoring through the lens of NMS, and assess if and to what extent the resulting picture is consistent with that conveyed by anecdotal evidence. Section 1 lays out the general background of the analysis. After giving a short overview of the main findings from literature, it defines what in the paper is meant by “service offshoring” and sets out the methodology underlying the analysis. Section 2 investigates NMS trade in services during the 1995-2007 period from a global and European perspective. On the basis of official trade statistics, Section 3 documents a set of features about NMS trade in services which might be relevant for enhanced service offshoring. It also explores how well NMS are suited to cope with the challenges raised by service globalisation. Section 4 combines official FDI statistics with proxies and data from alternative sources to underpin the observed trends in NMS trade in services. Section 5 concludes.

## **1. General Background of the Analysis**

### **1.1 Main findings of research in a nutshell**

A brief review of the main insights emerging from the literature on the topic of service offshoring may provide both a good starting point and a general background for analyzing the phenomenon in the context of the NMS economies.

Adopting a firm-level view, service offshoring is arising as an attractive business model to which companies increasingly resort in response to intensified global

competition. By focusing on core activities and by outsourcing other tasks, firms may consolidate or enhance their competitiveness through specialization and more efficient organization, cost cutting, economies of scale and spreading risks. Essentially, offshoring of business processes by firms is not an entirely new phenomenon. Manufacturing firms have sourced components from other countries for many years, while the outsourcing of business processes within a country has existed in some form for centuries (UNCTAD, 2004, p. 156). New are rather the forces which are driving and shaping services offshoring in the present global economic setting, and subsequently its dynamics, the forms it may take, as well as its scope (Ghibuțiu *et al.*, 2007, p. 3).

From the perspective of the world economy, service offshoring reflects an ongoing shift in the patterns of production and trade in services with wide-ranging consequences for the international division of labor. As such, it is a relatively recent development in the global landscape, i.e. a new form of globalization, driven by mutually reinforcing technological, economic, institutional and organizational factors (Ghibuțiu, 2008, p. 46). It may be seen as a particular form of trade, enabled by increased tradability of services due mainly to rapid advances in information technologies and communications (ITC) coupled with liberalization of trade and FDI flows at the national, regional and global level. As a result, service activities are now less constrained in their choice of location than they have been traditionally, meaning that many types of service categories that were previously only tradable through the movement of the provider (i.e. through face-to-face contact) can be now supplied from remote locations. For many firms in all economic sectors this means that the production of various ITC-enabled services may be "outsourced", i.e. turned over to other specialized companies. And if it can be outsourced, then it can be generally also offshored (Kirkegaard, 2005, p. 4). Moreover, by fragmenting the production of ITC-enabled services internationally - in locations situated outside the firms' home countries - in line with the comparative advantages of different locations and the competitiveness-enhancing strategies at the firm level - companies can gain economies of scale from consolidating and standardizing their services activities across the globe. While ITC and continuing efforts to liberalize trade and FDI have made service offshoring feasible, the emergence of a global labor market for skilled workers - with many developing and transition countries characterized by relative abundance of skilled labor, available at low wage - turned service offshoring into a profitable way of doing business in the increasingly competitive global environment (Ghibuțiu *et al.*, 2007, p. 3).

While the gains from service offshoring at company level are straightforward, i.e. enhanced competitiveness - due to lowering costs, increases in productivity and quality of services - its impact from a macroeconomic perspective is, however, less clarified. Hence, its implications for an economy-wide sense continue to be a subject of controversy (Ghibuțiu, 2008, p. 48). Especially its potential disruptive effects on employment in the developed countries continue to fuel concerns among policy makers and the broader public, yet to a smaller degree among economists. Actually, the findings of numerous recent empirical investigations of the labor market-effects of service offshoring in the high-wage countries confirm the conclusion drawn earlier by Amiti and Wei (2004, p. 18), according to which "the risk of service offshoring

dramatically reducing job growth in the advanced economies has been greatly exaggerated". It is also important to note that several recent studies have emphasized the relatively modest size of service offshoring if viewed from a macroeconomic perspective. Even though the figures on annual growth rates of service offshoring put forward earlier by different media reports from private sources might look spectacular, when related to total inflows and outflows in the relative labor markets, or to total service trade, the figures seem to be far less impressive.

The new international division of labor emerging under the form of service offshoring is now basically regarded as a win-win game. There is large agreement among analysts that economic benefits - the outcome of specialization based on comparative advantage - are accruing to participants at both ends of the process. In conformity with the premise of the standard economic theory, the efficiency and productivity gains achieved through offshoring on long term should enhance the overall growth and employment opportunities of both the home and host economies, provided they are capable to adjust (e.g. by facing the short-term costs under the form of job losses in the former).<sup>2</sup> Host countries are considered to gain in terms of employment, upgrading of skills, capital inflows, technology transfer and increased trade flows, including the opportunity to enter new industries before domestic demand can support them. Home countries are seen to benefit from enhanced competitiveness, enlarged access to cheap and high-quality services, and the opportunity to move up the skill and technology ladder (UNCTAD, 2004, p. 213). Yet it is also widely admitted that fast changes in international specialization may lead to tensions (notably due to displacement of workers), and may imply adjustment costs that governments, enterprises and individuals will have to bear. Just like all forms of international trade - whether in goods or services - offshoring is likely to bring about both winners and losers, the key question for policy-makers being the design of proper policies to ensure that the former compensate the latter (van Welsum and Reif, 2005, p. 5).

Against this brief background arising from literature, the question then becomes, just what are the main trends and features shaping the service offshoring landscape in the NMS as host countries?

### **1.2 Terminology and methodology**

From the huge variety of concepts used currently to describe the phenomenon under discussion, we have opted for "offshoring" as the term most popularly used in the economic literature. Further, we have chosen to rely on the definition provided by the OECD (2004, p. 89), as the most suitable for our investigation. Accordingly, we understand by "service offshoring" the global sourcing of IT and ITC-enabled business services (such as customer services, back-office services and professional services), under its both forms, namely: (1) "international outsourcing", by which we mean the

<sup>2</sup> Yet, some economists are questioning the beneficial effects of service offshoring for the developed countries, and argue that it is going to threaten the current patterns of specialization, by which these countries are traditionally assumed to have a comparative advantage in knowledge and high-skill intensive goods and services. That is, precisely in those areas where Western companies are now facing competition from developing and transition countries endowed with abundant and cheap high-skilled labor, which is now tradable globally thanks to ITC (van Welsum and Reif, 2005, p. 5).

sourcing of a service from an independent supplier located abroad (unaffiliated trade); and (2) “captive offshoring”, meaning the sourcing of a service from an affiliated firm abroad (affiliated trade).

The analysis focuses on NMS-10, i.e. the eight countries from Central and Eastern Europe which became EU member states on May 1<sup>st</sup> 2004 (Hungary, the Czech Republic, Poland, Slovakia, Slovenia, Latvia, Lithuania and Estonia) and the two countries that acceded on January 1<sup>st</sup> 2007 (Romania and Bulgaria). In our attempt to gauge the phenomenon of service offshoring in these countries we adopt a three-tier approach (Ghibuțiu and Dumitriu, 2008, p. 197).

Firstly, we rely on Balance of Payments (BoP) trade statistics (Eurostat and WTO) to identify emerging trends in the evolution and composition of NMS trade in services, which might be put on account of increased offshoring. We start from the assumption that a typical consequence of a decision taken at the level of a firm located abroad to offshore services to a NMS should be a rise in the respective country’s exports of services as it becomes the new location from which the services supplies are sourced thereafter. As there are no readily available statistical indicators for measuring the scale, dynamics, and effects of offshoring on trade, we rely on indirect measures.<sup>3</sup> Following a widely applied methodology in the current literature, we use two service categories to approximate the potential impact of offshoring on NMS trade in services, namely: “computer and information services” (CIS) and “other business services” (OBS).<sup>4</sup> These two BoP categories are also referred to as IT services and ITC-enabled services, respectively. Their sum is assumed to cover the great variety of services that may potentially be affected by offshoring. Even though there are major pitfalls in the interpretation of trade data by linking them to different offshoring activities, BoP data help us to highlight the dynamics and relative size of IT services and ITC-enabled services within NMS total trade in services, and also allow us to calculate net exports.

Secondly, we try to trace evidence for increased offshoring in the NMS on the basis of available official FDI statistics, especially as service offshoring is estimated to take place predominantly through FDI. To this aim we use FDI data from Eurostat as well as proxies.

Thirdly, we confront our findings in terms of statistical data with information derived from alternative sources which are useful in catching those early emerging developments that official statistics are not yet ready to reflect or do report with great delay, respectively. In this context we provide some evidence from Romania as its recent experience is highly relevant both for the assumed upsurge of offshoring activities in the NMS, and the fast catching-up process under way in those NMS which may be characterized as “trailing”. \_

<sup>3</sup> For a discussion on the shortcomings of statistical systems and the pitfalls in tracking offshoring-related activities, see: OECD (2004), Amiti and Wei (2004), WTO (2005), etc.\_

<sup>4</sup> The “Other business services” item covers: *merchandising and other trade-related services; operational leasing; other services (legal, accounting, management consulting, public relations; advertising, market research, public opinion polling; research and development; architectural, engineering, and other technical services; agricultural, mining; other business services).*

Given the shortcomings of both trade and FDI statistics for gauging services offshoring, we recognize along with other authors that the interpretation of the results deriving from this kind of empirical exercise is liable to caveats.

## **2. Trade in Services and the NMS: A Global and Regional Perspective**

In this section we aim to address the following questions: Is there a rise in services offshoring in the NMS in recent years as featured by the BoP trade data? Do the data support the view that NMS are increasingly arising as recipients of offshored services? An insight into the evolution of NMS trade in services over the period 1995-2007 in terms of dynamics, composition and performance will help us to find the answers to these questions, by shedding light on those emerging developments which might be associated with expanding offshoring activities and hence have direct bearing on these countries' potential as offshoring locations.

### **2.1 The legacy of the past**

When analyzing the current service trade patterns of the NMS, it is of utmost importance to bear in mind that these countries are growing from a very low base. The previous economic system left these countries with huge structural imbalances and severely depressed service sectors. In the highly centralized economies, with nonexistent private sector and noncompetitive environment, with strong monopolistic positions of state-owned enterprises, lack of entrepreneurship and isolation from international markets, the scope for developing services in general and business services in particular has been drastically restricted (Ghibuțiu, 1999, p. 3). Besides, services have been relegated to a status of less importance in the process of growth and development both in terms of theory (ideology) and economic policy. Implicitly, trade in services did not focus the attention of policy decision-makers. It was regarded as a mere complement to trade in goods (e.g. transports) or a source of foreign exchange earnings (e.g. tourism).

Consequently, when the NMS started to move towards market-oriented policies and institutions, a wide range of service categories, particularly business-related services were either nonexistent or not developed according to Western standards. No wonder that at the beginning of the transformation process NMS ranked among the least service-oriented economies across the world, and as regards several service categories development started practically from scratch (Ghibuțiu, 1999, p. 3). The process of market-building and market-functioning demanded increasing amounts of business services, including legal services, accounting and auditing, advertising, market research, management consulting, etc. In the first years of transition these services could not be provided locally, due to lack of expertise and skills, particularly business management skills and marketing know-how, but also owing to shortage of capital and weak telecommunication infrastructure. It may be argued that foreign investors have opened the way for developing the new business service categories, and spurred the emergence of local business service companies. Not only that FDI enlarged the domestic supply of business services, forcing local providers to enhance their own performance through increased competition, but also contributed to

improving skills, spreading know-how, enabling global connections and increasing the quality of services

Since the start of the transformation process, the NMS have experienced substantial progress in adjusting and opening their economies, and integrating into the world economy both in terms of goods and service flows. However, despite sharing many common features, their evolution was far from being even.

Differences across the NMS may be explained in part by their specific starting conditions, but the primary cause relates to speed, depth and comprehensiveness in promoting economic and institutional reforms. Nevertheless, NMS succeeded to manage within a historically very short timeframe several complex and overlapping processes, i.e., transition towards a market economy, regional and global economic integration, as well as facing the challenges raised by technological progress and increasing globalization. This is all so more remarkable when we take into account the low level they started their systemic transformation.

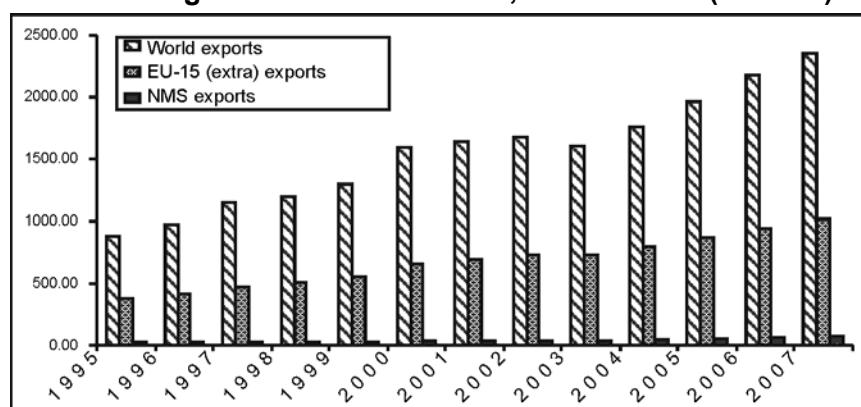
### 2.2 Recent trends in NMS services trade

The prospects of EU accession, the consequent adoption of the *acquis communautaire* as well as the NMS gradual integration into the European market have increased pressures to upgrade their services supply to the level of the old EU members, and to attract FDI into higher value added services, including export-oriented services (Ghibuțiu, 2008, p. 51). Those NMS that managed to attract from the very beginning of the transition large FDI due mainly to rapid and comprehensive economic reforms have witnessed a more rapid shift towards a service-oriented economy. But overall, the progress of the NMS in terms of services development has been remarkable, even though these countries are still far from the performance of EU-15 in several respects.

What are the peculiarities of NMS international trade in services during the period 1995-2007 from the perspective of the main trends prevailing at the global and European level?

Figure 1

NMS and global trade in services, in 1995-2007 (EUR bn)



Note: Exports in USD (nominal) converted into EUR/ECU at average annual exchange rates.



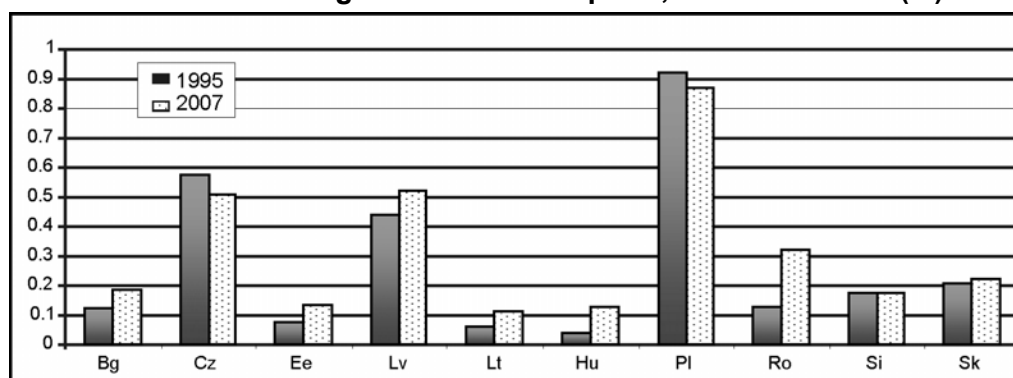
Source: Own calculations based on WTO (2008) and Eurostat (2008).

First of all, the picture which arises from the current BoP trade data is that of a still low degree of involvement of the NMS domestic service industries in international trade flows. Figure 1 shows that global trade in services has been growing steadily over the 1995-2007 period. At the same time, it reveals the wide gap which exists between the NMS and EU-15 in respect of the magnitude of services flows supplied internationally.

As percentage share in total global service flows, the NMS as a whole accounted for mere 3.2% in total world service exports in 2007. Comparatively, the weight of EU-15 in total world service exports was 43.5% in the same year. In the individual NMS, the respective shares ranged between 0.1% in Lithuania and 0.9% in Poland. Nevertheless, an overall increase of NMS participation in global services trade during the period 1995-2007 may be noticed, as seen in Figure 2.

Figure 2

Share of NMS in global services exports, in 2007 vs 1995 (%)



Note: Exports in USD (nominal) converted into EUR/ECU at average annual exchange rates.

Source: Own calculations based on WTO (2008) and Eurostat (2008).

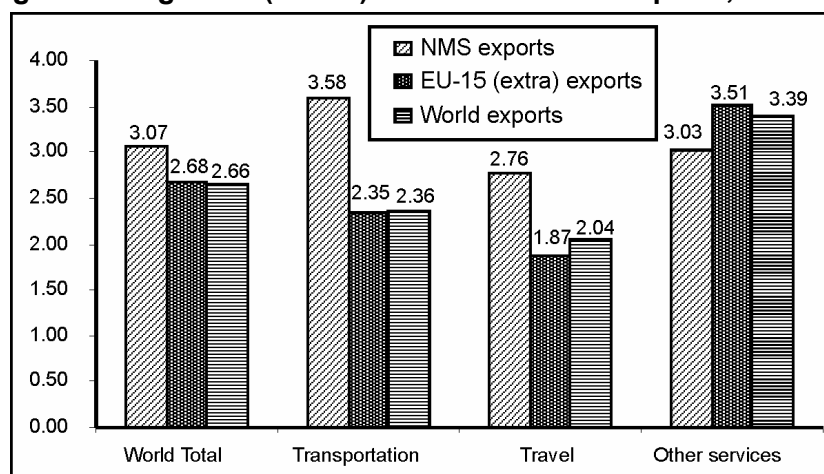
The modest share of NMS in global service trade flows illustrates the still low export capabilities in services of these countries. Their service share in global trade is below that of goods, but the difference is not notable. In some of the NMS, this is in sharp contrast with both their size and potential (e.g., Romania). In nominal value terms, the top 5 service exporters in 2007 were: Poland (EUR 20.9 billion), the Czech Republic (EUR 12.3 billion), Hungary (EUR 12.2 billion), Romania (EUR 7.6 billion) and Slovakia (EUR 5.2 billion), while the top 5 importers included the same countries in the same order.

NMS are characterized by a relatively low degree of specialization in services, as reflected by the share of their services exports in GDP. This indicator has the advantage of removing the effect of differences in the size of the NMS economies. With their 9.04% share of services exports in GDP as a group in 2007, the NMS fare quite well when related to the percentage share of global services exports in world GDP (5.4%). The individual countries with the highest level of this indicator include Estonia (21%), Bulgaria (16%) and Latvia (14%), while those with the lowest level are Romania (6%) and Poland (7%).

In value terms, NMS total service exports augmented from EUR 26.5 billion in 1995 to EUR 74.4 billion (in nominal terms) in 2007, corresponding to a 3.1 times increase, as against a 2.7 times increase both at the global and EU-15 level. While the dynamics of service exports in the NMS is superior to that of world and EU-15 trade, respectively, when breaking down NMS total service exports by main components, a quite different picture emerges in comparison with the world and EU-15 (Figure 3).

Figure 3

**Average annual growth (CAGR) of NMS services exports, in 1995-2007**



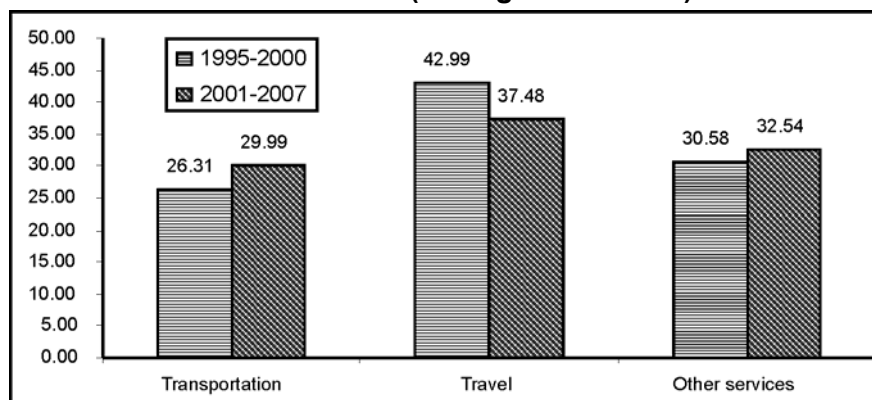
Note: Exports in USD (nominal) converted into EUR/ECU at average annual exchange rates.  
 Source: Own calculations based on WTO (2008) and Eurostat (2008).

Looking at the evolution of the NMS international services flows by major components, it may be observed that “other services”, which includes the large variety of business services and which is the fastest growing component both in EU-15 and worldwide, increased its share in terms of exports from 31% on average in 1995-2000 to just 33% in 2001-2007 (Figure 4).

Comparatively, the share of “other services” is notably higher at the global level, and has been growing more substantially, i.e. from 42% to 48% over the respective sub-periods, according to our calculations. The discrepancies are even more pronounced when comparing the NMS “other services” export share with that of the UE-15 in the analyzed sub-periods, i.e., 45% and 53%, respectively. Conversely, the NMS ratio of “travel” to their total services exports is much higher, i.e. 43% on average in 1995-2000 and 37% in 2001-2007, respectively, as compared to the world average (34% and 29%, respectively) or the EU-15 average (31% and 26%). Differences between the NMS as a group and the world/EU average exist also in respect of the share of “transportation” in total services exports, which is notably higher in the former. Moreover, in contrast with the trends at the European and global level, the share of this component increased in the NMS from 26% on average in 1995-2000 to 30% in 2001-2007, while it decreased slightly from 24% to 23% in the world, and from 23% to 21% in EU-15.

Figure 4

**Breakdown of NMS services exports, by main components, in 1995-2000 and 2001-2007 (average share in %)**



Note: Exports in USD (nominal) converted into EUR/ECU at average annual exchange rates.  
Source: Own calculations based on Eurostat data (2008).

The structure of NMS service trade in general, and the relatively low share of “other services” in particular, reflect in part reminiscences of their trade patterns prevalent before the systemic transformation, i.e. the predominance of more traditional service categories - such as travel, transportation and related services - and the relatively scarce share of advanced business services. It may also reflect the comparative advantages these countries have in travel and transportation. \_

Summing up, NMS as a group are accounting for a modest share in global service flows. Also the share of the “other services” component in their total service exports is much lower when compared to the world average, and especially the EU-15. However, in terms of dynamics, these countries’ service exports are growing faster than globally or regionally.

Moreover, a quite interesting picture arises when taking a deeper look at the “other services” component of NMS trade in services in the more recent years. The dynamic developments revolving around specific business-related services covered by this component are leading us to the assumption that they are related largely to enhanced services offshoring activities hosted by the NMS economies (see PART II of the paper).

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