

To Offshore or Nearshore IT services? – An investigation using transaction cost theory

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Abstract

The phenomenon of offshoring, that is, the outsourcing of highly-qualified services into low wage countries was until now considered an economy-specific solution to counteract the constant rise in costs caused by the intensified global competition. At the same time, this form of cross-country division of labor had been prognosticated by various studies to lead to overall positive economic effects. Recently, however, there has been much discussion in the political and management ranks on the controversial issue of the advantageousness of offshoring. The trend, which has been enforced by numerous consultants, has led to a decline in domestic employment as well as not accomplishing cost savings thus intensifying doubt over its validity.

The following paper deals with the advantageousness of offshoring in the case of IT services. In order to detach oneself from the limited account given by looking at wage costs, the analysis is conducted from the viewpoint of transaction cost theory. In doing so, it constantly distinguishes between offshoring and nearshoring strategies and the alternatives in examining specific costs are weighed out against each other. It will be shown that relevant motivation and coordination costs vary depending on not only geographical distance but also cultural difference. As such, the role of effective cooperation and interface management is clarified in order to be able to reduce known transaction costs.

1 Relevance to the present

The phenomenon of offshoring is currently a topic of intensive public discussion. On almost daily basis companies announce offshoring-decisions in order to cut costs. The consequence is a massive outsourcing of highly-skilled white-collar jobs such as finance analysts or software specialists into low-wage countries. Many economists advocate this form of international division of labor, since a global competition would naturally call for a global solution. Some 200 years earlier RICARDO had already showed that gains in productivity can be realized through the utilization of comparative advantages.¹ The INTERNATIONAL INSTITUTE OF ECONOMICS in Washington calculated a yearly increase in productivity in America of 0.3 % attributable to outsourcing for the years 1995-2002.² The utilization of comparative advantages are not only based on differences in wage but also qualification. Additionally, progress in information- and communication-technology make it possible to have an efficient and affordable solution to coordinate work processes across borders. By concentrating on specific core competencies fixed costs can be converted into variable costs, thus decreasing overall costs, so that company objectives such as the maximization of the shareholder value can be achieved (see figure 1).

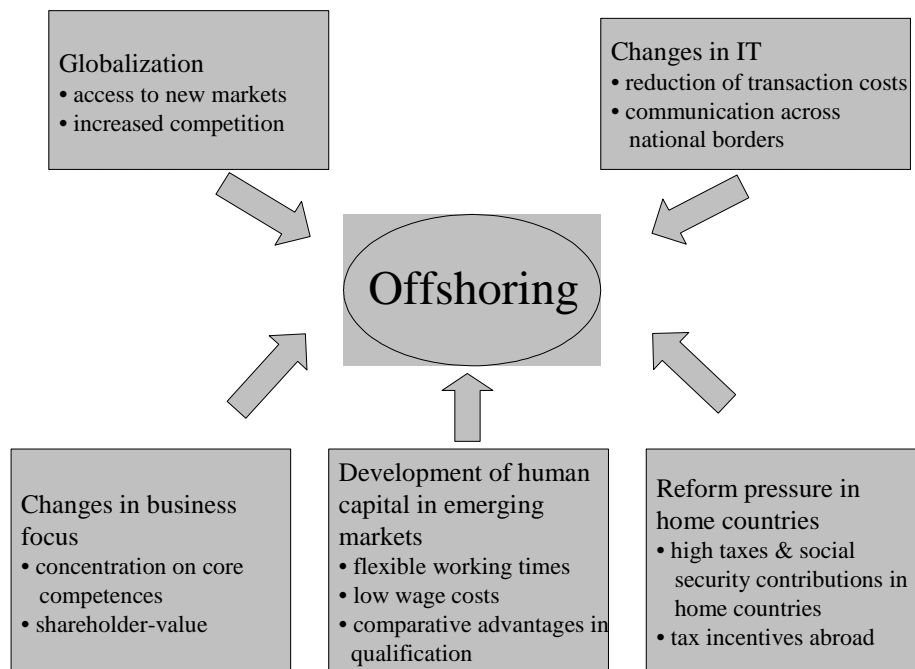


Figure 1: Drivers of offshoring

Nevertheless a controversial discussion about the advantageous of offshoring is currently taking place.³ American politicians expressed apprehensions about the jobless recovery and as a consequence an act was passed which prohibits the offshore outsourcing of public contracts.⁴ Simultaneously an insourcing of services previously outsourced to offshore countries can be observed. The US investment bank LEHMAN BROTHERS, for instance, announced the transfer back of their telephone service in India to the US.⁵ Many companies

¹ See RICARDO (1817).

² See N.A. (2004c).

³ See N.A. (2004b).

⁴ The US market research institute IDC estimates that until 2007 23 % of the IT service jobs in the US will be offshored - compared to 5 % in 2003. See BORCHERT/OTTOMEIER (2004) for further discussion.

⁵ See N.A. (2004a).

came to discover that the expected savings of up to 60 % could not always be realized.⁶ For that reason the euphemism smart-sourcing or right-sourcing has now emerged in this context.⁷ Numerous German firms realized that outsourcing services to the offshore destination India, as practiced by 90% of American companies⁸, could not fulfill their expectations. Instead of finding a solution to their cost-problems they were confronted with new cost predicaments, which lead back to differences in culture and language with their providers. For this reason the number of German firms which pursue nearsourcing⁹ is steadily increasing. In a study about offshoring strategies of European financial service providers, AT KEARNY confirms, with the help of a detailed evaluation model, the appeal of European nearshore locations in contrast to the conventional offshore destination India.¹⁰

The fact that an increasing number of companies is currently reassessing their offshoring strategies sheds doubt on the actual advantageousness of the trend of offshoring. As such, the following paper aims to weigh the alternatives of nearshoring and offshoring against each other from the perspective of cost theory and in particular transaction cost theory. First, wage costs in different countries representing typical offshore and nearshore locations are compared. Following that, an analysis of the differences in transaction costs between the two forms of outsourcing in relations to regional distance is done. Furthermore, the degree to which cultural distance is a determinant of transaction cost is studied.

In principle, all functions which do not require physical contact are offshore candidates. Therefore, typical offshore services are IT processes as well as IT supported business processes (Business Process Offshoring and IT enabled services, respectively).¹¹ These services typically require a large number of staff with close to no client interface. However, a majority of the offshored services are IT services.¹² The development of the Indian software exports shows the significant role of IT services compared to other offshore activities (see figure 2). For this reason, the following analysis focuses on IT services. However, the results of this study can be easily carried over to the case of BPO since these services are also IT-supported, making the following considerations in terms of cost relevant for such circumstances as well.

⁶ See LECIEJEWSKI (2003).

⁷ See HERRMANN (2004).

⁸ See AT KEARNY (2003).

⁹ Nearshoring is from the Central European viewpoint the outsourcing of services into (Eastern) European countries. Large advantages resulting out of differences in wage costs (such as in India) cannot be realized but language, cultural and regulative barriers are far lower when nearshoring than offshoring services abroad. See THEURL (2003), p. 31 et seqq. for further description of legal restrictions (especially concerning financial services) of outsourcing.

¹⁰ See AT KEARNY (2003).

¹¹ Typical outsourced ITeS are for instance personnel management, accounting or transaction processes in the financial services sector. The focus in IT offshoring lies in software development and service as well as help-desk activities. See AT KEARNY (2003).

¹² See FEDERAL MINISTRY OF ECONOMICS AND LABOUR (2003), p. 2.

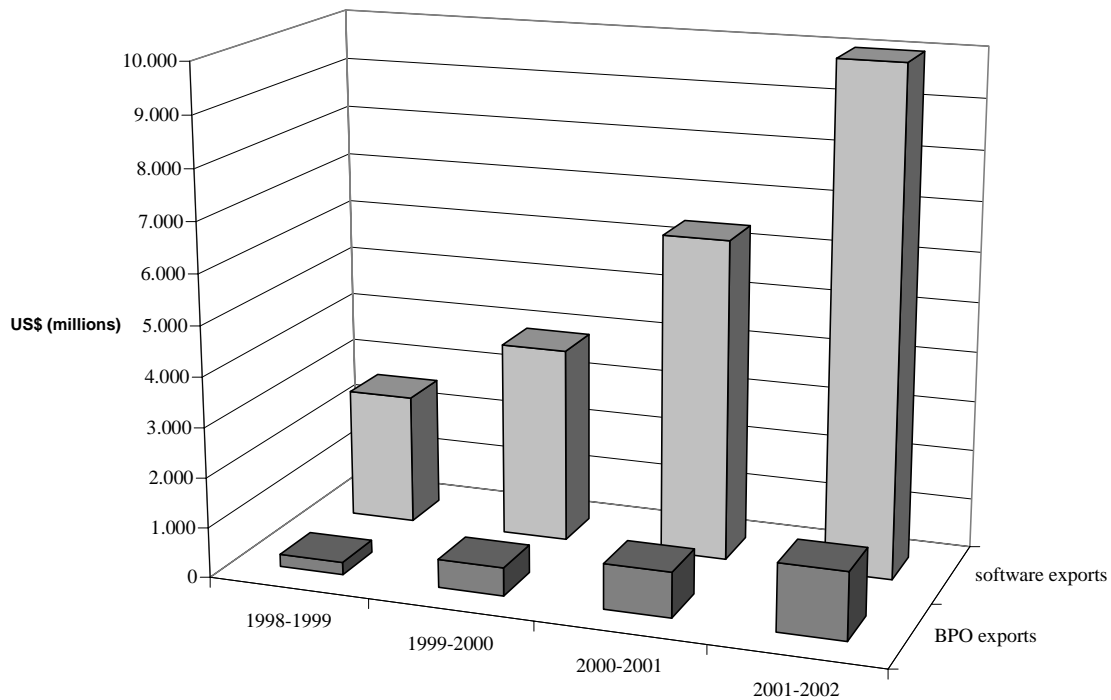


Figure 2: Development of BPO and software exports in India, 1998-2002
 Source: DELOITTE & TOUCHE (2003) and UNIWARE (2003)

Offshoring can be institutionalized in different forms. All principal institutionalization forms – from captive operation, cooperation in form of joint ventures to market solutions such as third-party offshoring – are represented in the practice of offshoring.¹³ According to the results of a survey conducted by MOCZADLO¹⁴, the majority of the respondents (41.3 %) operated in the form of cooperation with no equity participation among partners in offshore destinations. For medium-sized companies in particular, this form of institutionalization offers the only option to take part in the offshoring trend while simultaneously maintaining flexibility. For this reason, the following analysis concentrates solely on the cooperative form of offshoring.

2 Wage costs in offshore and nearshore areas

Drivers of offshoring have already been identified in section 1 (see also Figure 1). One trend which has decisively led to the implementation offshoring is the wage difference in newly industrializing countries of services with corresponding qualifications. Concurrently, cost pressures caused by intensified global competition propel the trend of outsourcing services to overseas areas.

Cost cutting, especially the reduction of wage costs, is often noted as the main motive by many firms for offshoring/nearshoring their services. This is further supported by numerous surveys, such as that conducted by the DIHK.¹⁵ A survey among their members shows that for 45 % of the member companies wage cost was the deciding factor for their service/production

¹³ Outsourcing can also be practiced in form of „false offshoring“. The firm sources services out to a domestic provider (bridgehead), who then uses an affiliate or a service-centre abroad in order to make an attractive offer. See KLAFS (2004), p. 107.

¹⁴ The study by Moczadlo (2002) is based on a survey among 318 firms. The interviewed companies either are currently in an offshoring process or plan to offshore or have offshored in the past.

¹⁵ See DIHK (2003).

outsourcing decision. A survey by DELOITTE & TOUCHE found that for 82 % of the firms surveyed the major motive behind their offshoring decision was cost cutting.¹⁶ In a study by MOCZADLO, 92 % of the nearshorers/offshorers interviewed responded that lower wage and incidental wage costs were a “very important” reason for their offshoring decision (see Figure 3).

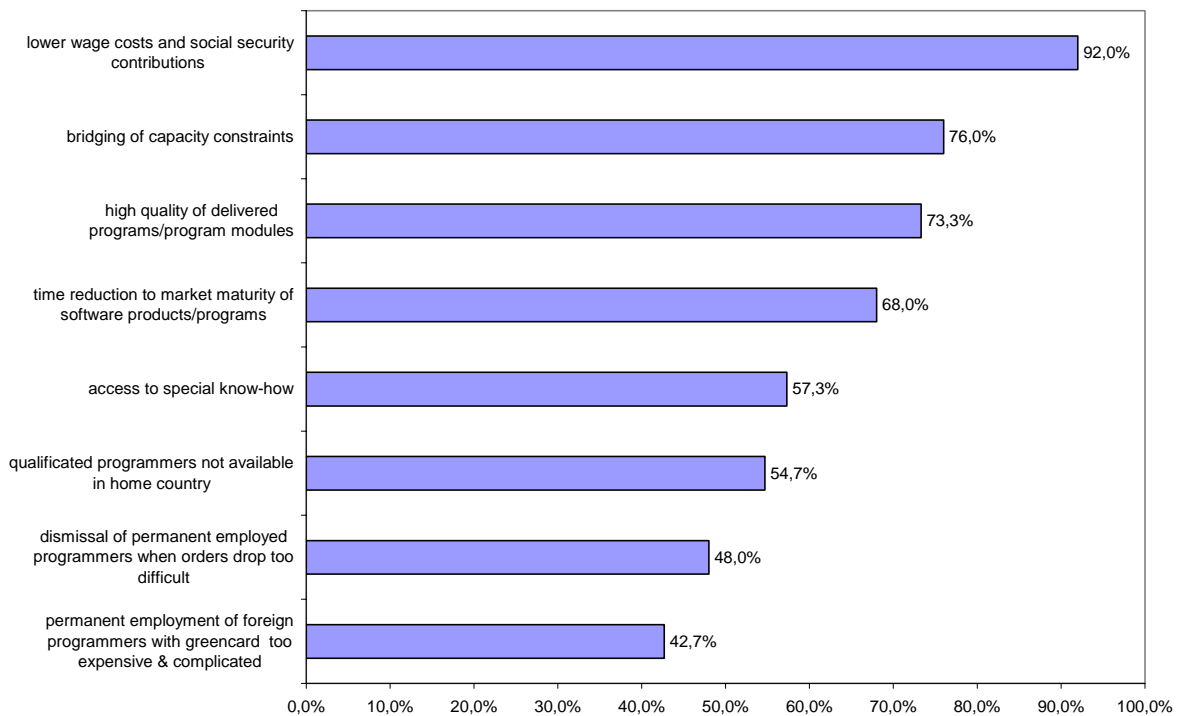


Figure 3: Motives for offshoring/nearshoring
Source: MOCZADLO (2003)

Comparing the gross salaries of engineers across different countries, there are in fact significant differences. Savings up to 60 % are possible. The wage levels in offshore areas (in this case India and China) are far lower than in European nearshore areas.¹⁷

3 Transaction costs for offshore and nearshore strategies

For long time the aspect of wage cost cutting was given great importance in relation to offshoring to emerging markets. With increasing experience in offshoring, however, the significance of cost reduction is put into perspective. It is revealed that other cost components that had so far been ignored increased with regional and cultural distance.

The management literature often claims that to single out considerations of absolute wage costs for strategies of outsourcing to emerging markets on account of productivity differences is too simplifying.¹⁸ It is necessary to compare unit labor costs and not succumb to any partial illusion. This argument can also be transferred to the case of service-offshoring. However, higher productivity alongside lower wage costs is one of the main reasons for the offshoring of IT-functions.¹⁹ Additionally, asynchronous working times enable a shorter and more

¹⁶ Other motives named were the outsourcing of non-core activities (65 %), increase in efficiency (47 %) and quality improvement (47 %). See DELOITTE & TOUCHE (2003), p. 22.

¹⁷ See LECIEJEWSKI (2003) as well as UNIWARE (2003) for detailed statistics of wage levels.

¹⁸ See ZENTES/SWOBODA/MORSCHETT (2004), p. 392 et seqq.

¹⁹ See MOCZADLO (2002), p. 4.

efficient organization of operations.²⁰ In summary, by sourcing IT services out to emerging markets lower unit labor costs can be achieved due to lower wage costs, productivity differences and gains in efficiency.

In the following study other cost components that can lead to a reduction of cost advantages owing to offshoring services to emerging markets will be analyzed. This will be conducted from the viewpoint of transaction costs. As mentioned in section 1, an increasing number of German companies prefer European nearshore countries when considering outsourcing IT, with Portugal, Ireland and the Eastern European countries being the most popular destinations. For this reason, in analyzing the costs the next section compares the two organizational solutions of nearshoring and offshoring. Indirect determinants of transaction costs, especially cultural differences, will be analyzed separately. Emphasis will be placed on the influence of these indirect determinants on the costs.

By definition transaction costs occur when products or services are transferred across a technically separable interface.²¹ Thus, they are a result of division of labor. Since offshoring and nearshoring are cases of specialization across vast distances, transaction costs can be expected to make up a major part of total costs.

The measurement of transaction costs, though, is problematic. On the one hand, no uniform terminology exists; on the other hand, production and transaction costs are recorded collectively making it impossible to determine transaction cost separately.²² Therefore, only qualitative statements can be made about the changes in transaction costs which vary with the organizational solutions of offshoring and nearshoring.²³ Henceforth, transaction costs are divided into coordination and motivation costs.²⁴ Coordination costs arise ex ante as well as ex post and have mostly to do with information procurement. Motivation costs arise only ex post when examining the contractual relationship and are caused by information asymmetries between the principal (outsourcer) and the agent (provider).

3.1 Coordination costs

Coordination costs consist of search and information costs, negotiation and agreement costs, surveillance and implementation costs as well as termination costs.

Search and information costs arise when searching for a suitable partner. They can occur in direct form as expenses or indirectly in the establishment of organized markets such as trade fairs. Communication costs between potential partners also contribute to this block of costs. Beyond that, information costs arise in connection with tests and quality controls. Particularly in the case of services, a check of the aptitude of the provider concerned is indispensable for

²⁰ See N.A. (2003a) as well as FLECKER/KIRSCHHOFER (2003), p. 14. A survey by DELOITTE & TOUCHE (2003) showed that 47 % of the interviewed companies outsource their IT services in order to increase efficiency.

²¹ Williamson's definition of transaction costs is used in this study. For a detailed description of other definitions see WANG (2003) and RICHTER/FURUBOTN (1996), p. 49 et seqq.

²² See BENHAM/BENHAM (2001) and RICHTER/FURUBOTN (1996), p. 56 et seqq. Various studies aim to estimate the transaction sector of whole economies. See WALLIS/NORTH (1986) for the US economy and DOLLERY/LEONG (1998) for the Australian economy.

²³ See AUBERT/PATRY/RIVARD (1998) for a general transaction and agency theoretical analysis of the risk factors of IT outsourcing.

²⁴ See MILGROM/ROBERTS (1992), p. 29 et seqq.

quality control. It is advisable to control for compliance with international quality standards in advance when offshoring IT.²⁵

In the study of MOCZADLO cited above, firms were asked to rate the importance of various possibilities for establishing the first contact with offshore partners. Over half of the respondents regard the private network as very important. Assuming that the private network loosens with increasing distance and hence resorting to other contact media (26.7 % rate fairs, exhibitions and congresses as very important) increases, one can conclude that search costs increase with increasing distance to one's location. Apart from that, by virtue of geographic proximity it is more likely to hold private or business contacts in European countries than in countries outside of Europe. It can therefore be expected that search and information costs when nearshoring are lower than when offshoring.²⁶

It has to be remarked that search and information costs depend on the size of the offshoring company. It is common practice for large companies to offshore projects by tender. After collecting information through a so-called Request for Information, a Request for Proposal is communicated to a group of potential partners.²⁷ The cost savings through such a form of information gathering can however be leveled out through the on-site visits necessary to verify the provider's information.

Negotiation and agreement costs arise in relation to time, receiving legal counsel and when inefficient results occur in the case of information asymmetries. The complexity and the magnitude of the expenses incurred when negotiating a contract depend for the most part on the competition or rather structure of the provider market.

In offshore areas the markets are more advanced compared to those in nearshore locations. INFOSYS, the first provider in the offshore market, has been offering its services since 1981. There are no comparable examples for nearshore areas.²⁸ In the meantime a competitive provider market has established itself offshore and is expanding continuously.²⁹ The competitors individually pursue intensive signaling, for example, by adhering to international quality standards, in order to stay in the market. Information asymmetries are therefore at least on the agent's side low.

Meanwhile standardized contracts (service-level-agreements) have gained broad acceptance. They settle topics such as the transfer of equipment and labor at the beginning of the business relation and contain a performance catalog which codify quality and service standards.³⁰ Negotiation costs can be reduced by applying service-level-agreements. However differences in culture and language can increase the complexity and therefore the costs when negotiating with foreign partners.

²⁵ The standards ISO9000 and CMM are common in the offshoring practice. A analysis of the top 300 providers in India showed that 216 firms have already implemented ISO9000. See KOBAYASHI-HILLARY (2004), p. 194 et seqq. for further details about standard practice among offshore providers.

²⁶ FLECKER/KIRSCHENHOFER (2003), p. 13 show on the basis of a case study that search costs can be reduced when nearshoring. The advantages result out of existing contacts, which can almost compensate higher wage costs compared to those in the offshoring solution.

²⁷ See KOBAYASHI-HILLARY (2004), p. 165 et seqq. for a detailed description of vendor selection in the offshoring practice.

²⁸ See UNIWARE (2003), p. 13.

²⁹ See KOBAYASHI-HILLARY (2004), p. 79 et seqq. for a detailed description of the provider market in India as well as its major players.

³⁰ See THEURL (2003), p. 30.

Weighing up the advantages and disadvantages of offshore markets, it can be concluded that negotiation and agreement costs are similar for both offshore and nearshore markets.

Termination costs arise when ending a contract.³¹ A major part of the costs occur when consulting a legal advisor. The crucial factor in this case is the respective legal system. Presumably, the need to seek out legal advice and information is lower in nearshore rather than in unfamiliar offshore destinations. Moreover, in emerging countries, costs can result from delays caused by bringing conflicts before a court. The key factor of a successful contract is not the contract per se but the context and the cultural framework in which it is being realized.

According to the study by MOCZADLO 69.3 % of the surveyed offshoring companies stated that they are satisfied with the termination options given by their partners. The study does not differentiate however between offshore and nearshore partners.

3.2 Motivation costs

Motivation costs are the sum of monitoring and commitment costs as well as the residual loss. Commitment costs arise on the agent's side and include all efforts to reduce the information asymmetry between the agent and the principal. They are however not relevant for this study since the cost analysis is being done from the principal's perspective.

Monitoring costs occur when surveying the performance of the provider/agent in order to prevent opportunistic behavior. In theory, monitoring costs when outsourcing IT services through internet and intranet applications should be the same irrespective of geographical distance, since quality and performance can be controlled online at any time.³² According to the study by MOCZADLO however 80.0 % of surveyed offshorers put great importance on personal encounters, so that monitoring costs do increase with spatial distance in reality.³³ Cost increases based on limited time frames should also be taken into account. Monitoring costs are therefore most likely to be higher for offshoring than nearshoring strategies.

Residual loss are prohibitive costs of implementing a perfect contract. Since absolute contracts cannot be realized in reality the agent/provider has an incentive to pursue their own interest, but the the outsourcing firm has the possibility to set up incentives through performance-related benefits.

The firms surveyed in the MOCZADLO study claimed to be satisfied with their offshore/nearshore partners with respect to following criteria: reliability (90.0 %), adherence to agreed milestones (72.0 %), punctuality of delivery (76.0 %), motivation (94.7 %) and devotedness (94.7 %).³⁴ Bonus systems to ensure the adherence to milestones, punctuality and program quality are included in only 7 % of the payment policies. It can therefore be concluded that the residual loss in offshore/nearshore areas does not vary much from the one that may be incurred in Germany, since the demand from German firms to set incentives is very low. As such, a differentiated consideration of changes in residual loss across the different outsourcing strategies is not necessary.

³¹ The ending-date of the offshore contract is known in the majority of cases. 40 % of the contracts with Indian providers are limited to a maximum of 2 years, whereas only 3 % are limited to 10 years and longer. See KOBAYASHI-HILLARY (2004), p. 184.

³² See FLECKER/KIRSCHENHOFER (2003), p. 8.

³³ See FLECKER/KIRSCHENHOFER (2003), p. 14 for a case study to this topic.

³⁴ See MCKINSEY GLOBAL INSTITUTE (2003).

4 Cultural differences as determinants of transaction costs?

In a study about Offshore Resourcing, IBM CONSULTING SERVICES identified differences in culture as the greatest risk.³⁵ The cooperation between offshore partners can fail based merely on divergent corporate cultures and philosophies.³⁶ Different cultural backgrounds can further aggravate the situation.

4.1 Hofstede's Cultural Dimensions

Inefficiencies are frequently a result of cultural problems and the communication problems involved. It is difficult, however, to quantify costs that are based on cultural differences. HOFSTEDE tried to measure differences in culture on the basis of a survey among employees of 50 IBM-subsidiaries worldwide.³⁷ By applying a factor analysis, HOFSTEDE could illustrate 4 dimensions³⁸ (see table 1).

1. The **Power Distance Index (PDI)** reflects the manner of a society when dealing with situations of inequality. The **PDI**-score gives information about powerful and less powerful members of society. Limited dependency or rather interdependency between employee and superior exist in countries which show high PDI scores.
2. The **Individualism Index (IDV)** describes to the importance to pursue individualistic objectives compared to collectivistic aims. Nations with high IDV-scores are characterized through individualistic behavior of its society members.
3. The **Masculinity Index (MAS)** reflects features of a society, which are usually assigned to sexes. A society with high MAS score is characterized by masculine features (e.g. career orientation) whereas low MAS scores are given mostly to societies with feminine aims (e.g. nurturing).
4. The **Uncertainty Avoidance Index (UAI)** can be interpreted as a measure for risk aversion. A score of "0" reflects risk affinity.

	PDI	IDV	MAS	UAI
Germany <i>outsourcing</i>	77	67	66	65
Portugal <i>nearshoring</i>	63	27	31	104
India <i>offshoring</i>	35	48	56	40

Table 1: HOFSTEDE's Cultural Dimensions by
Source: HOFSTEDE (1991)

The results of the HOFSTEDE study do not show the expected culture gap between geographically vast and politically different countries such as Germany and India. Cultural boundaries cannot therefore be put on a level with national borders. On the contrary, the indices show great cultural differences between Germany and Portugal. The suitability of the indices as a measure of cultural differences should therefore be questioned, since the differences between Germany and India could not possible affect the costs to the extent

³⁵ See IBM (2003).

³⁶ See BERGEMANN/SOURISSEAU (2003), STÜDLEIN (1997) and ZIMMER (2001).

³⁷ See HOFSTEDE (1991).

³⁸ The dimensions show only the relative and not the absolute rank of the respective country.

expected. Seen from this angle, HOFSTEDE’s study implies that cultural differences are far more complex than suggested by regional, political or religious differences.

Since the HOFSTEDE dimensions are calculated out of answers mainly concerning internal corporate aspects, it can be concluded that the indices reflect intra-organizational cultural differences. The method with which offshore and nearshore partner handle the complexity of inter-organizational cultural differences is however of greater importance.

With this as the backdrop, the subsequent chapter analyzes the impact on the transaction costs of cultural differences between firms. While the previous chapter dealt with differences in transaction costs between different forms of outsourcing, the following chapter focuses on the drivers of transaction costs, which are especially relevant when transferring “intermediary goods/services”. At such interfaces a confrontation of different cultures is inevitable requiring the (cooperation) management to minimize the transaction costs at these points.³⁹

4.2 Interface related transaction costs

Differences in culture have a great impact on transaction costs at the interfaces where the interaction between the offshorer and nearshorer is intensive and therefore complex. The following chapter tries to analyze the role of culture for transaction costs at the interfaces by using the example offshore/nearshore programming.

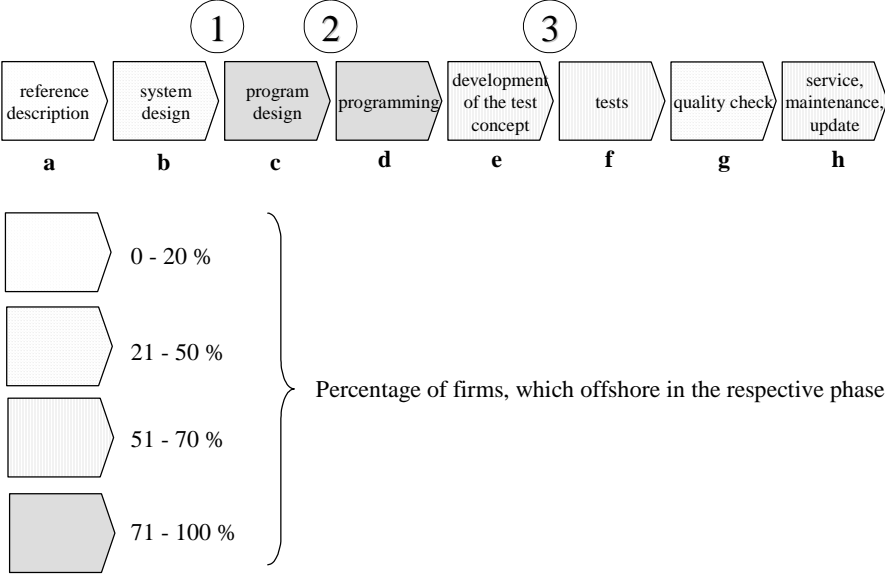


Figure 4: Value-added structure of a programming service
 Source: according to MOCZADLO (2002)

Figure 4 shows a typical value-added structure of a programming service. Each phase can be provided domestically or overseas. Assuming that a company outsources the phases (c) planning and (d) programming overseas, it is evident that differences in culture have a

³⁹ This perception corresponds to the culture-bound hypothesis in context of the culture-comparative management studies. Hereafter, management concepts and instruments are dependant on culture. Different cultural outlets require adapted management behaviour. Contrary perceptions are represented through the universal-approach and the culture-free hypothesis. See PERLITZ (2000), p. 292 et seqq.

decisive impact on transaction costs. Transaction costs, that are high to begin with, can further increase at these interfaces due to differences in culture between the employees involved. The coordination requirements are especially very high at these interfaces, since this is where intermediary services are transferred across corporate as well as national borders. Intra-organizational differences as described by HOFSTEDE are irrelevant at this stage. In whatever manner the phases (c) and (d) are managed by the project team offshore or nearshore is less significant for the overall result of the offshorer or nearshorer. Cultural differences between the project teams, for example, in the phases (a) and (d) are also of lesser importance. The key factors are the cultural differences and especially their correct handling at the interfaces.

The transaction costs depend primarily on the culture or rather cooperation management at the interfaces and only indirectly on overall cultural difference between countries.⁴⁰ It is important that the involved partners are aware of the differences and integrate these adequately. Intercultural problems are frequently the result of the partners presuming similarity concerning their cultures.⁴¹

In their study cited earlier, IBM CONSULTING SERVICES presents the cultural adaptation behavior of Indian employees.⁴² It is evident that Indian employees are open to other cultures and are prepared to adapt to them. It is questionable to what extent European nearshore provider are aware of the great culture differences reflected by the HOFSTEDE dimensions and accommodate these discrepancies in their interface management. In addition, established offshore providers such as Indian inshorers incorporate the previous experience they have amassed in dealing with offshore processes when managing interfaces. As the most established offshore suppliers in the world Indian providers have built up large centers with processes that are standardized and determined by quality norms. The objective of certification standards such as CMM, that most of the Indian software companies have already acquired, is the implementation of balanced and tested communication flows between the principal and agent.⁴³

The magnitude of the transaction costs for offshoring/nearshoring strategies depends not only on the regional distance but also on the experience of the partner in managing cultural differences at interfaces. That is why it is not possible to make a general statement about the advantageous of offshoring or nearshoring concerning costs caused by cultural differences. Various surveys have indeed identified India as the primary offshore destination.⁴⁴ It is therefore possible to evaluate, at least for India, transaction costs that are related to interfaces. Based on the study by IBM CONSULTING SERVICES it can be concluded that the cultural problem does not play a decisive role when offshoring services to India since Indian employees are highly readily adapt to other cultures. Furthermore, a country assessment conducted by MCKINSEY of factors such as government support, pool of labor, infrastructure, education system, cost advantage, quality, cultural affinity and knowledge of English, resulted in higher scores for India than, for instance, Russia.⁴⁵ In summary, Indian providers are able to successfully reduce culture-related transaction costs at interfaces through management experience.

⁴⁰ See UNIWARE (2003), p. 6.

⁴¹ See PERLITZ (2000), p. 297.

⁴² See IBM CONSULTING SERVICES (2003), p. 7.

⁴³ See UNIWARE (2003), p. 16.

⁴⁴ See DELOITTE & TOUCHE (2003), IBM CONSULTING SERVICES (2003) and MOCZADLO (2002).

⁴⁵ See MCKINSEY/NASSCOM (2002).

It has to be remarked that the outsourcing company can in its turn influence the magnitude of the transaction costs by deliberately positioning interfaces. In order to evade communication and information difficulties at critical interfaces, the offshoring/nearshoring firm can, for example, decide to outsource programming services (d), only during the development phase of the test concept (e). Critical interfaces where the probability of the need for communication and information is very high are labeled in figure 4 with the numbers 1, 2 and 3.

The alignment of the interfaces is also of great importance. As mentioned in chapter 1, those processes with close to no client interface are recommended for outsourcing (see figure 5). Transaction costs at internal interfaces can be reduced through appropriate management, whereas direct client contact can be aggravated by cultural differences in the absence of interface management.

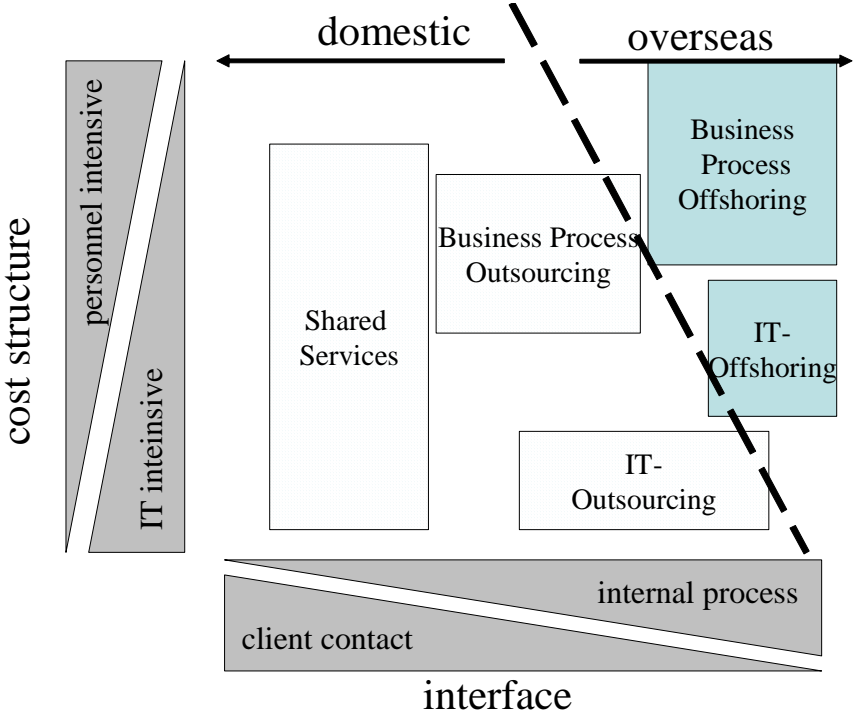


Figure 5: Optimization strategies outsourcing/offshoring of processes
 Source: according to AT KEARNY (2003)

5 Offshoring or nearshoring?






The reduction in wage costs is without doubt significantly greater when offshoring services abroad than when nearshoring. Nevertheless, a conclusive statement about the relation between wage costs and transaction costs cannot be made. Since considerable problems exist in calculating transaction costs, the determination of the weighting of a single transaction cost component presents itself as an even more complex procedure, but is one which is absolutely necessary and meaningful for individual cases. Across the board, it can however be concluded that transaction costs, in principle, are positively correlated with spatial distance.



Furthermore, it has been shown that cultural differences have a significant impact on transaction costs, especially at interfaces across companies as well as national borders. A differentiated consideration of the influence of cultural distance on transaction costs leads to the assumption that transaction costs can be reduced to a much greater degree through targeted culture/cooperation management by an established offshore provider than by a newly founded nearshore provider.

Transaction costs can hence not only be depicted by regional but also by cultural distance. High transaction costs in offshore areas can thus be compensated by appropriate interface management (see table 2). Yet, to be able to judge the effects of the impact from cultural differences, there is still no choice but to estimate the extent of the influence of this indirect determinant on the transaction.

In order to determine the advantageousness of both organizational solutions, information about the composition and weighting of the single cost components are needed. The MCKINSEY GLOBAL INSTITUTE approximates the savings in wage costs at about 45-55 % notwithstanding the additional costs caused by increased demand for communication and by the management of the offshore project.⁴⁶ This result should be viewed with criticism, however, since the individual cost components are difficult to estimate.

A trend to rightshoring – a hybrid of both strategies – can be observed on the part of various boards of management in order to minimize risks and maximize cost savings.⁴⁷ More data from practical experience have to be gathered, however, in order to judge the advantages and disadvantages of these latest outsourcing trends and to give appropriate recommendations for the appropriate decision and organization of these forms of outsourcing.

	offshoring	nearshoring
wage costs		
transaction costs (geographical distance)		
transaction costs (cultural distance)	<i>especially India</i> 	?
transaction costs total	?	?

 = relative lower costs
 = relative higher costs

⁴⁶ See MCKINSEY GLOBAL INSTITUTE (2003).
⁴⁷ See HÖNICKE (2004) and UNIWARE (2003).

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