

## THE DRIVER FOR THE BACKSOURCING PHENOMENON UNDER THE FORCE OF GLOBALIZATION

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### Abstract

Hardly any other development has dominated the economic dynamics of recent years as much as the accelerating internationalization of markets and companies. Globalization has meanwhile gone far beyond economic effects in its development. This results in changes in global, social, economic and political life. It is precisely this complexity that causes ambivalent feelings among people. Thus, regional, national and international globalization advocates and opponents have joined forces to raise awareness of their concerns through the public media. Globalisation definitely is a strong driver for fast strategic business decisions which were taken in the last years. Not always are decisions e.g. related to outsourcing or in general speaking labour costs cutting successful. This results often in a correction of the decisions taken, sometimes in so called backsourcing of production lines or capabilities. The aim of the work is to consider the cross-border shift of economic activities as part of globalization. Therefore, in the following, globalization will be characterised and the reasons for the so called backsourcing of production activities after insufficient results (return of investment) of outsourcing will be commented and illustrated by a case study.

### Keywords

Globalization, Outsourcing, Backsourcing, Organization, Relocation, Costs

### JEL Classification

M14, L10, L19, L20, L21, L22

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### Introduction

The main drivers of globalization since the early 1950s, and especially the 1990s to the present day, can be identified by the factors described in the following text.

A typical feature the globalization is that globalization has been driven by technological innovation. Each of these inventions set new standards for their time. Of particular importance to globalization were those technologies that reduced the costs of overcoming time and distance. Heard in earlier epochs as combustion engine, steamship, telephone and telegraph, the new wave of globalization is characterized by the emerging information and communication technology (ICT). (UNDP 1999)

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"What is different is that globalization in the 19th century, which is mainly due to transport costs, now it is driven by plunging communication costs." (Mokyr, J. 1997)

Thus, the engines of the current globalization epoch according to Mokyr (1997), the greatly reduced communication costs, while the wave of globalization was accelerated at the beginning of the 19th century by falling transport costs. Technological progress led to the development of basic innovations. The diffusion of basic innovations resulted in lower costs for communication (Internet, telephone) and transport (railways, steamboats). (Mokyr, J. 1997) Not only the multiplicity of influencing factors are new here, but also the faster temporal transition from invention to innovation as well as the Schumpeterian "creative destruction" that begins in the diffusion. (4 Footnote: The equilibrium state of an economy is changed by new combinations of factors of production, whereby old economic structures are destroyed and new ones develop.) (Schumpeter 1911) describes this process as "creative destruction." Although some decades of inventions were required for development, the period between the introduction of ICT and its application by 50 million users has been extremely short. For example the radio took 38 years, the personal computer for 16 years and the television for 13 years, the internet only had four years. (UNDP 1999)

The commercial breakthrough of new ICTs on a broad front took place only in the early 1980s and 1990s. Some examples:

- The cost of telephone calls from New York to London fell by 94% between 1980 and 2000. (Masson, P. 2001)
- Prices for computers including peripherals were reduced by approximately 94% between 1980 and 2000. (Masson, P. 2001)
- The number of worldwide Internet connections increased from 0.5 million to 9.5 million between 1990 and 1996. (German Bundestag 2002)
- In 2001, the number of worldwide users was already close to 500 million people. (World Bank 2003)
- Ship and air transport costs and satellite usage fees, however, showed only marginal changes. (World Bank 1995)

For example, technical progress in the ICT manufacturing industry and its application and global diffusion, through network effects, can be seen as defining features of the recent globalization epoch. The associated drop in ICT costs has greatly accelerated international trade in services, notably the exchange of knowledge, know-how and information, described by Baldwin and Martin (1999) as Trade in Ideas. The new technologies have become the central nerve fibres for virtually every kind of globalization activity and have led to a high-speed economy. (Baldwin, R. & Martin, P. 1999).

## 1. Current Approaches/ Scientific context

### 1.1 Background of Outsourcing in European Union

Offshoring and outsourcing of production capacity is being implemented by internationally operating companies in order to operate in international markets, to supply customers directly from their foreign markets and to benefit from cost advantages at the foreign location. The enlargement of the EU by ten states as of May 1, 2004 (As of May 1, 2004, the EU was expanded by the following ten states: Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Malta and Cyprus EUROPA.EU (2017), for example, has already driven this trend during the pre-accession phase, and in recent years outsourcing has also been dictated by the media as an inescapable strategic route that has been followed by countless managers without a sustained assessment of decision-making factors and alternatives. (Kinkel, S. & Maloca, 2008)

In general, it can be observed that companies are mainly relocating labour-intensive activities to low-wage countries. Rather, capital and knowledge-intensive production is left

in the German locations. This applies equally to research and development activities (R & D). (Peters, S. 2006)

The likelihood of outsourcing economic activities abroad increases "the larger the company, the lower the value added of the production and work processes, with a rather moderate product complexity, with standardized and labour-intensive products". In the studies of the Fraunhofer Institute and the Federal Statistical Office, which were carried out on the topics relocation and backsliding in recent years, there is a correlating tenor to the motives of outsourcing.

### **1.2 Characteristic of Backsourcing**

"Yesterday still low-wage country, today no longer pay: Due to rising salaries, the Group will deduct its sports shoe production from the Middle Kingdom." (FTD.DE 2008). Like or similar to a press release from the Financial Times Deutschland in July 2008 following the announcement by Adidas of the repatriation of shoe production from China or its withdrawal into new emerging markets, the headlines of the German daily press are. According to Adidas Group CEO Hainer, it is being examined whether to relocate to Laos, Vietnam or Cambodia before Germany could be considered as an alternative production location. For example, according to valid conditions of the production factors in Germany, a sports shoe would have to cost approximately 500, - €, according to Hainer's, if it were manufactured in the home market. (FTD.DE 2008)

Such backsourcing to Germany are location decisions of companies that are made up of an interdependence of two consecutive relocations and can be distinguished into three sequential periods: the relocation phase, which involves outsourcing in a broader sense, the production phase, when it involves outsourcing of production capacity and the backsourcing. (Schulte, A. 2002) This shows that backsourcing always has to be discussed in the context of outsourcing. The temporal course and the processes of the location decisions thus become an essential object of investigation.

Location decisions on the phenomenon of backsourcing entail a close network of relationships between domestic and foreign locations. Likewise, in co-operations without capital interlinking, for example in strategic alliances such as the Lufthansa Star Alliance, location decisions are linked to the establishment of close network or network relationships as well as the exchange of company resources such as personnel, operating resources and knowledge. So relocation does not just mean ending a pure market transaction with foreign external business partners. (Schulte, A. 2002)

## **2. Research objectives and methodology**

### **2.1 Driver and Motives of Backsourcing**

The author will give an overview about the most important driver for Backsourcing of abroad production. This will be based on literature research and more than 10 years of leading international consulting project experience in terms of outsourcing, shared services and organisational design.

The motives for outsourcing and backsourcing can change over time. The relocation of production in 2003 was more marked by a mix of motivations for outsourcing or backsourcing than in the 1990s. It is also possible to deduce from the increase in significance of individual relocation reasons which motives have gained in importance. (Kinkel, S. & Lay, G. 2005) According to the study by Kinkel and Lay (2005), 4.4% of all companies between 2001 and 2004 accounted for 4.4% of the core manufacturing industries 2003 parts of their production from abroad brought back to Germany. (Kinkel, S. & Lay, G. 2005)

The production location Germany at least seems still "quite alive", this results from a study of the Fraunhofer Institute for system and innovation research (FIS) in Karlsruhe. Statistically speaking just under 15% of the returnees did not outsource in the four to five years prior to back sourcing. Thus, it is indisputable that back sourcing is used as a short-term opportunity to correct severe strategic management errors. (Kinkel, S. & Maloca, S. 2008.) At present, practice reports are increasing, reporting on the relocation of numerous medium-sized companies to Germany. These include u. a. the company Steiff, which due to irreparable quality defects retrieves its outsourced production capacity from China to Germany. (SPIEGEL.DE (2008). The appreciation of Germany as a production location has clearly increased in recent months and with it the position of relocation in the location decisions. In particular, purely cost-motivated reasons for relocation have recently been increasingly questioned. (Kinkel, S. & Maloca, S. 2008)

## **2.2 Assessment of the Drivers and Motivation to the Phenomenon of Backsourcing**

The research based on motives for outsourcing and back sourcing can change over time. The relocation of production in 2003 was marked by a mix of motivations for outsourcing or back sourcing than in the 1990s. It is also possible to deduce from the increase in significance of individual relocation reasons which motives have gained in importance. (Kinkel, S. & Lay, G. 2005) According to the study by Kinkel and Lay (2005), 4.4% of all companies between 2001 and 2004 accounted for 4.4% of the core manufacturing industries 2003 parts of their production from abroad brought back to Germany. (Kinkel, S. & Lay, G. 2005)

### 2.2.1 Insufficient Assurance of Flexibility and Deliverability

One of the most frequently cited reason for complications in outsourcing projects, which may eventually lead to a relocation is the lack of flexibility to deliver abroad. The distance to the customers is counterproductive. If the finished parts need to be returned to final assembly or delivery to customers in the home country, in some cases short-term delivery bottlenecks is possible. As it turned out, the global players often underestimate the not inconsiderable processing costs with foreign suppliers. (Kinkel, S. & Lay, G. 2005) Bittermann, H.-J. (2007)

### 2.2.2 Lack of Compliance within Quality Standards and Risk Management

For example, about 60% of the respondents coined this decision to relocate; due to the poorer quality, costs for quality assurance, quality assurance and quality control of foreign locations were incurred. This is due to the fact that a new location requires a certain amount of learning until it produces in the usual production quality and productivity. This is often underestimated in terms of time and calculated in an imprecise way. (Kinkel, S. & Maloca, S. 2008)

Risk management needs to be part of any decision making process, to achieve the corporate objectives. Key role of risk management is to show uncertainties with their nature and on the other hand uncertainties. Uncertainties especially about the enhancement of different opportunities, about achieving defined targets with appropriate performance. But, it does not embed certainties of events which have already produced measurable effects. (Mateescu et al., 2015)

The role of process interactions management is also important factor for relocation. This can be shown by identifying and analyzing certain risk categories at each junction between two or more processes e.g. hierarchically (vertically) and at a chain processes level (horizontally). Managers consider that critical data and information can be located at the interface between processes. When production activities are outsourced to another country this can increase risks to perform aligned along key processes. This is depending on the value of the information managed at the process junction. While process interactions add no

value to the business, it is the linked processes landscape over all regions where the companies produces, that bring the value to the business. (Mateescu et al., 2014)

By constantly analyzing all impacted and impacting factors, risk management can make predictions and foresees possible any changes from within the organization, the economic and political climate. This makes it easier for the organization to adapt to change and makes it less vulnerable to negative events and would support to now backsource any production activities. (Heinemann et al., 2017) and (Mateescu et al., 2017)

### 2.2.3 Underestimated Coordination and Communication Costs

In approximately 29% of the companies, the reasons for the relocation are the coordination and communication costs. In this case, overhead costs, which include the coordination and communication of processes, are often underestimated, or the savings resulting from wage savings abroad are overstated. As a result, in some low-wage countries, the alleged cost benefits of increased coordination and communication weaknesses are reversed. (Kinkel, S. & Lay, G. 2005), (Bittermann, H.-J. 2007).

Furthermore, the costs of care and coordination, which are provided by domestic locations, often underestimated. Coordination ties up employee capacities in Germany and thus increases their capacity utilization, which can lead to additional costs in the form of overtime or additional employees. This can also affect domestic business if employees can no longer provide their required service as a result of overcharging. According to Kinkel and Zanker 2007, the care costs in the start-up phase amount to about 10% of the total costs. (Kinkel, S. & Zanker, C. 2007)

### 2.2.4 Underestimated Development of Cost and Cost Dynamic of Production Factors

Thus, the cause of this motive may be lower expected personnel, capital, material or manufacturing costs. They can either have increased so much in the course of their stay abroad due to incalculable events, so that the overall cost situation is comparatively worse than that of a production at the home location. On the other hand, a cost component of the production factors may have risen to such an extent that the cost advantages from other factors of production no longer prevail, and thus the entire cost situation becomes in the worst case deficit. (Project experience Lange, S. 2018)

Labor costs are to be differentiated for different qualification groups on site. The productivity of the employees is crucial for the pros and cons of a location. The prospect of slowly rising wages compared to the home location can be an advantage, even if the wages under status quo viewing are approximately equal in the comparison alternatives. Thus, the alternative is awarded on the condition that their wages are less dynamic. (Project experience Lange, S. 2018)

The number of available working days and holidays or public holidays in the country, the length and flexibility of local staff working hours should be thoroughly examined. Qualitative research shows that companies have insufficiently integrated future expectations regarding cost and price developments at the foreign location into their relocation calculus. Thus, it may happen that originally beneficial outsourcing over time, due to the change in propriety due to different dynamic development of global locations, no longer proves superior in comparison to the German place of origin. (Kinkel, S. 2004)

### 2.2.5 Lack of Availability of Key Capabilities, Governance, Organization Structure

Since the operating personnel available at the foreign site cannot exercise managerial functions from the outset, but should be sufficiently trained and trained, the increased training costs of the workforce and skilled workers for the transitional phase at the new location is a not inconsiderable cost driver. For example, the companies require highly

qualified personnel, among others, to carry out innovative, flexible and high-quality manufacturing processes. (Kinkel, S. & Zanker, C. 2007)

A well-defined corporate governance over all countries where the company operates (produces) needs not only be defined, it needs to be implemented, adopted, reviewed and frequently there should be changes on the structure aligned with the strategy and vision of the company. Future research activities will be focusing as well in the corporate governance connected with the international risk management and will be integrated into all management processes. (Lange et al., 2017)

Most of the organizational structures nowadays and even for the close future beside the functional, geographical, product customer segment and channel structure more related to flexible models as team based or project based organizational structures. In the past the structure at the production country was not always much aligned with the headquarter structure, that caused problems in transparency, decision making and inefficiency and caused Backsourcing. Because most of the time the company needs resources and capabilities of cross functions and countries to work on specific topics internally as well as externally for their clients. (Lange et al., 2016)

### **Conclusions**

In summary, it should be noted that in the creation of relocations, cost advantages of a large number of returnees were overestimated and thus risks such as quality and flexibility components were tended to be underestimated. Before being relocated, companies are forced to seek solutions locally. For relocations due to capacity expansions or market entry strategies, backsliding is less. Under these motives, the majority of companies outsource their entire products and not just isolated production steps.

Legal and political stability in the target region form the basis for considering well-placed outsourcing as a strategic option. The logistical situation to production plants, warehouses, suppliers, customers and forwarding agencies are also decisive. For future market perspectives and, for example, the enlargement of the EU member states, it is often important whether the potential future location of the prospective member states makes it easy to identify and what the expected growth potential in the related sector is.

Production sites, such as Bangalore, India, which was once considered a "tech-earth", were able to meet the growing needs of fast foreign investment, especially in the field of infrastructure and property prices, as well as increasing staff turnover coupled with rapidly rising payrolls. Lack of qualified professionals, cannot cope. For example, investors from the BRIC site increasingly renounced their activities and are currently going strong to South Africa, one of the new emerging markets, which attracts even lower wage rates and generally lower production factor costs than the BRIC countries.

Investment grants and subsidies can greatly influence location decisions. For example, this strategy enhances the region of East Germany as an investment location. Tax advantages in terms of trade tax, property tax and the taxation of corporate profits are interesting for corporate policy. Furthermore, it must be ensured that highly automated production with very good process reliability is possible. In order to avoid temporal and coordinative disadvantages in terms of the link between production and R & D, an immediate spatial proximity between R & D and production can be advantageous.

The corporate governance of an international acting company needs not only be defined, it needs to be implemented, adopted, reviewed very frequently and if necessary after the review there should be major changes on the structure aligned with the overall corporate strategy, mission and vision. (Lange et al., 2017)

Future research activities will be focusing more in the corporate governance well connected with the risk management and integrated into all management processes, this will be better linked. (Zäh, F. et al. 2005)

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