

Emergence of Research Off-Shoring to Eastern Europe


CRISIL YOUNG THOUGHT LEADER SERIES

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Word Count (Excluding Headings and Appendix and Tables):2489



Many large KPO firms are setting up delivery centres in various countries in Eastern Europe. The paper analyses why many firms are doing so, what are the kind of services they are providing from that location, what are the pros and cons of the strategy, and what is the recommendation for the future for these firms.

Profile of Author

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Executive Summary

The global knowledge process outsourcing market is currently worth around **US \$4.4 billion**, and it is growing by around **39%** each year, to reach **US \$16.7 billion** in revenue in 2010-11. India, China, South East Asian economies have been the mainstay for most companies looking to offshore their knowledge operations out of the home country. However, an important and recent development in offshoring is the emergence of diverse new locations such as countries of Eastern Europe supplying the massive growth in demand for offshoring. This paper examines the trend of **Nearshoring** and the **advantages of Eastern Europe** as compared to traditionally popular locations such as India. The reasons for the same are analyzed under three main heads: financial attractiveness, people and skills availability and business environment. Two main threads run through all the companies which off shored in the Knowledge processing domain: the captive model has been used and the work offshored has been mainly low end commoditized work.

This paper also studies how the shift of Knowledge Process Outsourcing to these new locations in the near future will be **driven by factors** such as increasing expenditure spend by Western Europe on Outsourcing, Consolidation of new service models, Shift to global service offshoring models and Skill shortage in Western countries. However, **certain pitfalls remaining** in the way of companies offshoring; namely lack of scale of existing players, regulatory concerns in labour laws and weak institutions and absence of favourable policies.

Given the fact that in the near future, India shall continue to retain its place as the most favourable place for a KPO operation, **my recommendation is that companies should use a “Hub and Spoke” Model** for their operations, in which a provider in India may constitute the “Centre” and other units around the world such as Eastern Europe may provide the appropriate “Spokes.”In conclusion, **suggestions are given to companies** willing to shift their knowledge operations there: to look beyond the traditional cities where wages are rising fast towards new locations; to offshore services having a greater communication component there as well as to shift certain sector specific activities such as finance and law there owing to similar regulatory laws and practices.

Introduction

The global knowledge process outsourcing market is currently worth around **US \$4.4 billion**, and it is growing by around **39%** each year, to reach **US \$16.7 billion** in revenue in 2010-11. The rapid growth is a result of the increasing pressure on businesses to cut costs through consolidation and wage arbitrage as well as the severe shortage of skilled workers that is starting to hit the more developed countries. India, China, South East Asian economies have been the mainstay for most companies looking to offshore their operations out of the home country. However, an important and recent development in offshoring is the emergence of diverse new locations such as countries of Eastern Europe supplying the massive growth in demand for offshoring. This paper examines how Knowledge Process Outsourcing in the near future will be driven by factors such as breadth and depth of coverage, domain expertise, location advantage (e.g., near-shoring and language capabilities), sales and marketing capabilities, data compliance with respect to regulatory standards (especially those defined by the United States, Canada and the European Union) and the management of business risks.

Emergence of Nearshoring

Types of Offshoring

On the basis of location, Offshoring operations are usually divided into

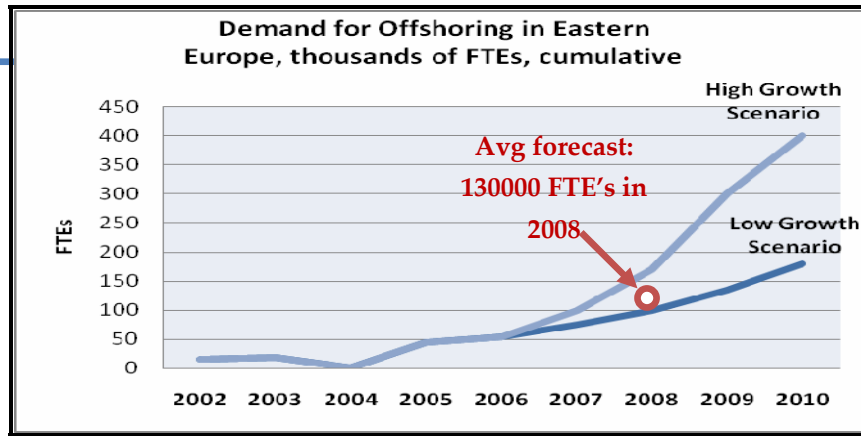
- **Farshore**, those that are distant from the markets they serve. These include countries like India and China
- **Nearshore**, those that are closer. Eastern Europe being closer to the offshoring countries fall into the latter.

Growth of Nearshoring ¹

FIGURE 1

¹ Offshoring and its close cousin Nearshoring are relative terms. North American corporations refer to the transfer of work to Caribbean countries as nearshoring. Western European companies use that term for the transfer of work to Eastern Europe.

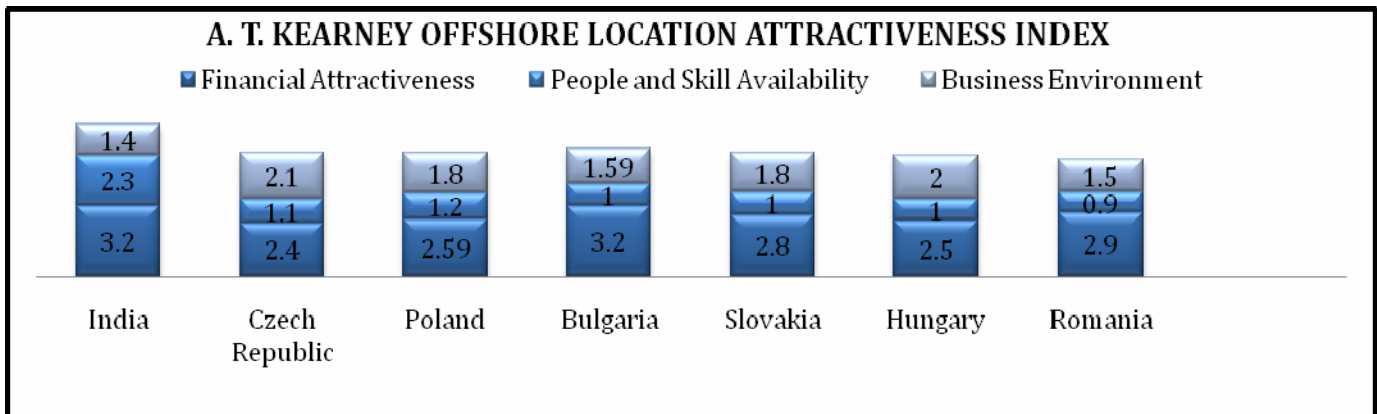
Emergence of Research Off-Shoring to Eastern Europe



Source: Mc Kinsey Global Institute Analysis. FTEs is full time equivalents

The figure above elucidates the fast offshoring growth in Eastern Europe². This fact is also reflected in the high ranks of these countries in the **AT Kearney Offshore Location Attractiveness Index 2007**³. The ratings are given below and depict that though India beats the Eastern European countries overall, they are catching up in terms of business environment and financial attractiveness.

FIGURE 2



Source: AT Kearney. The weight distribution for the three categories is 40:30:30 meaning that financial structure is rated on a scale of 1 to 4, and that business environment and people on the scale of 1 to 3

Type of Research Work being Offshored to Eastern Europe

The table below shows the entire gamut of activities the KPO industry.

TYPICAL KPO ACTIVITIES

Computing & Related Activities	R & D	Other Business Activities
<ul style="list-style-type: none"> • Hardware Consultancy • Software Consultancy & supply • Data Processing • Database activities 	<ul style="list-style-type: none"> • Research & Experimental Development in natural sciences and engineering • Research & Experimental Development in social sciences and humanities • Pharma R & D, Medical Services • Engineering R & D 	<ul style="list-style-type: none"> • Legal Activities • Accounting & finance • Market research • Technical Testing and Analysis

² Refer to Suj

by D

³ This index rates countries against 43 measurements across three major categories: financial attractiveness, people and skills availability, and business environment.

Type of Offshoring Centres

Most service centers in Eastern Europe today are so-called **captives**—they are owned by the companies sending them work. Some examples of companies that have moved their offshoring services to Eastern Europe include

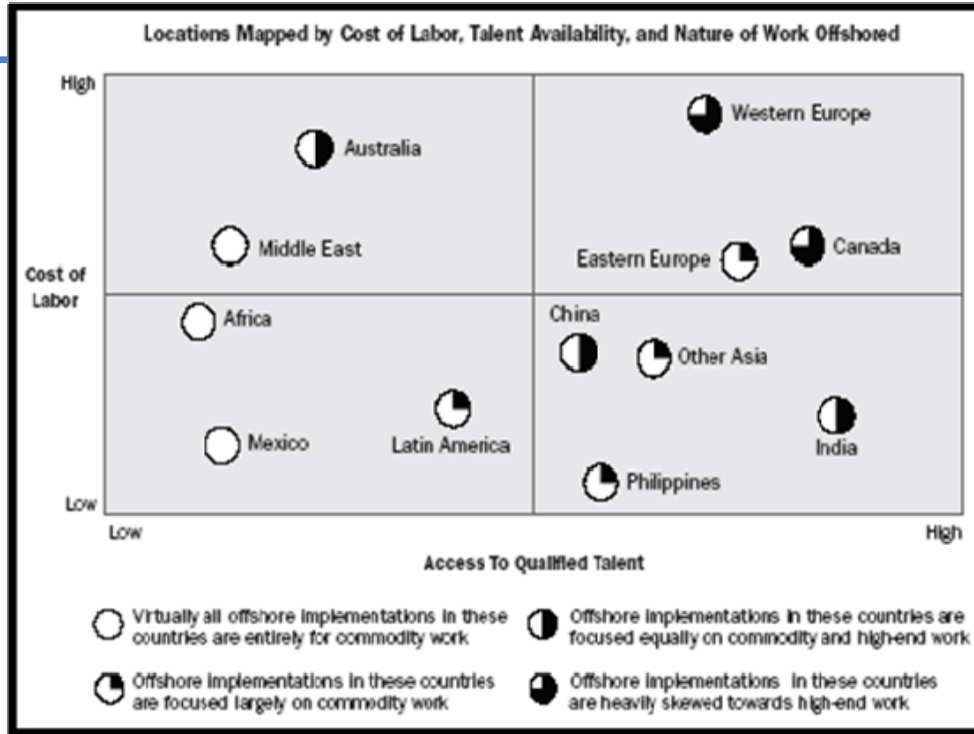
- Leading global services supplier, Accenture, has a finance and accounting outsourcing center in Prague.
- In Lodz, Philips opened a services center with capacity for human resources management, purchasing, finances and accounting for all European operations.
- Financial major CitiBank employs 300 people in a settlement center in Olsztyn, North of Warsaw, processing transactions for Poland, the Czech Republic and Slovakia.

Independent Eastern European providers of knowledge process services have a significant opportunity, but with few exceptions—Ericpol Telecom in Poland, for example—these companies are not on the map compared with better known global and Indian players, some of which are setting up their own centers in Eastern Europe. Thus lack of well known companies providing offshoring services is proving to be a deterrent for the growth of this industry.

Type of Offshoring Work

With regard to Eastern Europe, what can be seen is that most of the work offshored now is typically “**commodity work**”, that is work which is of basic knowledge level and does not require high specialization such as engineering R & D, software product development, basic accounting and payroll services and data analytics. The high end work, such as Legal Services, Medical Services, Equity research, Pharma R & D, writing and content development, animation and market research are primarily moving to India

FIGURE 3



Source: AT Kearney. The weight distribution for the three categories is 40:30:30 meaning that financial structure is rated on a scale of 1 to 4, and that business environment and people on the scale of 1 to 3

Reasons for Movement of Research Offshoring to Eastern Europe

Most Eastern European countries have achieved impressive development since the fall of the Iron Curtain. Macroeconomic stabilization, robust growth and a rising standard of living are the fruits of a largely successful transition process; and are factors behind their emergence as offshore power

FIGURE 4: REASONS FOR EMERGENCE OF KPOs IN EASTERN EUROPE & COMPARISON WITH INDIA

Category	Sub Category	Metrics	India	Eastern Europe
FINANCIAL ATTRACTIVENESS	Compensation Costs	Average Wages	Low	High
		Median Compensation Costs for relevant positions	Low	High
	Infrastructure Costs	Rental Costs	High	Low
		Commercial electricity Rates	High	Low
		International telecom costs	High	Low
	Tax and Regulatory Costs	Travel to major customer destinations	High	Low
		Relative tax burden	Low	Varies
Corruption Perception		High	Low	
		Currency Appreciation or Depreciation	High	Low
PEOPLE SKILLS & AVAILABILITY	Remote Services Sector	Size of existing offshoring sector	Big	Small
		Contact Center and IT Center quality certifications	High	Low
		Quality Ratings of management schools and	High	Low

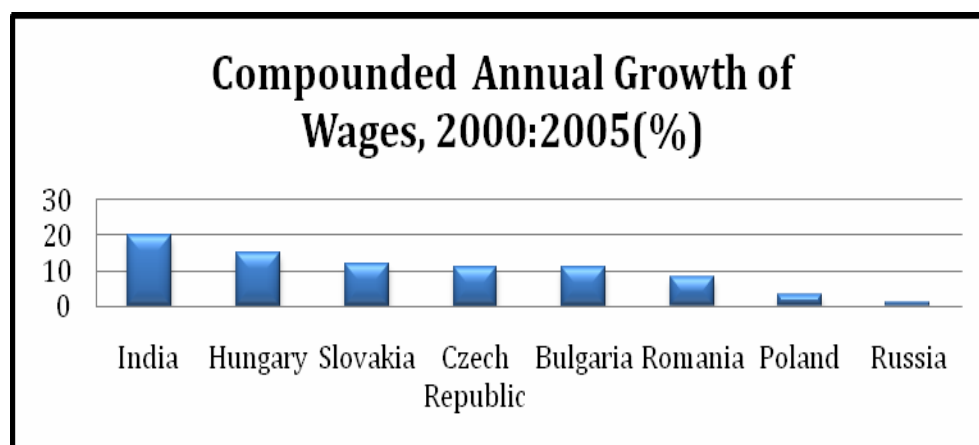
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		Training		
	Labour Force availability	Total Work Force	Large	Small
		University Educated workforce	Low	High
		Workforce flexibility	Low	High
	Education and Language	Scores on standardized education and language test	Low	High
	Attrition Risk	Relative KPO Sector growth and unemployment rates	High	Low
BUSINESS ENVIRONMENT	Country Environment	Overall business and political environment	High	Low
		FDI confidence Index	High	Low
		Security Risk	High	Low
		Regulatory Burden	Low	High
		Government support for the ICT Sector	High	Low
	Infrastructure Costs	Overall Infrastructure Quality	Low	High
		Quality of Telecom, internet and electricity infrastructure	Low	High
	Cultural Exposure	Cultural affinity	Low	High
	Intellectual Property (IP)	Ratings of IP protection and IP laws	Low	High
		Software piracy rates	High	Low
Information Security Certifications		Low	High	

Financial Attractiveness

Labour Costs: Producing knowledge services is labour intensive, which is why wages and non-wage labour costs are important. Though Eastern Europe is comparatively more expensive than India and China, the newly emerging offshoring countries can still be tapped at lower wage rates. An engineer can be hired for USD 3.50 per hour in China or USD 2.40⁴ per hour in India, whereas in Romania the corresponding wage is around USD 2.60 per hour and in Bulgaria USD 1.40 per hour. Also, rate of wage growth is much lower than the former, contributing to most of the shift.

FIGURE 5



Source: LABORSTA, McKinsey analysis. Wages are in euros

⁴ Hourly wages as published in Business Week on December 19, 2005. Comparing wages internationally is difficult as the individual characteristics of employees and regional differences can lead to major fluctuations. These are rough figures for indicative purposes.

Taxes and Tariffs: This issue needs to be considered and accounted for in the formation of any offshore relationship to outsource, as it has a major bearing on costs involved. There is some concern that the Indian governments will end the special tax incentives, since the industry has now grown from a fledgling one in the 1990s when it needed support to a world leader now. This is likely to favour the Eastern European countries, with conducive tax policies for offshoring.

Trade Agreements: The expansion of the European Union (EU) has united 27 European countries into a true single market with freedom of movement for goods, services, capital, and labor. Thus the EU makes it easier and more cost effective for buyers from Western Europe, with growing demand to offshore locally.

Technical & Administrative Support: In order to support operations at an offshoring center, technical and administrative support and client visits is required. In this context, considerations for travel requirements are also factored into offshoring considerations. For example, it is much quicker and more economical to send an engineer from the United States to a centre in Europe than it is to send the same engineer to China.

Contract cost: Offshoring conditions and requirements between the buyer and the seller for a specific service are laid down in a *Service Level Agreement* (SLA), and it is imperative that they are fulfilled. A measure of how long it takes and how much it costs for the legal enforcement of a pecuniary claim in the case of a dispute is relevant in this context. In India this can cost over 40% of the outstanding amount and in China over 20% whereas in Hungary and Czech Republic, the costs are lower at less than 10%. This again favours Europe as a potential offshoring destination.

Business Environment

Intellectual Property: IP laws throughout Asia are not stringent, to the point that many buyers worry that design ideas or product patents might end up in the hands of their competitors. This is an extremely important consideration for buyers considering low-cost country offshoring options in industries such as medical and health care where development costs are high and technology is cutting edge. This problem however is not faced in Eastern Europe to a large extent.

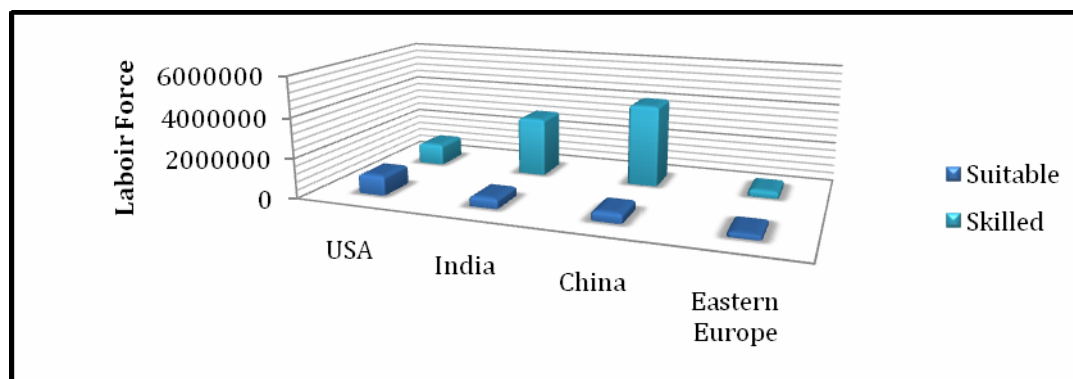
Political Risks: There are obviously some political risks inherent with offshoring in other countries, and generally buyers feel more comfortable with governments in their own region than they do with governments located halfway around the world. This augurs well for Eastern Europe, with increasing demand from Western Europe for offshoring.

Infrastructure: Eastern Europe Countries enjoy a better developed infrastructure in terms of office space, roads, power, telecommunications, internet accessibility etc. This proves to be a major long term advantage.

People & Skills Availability

High Standard of Education: The supply of not only cheap, but also well-trained labour is a key determinant of the appeal of a location. Most Eastern European countries can boast competitive educational systems⁵, in line with the US and the UK. India and China, in spite of having a large skilled population of engineers, mathematicians, statisticians and physicists needed for KPO industry have a very small proportion of suitable candidates with adequate knowledge. On the other hand countries like Czech, Hungary and Poland have a higher proportion of suitable candidates, motivating countries to shift their research centers there.

FIGURE 6: SKILLED Vs SUITABLE CANDIDATES



Source: McKinsey Global Institute, 2005. Supply of skilled people include engineers, mathematicians, statisticians, lawyers, accountants, physicists

Cultural Proximity: Eastern European countries have close geographical and cultural ties with the markets of Western World. Three reasons in this regard are relevant

- **Personal contact:** Complex problems are best solved face to face. Nearshoring locations are closer to the client, which makes visiting each other easier.
- **Common language:** Nearshoring locations often have personnel that are proficient in the language of their client – even though their official languages may differ.
- **Cultural understanding:** Language skills and knowledge of the culture and customs represent the prerequisites for efficient communication. In most cases nearshore personnel have a better knowledge and understanding of the cultural background of their clients than their counterparts in offshore locations. This allows easier, more implicit communication as misinterpretations occur less frequently.

Drivers for Nearshoring

⁵ Refer Graph in Appendix on Competitive Education system

Strong Demand from European Companies

Over the past decade, the drive towards offshoring was mainly by United States and UK based companies. Now the strongest new demand is coming from Western Europe⁶ such as German⁷, French and Nordic companies who are looking to gain the cost and efficiency benefits enjoyed by their Anglo-Saxon competitors, but are far less comfortable moving whole swathes of their business to a far-off, English speaking location like India. They want to see services in their own languages (French, Spanish etc) and tend to demand a higher degree of cultural fit, especially in customer-facing knowledge intensive activities. They also like geographical proximity and similar time zones. At the same time, the new members of the European Union— particularly the Czech Republic, Hungary, Poland, and Slovakia—can offer average labor cost savings of 40 to 60 percent over costs in Western Europe, while cities in EU candidate and non-EU countries can offer cost advantages of 60 to 80 percent.

Consolidation of new, more complex functions

The second driver of nearshoring growth is the push on the part of those companies that have already enjoyed the benefits of offshoring in areas like business processing to shift new activities into pooled competence centres with research and development, business analysis and knowledge management. As the shared-services and outsourcing business starts to embrace more complex and customer-facing services, it requires precisely the kind of advantages that only Nearshoring operations can offer.

The Shift to a Global Service Model

The third driver of the nearshoring boom is the shift of mature shared-service centres in large international companies towards a global service delivery model i.e. creating a portfolio of service centres around the world that meet diverse business needs, working around the clock across all time zones, and taking advantage of a wide range of languages, skills and costs. These companies are not selecting nearshore over farshore locations per se. They are optimizing what international companies like to call their “global footprint” by creating a support structure for international business operations, based on making the most of a global pool of labour.

Potential Pitfalls for Companies looking to Offshore

Lack of Scale

Eastern European knowledge services providers, at their current scale, are having difficulty keeping up with the high growth they are generating. Since there is lack of any big player in the industry in Europe, companies are reluctant to offshore their critical work.

⁶ Refer Graph on Western Europe Outsourcing Expenditure Growth in Appendix

⁷ Refer to Demand Side Responses in Survey Conducted by DB Research and BITKOM In Appendix

Regulations and inconsistencies in labor laws

This is complicating expansion beyond national borders—expansion that is a necessary precursor to gaining scale comparable to that of the global providers.

Weak institutions

Macroeconomic and institutional factors also play a part in the choice of region to offshore. The quality of a country's institutions is clearly correlated to its level of economic development and since typical offshore locations such as Eastern Europe are mostly poorer countries, allowances thus have to be made on the institutional side. Most countries do not have a proper policy in place for promoting research offshoring, proving to be a disadvantage.

Future Recommendations: The Hub and Spoke Model

All companies need to factor in the pros and cons⁸ before deciding on whether to Nearshore or Offshore. To make effective choices, companies can use the decision matrix⁹ given below. More & more, the result of such analysis is leading companies to conclude that offshoring to Eastern Europe deserves a closer look.

FIGURE 5: DECISION MATRIX: OFFSHORING VS NEARSHORING

⁸ See SWOT Analysis in Appendix for summary

⁹ This matrix was first used by Ariba for Offshore Sourcing of Goods and then modified by BCG to be applied to Offshoring of Services

Hub and Spoke Model

However, given that India’s strengths in this segment cannot be ignored, **My Recommendation is that companies should use the Hub and Spoke Model¹⁰**. This implies that companies should, both those with their own captives and those that use third-party vendors, use India as the “Centre” and other units around the world such as Eastern Europe should provide the appropriate “Spokes” for the company. It is also popularly known as

Decision Question	Nearshoring	Offshoring
Is labour a significant contributor of the total cost of the service?	Labour constitutes less than 25 percent of the overall service cost	Labour constitutes more than 50 percent of the overall service cost
Are there Intellectual Property concerns?	Processes and Information offer a competitive advantage and IP is a primary concern	Processes and Information are mature and IP is not a primary concern
How important is seamless communication? Are there some specialized language requirements?	Communication is regular and vital to the operation. Home country language is preferable.	Regular communication is not vital, it is more through internet rather than voice; English is preferred language
What are the technical and organizational support requirements?	Support Requirements are extensive, and resources generally come from corporation’s home region	Support Requirements are not extensive or corporation has a global infrastructure to handle offshoring support.
Is cultural proximity of any significance in the work to be Offshored?	Yes. For example, Market Research and trend analysis would be more relevant if compiled in a country with similar culture	No. For example: Engineering R & D testing would be similarly done across the world
What is the type of offshoring centre to be set up: captive or offshoring services company?	Captive services are more popular and easy to set up. Lack of big established KPO players.	Work to be given to specialized KPO player. Several companies to choose from.

Multisourcing and uses multiple offshore suppliers to reduce the power that a single monopoly supplier and location might have to help companies achieve the advantages of a best-of-breed strategy.

This shall enable companies to have centres with different risk profiles by taking into account the reliability of infrastructure, political stability, and the possibility that talent might emigrate, be enticed by competitors, or prove less capable than anticipated; while enjoying the benefits of both the locations. Citibank and American Express both have used multisourcing approaches that resemble a classic hub-and-spoke model: They have offshore operations mainly in India, as well as three or four partners with whom they collaborate in other countries. This is an interesting model because the businesses actually get some of their offshore partners to work with them in their own hub centers, then they train them, and send their offshore partners back to the spoke center.

¹⁰ **Hub and spoke model:** An organization’s practice of having offshore operations of its own, as well as three or four partners with whom it collaborates. This mitigates the risk of having all services provided by a single service provider. Coined by Offshore Outsourcing, Dec. 14, 2005

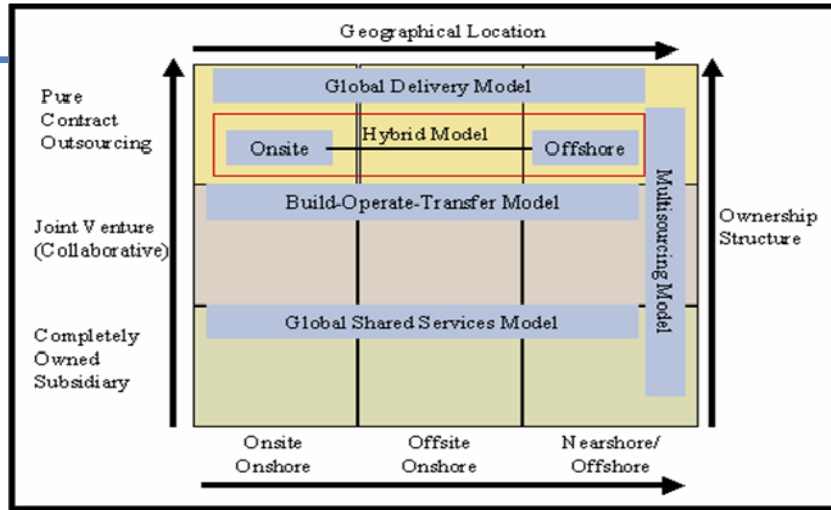


FIGURE 6: AVAILABLE OFFSHORING OPTIONS FOR COMPANIES

Source: Stenttman Hoffman

Recommendations for Companies Offshoring to Eastern Europe

1. Move beyond popular locations

Companies should look beyond the first-wave locations (such as Bratislava, Budapest, Kraków, and Prague), where wages for experienced workers are rising faster than inflation and explore midsize cities with little or no offshoring activity but large talent pools, where the labor cost advantage is more likely to remain attractive for the next decade. Beyond the well-known capitals, Eastern Europe has 40 to 50 provincial cities with universities large enough to supply a highly skilled labor force, along with cultural environments that lend themselves to the creation of suitable clusters of employers for university graduates. This wealth of options can help companies reduce their labor costs and spread potential risks across a portfolio of locations

FIGURE 7: Selected Eastern European cities, with Universities by tier

Offshoring locations by tier		Number of suitable graduates	Total number of offshoring locations by tier
Tier 1: Capitals, offshoring centers	Budapest, Hungary	7,900	8
	Prague, Czech Republic	3,700	
Tier 2: Existing demand, as yet no overheating	Łódź, Poland	5,700	20
	Brno, Czech Republic	2,800	
	Varna, Bulgaria	2,100	
Tier 3: Undiscovered locations (limited existing demand)	Katowice, Poland	7,400	35
	Iasi, Romania	3,100	
	Yekaterinburg (Sverdlovsk), Russia	3,000	
	Szeged, Hungary	1,700	
	Košice, Slovakia	900	
	Plovdiv, Bulgaria	700	

Source: McKinsey Analysis

2. Importance of comm

Eastern European companies strengths are precisely in those areas where communication between the purchaser and provider of outsourcing services is particularly important. Each company has to decide for itself how important it considers communication. It is to be expected that companies desire intensive communication with

their clients regarding complex, innovative or creative processes. A nearshoring location like Eastern Europe should be utilized as the intensity of the communication desired by the client increases.

3. Nearshore in case of “Special Sectors”

A number of legal, regulatory and professional liability issues prevent delocalisation within a number of subsectors, for example, in the legal and accounting sector. In fields like these, Eastern Europe should be preferred over India where accounting standards and laws are completely different.

Appendix

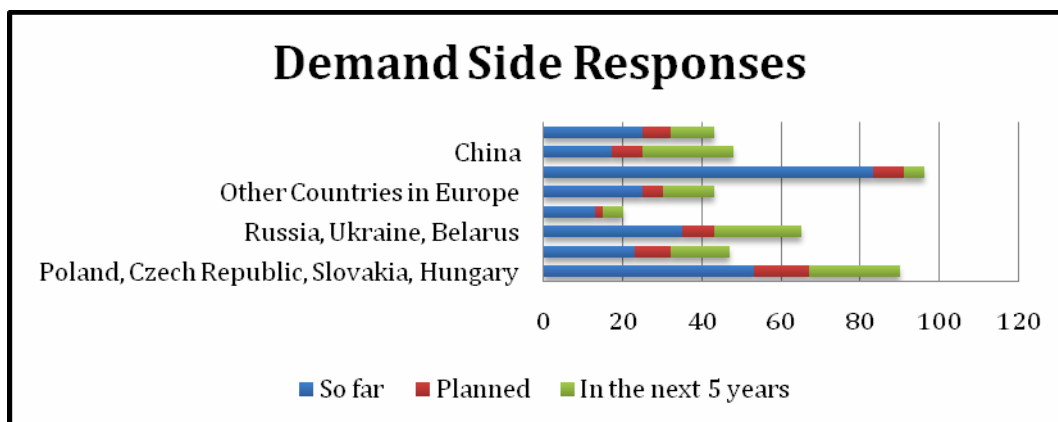
Primary Research conducted by Deutsche Bank

Joint survey conducted by BITKOM and DB Research in 2007

BITKOM and Deutsche Bank Research conducted a joint survey of companies providing or purchasing offshoring services. 572 completed questionnaires were analysed – 267 from providers and 305 from buyers of offshore services. The response rate came to about 10%. The survey focuses on Germany. Thanks to the support of Bitkom's partner association, SwissICT (www.swissict.ch), 38 providers and 65 purchasers from Switzerland also participated in the survey. 17 foreign providers that focus on the German market also took part (1 from Austria, 4 from Bulgaria, 1 from the Czech Republic, 2 from Lithuania, 1 from the Philippines, 1 from Poland, 1 from China, 2 from Romania and 4 from Russia). On the demand side 21.3% came from Switzerland and 1.3% from Austria. The majority of purchasers – 77.4% – came from Germany.

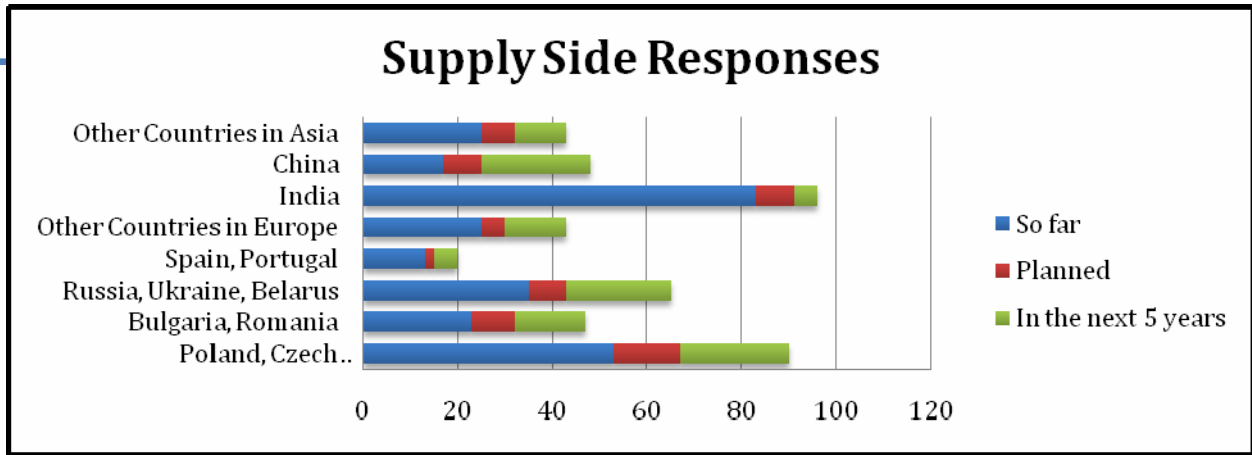
Demand Side

India is the most important location for offshoring at present, but Eastern Europe continues to narrow the gap. Especially the customers of German and Swiss providers have a greater interest in near-shore partners, i.e. their neighbours to the east in Poland, the Czech Republic, Slovakia and Hungary. These countries are expected to see the strongest growth going forward.



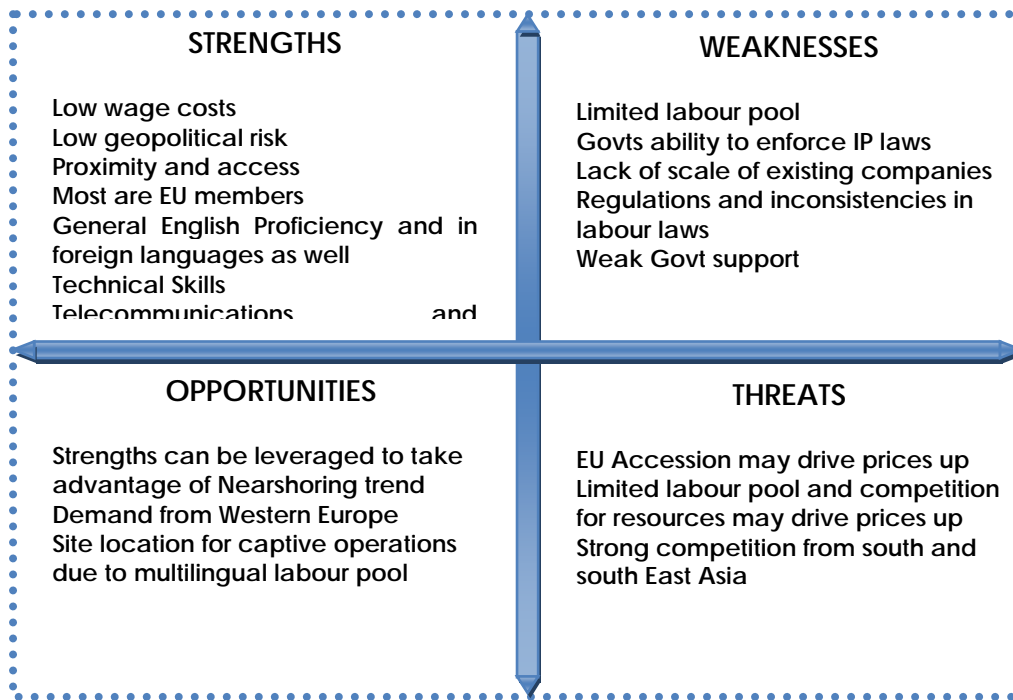
Supply Side

The providers themselves continue to put their money on India. But even they say that the strongest growth in the next 5 years is likely to be seen in the neighboring countries of central and Eastern Europe. China appears to be an increasingly attractive location, as well. Interest in the western European countries with relatively low wage levels (Ireland, Spain and Portugal) is comparatively moderate.



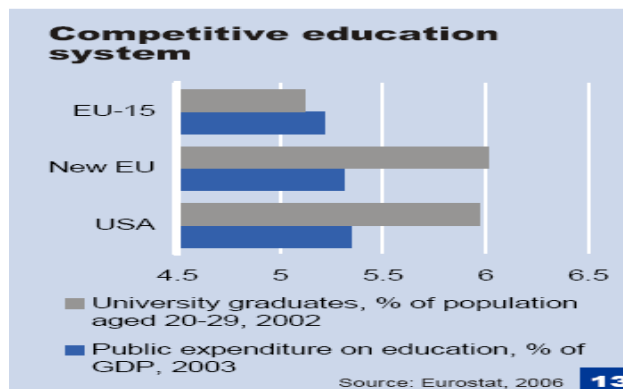
The survey reflects the strong growth in offshoring to Eastern European Countries in the near future.

SWOT Analysis of Eastern Europe

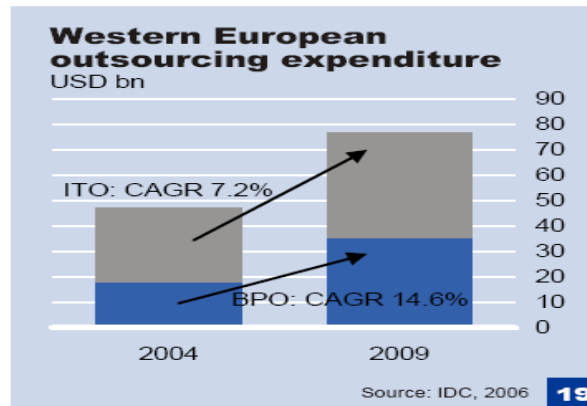


Competitive Education system

Here New EU refers to the Eastern European countries which have recently joined.



Rise in Outsourcing Expenditure by Western Europe



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