Attractiveness of South Africa and the Visegrad Countries as Business Service Off Shore Locations

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Abstract

The scale of off shoring business services and the increased number of receiver countries indicates a new structural development in the global economy. New offshore destinations, such as Visegrad countries and South Africa are becoming regional leaders in attracting business service investments. This article focuses first on the theoretical framework of the business services off shoring, second it considers trends in the growth of off shoring services in Visegrad countries and South Africa and discusses the reasons for their emergence as receiver countries. The location determinants of the Visegrad region are analysed based on 30 interviews in the biggest business service investments. Consequently, the performance of South Africa is evaluated against the identified location factors. The attractiveness of the Visegrad region is apparently based on location advantages like availability of skilled labour, low costs, favourable business and stable political environment, well developed infrastructure and geographical and cultural proximity to Western Europe. South Africa is facing issues related mainly to availability of skills, cost and quality of infrastructure and crime.

Keywords: South Africa, Visegrad, Off Shoring

1. Introduction

The stock of global foreign direct investment (FDI) has been permanently shifting away from manufacturing towards the service sector being accompanied by explosion of relocating a range of business associated services to what are regarded as low-cost locations. The position of the traditional offshore locations has been threatened in recent years by the emergence of new off shoring destinations. The Visegrad countries (V4- Czech Republic, Hungary, Poland and Slovakia) and South Africa (SA) rank next to each other in global service location indexes. They both went through a political transformation in the last two decades and are now regional leaders in attracting service off shoring projects. This new developments beg a set of questions regarding the main patterns and specificities of the services being relocated and the motives of companies relocating services to these countries.

This article focuses first on the theoretical framework of the business services off shoring. Second, the article considers trends in the growth of off shoring business services in V4 and SA and discusses the reasons for their emergence as receiver countries. The location determinants of the V4 countries are analysed based on empirical material drawn from 30 interviews conducted between September 2007 and September 2009 with senior managers in the biggest business service foreign investments in the four Visegrad countries[1]. Based on the criteria identified by the managers as crucial in off shoring decision process, the performance of South Africa is evaluated.

2. Theoretical framework

There are two basic motives driving foreign direct investment. The first motive for a company to invest abroad is to gain access to foreign market, which is referred to as horizontal investment (market seeking investment). In this case the company sets up a foreign plant in addition to its home plant (basically by duplicating its activities) in order to serve the foreign market, to gain access to customers, get closer to competition, or simply to overcome trade barriers. (Barba-Navaretti&Venables, 2004) The second motive is to gain access to inputs that are either scarce, more expensive or of lower quality in the home country than in the host country, which is referred to as vertical investment (resource seeking investment). In such case the company splits and relocates its activities by function (international fragmentation of the value chain), often to countries that are not target markets. This search for cheaper, better or more abundant inputs is also referred to as off shoring. When a company decides to invest abroad, it is primarily motivated to do so either by host country market, or by host country resources, seldom by both.

This basic division of foreign direct investments can be well observed also in the service sector (Caves, 2007). Market seeking investors establish a subsidiary in the host country to provide services for the local market and are usually attracted by specific market attributes. Resource seeking investors within the services sector are a relatively new phenomenon, resulting from the technological development, which made the fragmentation of the service sector functions possible (Coe, 1997; Jacobides, 2005) and from the ongoing liberalization of trade in services (UNCTAD, 2004). Mainly motivated by availability and low cost of qualified labour, these companies are off shoring[2] only particular service functions to the host country – usually administration (back office functions), finance, human resources, payroll services, logistics (middle- corporate functions), content development (knowledge services and R&D) and customer care. Such investments take place within both service and manufacturing sectors. Shared service centres (SSC) deal with the back, middle- corporate office functions and content development and support subsidiaries of the company abroad. Contact centres on the other hand deal with “front office” - customer facing - activities and serve the customers within a particular region, or globally.

3. Business service off shoring in V4 countries and South Africa

The scale of off shoring business services, the increased number of receiver countries and the expansion in the nature of functions that can be delinked and relocated signal a new structural development in the global economy (Levy, 2005). Although countries like India or Ireland have been established as receiver countries for the last three decades (White, 2004; Dossani & Kenney, 2007), a wider range of potential regions and countries is now considered. Both Central and Eastern Europe

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[1] For the full project report please see the Fifekova, M. (2010) Business Service Foreign Direct Investment in Central and Eastern Europe

[2]Offshoring is not to synonymous with outsourcing. Offshoring means the relocation of activities across national borders, where it may be provided by a subsidiary - captive offshoring - or outsourced to an external provider- offshore outsourcing. Outsourcing involves subcontracting the activities to a third party, which may or may not involve some degree of offshoring.

(CEE)[3]and South Africa are relatively new on the off shoring map. Following the end of communism in CEE and the end of apartheid in South Africa, these countries have been undergoing a remarkable transformation and in recent years are becoming increasingly popular destinations for foreign investors seeking to expand into new markets or to gain access to cheaper resources. V4 countries are viewed as geographically strategic low-cost near-shore locations for European business process off shoring (BPO) projects and South Africa is becoming the most favoured offshore contact centre location in the world, pushing India into second place in terms of call-handling quality, technological infrastructure and linguistic capabilities(Ion Group, 2005).

While from the 1990s onwardsV4 countries attracted mainly market-oriented horizontal investors as they offered huge unsaturated markets and improved economic and political environment, after 2000 the composition of the FDI flows started to change in line with the international trends in off shoring and outsourcing and the amount of business service investments started increasing. The picture is similar for SA, which saw especially its call-centre industry evolving rapidly over the past ten years.

The first business service FDI projects in the V4 region involved mainly back-office functions (finance, invoicing), which are less complicated. In the next stage, front office activities were transferred to the region and the process has been continuing with more value added and skill-intensive activities in recent years, seeing also R&D and knowledge services being offshore. SA attracts mainly front office activities focusing on inbound customer service (90% of all offshore service jobs) with outsourced processes including also after-sales services, data capture and conversion, accounting, human resource functions, and website design and development (Nakra, 2011).On the back-office side, the work delivered might be complex, but majority of activities offshored to SA can be considered relatively low skilled and there is no clear indication that the situation would be changing rapidly.

The growing importance of business service off shoring can be observed also through the increasing exports of services (as the motive of the investor is primarily to take advantage of local resource and not to serve the local market).V4 countries saw exports in services growing significantly since 2002.The growth rate of business service exports was most dynamic (around 20% on average after 2002). The majority of the V4 exports in services are directed towards the EU market (around 70%), which suggests that centres are providing services mainly for their customers or subsidiaries within Europe. Business service off shoring led to increased exports in services also in SA. We can see that while the service exports are growing steadily in all the countries, the dynamics of growth is changing in recent years with SA and Slovakia starting to lag behind the remaining economies.

3 Within the CEE region, Russia and the V4 countries are the main service FDI destinations.

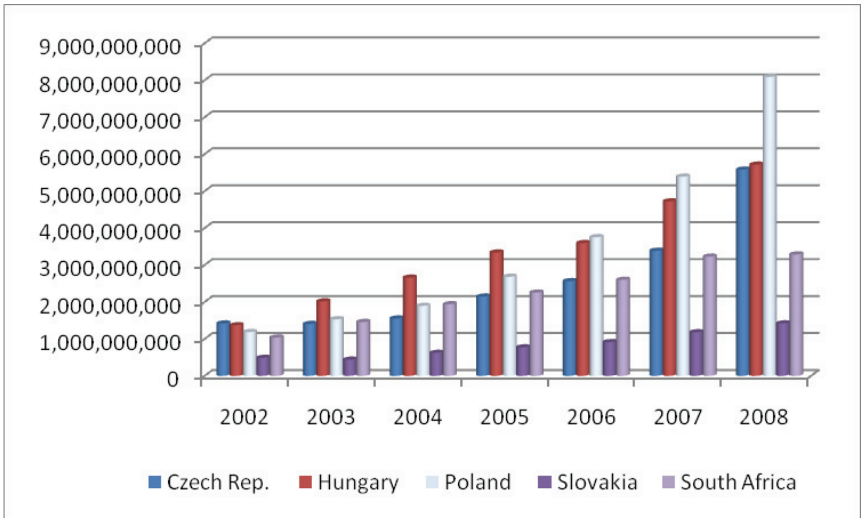

Figure 1 Export of Other Business Services from V4 countries and South Africa, in $US

Source: http://unstats.un.org
~ the data for South Africa are available only till 2008
~other business services include three sub-components: research and development services, professional and management consulting services and technical, trade-related and other business services (which include call centres)

Even though the above countries have already attracted a remarkable amount of BPO projects (offshore BPO industry in SA is growing at more than 30-40% each year (BPeSA, 2012)) and see their business service exports increasing, their share in the global flows of this type of investments is very low. However, these countries show a growing potential and might attract the bulk of European companies which started later with relocation of service activities. It is therefore crucial to understand the main factors influencing the location decision of the investors. The following section discusses the reasons for the selection of V4 countries (based on the 30 interviews) and compares the location advantages offered by V4 countries to those offered by SA.

4. Location Advantages of theV4 Region and South Africa

Availability and cost of qualified labour

The availability and cost of educated and skilled labour was stated by all the interviewed companies as one of the most influential factors in their decision to invest in the V4 countries. While the cost of labour was mentioned in 60% of the interviews, all the companies were concerned with the availability of qualified workforce skilled in information technology or other technical fields and languages (English and another European language was usually required). In addition, some companies required excellent communication and interpersonal skills, but subject matter expertise in areas such as accounting or HRM was not that important.

V4 countries are considered to have a "knowledge advantage" compared with other lower priced countries in terms of the knowledge of "smaller" languages and a good supply of university graduates in the required fields (Guzik & Micek, 2008). The interviewed shared centres stated that their employees are usually able to cover around 20–25 languages within the centre, which means, that they can speak to the majority of European customers in their mother tongue.

South Africa offers 345,000 English speaking graduates each year, which is attractive especially for customer facing investments from UK, Australia and USA. In addition to English, contact centres also offer services in Dutch, German, French, Italian, Portuguese and Spanish for the European market (Tradeinvest SA, 2012).Availability of workforce does not seem to be an issue either with 70% of population being aged 30 or younger and unemployment climbing to 24% (Off shoring South Africa, 2012). The problem, however, is shortage of skills. Investment into Western Cape have been greater than expected and leading managers of call centres report that availability of skills is their biggest challenge (Kananu, 2007). Government quotas on employment equality set against the continued imbalance in educational attainment, make it sometimes hard for a contact centre to recruit the right staff. In comparison to V4 countries, SA is lagging far behind both in primary and higher education (Global Competitiveness Index, 2012). Majority of activities off shored are therefore low skilled and take advantage of the language only. Another problem is also the cost of labour. South Africa cannot match locations such as India on costs. The costs are more comparable to countries like V4, which means that SA will need to offer greater quality.

Other costs

30% of the companies saw other costs as one of the relevant factors, which made V4 countries attractive. This related particularly to the costs of infrastructure, office space, operating costs and taxes.SA offers relatively cheap and available office space, but taxes are higher than in the CEE countries (which are gradually adopting a flat tax between 16-20%).

Strategic location

Geographical location was identified as considerably influential with 40% of companies preferring a location which has a strategic position within the region and good accessibility to potential customers. V4 countries have the advantage of being in the centre of the CEE region, close to Western Europe and other Middle East and African countries; therefore offer a variety of local languages and a strategic location to serve a relatively large market. Being close to customers, the home country of the investor, other company centres and business metropolises was cited as important by 50% of the companies. Further some companies had a specific requirement to be within a time zone that would enable them to serve other than EMEA region and provide 24/7 support to their customers. Cultural proximity to the markets served was cited explicitly as important by only one company.

South Africa benefits from the time zone similarities and strong cultural ties with both the US and the European Union (especially UK). It also serves as a gateway to the whole African continent (service hub for operations in Sub-Saharan region), but its location is not very favourable considering the proximity to other developed markets or home countries of the investor.

Quality of infrastructure

The quality of infrastructure, especially information and communication infrastructure (telecommunication, power networks or fast internet connection) was cited as important by 50%of the companies. The quality and availability of infrastructure was seen as being far more important than its cost.

South Africa saw significant structural improvements to the transport, energy and telecommunication sectors resulting in increased capacity and reduction in prices, even though telecommunication costs remain a serious challenge. The quality of infrastructure according to the Global Competitiveness Report (2012) is comparable to other peer group countries, but not adequate (AT. Kearney, 2011; WB, 2010).Especially power shortages are one of the most common concerns of managers (WB, 2010).

Political and business environment

The importance of the political and economic environment was mentioned by 50% of the interviewed managers. This included political stability, progressive governments, tax and social reforms, membership of NATO and good macroeconomic conditions. The regulatory environment of V4 countries is viewed as favourable, the rule of law is regarded as relatively strong and EU-membership is often quoted as the main reason behind a clear increase in the attention paid to V4 countries.

South Africa has the most stable and best regulated business environment in the region and offers political and socioeconomic stability. According to the World Bank's Doing Business study (2011), it is easier to set up or close a business in South Africa than in most peer group countries (all the V4 countries have worse rankings than SA).On the other hand, even though FIFA 2010 world cup strengthened country's reputation, SA is still considered a riskier location for FDIs than many of its comparators. Among the factors feeding this view is the perception that crime is more prevalent in South Africa than other emerging market economies (WB, 2010).One third of managers, who responded to the 2008 Enterprise Survey regarded crime as a major obstacle to business growth in SA.

Government incentives

Investment incentives are considered to be of crucial importance in attracting foreign investors. In the interviewed sample, however, incentives had little or no impact on the location decision. None of the firms attached much importance to incentives, although companies did not hesitate to use them when offered.

South Africa introduced in 2007 a rather generous Government Assistance and Support (GAS) programme to support the BPO sector. Such provision of government incentives should be treated with caution in case companies do not take it into consideration when making their location decision.

In the Nelson Hall report (2011), similar location factors to those in V4 were identified by 13 companies that off shored business services to South Africa. Most valued location advantages were availability of workforce, quality of services, language skills, cultural affinity and time zone, which can therefore be considered the strengths SA could build on.

All these findings are in line with the A.T. Kearney`s Global Services Location Index, which ranks top 50 countries worldwide against 41 measurements in three major categories: cost, people skills and availability and business environment, based on their relative attractiveness as offshore locations. In 2005 South Africa ranked 32, in 2009 it was 39 and in 2011 SA ranked 45 (Poland 24, Hungary 31, Czech Republic 35 and Slovakia 40). Its position reflects weaker scores on education, infrastructure and country environment, which are the same problems as identified above. Deteriorating infrastructure was also the main reason behind the drop in 2009 rankings. In other criteria SA achieves similar scores as the other V4 countries. The position of the V4 countries is worsening as well due to increasing costs.

5. Conclusion

Business service off shoring has experienced a substantial growth over the last two decades across the globe and both the V4 region and South Africa are becoming the regional leaders in attracting these investments. The attractiveness of the V4 region is apparently based on a small number of factors, like availability of skilled labour with strong language skills, low costs, favourable business and stable political environment, well developed infrastructure and geographical and cultural proximity to Western Europe. Although the labour costs are much higher than in many Asian countries, all the above mentioned factors have significant influence on the overall costs and make the V4 an attractive offshore location. It could be concluded that service investments are driven by the foreign investor's desire to gain access to skills and business environment comparable to home country conditions, while capturing some of the cost advantages. Services, particularly those associated with businesses, often depend on knowledge and information, so the skill level of the available workforce is likely to be the principal differentiating factor among locations.

These are important conclusions also for South Africa, which is facing problems in several crucial location factors identified by the investors. SA should adopt specific policies to increase its competitiveness and improve the factors that are pulling it back, such as availability of skills, cost and quality of infrastructure and crime, otherwise it will miss the investment boom resulting from the increase of vertical service investments. Attention should be given mainly to the sophisticated, high value-added service FDI projects which are believed to drive the development of the knowledge-based economy. SA could for example capitalize on its high ranking in financial services by attracting more finance related back office projects, rather than call centres, which is the area of current focus. The fact that companies value language fluency, cultural proximity and time zone similarities means that South Africa needs to target mainly Western Europe as the initial source of business.

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