An Anglo-German Foundation Report

High-Tech Business Services and Innovation in Germany and the UK: The Case of IT Outsourcing

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Executive Summary

In the last three decades, advanced capitalist countries have experienced an expansion in the service economy. Yet it is those service activities that are said to be technological- or knowledge-intensive which are claimed to bring the maximum benefits for economic growth, innovation and productivity. Examples include management consultancy services, software and computer services, legal and accountancy services, engineering services and research and development services. These high-tech business services are said to add value and specialised knowledge to the production processes in manufacturing firms and to improve the quality (and specification) of services delivery in the public and private service sectors.

While many organisations have developed such activities in-house, recent years have witnessed a trend of externalisation in which organisations have chosen to outsource to an external, specialist supplier. The prospects for, and implications of, high-tech business services thus require knowledge of the interactions and interlinkages between the client organisation, on the one hand, and the supplier of business services, on the other. In Germany, there is potential for conflict between the short-term nature of these client–supplier linkages and the slow, incremental changes characteristic of its national system of innovation. In the UK, the issue is that increasingly fragmented chains of contracting may obscure lines of accountability, erode trust and weaken the positive spin-offs from business services firms.

This study reports on these issues through investigating the case of IT outsourcing in Germany and the UK. In both countries, the rapidly growing IT outsourcing market is an important driver underpinning growth in the computer services sector. Thirteen examples of large IT outsourcing contracts were selected (6 in Germany, 7 in the UK), ranging in value from €25 million to more than €5,000 million. In each case, interviews were conducted with managers in the IT firm and in the client organisation.

The cases examined cannot be characterised as simple market transactions. In both Germany and the UK, the IT outsourcing agreements involved a complex mix of formalised contracts, informal trusting relations and, crucially, the transfer of IT staff (from the client to the IT supplier). Client organisation managers generally expected IT outsourcing to enhance performance and innovation – through economies of scale, production efficiencies and access to specialised knowledge. However, quite unexpectedly, managing this process demanded a great deal of management input (from both client and supplier) and client investment in retaining relevant expertise.

Both sides to the different outsourcing contracts believed a trusting, partnership approach could foster mutual gains. However, the evidence reveals several areas of tension caused by conflicting goals of the client and supplier organisations; examples include conflict between a focus on unit cost service provision versus the freedom to upgrade systems, or between standardisation of additional services versus customisation to fit in with the client's business needs. These conflicts called into question the sustainability of management efforts to deliver innovation. In addition, the practice of recurrent contracting raised the risk that neither client nor supplier would take responsibility for investment in skills among IT workers.

Against these general patterns, the data demonstrate significant differences between Germany and the UK in the implications of the expanding IT outsourcing market. In Germany, externalisation of IT is more likely to follow a transitional route in the form of a joint venture with an IT supplier than an immediate outsourcing arrangement, as tends to be the case in the UK. Comparison of joint ventures with other cases suggests that the stronger degree of ownership integration between client and supplier enabled client managers to retain control over the externalisation process and afforded a degree of stability for those IT workers required to transfer employers.

An additional difference is that managers in Germany, compared to those in the UK, appeared to benefit from a deeper embeddedness in institutionalised norms of technical standards and technical skill. This means that managers on both sides of the outsourcing agreement were in a stronger position to negotiate contracts. In particular, the tendency for client organisations in Germany to be 'smarter' than their counterparts in the UK meant that they were able to exploit the market incentives of multi-supplier contracts, to manage proficiently the contract for base-line services provision, and to design contracts for additional services to fit with the broader business strategy. In contrast, client organisations in the UK tended to rely solely on trusting, 'partnership' relations (reflecting problems of low technical knowledge among managers), which were associated with a relatively high risk of conflict and opportunistic behaviour.

Major restructuring among firms across a range of sectors suggests that there is nothing inevitable about the continued trend of IT outsourcing. Indeed, some commentators suggest that the age of the 'mega-deal' is over; among our cases, one client did reverse its policy and took IT back in-house. Nevertheless, the market continues to grow and our research data suggest several areas in which policy can make a positive contribution to exploiting the productivity- and innovation-enhancing capacities of IT outsourcing.

Those charged with innovation policy in the UK can learn lessons from Germany regarding the way stronger trade associations and more clearly defined technical standards contribute to a more stable and co-operative contractual agreement between client and supplier.

In the realm of employment, employer associations and trade unions in both countries need to address the issue of how to reproduce IT skills in a context of uncertain, short-term contracting for services provision. As might be expected, industrial relations were more stable in Germany, compared to the UK, and this contributed to more co-operative outsourcing arrangements. As such, the UK, with its near absent voice mechanisms for IT staff, ought to develop proper channels for information and consultation, following the model of Works Councils in Germany.

Finally, trends towards concentration among IT suppliers suggest there is an increasing risk of client organisations becoming locked into a large outsourcing deal with a single supplier. Policy action is thus required in both countries to improve client organisations' capacity to exploit multi-supplier contracting arrangements and, possibly, to support more small-scale arrangements (such as local joint ventures).

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Notes to the editor:

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