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OUTSOURCING AND LABOR DEMAND STRUCTURE: EVIDENCE OF VIETNAMESE SMALL AND MEDIUM ENTERPRISES

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Keywords:	Outsourcing, labor demand, skilled vs. unskilled labor, small and medium sized enterprises

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OUTSOURCING AND LABOR DEMAND STRUCTURE: EVIDENCE OF VIETNAMESE SMALL AND MEDIUM ENTERPRISES

Abstract:

Purpose - The study investigates the impact of outsourcing on SMEs' labor demand in a developing country like Vietnam. Also, it explores the mediating role of foreign trade experience in shifting toward firms' usage more of the unskilled labor.

Design/methodology/approach - The panel data set of small and medium sized enterprises is used in this study. It was originated from biannual surveys which were conducted by the collaboration between educational organizations and government agencies under DANIDA project in the 2011 – 2015 period. The research models are based on the function of conditional labor demand, which applies the Driscoll-Kraay standard errors to adjust the problem of changing variance and autocorrelation.

Findings – SMEs have acted as contracting out (contractors) or receiving outsourcing contract (contractees). Our results suggest that conducting more outsourcing contracts has increased a demand for unskilled labor for enterprises. In contrast, when they sub-contract to the third party, enterprises have a tendency to diminish unskilled labor in compensating for using more skilled labor, possibly because they keep high-value activities for internal production. Moreover, getting business experience with foreign partners helps decrease unskilled labor intensity of enterprises on the one hand but drive the impact of outsourcing towards the labor adjustment of contractors of using more unskilled labor on the other hand.

Originality - Although outsourcing has been widely applied by large firms, the research studying its impact on labor demand at small and medium sized enterprise level in a developing is limited. Especially, this study can shed light on the mediating role of foreign trade experience and provide an evidence of the specialization theory.

Keywords - *Outsourcing, labor demand, skilled vs. unskilled labor, small and medium sized enterprises (SMEs)*

JEL: D24, J23, L24

Paper type - Research paper

1. Introduction

In recent years, globalization has been activated firms focus on their competences and outsource part of the production and business to the third parties. In the industry 4.0 era, technology has also eliminated geographical barriers for contracting in and out thanks to faster reduction in transaction cost than in production cost. How to get the work accomplished and the components needed right away, intermediate products and finished products can be delivered faster and cheaper. Enterprises have found that an advantage in moving towards lower wages and cheaper materials available in other companies or in other countries while maintaining production expertise requires a skilled workforce as before (Lonsda and Cox, 2000). Lei and Hitt (1995) define outsourcing as the reliance of the firm on resources and components from external for the firms' value-added. In another study of Matejun (2010), outsourcing is a perception of management in which enterprises use a potential external partner to fulfill the limited resources of the business with a wide range of contemporary management or temporary contract. This concept, due to its immanent resource shortages, was usually applied in the context of small and medium-sized enterprises (SMEs). The fact that this zone accounts for 90% of businesses and contribute over 40% to GDP and 80% of job creation plays a crucial role in the economy (World Bank, 2020). As calculated from the Vietnamese General Statistics Office, SMEs, in 2021, accounts for 97% of the total number of enterprises operating in Vietnam, contributing up to 45% to GDP, 31% of total budget revenues and attracts over 5 million employees.

Although outsourcing activities are widely well-known, its origin might be traced back to the late 1970s and early 1980s as a way for enterprises to look for outsourcing to maximize profits of the business (Corbett, 2004). Over few decades, in an extremely competitive business environment, outsourcing applications brings considerable benefits to business such as reducing cost, increasing productivity, improving efficiency, and paying attention to core business activities that help to cut down on human resource costs and improve product quality. There is a tendency attracting researchers to take up study whether or not outsourcing contributes to changing labor demand (Feenstra and Hanson, 1999; Crino, 2009; Winkler, 2010; Andersson et al., 2017; Akay and Savsin, 2022). Most previous studies calculated outsourcing based on imported data whereas not much research has been performed with business data and specific information on outsourcing and concentrated in developed countries. So far, to the best of our knowledge, there has been no research on outsourced labor demand in emerging countries like Vietnam, especially with SMEs.

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3 While existing theoretical and empirical studies have conducted outsourcing as offshoring for the
4 case of developed economies and found out its positive impact on high-skilled labor demand, this
5 study stand on the opposite argument that SMEs keep optimizing their core competence in
6 producing low-value added chain in the national and global economy so the effect will be in
7 contrast to that in developed economy if the Hecksher - Ohlin theory holds. According to the
8 Hecksher – Ohlin’s endowment factor theory, integrating into the global trade will make a
9 developed country specialize in the industries using factor abundant like high-skilled labor while
10 a developing country focus on the different industries using low-skilled labor. Furthermore, we
11 are investigating the different role of an SME in receiving outsourcing as contractees and in
12 contracting out as contractors. Also, firms’ participation in exporting is examined to figure out
13 how its foreign trade experience may keep a mediating role in labor adjustment due to outsourcing.
14 Findings from the study will provide more insights and solutions for emerging market
15 policymakers to help meet labor needs in the increasingly popular outsourcing context.

16 The remaining parts in this paper are well organized as follows: section 2 provides a theoretical
17 basis for the reason why outsourcing affects the labor structure of enterprises; section 3 describes
18 the data and research methodology; sections 4 and 5 briefly discuss research results and
19 conclusions with some policy recommendations.

2. Literature Review

20 An explanation of why enterprises do not produce internally but outsourcing could be answered
21 by three theoretical models: transaction cost theory (TCT), resource dependence theory, and
22 resource-based view (RBV) (Gerbl et al., 2009). *Transaction cost theory (TCT)*, theory of
23 preliminary outsourcing, was set out by Coase (1937) and developed by Williamson (1989). This
24 theory sets out conditions including transaction costs and behavioral assumptions that influence
25 organization's decisions for internal management (within boundaries) or externally (such as
26 outsourcing). Holmes (1986) argues that outsourcing has three functions: First, if enterprises
27 operate in markets with uncertain demand, they can outsource their excess works to meet the
28 increasing demand without investing in high-priced equipment. Second, if the production of
29 specific products requires specialized inputs, they can take advantage of specially qualified
30 contractors. Third, these strategies are all capable of improving the company's revenue (through
31 higher production quantity or quality) and reducing costs (due to contractor efficiency, risk
32 absorption risk, and technology investment). Enterprises continue to compare between transaction

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3 costs and production economies; however, outsourcing decisions of a business depends upon the
4 ability to save transaction costs (Williamson, 1989). The assumption of *resource dependence*
5 *theory* is a motivation for firms to look for opportunities to increase their strength (Pfeffer and
6 Salancik, 1978). Therefore, upon facing the problem of lacking resources and providing additional
7 resources, enterprises greatly attempt to establish a relationship with large business. As a result,
8 they can change their structure and competitive strategy for outsourcing resources (Ulrich and
9 Barney, 1984). This theory recommends economists to outsource their feeble manufacturing
10 activities and follow transparent steps to gain benefits from outsourcing (Teng et al., 1995). The
11 third theory of outsourcing activities, *resource-based view*, complements the transaction cost
12 theory and the resource dependence theory by focusing on resource accumulation. External
13 resources enable enterprises to develop a sustainable competitive advantage which is valuable,
14 difficult to imitate and not replaced in comparison with their internal resources (Arnold, 2000).
15 Outsourcing helps firms address resource constraints by maintaining existing resources and
16 enhancing strategic capabilities (Teng et al, 1995).
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19 The existing literature on the impact of outsourcing on labor demand have relied on treating
20 outsourcing as the integration of firms in global value chain. The impact of an increase in the
21 outsourcing on the labor market has become increasingly concerned in recent years. Traditional
22 trade theories largely explain relative wage movements across industries, the significant decline in
23 wages and employment of unskilled labor in the industries. In the context of this research,
24 outsourcing for an SME could be considered the operating activity into the domestic value chain
25 in production.
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28 Some main theories explaining outsourcing effects in international trade and labor structure are
29 presented (Crinò, 2009). Firstly, outsourcing in terms of offshoring activates skill-biased
30 technological change (SBTC) (Ekholm and Midelfart, 2005). Rising skilled labor is due to SBTC's
31 broadening in intensive skill area while skilled labor decrease is caused by SBTC's expansion in
32 non-specialized areas. In some countries, when skill premia are decreasing, SBTC usually pays
33 attention to non-specialized areas. By contrast, when skill is increasing, SBTC usually focuses on
34 skill-intensive areas (Haskel and Slaughter, 2002). Secondly, it is the trade of intermediate inputs
35 and raw material offsets so outsourcing generates a relative decrease in the demand for unskilled
36 labor (Feenstra and Hanson, 1999). Similarly, Heckscher-Ohlin model in Zhu and Trefler (2005),
37 production transfer from OECD countries to developing countries reduces unskilled labor in
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3 developed countries and increases the demand for unskilled labor in developing countries.
4 Empirical studies have anchored outsourcing in kind of offshoring due to data limitation for firms'
5 outsourcing domestically. They have figured out material offshoring has raised skilled worker
6 share of the wage bill in developed countries (Strauss-Kahn (2004), Hsieh and Woo (2005), Egger
7 and Egger (2005) for France, Hong Kong, and Austria respectively).
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11 In terms of micro-level studies, Görg and Hanley (2004), conducting empirical studies about the
12 effect of international outsourcing on labor demand at the level of the individual plant, used plant-
13 level data for the Irish Electronics Industry, a rapidly developing industry. The result demonstrates
14 a significant reduction in labor demand at plant level in the short term. Winkler (2010) combines
15 the output data during the period 1995-2006 with the data of German manufacturing enterprises to
16 research on outsourcing effects on productivity and labor demand. The results show that
17 outsourcing increases labor productivity in the manufacturing sector but it reduces labor demand
18 in Germany by an average of 0.08% to 0.23% annually. Senses (2006), using data on roughly
19 25,000 US manufacturing firms between 1980 and 1995, found that labor demand for production
20 workers has become substantially more elastic between 1980 and 1992 within outsourcing
21 industries. Andersson et al (2017), using business data for manufacturers in Sweden from 1997 to
22 2002, finds that outsourcing is positively associated with an increase in high-skilled labor demand.
23 The studies that are of interest all conclude that offshoring (often referred to as outsourcing) has
24 contributed to a change in labor demand at a high-skilled level.
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37 In summary, not much research on outsourcing on the impact of labor structure in developing
38 countries has been conducted possibly due to limitation of data availability. Moreover, for
39 empirical studies in Vietnam, with limited knowledge, we have not found similar research which
40 is the comprehensive analysis of outsourcing impact on the labor demand of SMEs.
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44 **3. Data and Research Methodology**

45 This research uses a panel data set of Vietnamese SMEs in the 2011-2015 period, which comes
46 from biannual surveys for nearly 2,500 enterprises in ten provinces in the North (Hanoi, Ha Tay,
47 Hai Phong, and Phu Tho), in the Central (Khanh Hoa, Nghe An, Lam Dong, Quang Nam) and in
48 the South (Long An, Ho Chi Minh). These surveys were conducted by the collaboration of
49 educational organizations and government agencies: Stockholm School of Economics (SSE),
50 Faculty of Economics – University of Copenhagen, Labor Research Institute and Social Affairs
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(ILSSA) in Ministry of Labor, Invalids and Social Affairs (MOLISA). Although many questions were raised to the business respondents, that relevant information which will be used in the research models were selected such as employees' position at work, revenue, capital, research and development cost, import-and-export experience, and outsourcing decision and expenditure for outsourcing.

The research model is applied as below based on previous studies such as Winkler (2010), Andersson et al. (2016), Girma and Görg (2004), and Diaz-Mora (2006). However, outsourcing activity at the firm level data is firstly used in this research thanks to data availability. For the panel data set, the Hausman test shows that the fixed effect method provides more robust result over the random effect method, then the estimates are corrected with Driscoll-Kraay standard errors.

SS_{ijt}

$$= \delta_0 + \delta_1 \ln Productivity_{ijt} + \delta_2 \ln wage_{ijt} + \delta_3 firmsize_{ijt} + \delta_4 \mathbf{outsourc}^*_{ijt} + \delta_5 capitalstructure_{ijt} + \delta_6 R\&D_{ijt} + \delta_7 Foreignexperince_{ijt} + \delta_8 cetificateISO_{ijt} + \delta_9 trainnew_{ijt} + \delta_{10} year_{ijt} + v_{ijt}$$

where,

The dependent variable SS_{ijt}^* is the proportion of unskilled labor to total labor in firm i, industry j and year t (Egger and Egger, 2005). Unskilled labors cover office workers, service workers (cleaners, food servers), and unskilled laborers.

$\mathbf{outsourc}^*_{ijt}$ is separated into two types: (1) $outsourc^1_{ijt}$ is the ratio of outsourcing revenue to total revenue (firms act as contractees to implement an outsource contract), and (2) $outsourc^2_{ijt}$ is the ratio of outsourcing costs to total expenses (firms act as contractors to contract out to the other partners).

All the following variables are for firm i in industry j and year t.

$\ln Productivity_{ijt}$, $\ln wage_{ijt}$, $firmsize_{ijt}$ are measured by logarithms of labor productivity (total revenue/labor), total wages paid to employees (unit:1,000vnd), and total assets respectively.

$R\&D_{ijt}$ is the proportion of research and development expenditure to total investment.

$Foreignexperince_{ijt}$ is the dummy variable, it gets value of 1 if enterprises have export activity; or 0 otherwise.

Lnwage	0.101	-0.2015	1								
Firmsize	0.0537	0.0231	0.5027	1							
Outsource ¹	0.0159	-0.1075	0.0292	0.0347	1						
Outsource ²	-0.0237	-0.0076	-0.0868	-0.0062	0.1624	1					
R&D	-0.0026	-0.0037	0.0612	0.0422	0.0057	-0.0175	1				
Foreignexperience	0.023	0.023	0.1812	0.2822	0.0129	-0.0114	0.0441	1			
certificatISO	0.0106	0.0075	0.1268	0.3201	0.0236	0.0078	0.0652	0.1401	1		
Trainnew	0.02	-0.004	0.1108	0.2061	0.0207	0.0076	0.0556	0.1213	0.2097	1	
Year	-0.0065	-0.0272	-0.0295	-0.0235	0.0003	-0.0023	0.0257	-0.0035	-0.015	-0.0186	1

Source: Authors' calculations

4. Empirical results

In this study, the effect of outsourcing to an SME's labor demand will be investigated via two roles of a firm in either receiving an outsource contract as a contractee or contracting out to the other companies as a contractor. Table 3 reports the empirical result for the whole sample (column 1); for those firms that receive outsourcing contracts as contractees (column 2) and then considering the intermediating role of firms' foreign trade experience (column 3).

The results in columns 2&3 show that the outsourcing participation of an SME has a positive effect on the demand of unskilled labor. It also presents that if firms receive 1% outsourcing, they can increase the number of unskilled labors by 1.1%, which is different from those case studies for developed countries as in Hsieh and Woo (2005) or Egger and Egger (2005). Possibly, Vietnam is a developing country with labor-abundance, so SMEs might take this advantage of cheap labor for simple jobs as a way to select a reasonable market segment. Accordingly, SMEs in a developing country exploit cheap labor resource by receive outsourcing contract.

In the model, foreign trade experience of a firm represents the participation in the global value chain. By using an interaction of this variable with outsourcing, we found that there is no intermediating role of this variable, meaning integrating into foreign market brings no change in the outsourcing effect to labor structure of an SME. However, foreign trade experience itself has a negative impact on the rate of unskilled labor of enterprises which received outsourcing works. This shows that when firms participate in the global trade, they will demand less unskilled labor or more skilled labor. In contrast, higher recruitment on unskilled labor happens with those SMEs with higher labor productivity and wage, larger capital or longer operation time span. For a

developing country like, the Hecksher - Ohlin theory may hold when SMEs specialize in those industries which is labor-intensive.

Table 3. The impact of outsourcing on SME contractees' labor structure

	All firms	Outsource receivers_ Contractees	Outsource receivers_ Contractees
LnProductivity	-0.003*	0.021**	0.021***
Firm-size	0.031***	0.022***	0.022***
Lnwage	-0.018*	0.045***	0.045***
Outsource ¹	0.000	0.011*	0.012***
Outsource ¹ *Foreignexperience			-0.010
R&D	0.030*	-0.003	-0.005
Foreignexperience	0.026***	-0.092***	-0.090***
Trainnew	-0.057***	0.056	0.056
Certificate ISO	0.001	0.012	0.016
Year	-0.000***	0.009***	0.009***
<i>Observations</i>	6,195	692	692

Notes: *, **, and *** significant at 10 per cent, 5 per cent, and 1 per cent, respectively.

Source: Authors' calculations

It can also be seen in Table 4, the impact of SMEs' outsourcing on demand for unskilled workers is further illustrated. Column 1 shows the results of all firms, including those did not outsource their jobs while columns 2 and 3 present enterprises outsourced their work to other domestic firms. Again, the final column considers the intermediating role of firms' foreign trade experience.

As a result, firms outsourced their jobs (outsource²) have a negative impact on the proportion of unskilled labor. This finding is consistent with those of previous studies that enterprises paying attention to jobs generate high values in the value chain (Quinn & Hilmer, 1994; Egger and Egger, 2005). SMEs outsource their simple jobs and reduce the number of unskilled workers so as to focus on labor with high expertise and skills to create more added values for business. Firms' foreign trade experience has a negative impact on the proportion of unskilled

labor. SMEs may be able to learn from their foreign partners about how to outsource and manage their human capital effectively. Quinn & Hilmer (1994) presents that outsourcing simple jobs helps to reduce cost and firms can focus resources on their core values. However, the more they are involved in foreign market, the impact of outsource on unskilled labor turn to be reversed, indicating higher demand of unskilled labor. That may shed light on for the developing country like Vietnam, firms with exporting stay specializing in unskilled labor-intensive industry when they do outsource. R&D activity has a positive impact on the number of unskilled labors, for both groups of firms with and without outsourcing. This finding shows that SMEs in developing countries intend to invest in strengths in the short term with labor-intensive jobs without having long-term vision (Mittal et al, 2018).

Table 4. The impact of outsourcing on SME contractors' labor structure

	All firms	Firms_outsource Contractors	Firms_outsource Contractors
LnProductivity	-0.002	0.018***	0.018***
Firm-size	0.031***	-0.007	-0.006
Lnwage	-0.020	0.025**	0.025**
Outsource ²	0.000	-0.047***	-0.047***
Outsource ² *Foreignexperience			1.124**
R&D	0.027*	0.066**	0.067**
Foreignexperience	0.024***	-0.124***	-0.130***
Trainnew	-0.055***	-0.010	-0.010
Certificate ISO	-0.002	-0.012	-0.014
Year	-0.000***	0.014***	0.014***
<i>Observations</i>	6,004	883	883

Notes: *, **, and *** significant at 10 per cent, 5 per cent, and 1 per cent, respectively.

Source: Authors' calculations

5. Conclusions

This study clarifies how Vietnamese SMEs optimize labor structure when being involved with outsourcing. Moreover, the role of how foreign trade experience in mediating the impact of outsourcing can be better understood. Empirical results, based on the study of SMEs in Vietnam

from 2011 to 2015, display a marginal impact of outsourcing on the demand for unskilled labor. With similar results to that of Görg et al. (2004) and Winkler (2010), outsourcing reduces the number of workers in the factory. Moreover, enterprises getting outsourcing jobs increase the demand for this group of workers. The enterprises prioritize focusing resources on highly skilled labors as they increase outsourcing. Enterprises having opportunities to learn from trading abroad increase the demand for untrained labor. From macro-perspective of global economy, outsourcing cost adjustment needs to be controlled at competitive level to ensure an increase in the number of outsourcing activities. SMEs in a developing country may implement outsourcing contract for low-value chains. When outsourcing is a model of the business collaboration for today, increasing the role as contractees may help the economy resolved job demand for low skilled labor force. Those firms with higher potential to source out their activity can focus on their core competences to keep higher value activity. The government needs solutions to improve workforce quality with new skills, consequently, helping enterprises get more high-value outsourcing activities.

Appendix

Table A1. Firms as outsourcing contractees

Year	No get outsource contract	outsource contractee	Total	Percentage outsource contractee
2011	2190	232	2422	9.579%
2013	2220	239	2459	9.719%
2015	2330	251	2581	9.725%
Total	6740	722	7462	9.676%

Table A2. Firms as outsourcing contractors

Year	No outsource	outsource contractor	Total	Percentage outsource contractor
2011	2328	94	2422	3.881%
2013	2372	87	2459	3.538%
2015	2469	112	2581	4.339%
total	7169	293	7462	3.927%

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OUTSOURCING AND LABOR DEMAND STRUCTURE: EVIDENCE OF VIETNAMESE SMALL AND MEDIUM ENTERPRISES

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Yes

No

*** 1. Originality: Does the paper contain new and significant information adequate to justify publication?**

the 3 underlying theories about TCT, Resource Dependence and RBV = clarified this all

*** 2. Relationship to Literature: Does the paper demonstrate an adequate understanding of the relevant literature in the field and cite an appropriate range of literature sources? Is any significant work ignored?**

yes, the manuscript has adequate sources

*** 3. Methodology: Is the paper's argument built on an appropriate base of theory, concepts, or other ideas? Has the research or equivalent intellectual work on which the paper is based been well designed? Are the methods employed appropriate?**

yes, the data with all the elements have about nearly 2,500 enterprises

*** 4. Results: Are results presented clearly and analysed appropriately? Do the conclusions adequately tie together the other elements of the paper?**

- if 1% increase in outsourcing, it translated into 1,1% increase in unskilled labor. This shows contrast on the SMEs developing countries though. What is this represent into? Under which categories that this phenomena will be surrounded & proposed as solutions?

- same as the foreign experience with the higher recruitment & unskilled labor?

*** 5. Practicality and/or Research implications: Does the paper identify clearly any implications for practice and/or further research? Are these implications consistent with the findings and conclusions of the paper?**

yes

*** 6. Quality of Communication: Does the paper clearly express its case, measured against the technical language of the field and the expected knowledge of the journal's readership? Has attention been paid to the clarity of expression and readability, such as sentence structure, jargon use, acronyms, etc.**

- some of the theories were relied on old/traditional theories = which was outdated & need to be produced in a recent articles. Keep the sources in placed may be up to the most current of 2000 or beyond to have the most inaccurate journals

- of nearly 2011-2015 with about 2,500 companies to compiled for a formulas = productivity, wage, firm size, outsourced, capital structure, R & D, Foreign Experiences, certificate ISO, training & year = it is a

*** Recommendation**

- Accept
- Minor Revision
- Major Revision

Reject

Confidential Comments to the Editor-in-Chief

***Comments to the Author**