Offshoring and Outsourcing

LEARNING OBJECTIVES   *The material in this chapter prepares students to:*

- Understand the size and extent of offshoring and outsourcing.

- Know the risks and benefits of offshoring and outsourcing.

- Decide what activities in a firm should be offshored or outsourced.

The hype: 3,400,000 white collar jobs with $151 billion in annual wages will leave the United States for low-wage countries by 2015. A Silicon Valley venture capital firm partner states "In a couple of years, 90% of all start-ups will have some connection to India or China." The Gartner Group forecasts that offshore BPO (Business Process Outsourcing) will have an 80% compound annual growth rate through 2007. "Any job that is English language based . . . can be done in India," claims Scott Bayman, CEO of GE India.[1]

The offshoring of white collar jobs seems especially unnerving to many people in developed nations. When manufacturing jobs fled to low-wage countries, solace could be taken in the prediction that a new age of the "service economy" was being entered, and that shedding low-wage, dull, routine jobs was a precursor to a new economy filled with high-wage, interesting, innovative jobs that required educated workers. With the offshoring boom, however, some of those high-wage jobs are moving offshore. Some high-end consulting firms are getting their client presentation PowerPoint slides made overseas. Stock research for U.S. investment banks is being done in India. Even white collar jobs at venerable U.S. firms seem to be at risk. An internal IBM memo leaked to *The Wall Street Journal* indicated that up to 4,700 white collar jobs with annual salaries of $75,000–$100,000 were to be offshored to workers in India whose expected salary range was $10,000–$20,000 per year (Bulkeley, 2003). Those losing their jobs would be required to train their replacements in the United States for several weeks. They would then have 60 days to find another job within IBM, or face unemployment.

How can developed countries compete when someone in a lesser developed nation will do the same job for one-tenth the salary? The issue has gotten the attention of the U.S. Congress, which is considering several laws restricting offshoring (see Service Operations Management Practice: The Empire Strikes Back). This mood seemed to be perfectly captured by the *BusinessWeek* magazine cover page: "Is Your Job Next?" (February 3, 2003).

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1 *Sources*: Hilsenbath (2004), Geewax (2004), *The Wall Street Journal* 2004, Knowledge@Wharton, 2003a, Clott (2004), p.166, respectively.

SERVICE OPERATIONS MANAGEMENT PRACTICES

The Empire Strikes Back

The U.S. Congress is considering many laws that have an impact on offshoring. The names of these acts are:

- Defending American Jobs Act
- U.S. Workers Protection Act
- USA Jobs Protection Act
- Jobs for America Act
- Trade Adjustment Assistance Act (1974) extension to services

(Currently, the Trade Adjustment Assistance Act provides training to manufacturing employees who are laid off because their jobs are sent overseas. Currently, this act applies only to manufacturing jobs, not service sector jobs.)

At least 36 States are considering over 100 laws banning or restricting offshoring in some form. Many of these laws are probably unconstitutional, as they usurp foreign affairs powers from the federal government, or otherwise illegal, as they violate existing international treaties, but they are politically popular to propose to angry, unemployed constituents.

The effects of these possible laws are:

- End corporate tax structure favoring offshoring
- Require a three month lay-off notice if offshoring
- Require informing customers of where work is processed
- Ban sending private information (financial, medical, or other personally identifiable information) overseas
- Eliminate corporate tax deductions for expenses of offshoring jobs
- Bar federal loans, grants, or contracts to a firm if it lays off more U.S. than non-U.S. workers, and
- Bar federal contracts to offshore locations unless the activities were previously performed offshore.

Source: (Phillips, 2004, Klinger and Sykes, 2004)

This chapter examines the phenomenon of offshoring and a term offshoring is frequently confused with: Outsourcing. We detail what types of activities are currently outsourced or offshored. The ethics of offshoring and outsourcing are explored, with a focus on who profits from these activities and the governmental responses that have occurred. Finally, a road map is developed to help sort out what types of activities should be offshored, kept on shore, outsourced, or in-sourced.

OUTSOURCING

The words "offshoring" and "outsourcing" are frequently used interchangeably, but actually have very different meanings. *Outsourcing* refers to hiring another company to perform a task that is currently performed internally. The vast bulk of outsourcing is done "onshore," so it is a separate decision from offshoring. Typically, outsourced activities are deemed not central to the mission of a company, or activities that outside vendors can perform more efficiently, with better response time, and/or at better

quality. For example, many firms outsource peripheral functions such as their cafeterias, janitorial duties, copy centers, trucking, building maintenance, payroll, etc. These activities are usually seen as not being the core, central activities of the firm doing the outsourcing. Further, it is reasonable to assume that a firm that runs, say, hundreds of cafeterias as their main business could run a cafeteria more effectively than a firm that only runs one cafeteria, where the cafeteria is merely a side business. Examples of this type of outsourcing include outsourcing payroll to ADP, or document processing to Xerox.

Another main reason for outsourcing is to gain expertise in technically advanced areas. The Information Technology (IT) area in many firms is outsourced due to this issue. IT physical technology and software changes rapidly. Many firms feel that small, in-house units have a hard time keeping up with the latest technology. It is believed that firms that dedicate themselves to these tasks, such as EDS, Computer Sciences Corp., IBM, or Perot Systems can be more innovative in this area because they are specialized firms. Even relatively large firms have outsourced IT. An early leader in this thinking was Eastman-Kodak, a Fortune 200 firm, that outsourced virtually all its IT functions in 1989. Virtually all firms outsource much of their legal work for this reason, as well. Although large firms will have in-house lawyers on their payroll, they outsource much of the more difficult work to established law firms.

Activities that have a high degree of variance are also good candidates for outsourcing. That is, if one day 50 employees are needed and the next day only 10, then to provide good service 50 people should be on the payroll. An outsourcer, however, can utilize the benefits of centralization (see Chapter 14). That is, the day that one of their clients needs 50 people is often the day another client only needs 10, and vice-versa, so an outsourcer can save substantial money by staffing for the average demand level, rather than staffing for peak demand. For example, Intuit outsources its sales and product service processes, even though they are considered "core" processes. Intuit's main products are tax and accounting related (e.g., the tax software "Turbotax®"), which have very heavy seasonality. According to their Operations SVP, "If we did not outsource these contacts, we would spend more of our time hiring, training, and laying off seasonal employees than executing for our customers" (Adsit 2003, p.99).

Potential outsourced activities would follow the logic introduced in Chapter 7 on decoupling of services. If an activity can be reasonably decoupled, then it is a *candidate* for outsourcing. For example, in the auto loan process for the mythical Bank of A, repossessing autos for unpaid loans is a portion of the process. We examine three basic choices—though more than three choices exist—Bank of A has in determining who does repossession work that are of interest for this chapter: (A) have a Bank of A employee who has substantial contact with the customer do the repossessing, (B) have a decoupled unit within Bank of A do it, or (C) contract out the whole, messy business to the third party provider, such as "Repos 'R' Us." (A summary of these choices and what one should be looking for in terms of activity characteristics is in Table 8.1.)

A business would consider several factors to determine which choice to make. As noted in the last chapter, scale is important. If this activity takes place infrequently, a dedicated unit (option B) is too expensive. Outsourcing (option C) can be used for infrequent jobs (a firm "outsources" the job of taking someone to the airport to a taxi-cab company), but is usually not appropriate for more frequent activities. Going through the search for a repossession firm, creating a contract with service level metrics, monitoring the service provider to make sure it does the job properly, and enforcing a contract is simply too much effort for any gain involved. For example,

TABLE 8.1: *Activity Characteristics to Consider for Outsourcing*

| | Outsourcing Choice | | |
| | In-Sourcing | | |
Activity Characteristic	Coupled (Choice A)	Decoupled (Choice B)	Outsourced (Choice C)
Scale	All	Moderate or High	Low or High
Expertise needed	Customer specific	Firm specific	Process oriented
Strategic importance			Low
Demand			High Variability

Source: Reprinted with permission from *Journal of Marketing*, published by the American Marketing Association, A. Parasuraman, Valarie A. Zeithaml, and Leonard L. Berry, Fall 1985/Vol. 49, p. 47.

experts recommend that accounts receivable departments should be kept in-house if there are fewer than 50 jobs to be outsourced (Gattenio, 2004).

If the scale is sufficient, either options B or C may be considered—but with the disadvantages detailed in Chapter 7, which are summarized briefly here. Because options B and C move the activity away from the central point of customer contact, there can be some problems.

The goals and measures of a dedicated back-office unit may be different from what a front-office considers good service. It is natural for dedicated or outsourced units to have a cost focus, as they are often measured by productivity. So, rather than staffing sufficiently to handle all the work on a heavy day, it may staff to an average workload and let service requests gather dust on heavy days.

There may be a problem with "organizational commitment." That is, workers that do not have contact with the customer are unlikely to have as much empathy with the customer as those who do, leading to less of a desire to provide flexibility for non-standard customer requests or situations. Further, since outsourced workers do not work directly for the outsourcing firm, there is a chance they will be less loyal to that firm, and less likely to burn the midnight oil to help the firm thrive. These and other reasons discussed in Chapter 7 often cause firms to keep potentially outsourced activities in-house, and in the front office.

As noted in Chapter 7, scale and technology are intertwined. Some technology operates efficiently only at a scale that precludes keeping work in-house. For example, many small banks outsource the check processing function to larger banks, as the most efficient check sorting machinery is very costly and operates efficiently only at high volume.

There are also qualitative differences between outsourcing and having dedicated internal units (Table 8.2). Outsourcers could be considered experts at their particular task, so they can often perform tasks more cheaply and at better quality than dedicated internal units. But outsourcing generally is more risky. Outsourcing suffers more acutely from contract risk, firm risk, pricing risk, information privacy risk, and strategic competence risk.

Contract Risk

The relationship with an outsourcing firm is governed by a contract, whereas the relationship of an internal unit can be influenced in more informal ways. That is, an

TABLE 8.2: *Risks and Benefits of Outsourcing*

Benefits	Risks
Access to expertise	Contract appropriateness
Pooling effect on variability	Outsource firm (solvency, strikes)
Lower costs	Future pricing
Higher quality	Information privacy
	Competitive advantage
	Firm specific risks
	Loss of firm knowledge
	Loss of career paths
	Organizational identification
	Loss of customer empathy
	Loss of employee-firm identification

outsourcer may contractually live up to the specified Service Level Agreements in the contract, but if not all the actual desired services were specified in the contract, or if business conditions change and different levels of service are desired, conditions cannot be as easily altered with an outsourcer.

Outsource Firm Risk and Pricing Risk

Once a task is outsourced it can be expensive and difficult to change outsourcers or to bring the task back in-house. Both *firm risk* and *pricing risk* speak to this issue. *Firm risk* is the risk that the outsourcer may collapse financially, forcing a company to find a new solution on short notice. It's the unsettling feeling that "(i)f the vendor goes bankrupt, all I can do is try to hire its former employees" (Barthelemy, 2003, p.88). Outsourcing firms may experience labor strikes, so even if the client firm typically enjoys good labor relations, they can still be shut down. *Pricing risk* is the risk that a company can become so tied into a particular outsourcer that the outsourcer can drastically increase prices in the future, or not cut prices when prices in the rest of the industry are falling, leaving a company with few options other than to pay.

Competitive Advantage and Information Privacy Risk

Several risks relate to the competitive environment. Depending on the task outsourced, sensitive company information is shared with an outsourcer. A risk exists that the outsourcer could share or sell this information to competitors. Finally, there is a competitive risk of mediocrity endemic to outsourcing. By outsourcing a process to a firm that performs that process for many other firms, one is essentially giving up trying to be better than the competition at that process. Consequently, outsourcing is generally restricted to processes that are not seen as being at the strategic core of a firm.

Firm Specific Risks

If a firm outsources a task, the institutional knowledge associated with that task also leaves. There are no longer personnel on hand who know entire processes, which can lead to breakdowns as processes change. That is, there's no one with the knowledge to say, "if we do it that way, it causes a problem in the next process." Another firm-specific risk is that of dwindling career paths. Outsourcing creates flatter corporate hierarchies, with fewer rungs on the corporate ladder to climb.

OFFSHORING

Offshoring is a decision independent from outsourcing, but highly intertwined with decoupling (Chapter 7). Offshoring can be defined as performing work for customers in one country in a different country. The offshored unit can be either "captive" (owned by the same firm that did the work onshore) or outsourced. For example, General Electric, American Express, British Airways, Swissair and many other firms have captive call centers in India (*The Economist,* 2003b). The workers in India handle callers from the United States (offshoring), but are employees of the American firm.

Most service jobs can never be offshored. Serving a meal, making a bed, fixing a flat tire on the highway, and the vast bulk of service jobs must be done in person. However, the scope of jobs that are able to be offshored is wide. Basically, any task that is either transmitted electronically or can be shipped is a candidate for off-shoring. "Transmitted electronically" encompasses data sent via computer, voice and video communication, as well as scanned documents. Currently, offshored activities range from mundane data entry to high level product design (Table 8.3).

Some especially embarrassing incidents of offshoring include New York City parking tickets being processed in Ghana (Worth, 2002), and New Jersey's welfare help line being answered in India (*The Economist*, 2003b). Due to public outcry, both of these activities were brought back to the United States.

Manufacturing offshoring has occurred in substantial numbers for quite some time, but services offshoring has a more recent feel, and has increased rapidly since 2000. However, services offshoring has existed in small amounts for several decades: American Airlines began processing airline tickets in the Caribbean in 1983.

By the mid-1990s it is estimated that 10,000 workers in the Caribbean, 3,000 in Ireland, and 10,000–20,000 in Asia were performing offshored service work for U.S. firms (Wilson, 1995). Largely, this was processing paper work. Paper was physically flown in and dumped in the in-boxes of workers, who might turn around the work in a few weeks. The main task these workers performed was factory-like keypunching of data that was not time sensitive. The reason for moving this work offshore was the enormous cost advantage: At the time, the price per 1,000 verified keystrokes was $1.50–$3.50 in the United States, but only $0.90–$1.25 in the Philippines (Wilson, 1995).

Technology, however, transformed the type of work that could be done, and the response time in which it could be been done. Voice communication technology has

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TABLE 8.3: *Activities Often Offshored*

Professional judgment:
   medical diagnosis (e.g., radiology), computer programming, product design, architecture, legal services, tax preparation, document editing, securities research, consulting presentation preparation

Communication oriented:
   call centers, customer contact centers

Back-office transaction processes:
   human resource department activity (medical reimbursements, payroll, benefits),
   finance department activity (accounts receivable, accounts payable),
   loan administration (initial mortgage application processing, payment processing, collateral tracking, loan payoffs, collections),
   insurance (new account setup, policy issue, address/beneficiary information change, claims processing: examination, capture, settlement, and correspondence),
   data entry (credit card receipts, warranty cards, medical transcription, etc.)

changed most abruptly, so call centers provide a good example of the explosiveness and suddenness of the technological impact. In the past, it was operationally infeasible to locate a call center overseas. In 1966, there were so few telephone connections between the United States and Europe that only 138 simultaneous trans-Atlantic conversations were possible (Frank and Cook, 1995, p.48). A story told is that some Citibank employees would be "dedicated dialers," repeatedly trying to connect with their European offices. Once a connection was made, giving it up was unthinkable—employees would read the paper to one another over the phone rather than stop the call. The first trans-oceanic fiberoptic cable, in 1988, could by itself carry 40,000 conversations, but it was still cost prohibitive to call overseas. In the late 1990's, however, the amount of fiberoptic cable was increased, and the call carrying capacity of any one fiber was drastically increased by the technological advances of multiplexing (putting multiple calls on the same line) and optical switching (replacing old electronic telephone switching equipment with light-based switches). Between 2001 and 2002, the capacity of fiber-optic lines from the United States to India increased nearly seven fold. As of early 2004, the cost of a trans-oceanic line capable of handling 128 simultaneous calls had plummeted to $11,000/month, one-fourth of what it was only two years prior (Drucker, 2004). Within the short span of a couple of years, the entire cost structure of the call center industry has changed. Third-world labor has always been drastically cheaper than in developed countries, but the technology cost barrier has crumbled.

Technology has also had a profound impact on paper-based offshoring. As noted previously, offshoring paper-based work such as accounts receivable, payroll, etc., involved actually physically transporting the original documents overseas, which resulted in time delays. They were then keypunched into a computer system, and the data relayed back by satellite. Now, original documents are scanned in the home country, and the scanned images can be sent electronically overseas, reducing both shipping costs and response time. This was not a welcome strategy prior to 2000 because the bandwidth available to move these images overseas was highly restricted.

A substantial portion of offshore services involves computer programming, and "technology" played an important role there, as well. In the late 1990's, it was feared that many older computer codes would cause substantial problems for businesses when the year 2000 occurred. Although computer RAM and hard disk space is rarely a constraint today, it was a major problem at the dawn of the computer era. To save space, a significant amount of software written through the 1980's assumed that any yearly date would begin with 19 and required only the last two digits as input. Of course, in the year 2000, these programs would view the year as either 1900 or 19100. It was feared that this problem would create havoc throughout computer systems, so the old computer code had to be rewritten. There was too much work to do for domestic programmers, so much of this task was sent out to places like India. The results of this collaboration of necessity helped convince developed nations that lesser developed nations could produce timely, accurate, and cheap code, and writing code continues to be the largest outsourced task today.

QUANTIFYING OFFSHORING

The precise extent of services offshoring can only be guessed at. No government collects authoritative numbers, and many companies are very secretive about their offshoring practices, as they are worried about domestic customer backlash.

The estimates of how many jobs have been lost in the United States due to outsourcing: 400,000 by Forrester Research (Vina and Mudd, 2003), 200,000 by the

Information Technology Association. How many people are in India and the Philippines answering telephone calls from the United States?: 250,000, according to the Technology Marketing Corporation, 55,000 according to Warburg-Pincus (*Knowledge@Wharton*, 2004b), while another source cited 160,000 (Basu, 2003). The total number of jobs in India doing offshore work? NASSCOM says 171,000 (Vina and Mudd, 2003), *Fortune* magazine quoted 350,000 (Fox, 2003).

In terms of dollar impact, the numbers are equally diverse. McKinsey Global Institute (2003) stated that $30–$35 billion/year is offshored from the United States, with Ireland the leader at $8.3 billion and India in second at $7.7 billion. Infosys (2002), a billion-dollar-per-year Indian firm, estimates there are $10.2 billion offshored to India alone. The Gartner Group estimated world-wide offshore Business Process Outsourcing activity at $1.3 billion, but Giga Information Group estimated Indian BPO alone at $1.5 billion (*Knowledge@Wharton*, 2004c).

OFFSHORING AND COMPETITIVE CAPABILITIES: COST

While the extent of offshoring is debatable, there are clear reasons to offshore. The reason that gets the most attention is comparative labor rates. While a call center employee in the United States might make $25,000/year, a call center employee at ExlService in India, a leading offshore BPO firm, averages $4,000/year (2002 wages).

However, the differential wage rates are misleading, as there are other costs involved. At a wage rate of $4,000/year, employees cannot afford cars, so it is not unusual for employers to provide free transportation to and from work. There are usually no restaurants nearby work, and even if there were, due to time zone differences Indian call centers serving the U.S. market must work during the middle of their night, so "lunch" is at midnight. Consequently, free or highly subsidized employee cafeterias are common. While terrorism is a concern worldwide, both the Philippines and India have had numerous terrorist attacks on their soil. Expenses related to security can be high. On a visit to an Indian call center the author of this chapter had his car searched for bombs merely to enter the parking lot, then had to pass through several heavily armed guards to enter the facility. In lesser developed countries, infrastructure is not as well developed, leading to higher costs. For example, it is not unusual for electrical or telephone service to shut down. In response, offshore service providers often purchase their own electrical generators and have duplicative technology for telephone access.

Training is much more extensive and expensive, especially in call centers, where an offshore employee must interact in real time with someone from another culture. American Express puts their Indian employees who speak to U.S. customers through 3–4 months of training. On average, English-speaking Indians speak English faster than the typical American, and they speak English with an accent that creates difficulties for Americans. Consequently, a common part of training is both slowing down their speech and accent neutralization. It also greatly helps to know not merely the language of a customer, but the local idiom of that language. Some firms require or encourage call center employees serving the United States to watch episodes of popular TV shows to keep up with trends and speech patterns. The expense of training is vital due to turnover: While turnover appears to be quite a bit less in India than the United States, 30% is not uncommon, meaning that the percentage of time in training is a significant portion of their total employment.

Differential tax rates also drive offshoring, as many countries have provided specific tax advantages to attract offshoring. Ireland attracted a large amount of offshoring

due in large part to the tax advantages provided. The standard U.S. corporate tax rate is 35%. The standard tax rate in Ireland is 43%, but BPO firms get a preferential rate of 10% until 2010. Jamaica has a 34% tax rate normally, but the "Digiport" BPO free trade zones are tax free. Mauritius offers personal tax holidays to key employees involved in BPO. In general, corporate tax rates in many areas of the world are less than in the United States. and Europe. Offshoring tax policy has become a minor issue in the 2004 U.S. presidential race. As of the writing of this book, the U.S. tax code favors offshoring over keeping work domestic. U.S. corporations are allowed to defer taxes on offshore units until the money is repatriated back to the United States, thereby giving firms an interest free loan on taxes owed if they offshore work.

OFFSHORING AND COMPETITIVE CAPABILITIES: NON-COST ISSUES

Pro-offshoring Arguments

Besides clear cost advantages, another reason often cited for offshoring work is higher quality. Most of the jobs developed countries offshore are considered undesirable in the home countries. Call center work in the United States is generally not considered glamorous, and generally attracts workers who don't stay long. Most BPO offshoring involves data entry: Entering accounts payable/receivable into a computer system, typing handwritten medical records, and the like. Domestically, employee turnover for these jobs often reaches 100%, and the jobs have little status.

In other countries, however, that is not the case. In India, call center operators brag about having 20 to 100 applicants for every job and being able to hire college graduates for these positions. This work is seen as "professional," and has a much higher status than in the United States. Because these jobs garner higher esteem in other parts of the world, companies can get higher quality workers who pay more attention to detail. One British bank reported call center agents in India process 20% more transactions, with 3% higher accuracy, than their counterparts in Britain (Agrawal et al., 2003). A "prominent financial services company" in the United States offshored and outsourced their call center to the Philippines and reported a combined 25% reduction in call handling time with an increase in customer satisfaction levels (Hagel, 2004).

The quality differential is marketed heavily for computer programming projects. There is a process certification for software developers called CMM (Capability Maturity Model). The highest rank is CMM level 5. Fifty of the 74 CMM Level 5 firms in the world are in India (*http://www.sei.cmu.edu/cmm/high-maturity/HighMatOrgs.pdf*).

A possible advantage in some businesses can involve response time. One can exploit time zone differences to get work done more quickly, known as playing "beat the clock." A request e-mailed at the end of the normal work day in the Western Hemisphere will arrive at the beginning of the normal work day in the East. So, by the time the normal work day starts again in the West, a number of work hours can be dedicated to the request.
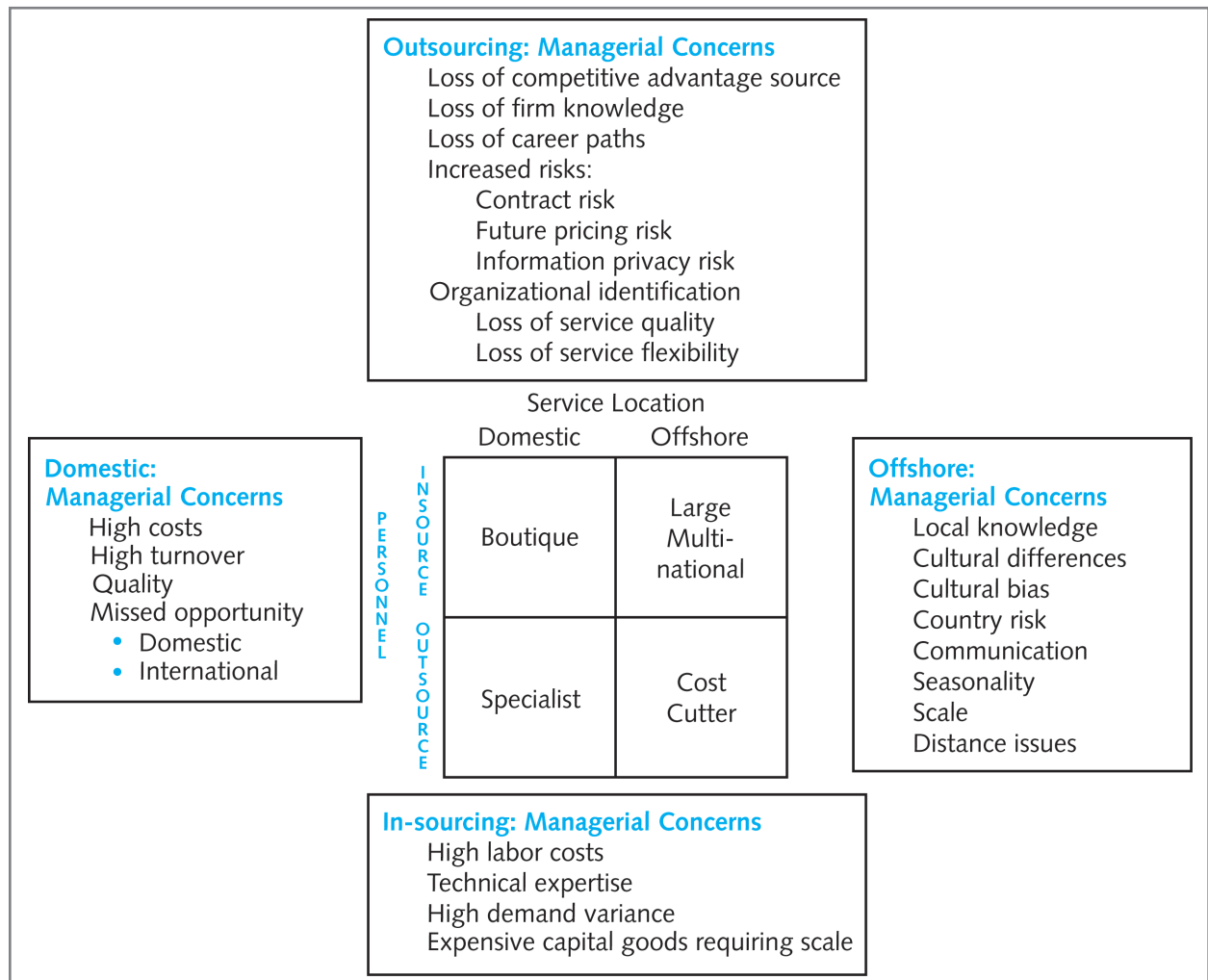
Anti-offshoring Arguments

Thus far, only issues favoring offshoring have been expressed. However, there are many factors that militate against offshoring. Projects that require constant communication or refinement, seasonal or temporary services, services of insufficient size, services where local knowledge or tacit knowledge are important, where cultural differences are salient, or where cultural biases are present are poor candidates for offshoring.

Offshoring shares many of the negative elements noted in Table 8.2. Even if the offshore unit is not outsourced, the physical distance can create problems: There may be an increased risk of loss of customer empathy and loss of career paths. In addition to the risks noted in Table 8.2, country risk needs to be considered when offshoring. The managerial concerns are summarized on Figure 8.1.

Communication Requirements

The prior section ended with a possible increase in productivity and response time: Play "beat the clock" and magically get work done while you sleep. If this sounds like an ad from a late night infomercial, it's because it can have a similar result. Frequently, a substantial amount of communication is required to get a job done correctly. The initial charge is either too vague, has some errors or omissions, is misinterpreted by the receiving party, or, as more facts are found, turns out to be wrong. For tasks that require a substantial interplay between customer and service provider time zone differences can cause problems.

FIGURE 8.1: *Choices for Electronically Transmitted Services*

Outsourcing: Managerial Concerns
- Loss of competitive advantage source
- Loss of firm knowledge
- Loss of career paths
- Increased risks:
  - Contract risk
  - Future pricing risk
  - Information privacy risk
- Organizational identification
  - Loss of service quality
  - Loss of service flexibility

Domestic: Managerial Concerns
- High costs
- High turnover
- Quality
- Missed opportunity
  - Domestic
  - International

PERSONNEL

INSOURCE

OUTSOURCE

Service Location

	Domestic	Offshore
	Boutique	Large Multi-national
	Specialist	Cost Cutter

Offshore: Managerial Concerns
- Local knowledge
- Cultural differences
- Cultural bias
- Country risk
- Communication
- Seasonality
- Scale
- Distance issues

In-sourcing: Managerial Concerns
- High labor costs
- Technical expertise
- High demand variance
- Expensive capital goods requiring scale

SERVICE OPERATIONS MANAGEMENT PRACTICES

Who's Offshoring Where?

The choice of offshoring destination differs dramatically by country of origin. Below is a list of common offshoring destinations. For the most part, this is language oriented. Unlike manufacturing offshoring, services offshoring generally requires a detailed knowledge of the offshoring country's language. For example, former colonial relationships often result in a large pool of indigenous population who know the language of the colonial power—a talent which can land offshoring jobs. There may also be a "cultural proximity" element: Those cultures that are most alike do more business.

Offshoring country	Offshoring to
U.S.	India, Philippines
United Kingdom	India
Spain, Portugal	South America
Germany, Switzerland, Austria	Eastern Europe (Hungary, Czechoslovakia)
Finland	Estonia
France	Rumania, Mauritius
Italy	Serbia
Japan	North East China

Beyond the time zone issue, any geographic separation makes work that requires constant communication difficult. One way to adapt to this is to have employees of the outsourcing firm physically in the building with the firm doing the outsourcing. This is very common in services outsourcing in general, such as copy centers, janitorial, etc. This technique allows for a job to be outsourced, but not offshored.

Cultural Bias

An important political issue is customer tolerance to offshoring. This is a political issue that is of great concern to many customers, just as the "made in America" campaigns caused customer anger at foreign manufactured goods years ago. There may be entirely xenophobic reactions by customers hating all offshoring, or customer objections might have an underlying racial element. For example, a customer may be quite angry at the thought of offshoring to India, but if the call is answered in Ireland, it's "OK." Some have posited that a relative lack of "cultural openness" explains the relatively small amount of offshoring from the main European countries, although a significant amount of European business is involved in offshoring (see Service Operations Management Practice: Who's Offshoring Where?).

A great deal of training in some call centers is devoted to hiding the fact that the service provider is offshore. Instead of answering the phone, "hello, this is Akbar, you have reached New Delhi," some call centers have required their workers to assume names common to the population calling them and to adopt fake home towns in the country of interest, so "Akbar from New Delhi" becomes "Chip from Chicago" (Landler, 2001).

There is little evidence on the extent of customer resistance and cultural bias, but there is one experiment to report. The online lender E-Loan, Inc., gave customers a

choice: Have your loan handled now, in India, or request your loan be processed in the United States, and wait as long as two days more: 86% of their customers chose India (Drucker and Brown, 2004). On the other hand, Dell Computer's move back to the United States from India may be related to this issue, or it may be due to higher quality of its U.S. employees (*The Economist*, 2003a).

Cultural bias works in both directions. Many developing countries have cultural norms and mores that are in conflict with working for Western corporations. Specifically, women who dress appropriately for office work are viewed as promiscuous in some countries (Freeman, 2000), and some Indians see call center work as destructive to traditional family values there (Abraham, 2004). Some types of work are simply inconsistent with certain cultures. As an extreme case, can one imagine offshoring the Victoria's Secret call center to a traditional Muslim country?

Country Risk

If international relations between countries become tense, governments may impose trade constraints, which could effectively shut down a business if all its back-office operations were being performed in that country. Some of the bills being considered in the U.S. Congress at the writing of this book could shut down the medical transcription offshoring industry and the offshoring of many financial processes due to data privacy concerns.

Country risk also includes economic factors. For example, while Indian labor is certainly cheaper than U.S. labor, it has been reported that the offshoring boom is increasing Indian call center wages by 10–15% per year. Also, exchange rate changes can turn long-term commitments sour.

Both the increased distance and different legal systems involved in offshoring heighten contract risk. Contracts must be written that are binding in both legal systems. But there is a deeper issue: Even if the offshore firm clearly breaks a contract and owes penalties, what is the probability a firm can win a legal dispute against a foreign firm in the foreign country? The level of trust with a foreign firm has to be higher than the level of trust with a domestic outsourcer.

Further, there are idiosyncratic country risks that need to be taken into account. Just as anyone setting up a facility on the San Andreas fault in California needs to have an earthquake contingency plan, setting up operations offshore means developing contingency plans based on the specific threats to that location.

Cultural Differences

Potentially more important are the cultural and language differences between customers, domestic employees, and offshored employees. Although offshored workers assisting U.S. customers generally must understand the English language, there may be differences between how the workers and customers use language, leading to problems. In the United States, the word "turnover" means employees leaving, but means "gross revenue" to most other English speaking people around the world. The abbreviation "4 2nate" for the word "fortunate" is readily translatable for a native English speaker, but may cause problems for a worker that mentally translates "4" and "2" into their native language and then wonders who "Nate" could be and what he wants 42 of? Training in the idiom of the customer is important, but no reasonable amount of training can cover all situations.

Cultural problems also manifest themselves in terms of behavior, specifically humor or rudeness. What is merely "direct" in one culture is "rude" in another.

Consequently, offshore workers may be angering customers without realizing it. Often, humor doesn't travel well between cultures. While this is unimportant for transaction-oriented work, it can be important for more high-level or high-communication oriented work. Situations where establishing a good rapport with the customer is important, such as outbound sales or collection calls, could be affected.

Cultural differences may hamper the empathy between employees and customers. It is conceivable that workers making $300/month may feel little connection with, and may even resent, customers from another, more wealthy, part of the world making $3,000/month who complain about not having enough money.

Local Knowledge/Tacit Knowledge Requirement

Other types of services where offshoring makes little sense are services where local knowledge or tacit knowledge are key. This type of knowledge has long been the "official" reason for giving travel agents free trips to resorts. Someone who has actually "been there and done that" is a better resource than someone looking at a description on a computer screen. Local knowledge can allow someone to say "I've seen a lot of people wearing that color in downtown Chicago this year," or "if you're rafting the Stanislaus River this May, you might also want a wet suit—the water is about 36 degrees." Offshore employees just wouldn't make the sale.

Lack of Scale, Seasonality, and New Businesses

In the discussion on outsourcing, it was noted that scale is helpful—outsourcing small tasks is more trouble than it can possibly be worth. Offshoring is even more extreme. Starting up an offshore destination often involves hiring an intermediary between the domestic and offshored workers, having executives travel and observe the offshore destination, and having a team "qualify" potential offshore suppliers. For these reasons, there is a large fixed cost to starting an offshore operation. This large fixed cost cannot be overcome unless the size of the job to be offshored is sufficiently large.

A similar problem with overcoming setup costs accrues to seasonal tasks and start-up operations. Seasonal work, like staffing retail oriented call centers during the Christmas season, is difficult to do in offshore environments due to the length of training offshore workers require. Similarly, start-up operations are usually both small and uncertain—their operations may change significantly, or even be shut down. The higher fixed cost of operating offshore is difficult to justify in these cases.

Losses Due to Distance

The physical distance and crossing of national borders necessary in offshoring exacerbate some problems inherent to outsourcing. When customers are 12,000 miles away, it may be easier to feel less empathy for them. Career paths also lose out in offshoring. Domestic junior people may not want to start for a firm at the bottom, if the bottom means moving to a third-world country and being paid $300/month. Consequently, domestic employees may never experience those jobs. Conversely, once an offshore employee has reached the peak position in what is offshored, she or he faces moving to a different country to advance. While some will jump at the opportunity, others will not.

THE ETHICS OF OFFSHORING

Is offshoring good or bad for the offshoring country? Should the government get involved?

Typical arguments proposed against offshoring manufacturing tasks in the past decades don't seem relevant to the services debate. It was often said that other

countries prevailed in the manufacture of steel or textiles because they ignored environmental concerns or exploited child labor—but these aren't genuine concerns for much of services offshoring. The call center employees are college graduates, not 10-year-olds, and how much industrial pollution does typing data into a computer cause?

The traditional pro-offshoring argument is that it fuels economic growth and is beneficial to all countries. Economic offshoring arguments date from the theories of Ricardo in the early 1800's: International trade benefits everyone. The consulting firm McKinsey and Co. (McKinsey Global Institute, 2003), has estimated the economic benefit of offshoring services to other nations for the United States For every $1 offshored, they claim the United States benefits $1.12–1.14. The breakdown is as follows:

> Immediate benefits:
> $0.58 cost reduction to a U.S. firm,
> $0.05 other countries buying more U.S. goods,
> $0.04 repatriation of profits from captive offshore units of U.S. multinational firms, and delayed benefits
> $0.45 – 0.47 in redeployed U.S. labor (workers whose jobs are offshored taking other jobs).

This calculation seems to make an obvious case for offshoring, but it neglects an important fact—the pain of offshoring is not distributed equally. Specifically, the $0.45 – 0.47 in "redeployed labor" is calculated thusly: 72% of offshored process dollars is labor, and 69% of those who lose their jobs are re-employed. Of those re-employed, they average making 96% of their former wage: $72\% \times 69\% \times 96\% = \$0.48$ in eventual benefit (the $0.45–0.47 is "conservative"). This means, of course, that $100 - 69 = 31\%$ of workers whose jobs are outsourced remain unemployed, an unacceptable proposition if millions of jobs are outsourced quickly. In their report, McKinsey called for "retraining" for those whose jobs are offshored. But the operative question seems to be "retraining to do what?" Concerns over unemployment have led to a number of potential laws being discussed in the U.S. Congress (see Service Operations Management Practices: The Empire Strikes Back).

The subject of international political relationships becomes important for offshoring. Some trade relationships that have been highly important historically include Japan's lack of access to oil in World War II, as Japan had no domestic supply. An argument against offshoring "key" industries is that a country may need them in a time of crisis and not have access to them. Considering political risk, does the United States, as a nation, want to have the ability to program its computers in foreign hands? Should a potentially hostile nation, or at least a nation whose self-interest will not always coincide with the interests of the United States, have access to (or control of) the detailed medical records or financial records of millions of its citizens? Would detailed knowledge of bank accounts, credit records, welfare rolls, and other back-office data, help a hostile group find citizens to bribe or inflict harm on the United States?

Given the potential of international disputes leading to trade sanctions, does the United States want large portions of its back-office work to be performed in countries that may no longer be able to trade with the United States? Or, alternatively, will offshoring help the international situation? Does the intertwining of economies lead to better understanding, more tolerance of differences, or a lesser chance of hostile action?

While there are many opinions regarding these questions, facts are in short supply.

IMPLEMENTING OFFSHORE OPERATIONS

Merely transplanting operations performed in one country to another does not take full advantage of the possibilities. Copying an operation in a lower wage country will

reduce labor costs, but more benefits can be extracted if different work is done, or work is performed in different ways.

Consider the "collections" function. Collections refers to getting customers who are behind in their payments to pay up. Often this is not just making a phone call. A firm frequently has to invest many hours in skip-tracing customers, meaning finding out where a customer now lives. If a firm is paying a collections clerk $4,000/year the firm will have a far lower threshold of customers to collect from than if it is paying a clerk $30,000/year. That is, a firm can chase down debtors with far lower outstanding debt.

The lower labor costs might also cause competitive priorities to change. Figure 8.2 depicts a typical relationship between cost and "service" in a waiting line operation such as a call center. Here, "service" is defined by how quickly the average call is answered. Because of the variability of incoming calls—sometimes 20 at once, sometimes none for long stretches—and the variability of time spent by an operator answering calls, getting close to an average of immediate response is immensely costly (see Chapter 14). Since the low-cost country labor is less expense, getting to any particular level of quality costs less money. So, it might be the case that the optimal trade-off of response time versus cost reduces both cost and response time in a low-wage environment.

Due to the different ratio of capital and labor costs, it makes sense to organize activities differently offshore. For example, in call centers in the United States, labor is the main cost driver, whereas in India, the cost of the technology and the telecommunications cost for the call itself is a far higher percentage of overall costs. In the United States, it makes sense to have added technology that enables a call center operator to make online, real time changes to a system with a customer waiting on the telephone line. In a more capital-intensive environment, it makes more sense to reduce the time using the telephone line and make changes off-line.

For basic data entry work, labor cost is still the predominant concern in developed countries, so there is generally one shift. If the role of capital and labor costs are reversed, it might make sense to have work shifts around the clock to minimize machinery costs (Agrawal et al., 2003).

FIGURE 8.2: *Cost Versus Service in High- and Low-wage Countries*
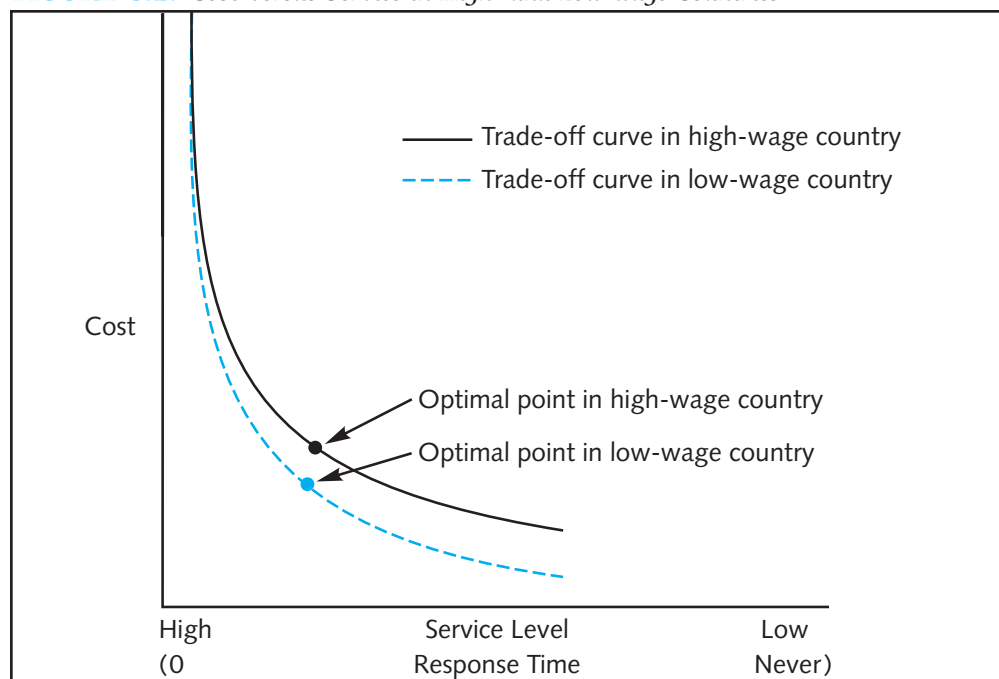
Summary

The terms "outsourcing" and "offshoring" are used interchangeably by some, but they are very different concepts, with very different risks and benefits.

The vast majority of outsourcing is domestic, rather than offshore. Services outsourcing is commonplace and used by many businesses to cut costs or keep up with technological advance. However, it should not be entered into blindly. While there are many situations that call for outsourcing, there are also many situations that are best served by keeping tasks in-house.

Services offshoring, while still small, has received enormous attention. This attention derives from labor rate differentials and the range of services moving offshore. White-collar, professional work, thought by workers in developed countries to be their exclusive domain, is now being offshored to less-developed nations. And those offshore workers have salaries as little as one-tenth of the workers they are replacing. A prevailing feeling among many is that no job is safe.

However, there are many risks and downsides to offshoring. The loss of local and tacit knowledge, the cultural conflict, and the additional country risk associated with offshoring argue that many information-oriented jobs will remain onshore.

Review Questions

1. What is the difference between offshoring and outsourcing?
2. What are the main benefits of outsourcing?
3. What activities should a firm not outsource?
4. Why are firms offshoring service work?
5. What are the risks involved in offshoring?

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CASE STUDY

Offshoring a Call Center for Everdream[2]

Finding the right talent for its call center has been a perennial challenge for Everdream, an IT services provider, even though it's based in Fremont, California in the heart of Silicon Valley. The company, which offers an outsourced hosted solution for desktop management, is constantly searching for employees with technical savvy who are also willing to work in an entry-level call center support position. "While these are entry-level positions, we need people who know their way around operating systems and who also know how to treat our customers with the proper level of courtesy and care," says CEO Gary Griffiths.

The company pays about $30,000 a year to entry-level employees in its Charlotte, North Carolina facility and $38,000 at its California-based headquarters call center.

Griffiths says the company began to consider an offshore option in 2002 because it was worried about scalability. "We were concerned about our ability to grow at the rate we thought was necessary. Even though America was in the midst of a so-called jobless recovery, we couldn't find the right talent quickly enough," he explains. Of course, the reduced labor costs of an offshore provider were an enticement, too. But Griffiths says scalability was the primary driver.

The top-down initiative was also a product of outsourcing thinking: Everdream's management felt the company was a technology company, so it would be better off outsourcing its own call center operations to a call center expert.

In October 2002, the company issued a Request for Proposal (RFP) to 12 companies. Everdream explored all its options, looking at onshore, nearshore and offshore companies. Candidates were based everywhere from Bangalore, India to close by the Charlotte center in Florida.

Choosing Costa Rica over India

"We decided early on that we were not comfortable going to India," says Griffiths. First, he felt the distance from California was just too great, since Everdream employees would be onsite during the transition phase "when we handed over the crown jewels." Second, Everdream grilled its prospective suppliers by asking them how they would handle specific situations. "Based on those responses, we didn't feel the Indian suppliers could maintain the quality levels we required," says Belle Kulick, Everdream's Vice President of Operations, who was aware of what the company's customers expected.

After extensive due diligence, Everdream selected a call center supplier in Costa Rica—the executives felt comfortable in the Central American country. Other technology companies like Intel and Microsoft were already outsourcing to Costa Rican suppliers. The Costa Rican team to be assigned to Everdream had just finished

2. Reprinted with permission of the Everest Group and Outsourcing Journal, http://www.outsourcing-center.com. Original article: Rosenthal, B., "Why a Silicon Valley Supplier Brought Its Offshore Call Center Home," *Outsourcing Journal*, May 2004 issue.

CASE STUDY

working on a Toshiba account. "We thought once we got the Costa Rican operation working, we could expand our offshore presence to India or the Philippines," Griffiths says.

Opening a captive operation in a foreign country "was never an option," according to the CEO. If the company went the offshore route, it wanted an outsourcing partner already on the ground. Realistically, that was not an option anyway since Everdream was only outsourcing 40 jobs; it planned to keep a small U.S. presence as it experimented with this new way of doing business.

After selecting the partner in January, 2003, Everdream began its pilot in February. Thirteen employees and a trainer from the Costa Rican supplier flew to California for three months of training. Then those people, who now formed the core Everdream team, went back to Costa Rica. In addition to manning the call center, their job was to train two more classes to handle Everdream's work.

Everdream trainers from California accompanied the supplier's workers when they returned to their home base. The American employees remained at the supplier's site for 90 days to help the new team become operational.

Problems Training the B Team

The problems arose when the core team attempted to train the B and C teams. "We knew the initial 13 were the cream of the crop. But we didn't anticipate the wide gap in knowledge between them and the other people assigned to our account," reports Griffiths. Unfortunately, offshoring didn't solve the scalability problem.

In its American centers, Everdream figures new agents need eight weeks of training before they're ready to answer customer questions solo. "We expected an intensive learning curve in Costa Rica," says Kulick. But the offshore employees who weren't trained in California couldn't perform at the expected level. So Everdream employees held a second training session for the Costa Rican team. Over time Everdream realized "they were never able to get to that next level we required," she reports.

Because the team could not reach the needed knowledge levels, the Costa Rican office needed twice as many agents to handle the same number of calls as the California office. "The lack of productivity wiped out the cost savings," Griffith calculates.

During the RFP process, the due diligence team had investigated these skill levels. The Costa Rican supplier demonstrated that most of its employees had college degrees. But the American company discovered "their degrees apparently aren't equal to ours," Kulick notes.

CASE STUDY

A Mismatch of Corporate Cultures

Everdream also discovered there was a mismatch in corporate cultures between it and the service provider. The Costa Rican company was used to answering calls about a specific product or operating system that had easy-to-use documentation. It was simple to script responses in a cookbook fashion.

On the other hand, Everdream's slogan is: "Any problem. Any time. No excuses." Its employees have to know about several different applications and operating environments. The wide variety of questions they receive daily makes it impossible to script support responses. "We give our employees a high level of autonomy to solve problems. We expect them to think out of the box," says Griffiths.

In the end, Everdream realized each company had a different management philosophy. "They were a call center company and we are an outsourcing services company," he explains. "Our customers pay us money because they want premium service."

Meanwhile, Kulick noticed that Everdream's customer satisfaction ratings, always at 96% or higher, had fallen to less than 90 percent. "That was a disaster," says Griffiths. That's when both parties agreed the arrangement was not working. In March 2004, Everdream moved its work back to the United States and began looking for those hard-to-find people in Charlotte and the Silicon Valley.

While Everdream is back to square one in dealing with its scalability challenge, Griffiths says his team learned a lot from its offshore experience. First, he's not giving up on outsourcing if he can find the right partner. But for now, he's going to stay stateside. Everdeam would consider outsourcing a call center to a supplier in a U.S. city where labor costs are lower than Silicon Valley.

Second, the experience was a useful exercise in learning exactly what the company is about. Future training for any new provider would focus more heavily on the key business fundamentals management had to dissect in explaining its business to an outsider.

"Our board says offshoring was a worthwhile experience. We learned what our customers truly value about us. Now we have a clearer idea of what our customers want. And we know more about our business than we ever did," concludes Griffiths.

Questions:

- Is Everdream's position on offshoring to India reasonable?
- What offshoring or outsourcing lessons from Everdream's experience can be used by other firms?