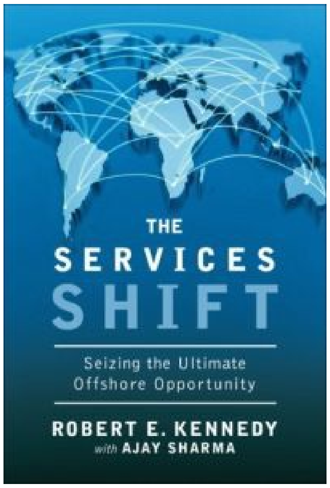

Book The Services Shift

Seizing the Ultimate Offshore Opportunity

Robert E. Kennedy and Ajay Sharma
FT Press, 2009
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Recommendation

Shipping U.S. manufacturing jobs to offshore destinations is already controversial, but what's happened so far is just the first wave of "offshoring," says globalization professor Robert E. Kennedy, writing with researcher Ajay Sharma. A far larger wave is cresting: service offshoring. This is problematic because services now account for a larger portion of the U.S. gross domestic product than manufacturing. Technology is making many high-value services fair game for offshoring. The first wave of service offshoring involved sending relatively low-value services, such as call centers, to India. But now firms are outsourcing even medical jobs, including radiology. This book tells managers why offshoring is moving up the service value chain, how to harness its benefits and what to do about its risks – though the authors might have paid more attention to the disappointing results some companies have derived from offshoring. Despite their stated political neutrality about offshoring, these experts do seem to favor it, as seen in their resigned treatment of job loss concerns and their optimism about the complexities of executing offshoring programs, though they acknowledge that they treat in scant pages procedural matters that have been the subject of entire books. *BooksInShort* recommends their detailed, knowledgeable backgrounder to those who want a lot of very useful information about offshoring, while noting that it may not meet all the needs of managers who call for caution before setting sail.

Take-Aways

- Competitive advantages in cost and quality compel outsourcing.
- The five forces that drive increased "offshoring" from U.S. firms are here to stay.
- They are: better technology, liberalized markets, the quest for affordable quality, emerging nations' increased service offerings and the "global business culture."
- Successful outsourcing hinges on knowing the workflow, mitigating risks, selecting the right place and provider, and creating a seamless process transfer.
- Drawbacks include logistical, personnel, customer service and market challenges.
- Offshore services now include higher-skilled work, even complex medical tasks.
- U.S. firms prefer offshore locations with English proficiency. Thus, India, Ireland, Canada, the Philippines and Israel have an edge over other destinations.
- Leaders will need new skills, like systems management, to lead offshore efforts. They face a new framework: governing systems instead of people.
- The global economic gain from offshoring balances the loss of U.S. jobs.
- Instead of trying to prevent jobs from moving, U.S. politicians should help those whose jobs must move.

Summary

Wave upon Wave

The “services shift” is moving beyond sending call centers and mundane business processes from the U.S. to other countries. Higher-value services are following the first wave of outsourcing that took manufacturing and low-end services abroad. Service offshoring is big and becoming bigger, so every manager must understand it and prepare accordingly. The globalization of services is not just about cutting costs but about achieving high quality and fundamentally reorganizing work. With that base, five compelling forces – which are “here to stay” – drive this wave of offshoring:

1. **“Technological innovations”** – This includes widening internet access and digitization.
2. **“Emerging market growth”** – Developing nations are selling more services
3. **“Global macroeconomic liberalization”** – More nations allow international business.
4. **“The corporate imperative to...reduce costs and improve quality”** – Offshoring “can lead to major productivity and quality improvements.”
5. **“Global business culture”** – “Western management” is spreading, and so is English.

> “When a country increases trade, everyone in that country benefits from the cheaper goods now available from abroad.”

Globalization distributes its gains thinly across multitudes of people, but the pain it causes is concentrated in the distressed individuals, regions and industries where offshoring is taking away employment. The incremental economic benefits that outsourcing brings to more numerous populations and regions are hard to see as jobs depart. Yet, “Who loses?” is the wrong query for managers and the press to ask. The right focus is, “Where should this work be done for the best economic and efficiency gains?” Offshoring is politically controversial, but managers can’t wait for politicians to settle the question. Firms that do not act could fall behind in competitiveness, but managers first must study both outsourcing’s drawbacks and its important opportunities.

The Competitive Advantages of Offshoring

For helpful frameworks for thinking about outsourcing, turn to Harvard professor Michael Porter’s theory of the value chain and Nobel economist Ronald Coase’s theory of how transaction costs affect a firm’s competitive standing. Porter’s analysis says that competitive advantage comes from two sources: cost superiority and marketplace differentiation. He logically suggests that firms should outsource noncore activities, often to offshore vendors, while focusing their efforts on their sources of competitive advantage. Thus, companies should not invest heavily in functions that do not provide a competitive advantage. This is one reason why firms that are not in the cleaning or restaurant business opted to outsource janitorial and canteen services long ago.

> “If millions of people now have access to a wider variety of cheaper goods, we have to offset these gains against the losses to displaced workers.”

Coase’s analysis of “transaction cost economics” (TCE) and Oliver Williamson’s subsequent development of this metric, spotlighted three kinds of expenses: the costs of finding necessary information, the costs of negotiation and the costs of making sure contracted counterparties perform. Their work implies that cost control can be more important to a company’s success than strategy – creating the logical implication that offshoring can be an important factor in corporate performance and competitiveness.

> “When you look to move activities offshore, think process rather than task. Think about the end-to-end flow of work, rather than isolated islands of tasks.”

Theories about competitive advantage explain both that countries should focus on what they do well and that customers will benefit when competition improves the cost and quality of goods or services. Managers who compete worldwide face an escalating demand for low costs and high quality within a riskier environment that prioritizes the ability to react quickly to unexpected events. These challenges make it imprudent, if not impossible, for executives to ignore the competitive advantages of offshoring. Of course, outsourcing presents many implementation, logistical, human resources, customer service and competitive challenges. The need for face-to-face communication, especially when a firm must convey complex information and receive a response, is just one limited example. However, “the boundary of the firm has evolved significantly” as the web and “ubiquitous telephony” have reduced “the information barrier.”

> “The only way to raise overall productivity is to undergo the process of dislocation and reallocation of productive resources.”

Although the trade in services resembles the trade in manufactured goods in certain ways, many services require more hands-on labor than most manufacturing, so the cost differential offered by low-wage countries is an even more significant competitive edge. For example, consider medical transcription. The high error rate of speech-recognition technology dashed early hopes that this software would take the labor out of transcribing medical records. Offshoring offers a more effective way to reduce transcription’s labor cost. The Philippines is emerging as a major provider of medical transcriptions, an international industry with $25 billion in annual revenue.

> “A firm should select one overarching strategy (low cost or differentiated) and configure all activities to support this strategy – that is, bring them into alignment.”

Similarly, more professional medical practices, such as teleradiology, are already on the move for reasons of logistics and cost: “U.S. certified” Indian radiologists earn some $28,000 a year compared to $365,000 for U.S.-based radiologists. And those working day shifts in India, Israel and Australia can read films during the U.S. night. Technology has made it possible for companies to move even intensive-care unit monitoring offshore – if regulatory barriers fell. Medical practice has no vaccine to immunize itself against offshoring. As the *New England Journal of Medicine* noted, “As health care becomes digitized, many activities ranging from diagnostic imaging to the manipulation of laparoscopic instruments are rendered borderless.”

Where to Turn

India entered the offshoring arena in the ’70s, but today’s supply market spans more than 30 countries. India is no longer the only offshoring game in town. Ireland, Canada, the Philippines and Israel, among many others, are competing with India now. These four countries have a powerful advantage in their widespread use of the global business language – English. When making the decision about which country is appropriate for your firm’s outsourcing, consider its overall profile, business climate, availability of relevant skills and cost competitiveness.

The selection of vendors hinges on evaluating costs versus savings, reaching “sufficient scale” for economically meaningful programs, finding providers with the right abilities and setting up good organizational processes. Potential vendors of outsourced services fall into four major categories:

1. **Multinational units** – American Express, Microsoft, Oracle and Motorola outsource work to overseas units they own, thus sending work offshore while keeping it in-house.
2. **IT services** – The major firms in this field – Infosys, Wipro, Satyam and TCS – are growing in various ways, from forming subsidiaries to making acquisitions.
3. **Global outsourcers** – Sitel, IBM, Siemens and their peers are "growing...aggressively."
4. **Process specialists** – These companies, like Genpact and WNS, often focus on call centers and the like, though many extend other services, such as process engineering.

Eight Steps to Successful Offshoring

Firms usually outsource functions to achieve lower costs, better operational processes or organizational transformation. How well a firm performs these eight steps will shape its results:

1. Know what jobs occur in the process. Be aware that a "task" is not a "process."
2. Diagram the flow of work in the process.
3. Identify the system's tools, techniques, and organizational or technological basis.
4. Determine and assess the risks, and work to reduce them.
5. Evaluate service providers and choose one.
6. Decide which region or country is most appropriate.
7. Transfer the process.
8. Make offshoring seamless with good operational linkages and communication channels.

New Management Skills Needed

Beyond the risks involved in transferring a service, operational risks include adverse reactions from consumers and employees. Some firms try to minimize customer outcries by offering clients a choice about which processes to outsource. Staff reactions to outsourcing may depend on the circumstances. Adding overseas capabilities is more acceptable when it doesn't cut domestic jobs. Managers will need to learn new ways of working to cope with the services shift. In many cases, they will no longer exercise direct, face-to-face management. In the offshoring environment, systems replace people, so the managers who succeed will be systems-oriented and comfortable with networked environments. Their knowledge about processes and their ability to demonstrate their competence statistically will become more important than their specific understanding of their companies' organization and politics. Firms will need to recruit a new breed of manager who, often, is more quantitative and less intuitive, more comfortable crossing hierarchical and geographical borders, and less dependent on markers of status and clear career paths. A manager's abilities to negotiate and work autonomously will be critical soft skills.

> "Within the United States, service industries account for around 80% of employment, so it is only natural for people to worry about job losses due to offshoring."

For example, Penske Truck Leasing began to outsource some operations to Genpact in Mexico in 1999, and sent increasing amounts of work to Genpact's India operation in 2001 and 2002. The experience of offshoring improved Penske's understanding of its own processes. Its Indian service providers demanded clear statistical metrics to measure their success – metrics Penske had never before developed. Some managers could not adapt to offshoring. They missed personal interaction with their workers, found the added travel burdensome and disliked the impersonal nature of managing staffers on another continent. Nearly 50% of Penske's managers "had to transition out"; replacing them was an unexpected, hard-to-meet challenge for the company.

Policy Response and the Way Forward

Many of the service workers whose jobs could now be at risk may be able to resist offshoring, since many are more educated, wealthy, powerful and vocal than their blue-collar predecessors. However, less wealthy service workers may benefit from working in fields that are most resistant to offshoring, such as hairdressing, law enforcement and school teaching. Although it seems unlikely, constant economic evaluation and technological evolution could potentially throw even some parts of these careers into the waves of offshoring.

> "Can a given service be digitized? Can it be done without a face-to-face interaction? If so, it probably can be offshored."

Because of outsourcing's impact on U.S. employment, some societal forces – such as legislative efforts – are at work to impede it. These attempts will fail because government really can't stop a movement that is advancing based on such economic and competitive necessity. And government should not try to do that. Instead of attempting to prevent jobs from moving, politicians should focus on helping those whose jobs must move. The right policy is to institute "trade adjustment assistance" to bring aid, retraining and new jobs to the casualties of offshoring.

> "In the Old World, there was a lot of management by walking about. You knew all your workers very well....In the new model, 90% of my workers are over 1,000 miles away. We manage through process metrics and by the numbers." (Penske manager)

Economic history is unambiguous in showing that free trade is good for recipient local economies. The services trade is no exception. This sector will deliver more benefits to more people with offshoring than without it. Offshoring increases the economic well-being of a majority of people. That means developing countries clearly have much to gain from the services shift, but their workforces must develop crucial skills, such as English fluency and computer competence, and vendors need to improve their communication infrastructures.

> "We in the United States tend to think that our role is to lead change, and the role of the rest of the world is to follow our lead. In offshoring, that has long since stopped being the case."

Expect continuing growth in offshoring as the global economy consolidates and breaks down artificial and uneconomic boundaries. More valuable services will shift. The emphasis on old-style cost reduction will ebb as the need to produce quality for a reasonable price becomes more important. Vast overseas pools of talent can compensate for the shortages of certain skill sets in the U.S., such as civil engineering. Scale economies will become evident in smaller and smaller projects. Eventually, even one-on-one services, such as tutoring, will be outsourced.

About the Authors

Robert E. Kennedy teaches business administration and directs the "Global Initiative" at the University of Michigan's Ross School of Business. He is also the executive director of the William Davidson Institute, where **Ajay Sharma** is the research manager for the "Globalization of Services Initiative."