

## **OFFSHORING: THE STATE OF PLAY AND A RESEARCH AGENDA**

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### **Abstract**

This paper describes the emergence and explosive growth of offshoring, associated technological drivers, and other factors (primarily lower labour costs) that drive it. A methodology for establishing, maintaining and renewing offshoring projects is proposed. Offshoring is no longer the preserve of organisations; individuals can exploit it. Offshoring threatens to replace First World jobs with less well-paid Third World jobs and raises consequent political issues. We note that offshoring has not enjoyed academic research proportional to its importance; suggest further research on offshoring, especially on the nature of the relationship between vendor and client; and note the difficulties of researching offshoring, a sensitive topic for many organisations.

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## **OFFSHORING: THE STATE OF PLAY AND A RESEARCH AGENDA**

Outsourcing and especially offshoring of business processes have recently excited management, management consultants, and governments. Offshoring has emerged because changes in technology exemplified by the World Wide Web (WWW) have made it easy for organisations to share large amounts of data almost instantly, with high fidelity, and at nearly zero marginal cost. Corporate costs can be substantially reduced by accessing cheap Third World resources, especially labour.

This paper defines relevant terms and briefly describes outsourcing's costs and benefits. It evidences the growth of offshoring and proposes a methodology for managing offshoring projects. It describes the risks inherent in offshoring; "personal offshoring"; and offshoring's social and political implications. Conclusions and suggestions for future research are given.

Outsourcing is "The act of transferring some of a company's recurring internal activities and decision rights to outside providers as set forth in a contract" (Greaver, 1999, p 3). Illogically, the term is usually applied to services, not manufacturing; and to continuing business functions, not projects. Offshoring is having business processes performed overseas, primarily to exploit low labour costs; it conventionally includes wholly owned overseas subsidiaries. The client and vendor are the organisations respectively obtaining and supplying services through an outsourcing agreement. The archetypal client and vendor are American and Indian firms respectively. The client's customers may be affected by offshoring.

There are myriad reasons for outsourcing. Fundamentally, outsourcing is a "third way" to vertical integration (associated with cumbersome hierarchies and lost focus) and reliance on market mechanisms. The latter entails administrative costs (identifying appropriate vendors and verifying their competence, communicating changing requirements to them, providing feedback and monitoring their performances), communication costs (transferring data and information between vendor and client) and risks (of vendors failing or being unable to meet specifications, or customers failing to pay). Outsourcing decisions depend on comparisons of the long-term costs, benefits, and risks of these different modes of supply.

### **TANGIBLE COSTS AND BENEFITS OF OFFSHORING**

The costs and benefits of outsourcing are detailed in, for example, Beaumont & Sohal, (2004). Major benefits are lower costs derived from expertise and economies of scale, and "sticking to the knitting". Costs include erosion of in-house skills and dependence on the vendor. The prime attraction of offshoring is lower labour costs. The consensus is that Indian labour costs about 15% of US labour (Cronin, Catchpole, & Hall, 2004, p 18; McKinsey&Company, 2003; Neelakantan, 2003; Overby, 2003a). Third World workers may be more productive than their First World counterparts (Dutta, Lanvin, & Paua, 2003). However, costs in India may increase in response to demand and increased congestion and operating costs e.g. in Bangalore.

McKinsey (2003) analyses of the effect of offshoring on cost components. Although labour savings dominate, offshoring changes other costs. Managing at a distance entails extra costs. Offshoring gives management a way of forcing standardization of business processes; this is especially relevant in organizations that have grown through takeovers and retained different processes. Lower cost may allow smaller orders and debts to be fulfilled or pursued profitably. A range of languages may allow an increased geographic scope. There may be a difference between the First and Third World input costs and tax rates and some

governments may offer inducements to attract foreign business. The different costs of labor and different skills of available in First and Third World countries may allow different parts of a process to be differentially located so as to exploit cheaper labour or available skills. X-ray images may be transmitted electronically to Third World countries where the analysis is done and recorded; the reports then being returned electronically to the originating doctor for discussion with patients.

## **GROWTH OF OFFSHORING**

The fundamental reasons for the explosive growth offshoring (McKinsey&Company, 2003, p. 5; National Computing Center, 2004, p 3; Scholer, 2003) are that technology makes India's lower costs accessible from the First World and has removed the barriers that protected internal departments from external competition. Independent of distance, data can be transferred to a vendor instantly, accurately, and at a nearly zero marginal cost. This technological change has eliminated some internal departments' natural monopoly; it is as easy to pass payroll data to ADP as to an internal department. Annual growth rates of 30 and 40% in offshoring reflect the cost savings.

## **AN OFFSHORING METHODOLOGY**

Several interrelated decisions have to be made when deciding to offshore the whole or part of a business process. A fundamental question is what functions should be offshored. Subsequent but related decisions depend on the organisation's strategy and objectives; its attitude to risk and public criticism; its relationship with its workforce; and the intensity of competition. Many writers have proposed overviews; methodologies; checklists; and lists of critical success factors pertaining to outsourcing (Cronin et al., 2004; Ho, Torres, & Vu, ; Keane Inc, 2004; Ker, Murphy, & Valle, 2000, pp. 11-13; Moore, 2002; National Computing Center, 2004, pp 10-16). We consider only the identification of processes suitable for offshoring. A methodology incorporating an outsourcing cycle is described in Beaumont & Sohal (2004).

Only some kinds of work can be advantageously outsourced or offshored but the scope is increasing as overseas workers acquire new skills, communication costs decline, and new technology is deployed. Classic applications are call centres (including help desks), myriad back-office operations (e.g. processing loans and mortgage applications, insurance claims; debt collection, employee expenses, data entry, analysis of x-ray images, and indexing documents); architectural or engineering design; and computer programming.

Edwards (2004, p. 11) identifies three layers of services. The top layer, comprising services tailored to individual businesses, is unlikely to be outsourced. The bottom layer, comprising processes common to all business, is very likely to be outsourced. The thick middle layer comprises services that are capable of being standardized, then outsourced. Enterprise Resource Packages (ERP) exemplified by SAP are forcing standardization and hence the potential for outsourcing (Gere, 2003). Globally, firms spend about \$US19 trillion on expenses of which only \$US1.4 trillion is outsourced (Edwards, 2004, p. 6).

Some transactions that used to require face-to-face contact can now be mediated by computers; many sales transactions are consummated on the Web and an Indian salesperson could present via video link.

## **INTANGIBLE COSTS AND RISKS OF OFFSHORING**

Some hidden costs of offshoring noted by Pinto (2005) and Overby (2003b) are:

### **The Effect of Cultural Differences**

Cultural differences may be impediments. National cultural differences can be discussed using Hofstede's (1988) five dimensions of Power Distance, Individualism, Masculinity, Uncertainty Avoidance, and Long or Short-term Orientation. These differences may be manifest in objectives and negotiations. Americans are stereotyped as being unconcerned with "soft" or long-term issues (instead focusing on cash flows), disrespectful of seniority; and careless of group processes important to Asians.

### **Security and Confidentiality**

Policing and the standards pertaining to securing company assets and customer confidentiality, implemented and monitored at home, may not apply or be as well policed in other countries (Scholer, 2003).

### **Information Asymmetry**

An Indian vendor knows local conditions such as input prices, possible changes in government policies, and infrastructure that the client cannot readily obtain. The client, not plugged into the local network, may not be forewarned by rumour that the vendor is about to go bankrupt.

### **Other**

It is prudent to retain some backup of data and skills at home least the offshoring deal comes unstuck. Offshoring may expose corporations to two sets of laws; customers may be concerned to find that their sensitive data are stored offshore; and unpopularity and possible domestic boycotts may be caused by the client "exporting jobs". Effective outsourcing may require cultural changes in the client. The IT manager whose department has been outsourced must obtain results by negotiating with the vendor instead of instructing subordinates.

## **MODES OF OFFSHORING**

Deciding whether and how to offshore a business process entails making several interrelated decisions. Assuming that a business process is being considered for offshoring, decisions have to be made on what mode of offshoring should be used (Cronin et al., 2004, p 18; Gere, 2003, Fig 2). The three independent dimensions are:

- Location: Farshore, Nearshore, Onshore, or In-house.
- Ownership: Insource, Outsource, or Joint venture.
- The degree of control granted to the vendor.

### **Location**

Farshore is a location (classically India) with markedly lower labour costs but potential difficulties exemplified by differences in language, culture, and infrastructure. Nearshore is a location exemplified by Canada or Australia with lower labour costs but a similar business culture and language. Onshore means that the operation is performed in the home country,

obviating cultural and language difficulties. In-house means that the operation is conducted on the client's premises.

### **Ownership**

Regardless of location, the process may be insourced, outsourced, or run as a joint venture. Insourcing is a formalized, pseudo-commercial supply relationship between two departments of the same organisation. In some cases (especially when a large and innovative project and its business implications cannot be tightly defined in advance) a joint venture between the client and vendor is appropriate.

### **Degree of Control**

Outsourcing comes in a variety of flavours partly reflecting the day to day control the vendor retains and the degree of co-operation required. Strassmann (1997) defines out-tasking as outsourcing in which the client designs and retains full control over the business process, the vendor simply providing the resources (usually labour or computer time). Contrastingly, a client may exploit vendor expertise by granting the vendor full control over how the operation is performed, monitoring the amount and quality of work done.

## **PERSONAL OFFSHORING**

Offshoring is usually treated as an option only for organisations but cheap communications and cheap travel also empower individuals. Computer literate consumers can purchase an increasingly wide range of goods and services (e.g. gambling and entertainment) non-locally, intensifying competitive pressure on local businesses once protected by distance. Consumers can avoid their country's legal restrictions and imposts by using the web to acquire pharmaceuticals, music and pornography, or indulge in self-diagnosis of real or imagined ailments.

A striking example of personal offshoring is the recent emergence of "medical tourism" (Bradley & Kim, 1994; Neelakantan, 2003). Customers can reduce costs by at least 50% and avoid lengthy queues by having medical procedures such as hip replacements performed overseas. It seems likely that Americans will increasingly obtain otherwise expensive professional services such as legal and financial advice from overseas.

## **POLITICAL AND SOCIAL IMPLICATIONS**

Price differences and data mobility imply that, on the face of it, white-collar jobs will move from First to Third World countries. Not just clerical and call centre jobs are threatened. Work such as architectural drafting, product design, legal analysis, financial and market analysis, indexing services, programming, and systems design could all be offshored. Professional work can be loosely defined as transforming and analysing data or extracting information from data; work done primarily on a PC can be done in a low-wage country. Some labour markets are now unconstrained by national boundaries; an emerging global market for English-speaking call centre operators will supplant national markets and reflect converging remuneration for First and Third World workers with identical skills.

Many groups e.g. McKinsey (2003 pp. 5-15) have forecast the effects of offshoring on First World job markets, most arguing that offshoring will increase the U.S. standard of living. From 2 to 4 million U.S jobs could move to the Third World in the next five years (EBS, 2005), but analysis of the net effect on job markets and consumers must incorporate indirect

and direct effects. Besides the direct effect of profit reduction and job losses in directly affected industries, the following indirect effects should be considered:

- Stakeholders in Indian vendors spend their increased income. This will have a multiplier effect on the Indian economy, stimulating imports, some from the U.S., and increase U.S. employment. Affluent Indians may visit America as tourists.
- American consumers will have their quality of life increased by cheaper and better quality services. They will spend a high proportion of the time and money saved on other goods and services.
- The extra competition will benefit consumers by limiting inflation and eroding the excess profits and restrictive practices of some industries (e.g. the medical and legal professions).
- The U.S. job market is dynamic. Edwards (2004, pp, 12-13) notes that most new technologies have been perceived as a threat to employment, but that new occupations emerge. "... Who would have guessed that America ...now has 139,000 psychologists, 104,000 floral designers and 51,000 manicurists and pedicurists?"

A serious socio/political problem remains (surfacing in the 2004 U.S elections). The benefits of offshoring for the U.S., although large, are thinly spread and not immediate. The considerable costs of offshoring are shared amongst a relatively few employees who lose well paid and stimulating jobs and may find it difficult to find equally rewarding jobs.

## **CONCLUSION AND SUGGESTED FURTHER RESEARCH**

### **Summary**

The forces (especially lower costs) underlying outsourcing and especially offshoring are irresistible. Competition and customers demanding constant improvements in quality and price will force the most squeamish firms' hands. Offshoring is the simplest way for First World firms to obtain substantial cost savings and improve service quality. Offshoring is a manifestation of intensified and globalised competition (Porter, 2003); Offshored services are following the migration of primary production and manufacturing from First to Third World countries. Because it will affect millions of white collar workers who are more articulate than their blue collar counterparts, offshoring will be a live political topic for several years. Especially pleasant (for some) and painful (for others) will be the emergence of global labour markets, e.g. in programming skills that imply converging remuneration. There are many choices to be made when offshoring a business process; managerial discipline and adherence to a methodology multiply the chances of success.

### **Further Research**

Offshoring suggests several research problems. As the bibliography implies, academic research on outsourcing and especially offshoring is not proportionate to its importance to industry. This may be attributable to the research difficulties alluded to below. Some outstanding research tasks are:

- The size and growth of the offshoring market needs to be ascertained. This is difficult (there are definitional difficulties) and expensive. Executives may be reluctant to admit that they are using offshoring or that work outsourced to an ostensibly local vendor is done overseas. An international research effort is needed to distribute the costs and obtain unbiased samples of organisations.

- The tangible and intangible costs and benefits of offshoring to participants and broader society, and the interaction between offshoring and organisations' strategies and evolution need to be ascertained. Case studies are probably the most appropriate instrument. However, a comprehensive study of one firm would require several interviews in the firm and with its vendors and/or clients; it is likely that some parties would decline participation because of offshoring's sensitivity. Low response rates would limit the findings' generalizability.
- Research determining the success of different methodologies and applications of offshoring is appropriate. Anecdotal evidence suggests that the relationship between vendor and client is often fraught but critical to success. Typically, euphoria experienced when the contract is signed sometimes turns to dismay when unanticipated difficulties emerge; a working relationship emerges after much hard work. These difficulties can be exacerbated by geographic and cultural differences. The influence on business success of the relationship between the two parties (intimate or arms-length) and its contractual basis (especially Service Level Agreements) merits research.
- Statistical studies relating knowledge of a firm's use of offshoring and financial success may be illuminating. Iconoclast Strassmann (1997) suggests that heavy use of outsourcing presages a firm's failure.
- The socio-political effects of offshoring merit investigation. Will they be as severe as some alarmists anticipate? What government policies would help spread offshoring benefits rapidly and widely? Will public disquiet impede free trade negotiations or fuel xenophobic political movements?

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