Global outsourcing & Trade in Services: A Review of Issues

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Goods Off-shoring

• Migration of manufacturing has a long history
  1. Market seeking offshore investments
  2. Cost-cutting investments
  3. Efficiency seeking
  4. Imports of finished goods
Long term effects

• E.g., the US imports:
  
• 90% of all its consumer electronics sales
• 80-85% of toys, footwear, luggage
• 60% of all computers  (US ITC cf. Gereffi et. al. 2004).
Outsourcing and off-shoring of services: the drivers

- Services generally regarded as non-traded, so surprise
  - (Health, hospitality, others)
  - Took off in the mid-1980s

- Initially low-value-added services off-shored
  - Back-office transactions, data entry, call centers

- Now, knowledge based work is being off-shored
  - Software, engineering, design, accounting, medical advice, insurance, accounting, legal services

- Technological change, high speed data-and-communication networks, computerization of work
  - Value of service trade in 2001 was 24% of total merchandise trade – so trade in services is growing rapidly (Banga 2005)
Trade in Services

- But what constitutes a ‘Service’?
- How is trade in goods different from trade in services?
- What are the barriers to trade in services? Are they different from the barriers to goods trade?
- What implication does this have for theory and policy?
What constitutes a service?*

1. Intangibility and transitoriness (in some not all cases)
   • “services are products of labor that perish the moment labor is performed” Hill (1997)

2. Non-transferability and non-storability
   • ‘Services defined as products that do not accumulate stock and cannot be stored’
     - Services must be consumed as they are performed

3. User and provider must interact – proximately or remotely
   • Service trade can take place at the factor or product level – so spatial separation possible

3 levels of interaction

(a) Mobile producer and immobile consumer
   (shifting labor to the construction site of another country)

(a) Mobile user and immobile provider
   (e.g. hospital, school)

(c) Mobile user and mobile provider
   (e.g. lectures)

Bhagwati 1984
Goods vs. Services

4. Factor mobility and trade are distinct in goods; but this separation does not hold in the case of services (Banga 2005)

   • In order to become tradable, services have to be applied to, or embodied in objects, or in information flows, or in persons.

5. Technological and regulatory costs associated with alternative ways of providing services become key

   • E.g., the ‘right to establish,’ ‘right of presence,’ and right of access is an important policy issue for service provision -- restrictions on factor inflows sufficient to restrict services vs. tariffs in goods

   • Has implications for labor mobility and immigration
The GATS classification of international service transactions

- **Mode 1**: cross-border supply of services (e.g. does not require the physical movement of supplier or consumer)
- **Mode 2**: Customer must move to location of supplier
- **Mode 3**: Services sold in the territory of a member by legal entities that have established a presence there but originate in the territory of another member country
- **Mode 4**: requiring the temporary movement of natural persons
In sum:

• Trade in services is characterized by three key features
  – Non-transferability, non-transportability, and non-storability
  – Heterogeneous product and flexible production
  – Imperfect competition

• Thus, the integration of global markets for services is likely to have very different contours than the global integration of goods provision
  – price differentials likely to persist
  – local regulatory systems are likely to affect producer costs, thus trade in services will depend on the regulatory structure of a country in important ways
What does this mean for the off-shoring of knowledge work?

2 views:

**Samuelson 2004** –

- The outsourcing of knowledge work fundamentally changes the dynamics of comparative advantage if in the trade relationship, one of the partners uses more intensively a factor for which they do not have an abundant endowment.

- Skill and capital intensive US trading with labor-abundant India or China but in goods or services which are skill-intensive.
• **Solow 2004:**

  - Across the board increases in foreign productivity that leave the pattern of comparative advantage unchanged cannot harm the domestic (industrial) economy except through income elasticity effects.

    • Income elasticity effects = if the US exports goods bought by low income countries, then they could face a relative or absolute shrinking of demand if their buyer country gets richer.

  - The key concern is that increases in foreign productivity that create or extinguish prior comparative advantages are much more complex and create effects that cannot be easily generalized.
The gaps*

- What is off-shored? (near-shored vs off-shored?)

- How much is being off-shored? How to measure what is off-shored and what is simply an import?

- What is off-shoreable?
  - Health, legal services, engineering services, R&D?

- So it is key to look empirically and understand what is happening on the ground to motivate theoretical insights

*See MIT-IPC report 2005
## Growth of Demand for BPO Services

<table>
<thead>
<tr>
<th>USD Billion</th>
<th>2003</th>
<th>2004</th>
<th>Y oY Growth %</th>
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<tbody>
<tr>
<td>Human resources</td>
<td>9.0</td>
<td>10.8</td>
<td>19.3</td>
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<tr>
<td>Procurement</td>
<td>1.3</td>
<td>1.7</td>
<td>24.9</td>
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<tr>
<td>Finance &amp; Account</td>
<td>13.9</td>
<td>15.1</td>
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<tr>
<td>Customer care</td>
<td>40.4</td>
<td>44.9</td>
<td>11.2</td>
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<tr>
<td>Logistics</td>
<td>166.7</td>
<td>182.4</td>
<td>9.4</td>
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<td>Engg R&amp;D</td>
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<td>Sales and Mktng</td>
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<td>147.2</td>
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<tr>
<td>Facility op&amp;mgmt</td>
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<td>7.8</td>
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<tr>
<td>Training</td>
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<tr>
<td>TOTAL</td>
<td>405.1</td>
<td>447.7</td>
<td>10.5</td>
</tr>
</tbody>
</table>

Source: Nasscom 2005
## What is off-shoreable

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<tr>
<th>USD Billion</th>
<th>Total Market</th>
<th>OFF-SHORABLE</th>
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<tr>
<td>Human resources</td>
<td>10.8</td>
<td>5.4</td>
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*Source: Nasscom 2005*
The Indian case

• Small labor market:
  – Total IT, ITes and BPO workers in India: 650,000-1.2 million compared to 38 million in textiles and apparel
Major US Outsourcers

- GE – 21,000 workers (5.6% of GE’s total workforce)
- HP – 11,000
- IBM – 6000
- Am Ex – 4000
- Dell - 3800-4500

Source: Nasscom 2005
Top 3 drivers

• Cost savings
• Increasing capacity
• Ability to take advantage of off shore labor

Limitations:

• Loss of institutional knowledge
• Poor communication with vendor
• Mismatch of firm cultures

Source: Columbia Univ survey
3 models of BPO service provision

• Captive

• JV

• Market-based, third party providers
CASE

GE Capital - International Services (GECIS)

– GE’s 70-70-70 rule
  – Outsourcing 70% of IT work; moving 70% of it offshore; of that moving 70% to India

  • Offices in Delhi, Bangalore, Calcutta, Mexico, Romania

  • Inception in 1998 as a captive center (Gurgaon)

  • Total workforce: 21,000 in India alone
Sequence

• 1998-2003/4 - Captive; GECIS owned by GE
  - Gecis not looked on as an R&D center that can provide a revenue stream for GE; Looked on as a way to cut costs

• 2003/4 - Sold to third party
  60% owned by 2 pvt. equity firms (US based); 40% owned by GE

• 2005-future - GE’s holding will ↓ to <25% prior to IPO
Lessons

• Divestment of parent seen as crucial for a successful IPO
  • Lessons from the TCS experience
  • GE’s holdings were >50% at time of IPO – not very successful
  • Why?
Cost Center vs. Profit Center

• Captive BPO operations seen are *cost centers*, not profit centers

• When sold to a third party, they become *profit centers* for the third party – thus there is greater motivation for growth.

  – Always a vehicle for cost-cutting for the parent

  – *but third party as owner worries about revenue streams – diversification of clients, and growth follows*
Cost vs. Revenue

• Third party will worry about revenue; this will lower cost of service for GE

• Gecis will now have to bid for GE’s business

• Diversify customers; lower costs, spread risk, increase efficiency, raise revenues

• For a BPO (Gecis) to be an effective cost-cutting tool for a parent (GE), services have to be provided by a third party
  – who will run the BPO as a profit center
Third-party Architecture

- As third party entity, “the architecture” of the company has changed.

- Current goal: In 2005, Gecis is targeting:
  - $4 million in revenue from non-GE customers
  - $35 million from GE

- Future goal: 70-75% revenue from non-GE clients

- Drive to hire more AVP’s & more experienced VPs -- AVPs are client-specific, more clients = more AVPs needed (more in a moment)
Costs

- Team = 22-24 people
  - 6 “Management”; 16-18 “Workers” (1:3)
- 1 Assistant Vice President
- 1 Manager
- 4 Assistant Managers
- 16-18 Analysts – 3-4 per AM
- 1 Analyst billed at $44,000/year of which salary is $8000/year
- Team managers not billed – on paper they do not “work;” they manage the work process
  - 18 billed to support 24
Internal labor market

- VP -- 15 years of exp - $40-43K ctc
- AVP – 10 years of experience in the field –
  Generic skills
  (entry can be lateral – Engg/MBAs/Army officers, Physicians)

- Manager – 6 years of experience (recruit from within)
- Analyst – 2 years of experience (Lateral)
- RA – BA (entry level)
Comparative costs*

- Cost of an average analyst in India = $8000/year; no overtime

- In GE America, cost of an average analyst = $80,000 - $150,000
  - Indian salary is 6-10% of US cost

- Training costs in India
  - Training hours 50-60% less; training costs 80-100% less ~

* As of July 2005
Turnover

“I feel discriminated against”

• Best Indian BPOs – Wipro, Infosys – offer Rs. 11k ($250) / month to an analyst compared to $670 at Gecis;

• Yet, turnover at GE is high; analysts leave after 2-3 years routinely - for an MBA, Ph.D, other work. Some get burnt out.

• They compare themselves not with Wipro or Infosys, but with counterparts in GE America, “They, their work is valued so much more.”
Which labor market does Gecis tap?

- Mostly from within GE for the top end (VPs, AVPs); from the local labor market for the rest

- CEO of Gecis is a former GE employee
  - But of Gecis’ 21,000, <1%, or 145 ~ high end staff is from GE

- After GE’s exit from direct ownership, Gecis is aggressively drawing upon high performers from within GE, especially Indian expatriates.
• Small labor pool to draw from – involutionary; churning within the parent co. is a large part of the hiring at the BPO. *(What are the costs?)*

• High costs of retraining

• High rates of attrition of the local workforce – management practices alone cannot explain turnover;
  – social forces,
  – the health problems and burn-out factor of the ‘graveyard shift,’
  – perceptions of work undervalued, and
  – divergent visions of future careers of entry level college graduates are important contextual drivers of turnover
Conclusions

• Many understudied issues from the perspective of both outsourcing firms and BPOs

  – E.g., Many US-focused studies assume that the selling off of outsourcing operations by parent firms represents a withdrawal of the parent from the outsourcing market; (“a failure of outsourcing”)

  – the GECIS case shows by contrast that this is often a tactic to convert a cost center into a profit center; and an aid to enhancing IPO valuation
Studies that compare managerial and workforce development strategies of US vs offshore outsourced operations assume that high labor turnover is driven for the most part by the firm’s HR model.

By contrast, the GECIS case focuses attention on turnover-drivers emanating from the motivations, career expectations and social stresses of the local workforce that have more to do with structural problems such as the health and social consequences of the graveyard shift, with career aspirations of a college educated upwardly mobile workforce, and issues of customer abuse, than with a firm-specific HR model.
• Deeper comparative, ethnographic work will be needed to understand the changing dynamic of the off-shoring of knowledge work and its consequences for local firms, local workers and local development in addition to implications for home country firms and workers.