Global outsourcing: effective functional strategy or deficient corporate governance?

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Abstract *Outsourcing information technology functions has become an increasingly accepted cost-reducing strategy in both the USA and Western Europe. What these managerial decisions mean in human resource terms is the elimination of high paying employment. In the USA, global outsourcing is now raising public policy concerns about its effects on the nation's long-term technological leadership and the ethical propriety of such corporate decisions on a key stakeholder – employees. Global outsourcing is a direct challenge to corporate citizenship (the new corporate governance model) and human capital theory (which recognizes the value of the knowledge worker to the success of the firm) now recognized by many US corporations. While accepting the managerial limits of these approaches, it is argued that corporations and industry associations need to develop and implement a human capital strategy which balances the negative consequences of global outsourcing with corporate citizenship responsibilities to employee and community stakeholders.*

Keywords *Corporate governance, Outsourcing, Human capital, Communication technologies*

In 1990, in what was then characterized as a daring concept, Kodak executives decided to ''outsource'' major components of its information systems function. Since then, outsourcing information technology (IT) functions has become increasingly accepted as a method of maximizing resource productivity, i.e. a functional strategy, in both the USA and Western Europe. During much of the 1990s, this IT outsourcing, where one company subcontracts specific tasks, such as de-bugging new software, handling technical requests, or managing a data center, to other domestic suppliers of IT services. However, when the Internet became a viable, worldwide phenomenon in the latter part of the decade, the domestic market was no longer the geographic limit for such services. As the new century arrived, so did ''global outsourcing'' of IT functions, with the Internet often being the conduit for such services being delivered beyond national borders. How popular is IT outsourcing? According to Gartner Dataquest (''Gartner''), a market research firm specializing in the IT industry, the number of US IT infrastructure outsourcing ''mega deals'', i.e. those worth $1 billion or more, increased from nine in 2001 (worth $15.1 billion) to 14 in 2002 (worth $28.4 billion) (Frauenheim, 2003). Furthermore, Gartner estimates that more than 300 of the Fortune 500 firms have business relationships with Indian-based IT service companies and that by 2004, more than 80 percent of US companies will consider using offshore IT services (Frauenheim, 2002). Many Western European firms are now outsourcing IT-related work to Eastern Europe, including countries such as the Czech Republic, Hungary, Poland, Romania, and Russia (McCue, 2003).

What these managerial decisions mean in human resource terms is the elimination of high paying employment for many US and Western European citizens. Forrester Research, another market research firm, estimated that the number of US computer-related jobs being outsourced globally will grow from 27,171 in 2000 to a cumulative total of 472,632 by 2015 (Frauenheim, 2002). But it is not only US IT services that are being globally outsourced: financial analysis is performed in India; bookkeeping is undertaken in Ireland, India and the Philippines; computer chips are designed in China and India; computer-generated sketches drawn in the Philippines, Hungary, and Chile; and customer service centers opened in India and the Philippines. Other white-collar professions are forecasted to follow this trend, including legal services and jobs in the life sciences. By 2015, Forrester Research estimates that a total of 3.3 million jobs and $136 billion in wages will transfer from the USA to countries such as China, India, Russia and the Philippines (Frauenheim, 2002). With these recent employment trends and forecasts, it is not surprising that that this issue is now raising some concern in the US public policy arena and consequently, with boards of directors. Questions are now being raised about global outsourcing effects on the long-term technological leadership of the USA and the ethical propriety of these corporate decisions on a key stakeholder: employees.

Why globally outsource?

The primary reason given by managers for globally outsourcing is the existence of a surplus of inexpensive, college-educated, and multi-lingual labor in many relatively low-wage countries, thus allowing management significant cost savings. For example, in the Philippines there is an oversupply of accountants that can be tapped; in India there are 520,000 IT engineers with starting salaries in the $5,000 range; and China graduates approximately 70,000 mechanical engineers a year (a specialty in high demand in Western economies), twice the number of the USA (Engardio, *et al.*, 2003). According to Arackal Digital Solutions Inc. (2002), globally outsourcing IT functions will reduce annual IT costs for a firm from 30 to 60 percent (i.e. depending on the size and nature of a company and the range of services involved). But there are other allegedly significant competitive advantages from globally outsourcing other than cost savings. For example, international outsourcing assists with a firm's globalization strategy by relying on a global outsourcing partner to extend operational reach; helps broaden infrastructure capabilities; and offers local market access advantages (Arackal Digital Solutions Inc., 2002). Furthermore, global outsourcing can help alleviate allegedly serious technical labor shortages in the USA and Western Europe. For example, Gartner estimates that there is a shortage of nearly 400,000 skilled IT workers in North America (Arackal Digital Solutions Inc., 2002). The bottom line is that once a job can be defined and its requirement codified so that those outside the firm can perform the duties, it becomes lower value and takes on commodity characteristics. This has certainly been the case with software coders and programmers, many of whose jobs have been shifted to India (Engardio, 2003).

But, as in most strategic decision-making exercises, management is faced with a multitude of potential pitfalls when deciding to globally outsource IT employment. From a political risk perspective various macro-environmental considerations, such as unstable governments, anti-US and/or anti-Western sentiments, currency devaluation and political unrest, can cause major business disruptions for the globally outsourcing firm (Anderson, n.d). Choosing the wrong partner to outsource work can result in markets flooded with counterfeit products, technology trade secrets may be exposed, and the firm may lose control of a corporate brand (Anderson, n.d.). Because legal systems overseas are much different than in the USA or Western Europe, enforcing intellectual property rights, such as patents, copyrights, trademarks and trade secrets, is both expensive and time consuming.

Recently, Gartner surveyed managers in 900 major US companies that globally outsource IT. A majority of respondents reported difficulty communicating with offshore suppliers and meeting deadlines (Engardio *et al.*, 2003). There were two significant questions that Gartner researchers were seeking answers for: first, what are companies really gaining and losing by firing white-collar workers in the USA and becoming more dependent on distant foreign operations? Second, what does this mean to the US's white collar workforce? Gartner's early conclusion is enlightening – and rather discouraging for those managers who view global outsourcing as a ''no-brainer'' competitive strategy to embrace (Engardio, 2003):

Many companies simply haven't thought these questions through. CEOs are rushing to shift jobs now in their desperation to slash costs and boost the bottom line, but with little understanding of whether or not they're enhancing or endangering core operations. The big problem is that not all corporations are adept at figuring out which jobs really should stay close to home and which are dispensable. Even fewer are very good at managing networks of support staff, R&D (research and development) teams, and other white collar workers that are dispersed around the globe. Nor do they know how to manage such a shift without sending threatening signals to white-collar staff that they really do want to keep. As a result, many corporations that will join the bandwagon are likely to stumble. And if it's perceived that companies are exporting good jobs simply to save a buck, Corporate America may be setting itself up for a nasty backlash as the pink slips mount.

Corporate citizenship in the new economy

In the USA, the concept of corporate social responsibility is transitioning to a new corporate governance approach for managing the relationship between the firm and its socio-political environment: corporate citizenship[1]. Boston College management professor Sandra Waddock (2003, p. 3) defines corporate citizenship as:

> . . . developing mutually beneficial, interactive and trusting relationships between the company and its many stakeholders – employees, customers, communities, suppliers, governments, investors and even non-governmental organizations and activists through the implementation of the company's strategies and operating practices. In this sense, being a good corporate citizen means treating all of a company's stakeholders (and the natural environment) with dignity and respect, being aware of the company's impacts on stakeholders and working collaboratively with them when appropriate to achieve mutually desired results.

Employing an institutional theory approach in his analysis, Hemphill (Forthcoming) argues that a corporate citizenship governance model has emerged in the US business community. Fundamentally, the macro (environmental) approach to institutional theory emphasizes:

1. the role of the state and external authority in imposing organizational arrangements; and
2. that organizational structures and processes may serve to legitimate organizations rather than to advance technical efficiency (Pfeffer, 1997).

In his paper, Hemphill (Forthcoming) analyzed the extent of private (''external authority'') and public (''state'') support offered for the US corporate citizenship model in recent years[2]. The results of his analysis shows that the involvement of major business organizations, such as The Conference Board and The Business Roundtable, and federal agencies, such as the US Departments of Commerce, State, and Treasury, in these national initiatives provides a strong foundation of legitimacy to the concept of corporate citizenship for US firms, both domestically and internationally. Furthermore, the programmatic emphasis of these initiatives is primarily focused on the quality of the business community's relationship with employee and community stakeholders.

The old economy was built on improvements in productivity driven by automation, technology and developments in management techniques. In the new economy, human capital, a term coined by Nobel Prize winning economist Gary Becker (1989), is becoming more important because economies, companies and employment are increasingly based on knowledge rather than physical labor and raw materials. Moreover, in the ''new economy,'' information and the people who possess and use it will become as important as the technology they use. Thus, human capital, or the knowledge worker, is paramount to the success of firms operating in this new competitive environment. Given this emphasis on the importance of the knowledge worker as a firm competitive asset to be nurtured and invested in, and the corresponding emphasis on the value of the employee stakeholder in the emerging corporate citizenship governance model, how does the apparent paradox of global outsourcing fit into the competitive strategy of new economy firms?

The corporate governance paradox

In the free market global economy, if there is a comparative cost advantage (given that other required business factors are met) to relocate business operations (whether it is blue-collar or white-collar jobs) outside the home country, firm management will do it. In fact, it may have little economic choice but to meet its competitors' decision to globally outsource certain functions, or find its products or services no longer competitive. While both corporate citizenship and human capital theory recognize the importance of a firm's knowledge workers to its ultimate economic success, there are certain limitations on what kinds of knowledge workers are considered essential. The most important factor for management in deciding whether to globally outsource is whether that position adds significant value to a company (Engardio, 2003). At one time, those employed in IT areas like computer code and software-application maintenance were working in jobs considered unique, complex and essential; however, their work is now considered rote, codified and a commodity, hence of lower-value and outsourced to a low bidder overseas. The economic (and social) impact on communities affected by such corporate decisions can be devastating. Are there ways for firms to assist employees affected by such decisions? Keeping productive knowledge workers should be a major concern of any company. In the long-term, recognizing corporate citizenship responsibilities to employees and the community is complementary to this economic imperative.

The phenomenon of global outsourcing of white collar positions is still in its early phase. As of 2002, companies based in India are taking in less than 5 percent of US IT spending (Frauenheim, 2002). Now is the time for USA and Western European firms to recognize their corporate citizenship responsibilities and institute an on-going human resource strategy that meets this increasing challenge of global outsourcing[3]. There are several components of such a human capital strategy. For many firms, instituting an internal labor market, where employees facing outsourcing can bid for open positions within the firm, would be of mutual assistance to firm and employee. Furthermore, offering generous tuition assistance for undergraduate and graduate degrees, certificate programs, and seminars (and allowing sufficient time to attend these programs) would encourage employees to upgrade their knowledge and skills and be promoted into more challenging and creative positions that are not being outsourced. While employees need to take personal responsibility for their careers, financial and managerial support for these educational and skills development programs has been declining in recent years. This has been a short-sighted decision on the part of management in industries dependent on employee creativity and innovation to sustain firm competitiveness. Another helpful initiative would be to outsource specific operations using a scheduled, graduated approach that will allow time for employees to seek new employment or job retraining opportunities, and reduce the immediate negative economic impact on the local community and the subsequent political repercussions on firms, industries and the business community. Moreover, private employee placement services should be made available for those employees not being retained by the firm, as well as the full employment services of the public sector. Will these efforts resolve the apparent corporate governance paradox? For many analysts the answer will be ''no''; but such efforts will help clarify the corporation's and employees' responsibilities and recognize the limitations inherent in this new social contract.

Global outsourcing and the public policy consequences

The issue of global outsourcing is now entering the public policy arena. In the USA, the AFL-CIO (Department of Professional Employees) is leading lobbying efforts at the federal- and state-level to bring this issue to the public's attention and acquire legislative redress (Gruenberg, 2003a). Furthermore, the Communications Workers of America have picketed a San Francisco Bay area outsourcing conference, and another high technology labor group, the Organization for the Rights of American Workers, has demonstrated outside global outsourcing conferences held in New York and Boston (Gilbert, 2003; Reich, 2003).

Recently, state governments in the USA have been pressured by labor groups to legislatively restrict private contractors from globally outsourcing employment under state contracts, a business practice that has already sent thousands of publicly paid jobs overseas (Gruenberg, 2003b). For example, intense lobbying and public pressure in New Jersey forced the state government to bring nine white-collar jobs that a private contractor had outsourced to India (for handling a ''help-line'' for welfare recipients) back to Camden, an area of high unemployment (Gruenberg, 2003a). In the state of Maryland, like in other states across America, legislation that would ban state agencies and contractors from exporting IT jobs to other countries has been introduced (Gruenberg, 2003a).

At the national level, the US House of Representatives, Small Business Committee, has already held two hearings on the issue of global outsourcing and its impact on US job losses in the IT industry (Gruenberg, 2003b). The US Congress has already initiated a legislative response to global outsourcing. On the 30 September 2003, it allowed the upper limit on H-1B visas issued to foreign high-technology workers to revert from 195,000 annually to its previous level of 65,000, largely to ensure that more of these professional positions are filled by US citizens (Reich, 2003).

Countries that are recipients of global outsourcing are increasingly aware of the potential political backlash growing in the USA and Western Europe. The National Association of Software and Service Companies (NASSCOM), one of India's largest business associations, recently released a report it commissioned with Evalueserve, a US business research and intellectual property service firm that is designed to evaluate the impact of IT and increased globalization on the US economy (National Association of Software and Service Companies-Evalueserve, 2003). By 2010, the NASSCOM-Evalueserve report estimates that the USA will face a domestic labor shortfall of 5.6 million (generated by an aging population and immigration restrictions) which can potentially cost the US economy $2 trillion if appropriate measures are not taken. The study results also found that global outsourcing keeps US businesses competitive, creates new markets for US goods and services, and fills the shortfall in labor services that the USA is expected to face in the next seven years.

While even critics who may agree that global outsourcing may help the overall economy, its negative impact on specific sectors (such as IT) is significant. Intel chairman, Andrew S. Grove, has warned that US dominance in the important software and services industries is in economic jeopardy (Krim, 2003). He reports that he is torn between his responsibility to shareholders to reduce costs and improve profits and to US IT workers who helped build the nation's technology industry, but who are now being replaced by cheaper labor (Krim, 2003). His answer is for government to help decide the proper balance between the two choices; otherwise companies will revert to their traditional obligation to increasing shareholder value (Krim, 2003).

For US corporate leaders (management and boards of directors), the legislative threat of protectionism is already on the agenda, and in a few cases, implemented by political leaders. While a strong case can be made that such legislation would hinder US firm competitiveness (since the US labor force and capital can be redeployed to higher-value industries and state-of-the-art research and development activities), if politically powerful middle-class Americans are significantly impacted as professional positions move out of the country, opposition to free trade could broaden (Engardio *et al.*, 2003). The benefits of global outsourcing must be balanced with the corporate citizenship responsibilities that US corporations are now espousing. The approach to a responsible human capital strategy, that directly addresses the threats of global outsourcing to employees, must be developed and embraced by companies and their industry associations[4]. The results of this human capital strategy will need to be transparently available to the public, and performance measures developed that reflect the reality of the new social contract and corporate citizenship governance model. A new corporate governance challenge is about to begin.

Notes

1 The development of the concept of corporate citizenship can be found in articles by Altman (1997, 1998), Altman and Vidaver-Cohen (2000), Burke (1999), Hemphill (Forthcoming), Maignan and Ferrell (2000), McIntosh *et al.* (1998), Tichy *et al.* (1997) and Waddock (1999). Also see *Special Issue: Corporate Citizenship* (2000), *Business and Society Review*, Vol. 105 No. 1.

2 Examples of public-private support for the corporate citizenship concept include: *The Conference on Corporate Citizenship* (1996) (Sponsored by the White House); *The Ron Brown Award for Corporate Leadership* (1996) (Sponsored by the US Department of Commerce and the Conference Board); *The Award for Corporate Excellence* (1999) (The Department of State); and Business LINC (1998) (Sponsored by the US Department of Treasury and The Business Roundtable).

3 PwC, an auditing and business services firm, surveyed the human resources strategies of 1,000 companies in 47 different countries in 2002. One interesting survey result was that only 60 percent of the firms had written human resource policies (Skapinker, 2003).

4 In its position paper on global outsourcing and offshore development, the Information Technology Association of America (ITAA) (2003), a major industry association representing over 400 corporations in the USA, strongly encouraged (among other recommendations) education, training, and constant retooling of future and current US workers in technology-related subjects.

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