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The Challenge to America of Business Process Outsourcing (“BPO”)

“IS YOUR JOB NEXT? A new round of globalization is sending upscale jobs offshore. They include chip design, engineering, basic research – even financial analysis. Can America lose these jobs and still prosper?” read the cover story of a recent issue of Business Week. The inability of our economy to create new jobs and absorb the growing number of unemployed, even as it is said to have recovered, has been referred to as a “jobless recovery.” Solutions to this dilemma are not easy. We believe Business Process Outsourcing (“BPO”) has been a profound factor in the exporting of jobs offshore to subsidiaries or third-party providers. Besides the loss of jobs and the failure to create new ones, this process has impacted virtually all parts of the economy. The recognition of the challenges to come do not seem very much in evidence outside a limited number of business publications or anecdotal stories in newspapers. In this article we will describe BPO’s impact and several issues it raises in areas such as health care, immigration, tax policy both to draw attention to what is happening and generate reasoned discussion as a basis for formulating policy.

The Situation

Though the US economy statistically recovered from the “mild” recession in 2001, unemployment has risen from approximately 4% to nearly 6%. This is a 50% increase in the number of unemployed people in the US labor market. Urban centers like New York City, which had a January unemployment rate of 8.6%, nearly 50% higher than the national average, have been particularly hard hit. The common description of a jobless recovery seems particularly apt. That is until you look a little closer.

Certainly the recession, the lingering effects of 9/11 and geo-political uncertainties have taken their toll on the US economy and go a long way to explaining current conditions in the US labor market. But there is another significant factor affecting the labor market that is not being widely discussed outside of the business media and corporate conference rooms. That factor is the practice of outsourcing white-collar jobs to lower cost centers overseas. Lower cost centers are typically places like Bangalore, India where the cost of doing business is substantially lower than it is in the US. In Bangalore wage, infrastructure and regulatory costs are a fraction of what they are in the US. As a result, businesses operating in these lower cost centers can produce the same amount of work at a fraction of what it would cost a business in the US, and often at a higher level of quality.

Startlingly, even a quick look at the labor markets in these offshore lower cost centers challenges the notion that our current recovery is not creating jobs. Jobs are being created during this recovery, just not in places like New York City, San Francisco, or Flint Michigan. Jobs are being

created in places like India, Jamaica, the Philippines, and even Sri Lanka. For instance, the National Association of Software and Service Companies (Nasscom) an association of software and IT-enabled services companies, estimates that India's IT-enabled services industry grew by 70% during 2001-2002. This trend is likely to continue as John C. McCarthy of Forester Research predicts that at least 3.3 million white-collar jobs and \$136 billion in wages will leave the US to low-cost centers offshore by 2015.¹

In this article we would like to draw attention to the magnitude and importance of what is happening in the hope of prompting serious discussion of how best to respond. A discussion, which we believe, has been glaringly absent. With Americans at all levels feeling the pressure of increased insecurity and limited financial prospects, we can't afford not to.

Why is this time different?

Statistics like those above may raise questions about why this is different from what we have seen before? Why is this different from the loss of manufacturing jobs overseas in the 70's and 80's? And why is this different from the 'great sucking sound' created as many US factory jobs were permanently lost to "Maquiladoras" just across the Rio Grande border in Mexico due to NAFTA?

The answer is, in some ways it is not different at all, but in other ways it is critically different.

As US corporations were exposed to greater competition from abroad and expanded into new markets overseas, pricing pressures forced corporations to change the organization of production. By the 70's and 80's corporations were regularly closing inefficient factories and laying-off workers in a bid to lower costs and increase quality. Central to this was the use of two practices, moving production facilities overseas and outsourcing, and they employed many different combinations of the two. The rationale for each was clear. By moving production facilities overseas, corporations could take advantage of the low costs and high skills of foreign labor markets while avoiding many of the regulatory complications of the US market. By outsourcing, corporations could focus on their main business or core competencies, achieve greater flexibility, turn assets into costs, and benefit from vendor expertise.

Understanding the relation between core competency and outsourcing is crucial to understanding what happened then and what is happening now. IBM serves as an instructive example in this regard. IBM used to consider building and selling computers as its core competency. Consequently, it used to build each part of the computers it sold and program the software that went with it. However, they were not in the business of payroll processing, so they were happy to outsource their own payroll processing to ADP, a vendor whose core competency includes providing of payroll services to many companies. In doing so ADP has developed processes and expertise and can deliver the payroll service far more cost-effectively and at higher quality level than IBM.

IBM can serve as an instructive example in another way as well. When IBM began producing PC's hardware as its core competency and decided to outsource the development of its operating system to a small company called Microsoft. That decision helped create the largest company in the world and almost ruined IBM in the process. Decision about core competencies and which processes to outsource can have resounding implications. A miscalculation can give away tremendous opportunities and value.

Needless to say the changes in the organization of production have had a profound effect on the US economy. The prevalence of outsourcing increased job insecurity and put a downward

¹ Business Week February 3, 2003: "Is Your Job Next?" by Peter Engardio, Aaron Bernstein, and Manjeet Kripalani (Pages 50 - 60)

pressure on wages. Perhaps more significantly, when US corporations moved production overseas, either through subsidiaries or external vendors, it was a zero sum situation in which the American loss was a foreign country's gain. For example, the total value of American imports from American-owned factories abroad rose from \$1.8 billion in 1969 to \$22 billion by 1983, adjusted for inflation.² As a result, the US economy evidenced slow growth through the 70's and into the 80's and the wages of American workers stagnated.³

The current exodus of jobs is also a result of moving facilities overseas and outsourcing, but this time it is outsourcing of a different sort. It is Business Process Outsourcing (BPO). Accenture, a leading management and technology services firm leading the charge to use BPO defines it succinctly as "Contracting with an external organization to take primary responsibility for providing a business process or function."⁴ In practice this generally means outsourcing back office functions such as: customer support, help desk, bill processing and payroll. These are typically white-collar office jobs that support an organization's core competencies or *raison d'être*.

Companies outsource these back office functions to other organizations so they can focus on their own core competencies, save money, and tap vendor expertise. In fact the arguments for BPO are so convincing to corporate managers that The Outsourcing Institute estimates that between 1996 and 2001 the percent of companies with sales of more than \$50 million that outsource had increased from 29% to 36%, and that BPO and traditional IT outsourcing together had grown to \$345 billion by October 2001.⁵ Further CFO Magazine reported that of the CFOs they surveyed 68.3% reports that their firms are currently involved in BPO and 63.6% thought their firms would increase their overall use of outsourcing.

Combined with increased global economic integration and ease of communication, the prevalence of BPO throughout corporate organizations makes it easier to move more and more jobs overseas, a phenomena referred to as Cross-Border BPO, in which corporations outsource business functions to subsidiaries or vendors overseas. It is this practice that is largely responsible for the growth in IT-enabled service industries in countries like the Philippines, Jamaica, Sri Lanka, and India. Reports by Gartner estimate that Cross-Border BPO will only continue to increase, growing from \$123.6 billion in 2001 to \$178.5 billion in 2005.

The rationale behind Cross-Border BPO is similar to the earlier outsourcing of manufacturing and the creation of "Maquiladoras" after NAFTA. Especially with the current anemic levels of revenue growth, cost reduction will continue to be a compelling motivator, as companies can achieve a 30% to 50% cost savings by employing Cross-Border BPO. Also back from the 70's and 80's are doubts about the value of the American worker. For example, turnover rates for back office positions in the US can run as high as 70% to 120%, while in India, where more than 100,000 young men and women between 20 to 23 years old work in call centers, turnover rates are as low as 12% to 35%. And to top it off, workers in India are often far more educated than their American counterparts, producing higher quality results.

But with all the similarities to what happened in the 70's, 80's and early 90's we can't lose sight of how the current exporting of American jobs through Cross-Border BPO is significantly different.

First, there are no natural barriers to limit the extent to which American jobs will be exported due to cross-border BPO. Unlike in the case of outsourced manufacturing goods in which

² The Work of Nations, by Robert Reich, pg 73

³ "Between 1969 and 1979 the value of manufactured imports relative to domestic production in the United States surged from less than 14 percent to 38 percent. By 1996, for every \$100 spent on goods produced in the United States, Americans were buying \$45 worth of manufactured imports." The Work of Nations, by Robert Reich, pg 72

⁴ "Business Process Outsourcing Big Bang: Creating Value in an Expanding Universe" White paper from the Accenture Institute for Strategic Change

⁵ "Everything Must Go: Business Process Outsourcing" CFO.Com 10/01/2001

transportation costs create a natural disincentive for expanding foreign manufacturing of goods, the digital infrastructure that BPO is based on requires an upfront capital investment. Once this infrastructure is in place, there is an added incentive to maximize its utilization thereby spreading the cost over as wide a base as possible.

Second, the jobs that are leaving now are qualitatively different than the jobs that left earlier. Many argued that the US was in a post-industrial information economy, and the loss of manufacturing jobs was part of the process of creative destruction. In the end, they argued, this would be positive, freeing American workers to take on higher value and higher paying jobs in the information economy. But the jobs leaving now are no longer the so-called 'blue-collar' jobs. And while a great number of the original jobs that left the country due to BPO were fairly low value 'white-collar' jobs, once the technical infrastructure is in place and companies get used to working with subsidiaries or vendors in other countries, there is no natural limit to the types of jobs that can be outsourced, including high-value jobs. A quick scan of the literature about cross-border BPO suggests that this is already happening, with the most widely adopted forms of BPO including:

- Travel Services
- Employee benefits
- Payroll
- Tax advice/processing
- Insurance administration
- Billing and Collections
- Recruitment
- Cash management
- Internal audit
- Human resources Administration

Other jobs being outsourced include:

- Purchasing and Disbursement
- Order entry
- Billing and collection
- Cash and investment management
- Customer relations

There is another crucial difference: What is happening now will affect the American worker differently than the changes that happened earlier. In the 70's, 80's and 90's American workers accepted greater job insecurity and longer working hours as manufacturing jobs were exported. In return for these sacrifices, the American worker was promised greater rewards of higher skill, higher value, higher paying jobs, if only they worked hard enough and continued to learn the new skills needed to participate in the information economy. American workers responded to that pledge, changed their lifestyles and worked hard to learn new skills. Our education infrastructure adapted to help American workers do this. A wealth of private classes sprung up, courses offered in community colleges were touted as a bridge to enter the information economy and universities geared students to the new realities of work. But now that the infrastructure is largely in place, the jobs that it is preparing people for may not be. These are the very jobs that are being exported to lower cost centers overseas. The American worker has paid the price to participate in the information economy, but may not have the opportunity to do so.

The Response – Who should do something about this?

The nature of current problem makes it clear that we should not expect the economy to return to normal when the current geopolitical uncertainties clear. The rationale for employing cross-border BPO will only be reinforced by competitive pressures as it gains momentum. The risks for not addressing the inevitable consequences are too great to accept. Clearly the scope of the current problem suggests that there will be no easy answers, but a quick look at those involved point us to who is best positioned to respond.

It is well documented that the American worker is working longer and harder, under increased pressure just to maintain his/her standard of living. There is little chance that he/she will be in a position or have the resources to address this problem.

In the US system corporate managers have one overriding responsibility, to maximize returns for shareholders. As long as Cross-Border BPO makes an economically compelling case, an individual corporate manager would be remiss if he/she did not use it. So there is little reason for corporate managers to address this problem.

Finally and appropriately that leaves the government on the city, state and federal levels. We say appropriately for 2 reasons, first because governments will be affected considerably, and second because governments are in the position to respond to this problem effectively.

While it is individual American workers who will feel the direct impact of jobs being shipped overseas, the widespread damages of this phenomenon will accrue to national and local economies.

Governments are in the position to respond effectively, because any effective response is likely to include systematic and regulatory changes as well as the provision of public goods (those goods that are best provided at the societal level).

Here it is important to note that this is not an issue of free trade versus protectionism. This is not a call for a return to Beggar Thy Neighbor policies of the past. Rather it is a question of how the US uses the resources at its disposal to position itself in the competitive landscape of a globalized economy and the value we as a society place on making it possible for American workers at all levels to maintain a reasonable and viable standard of living.

The Response – What should the government do?

Clearly this is a complicated problem, and it is unlikely that any single silver bullet response will address it. Further, we want to make clear that we are not putting forward a recipe for doing so, rather we are calling for a fruitful debate that is currently glaringly absent about the best and appropriate response. Nonetheless, there are several useful things we can say about possible responses.

First, a clear understanding of why corporations are turning to Cross-Border BPO, combined with knowledge of the decision-making criteria of corporate managers suggest a number of steps which can lead corporate managers to hire American workers. While we will save a detailed discussion of this for other forums, we will share one of the overriding strategic policy objectives that emerge from this line of reasoning. On the national and local levels, we suggest that assisting American workers develop, maintain, and extend a sustainable competitive advantage should be a strategic policy objective.

Second, given this strategic policy objective, we believe that on the tactical level policies should be assessed as positively, negatively or neutrally contributing to this objective. For the purpose of prompting serious discussion we offer 3 concrete policy examples that can be reviewed in this way.

Health Insurance – BPO Impact

Because health insurance in the US is typically tied to and offered by one's employer, job loss results in eventual loss of health insurance. For terminated workers who can afford it, a government program known as COBRA mandates that employers must allow terminated workers to extend their insurance coverage for a 12 or 18 month period at their own expense. After the COBRA extension period, the worker must scramble to find alternative coverage. Many do without and live with the consequences.

As the unemployed pool in absolute numbers has effectively increased by 50%, one can impute that approximately an additional 2 million workers have lost or are candidates to lose their health insurance.⁶

Indeed taking the Forester projections that BPO will result in an additional 3.3 million jobs transferred overseas by 2015, workers losing those jobs will likely lose their health insurance as well. For the nation as a whole, and particularly for major metropolitan regions such as New York, Chicago, San Francisco, Dallas, and Boston, where the cost of health care is among the highest in the nation, the absence of health insurance alternatives represents a ticking time bomb that requires attention.

An understanding of Cross-Border BPO suggests an additional reason for looking at this closely. All other things being equal, the fact that employers in the US are required to offer their employees access to health insurance increases the costs of highering a worker in the US, providing a disincentive for doing so. This policy has a negative impact on achieving the strategic objective of assisting American workers in achieving a sustainable competitive advantage vis-a-vis their counterparts overseas.

Far from suggesting that the problems Cross-Border BPO presents justify leaving each individual to his/her own devices to secure health insurance (as this would be a further competitive disadvantage for the American worker), we believe this is yet another strong argument for ending the arbitrary coupling of health insurance and employment. Not only would this be a concrete step toward improving the strategic positioning of the American worker, but it would also address the perverse practice of ending health insurance coverage when employment is terminated.

Dividend tax vs. Payroll tax

How can American workers compete against low cost providers overseas without sacrificing their economic situation? One obvious candidate for helping them to do this is reducing the payroll tax. The payroll tax is regressive and for many workers makes up a larger portion of their overall tax burden than income tax. Payroll tax is widely seen as a cost born by the worker and creates a competitive disadvantage for the American worker. Lowering it would enable the American worker to decrease the 30% to 50% cost gap between hiring domestic and overseas workers, helping to achieve the strategic policy objective.

If Congress is set on passing a massive tax cut, despite recent events to the contrary, there is ample reason to believe that lowering the payroll tax would be more productive than eliminating the tax on corporate dividends. Putting aside the dubious nature of arguments about the claim that eliminating the dividend tax would create incentives for corporate behavior, there are three other good reasons we should prefer a reduction in the payroll tax to the elimination of the dividend tax.

⁶ According to a Commerce Department press release dated September 30, 2002 the actual number of uninsured rose by 1.4 million to a total of 41.2 million from 2000 to 2001.

First, as Stiglitz noted in a recent article in *The New York Review of Books*, since many middle class people already hold the majority of their equities in tax protected vehicles such as 401k's, the benefits from eliminating the tax on corporate dividends would only accrue to the very wealthy, making it a poor stimulus or growth plan.

Second, by lowering payroll taxes on jobs in the US, the federal government can ensure that the benefits of the tax cut would stay in the US and contribute to the US economy. The elimination of the tax on corporate dividends offers no such assurances, as corporate expenditures and the extra income for the wealthy can easily flow out of the US.

Third, even if Congress wisely feels uncomfortable passing a massive tax cut, a reduction in payroll taxes could be paid for by extending the upper limit of payroll affected. This would not only help the competitive posture of the American worker, but would also ameliorate one of the most regressive elements in current US tax policy.

These three reasons, plus the strategic benefit that would accrue to the American worker in helping to reduce the 30% to 50% cost gap suggests this is a concrete policy suggestion that is worthy of careful consideration.

Immigration and Working Visas

An enduring strength of the United States has been its policy of taking in people from all over the world and benefiting from their traditions, cultures, brains and energy. In fact, with demographic studies showing that the US population is aging and growth is slowing, there are many reasons to believe that robust immigration will be necessary for future prosperity. However, we distinguish between immigration policy, which should likely remain untouched or broadened, and the policy of granting working visas such as H1B and L1, which should be closely reviewed.

In the late 1980s and early 1990s serious shortages of critical skills in the US economy, such as technology and nursing, prompted the expansion of these programs. H1B visas were regularly used by US corporations to sponsor and import foreign expertise for stays of various lengths, sometimes resulting in permanent "Green Card" status or immigration. There is abundant anecdotal evidence that these workers significantly helped created and sustain the boom of the late 90's. In fact, the prevalence of nurses in urban area hospitals working under H1B visas from India or the Philippines suggests that there is an enduring need for skilled workers in certain areas. However, the softening of the domestic job market for technology related workers suggest tightening of the number of H1B visas is in order.

The L-1 visa is a different story altogether. L-1 visas are available to persons who are being temporarily transferred to the United States to work in an executive, managerial or specialized knowledge capacity for a business. The person must have been employed in that position for one of the last three years before being transferred. The work must be for the same company, an affiliate or subsidiary for intervals up to three years.

A *Business Week* March 10 article titled "A Loophole as Big as a Mainframe" chronicles how many outsourcing firms use L-1 visas to bring in low-cost workers from overseas to replace higher cost American workers. Siemens' US operation in Lake Mary, Florida contracted with Tata Consulting Service, one of India's largest IT consulting firms to provide tech workers to replace existing American staff. The replacements are low-cost workers from Tata's India operations brought to the US via L-1 visas. Strictly speaking this is perfectly legal and made sense during the rising economy and shortage of tech savvy people. However, using L-1 visas to further weaken an already soft domestic labor market by importing lower-wage workers to the US further disadvantages the competitive posture of American workers. A serious review of this policy is warranted.

Final Words:

In this article we hope to have questioned the prevailing wisdom that we are currently in a "jobless recovery". After all jobs are being created, just not in the US. We believe that BPO is a significant factor in the exporting of American jobs. This presents a problem that can best be dealt with on the level of government policy and we call for a serious discussion of possible responses. We invite you to join us in taking up this issue.

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