



THE
SERVICES
SHIFT

Seizing the Ultimate
Offshore Opportunity

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with **AJAY SHARMA**

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Introduction

If you're an active manager in the first decade of the twenty-first century, you already know about the phenomenon of globalization in the manufacturing sector—although perhaps you don't know the full scope of that phenomenon. But by any measure, it's enormous. In 2006, the U.S. trade-to-GDP ratio was 28.0 percent, compared with 11.1 percent in 1970 and 20.4 percent in 1990.¹ In 2006, U.S. companies committed \$60 billion to new manufacturing foreign direct investment (FDI): a jump of *66 percent* over the previous year.²

The reasons behind this phenomenon are well documented, and they are widely—often hotly—discussed. They include the low cost of labor overseas, fewer regulatory restrictions, proximity to emerging markets (facilitating sales in those markets), the ability to focus home country resources on product development and marketing, the commoditization of manufacturing technology, the rise of supplier clusters in different countries, and so on.

But there's a parallel phenomenon occurring today—another kind of offshoring—that may soon overtake its manufacturing-based cousin in scale and scope: *the globalization of services*.

We call it “the services shift.”

This is a new and different phenomenon, and it's one whose implications are poorly understood by most corporate managers. True, most of us have heard stories about large corporations moving call centers and basic business processes (for example, software development, payroll, billing) offshore. And on a basic level, most of us understand the compelling logic that lies behind these developments. To the customer phoning in to argue about an entry on his or her monthly credit card statement, it doesn't matter much whether the contact center agent is sitting in Omaha, Nebraska, or Bangalore,

India. If it's cheaper to hire that agent in Bangalore than in Omaha, *and* if that offshore person is able to resolve the dispute successfully, then that service job is very likely to move offshore.

In fact, to a large extent, it already *has*.

But so far, it has been hard to get a clear picture of what's going on—and where and why. Where are the jobs going? Who's getting the benefits of the globalization of services? How big are those benefits? What companies benefit (or could benefit) from the offshoring of services? How, exactly, does it work? Who makes for a good partner in this realm? What are the public policy implications of this trend—and how can companies make long-term investments if the ground is shifting beneath their feet?

These are the questions we ask and answer in *The Services Shift*.

Outsourcing and Offshoring

First, some definitions, which we'll return to and flesh out in subsequent chapters. **Outsourcing** means moving a particular task outside an organization's boundaries. When a company decides to eliminate its in-house food service department and hire an outside contractor to run its cafeteria, it is "outsourcing" that function. For lots of "non-core" practical activities—such as staffing the cafeteria and cleaning the headquarters building—outsourcing means buying the service fairly close to home.

But many other activities aren't necessarily rooted in geography. In theory, at least, you *could* outsource these tasks to a contractor anywhere in the world. When a task moves across a geographic boundary, we call this "offshoring."

For example, recent years have seen the emergence of a phenomenon called the "electronic ICU (intensive care unit)"—a virtual ICU that uses video conferencing, remote bedside terminals,

and image-acquisition technology to monitor critically ill patients remotely. With eICU, a team of critical-care specialists sits at a remote location and continuously tracks patients' vital signs, and if something is amiss, the team contacts the onsite staff and recommends action.

One electronic ICU provider, VISICU, pitches its product as a way to cost-effectively improve medical care in hospitals that don't have enough critical-care physicians:

ICU patients require around-the-clock specialized care, however most ICUs don't have the specially trained physicians available to provide this. With an eICU facility linked via telemedicine and computer monitors to their hospital ICU rooms, they now can.³

VISICU likens its eICU solution to the air traffic control function, in which a team of technical specialists relies on software and tracking technology to assist in airplane navigation without actually being in the cockpit. The company claims to have implemented some form of the eICU solution in 34 U.S. hospitals, and has recently inked a \$25 million deal with Sutter Health, Northern California's leading non-profit provider of health-care services.

Currently, eICU is only outsourced—that is, turned over to domestic contractors—rather than offshored. But in this activity, *distance is irrelevant*. In fact, other than some truly formidable regulatory barriers, nothing stands in the way of moving the eICUs offshore, and thereby substituting foreign health-care technicians for domestic ones.

The white-coated doctor in your local hospital might seem forever immune to offshoring, but as the eICU example illustrates, that's not necessarily the case.

Offshoring, as the name implies, means moving a function and its associated jobs to another part of the world. Offshoring comprises a wide range of relationships between the “parent” company

and remote service providers. Sometimes those providers stay within the corporate boundary, but operate at a geographic distance. Sometimes they are outside the corporate boundaries (they are “outsourced offshorers”). In this book, we focus mainly on the offshoring phenomenon, although certainly domestic outsourcing is another important kind of “services shift.”

The word “offshoring,” useful as it is, is something of a red herring. The globalization of services is not simply a story about jobs being moved offshore. It’s about a *fundamental reorganization of work*, in which different tasks are being carried out by different individuals in different locations. As new global sourcing options become available, forward-looking managers are actively evaluating tasks, processes, and functions inside their firms—from back-office support to leading-edge research—to determine the most cost-effective *and* highest quality location to carry out these activities. In other words, it’s not just about finding a low-cost location. It’s about gaining access to the best combination of talent, resources, and local markets.

Why is it happening *now*?² Again, we’ll look into this question in greater depth in later chapters. But for now, we’ll simply point to five compelling forces:

- **Technological innovations**—These innovations include the spread of computer literacy, broadband Internet access, inexpensive international telephony, widespread digital records, and so on.
- **Emerging market growth**—Today, developing countries are working to “grow” their service sectors at least as aggressively as their manufacturing sectors. Countries around the world have witnessed India’s experience—with exports of software and IT-enabled services growing at a compounded annual growth rate of more than 43 percent, rising from \$128 million in 1991 to \$40.8 billion in 2007.⁴ These exports can be achieved with relatively low capital investment and environmental impact. Finally, the sector is attractive because it involves using a country’s brains, not its brawn.

- **Global macroeconomic liberalization**—Based on the standard measures of economic “openness,” more countries are able to engage in international trade and investment than ever before.
- **The corporate imperative to both reduce costs and improve quality**—Most business practitioners understand the concept of lower cost through offshoring; fewer understand that offshoring can lead to major productivity and quality improvements.
- **A convergence of global business culture**—This includes the global dissemination of Western management principles, the emergence of English as the global language of business, and so on.

Even this brief review of the factors pushing for the globalization of services should suggest, *strongly*, that this powerful trend is not a fad, but a huge, fundamental, and irreversible shift. According to McKinsey/NASSCOM, offshore IT and business process outsourcing (BPO) have only reached *one-ninth* and *one-twelfth* of their respective market potentials!⁵

What does this mean for your company? Business models and organizational structures will become more dynamic, more fluid, and more opportunistic. In fact, this transformation is already well underway.

What does this mean for *you*? Tomorrow’s managers also will have to become more flexible, more versatile, and more broad-gauge. The old ways of providing services—both in the traditional “service sector” and in the services-oriented activities of manufacturing firms—just won’t cut it in the face of the global services shift. You need to understand the offshoring options that are available to you, because—*without a doubt!*—your strongest competitors will certainly understand them, and exploit them.

Introducing the Authors

Who, exactly, is taking you on this global tour of offshoring? As much as possible in this book, we'll adopt the first-person plural voice: *we*. For the purposes of this part of the introduction, however, we'll switch briefly to the third person.

Author **Robert (Bob) Kennedy** is the Tom Lantos Professor of Business Administration and Director of the Global Initiative at the University of Michigan's Ross School of Business. He is also Executive Director of the William Davidson Institute (WDI): an independent, nonprofit research and educational institute located at the University of Michigan. Founded in 1992, the Institute focuses on business and policy issues in developing countries and operates in five broad areas: research, executive education, development consulting services, development and distribution of teaching materials, and supporting international activities at the University of Michigan.

Kennedy has been involved in research and advisory work directly related to offshoring for the better part of a decade. In 1999, he began working with Tata Consultancy Services, which is India's largest software firm, and one of the leading global drivers of services offshoring. Since then, Kennedy has published more than a dozen teaching cases on offshoring issues. Between 2002 and 2008, his international business and offshoring cases were assigned at every one of *BusinessWeek's* top 25 business schools.

In addition to his academic credentials, Kennedy has extensive "real-world" experience. He has worked as a consultant in more than 20 countries, performing advisory work for many of the firms engaged in cutting-edge offshoring practices. Prior to his academic career, he worked as a venture-capital investor in central Europe and has maintained this real-world orientation ever since.

Coauthor **Ajay Sharma** is Research Manager for the "Globalization of Services" initiative at the William Davidson Institute, and is an expert in IT and process consulting. After earning his bachelor's

degree in electrical engineering at the Institute of Technology, Banaras Hindu University (Varanasi) in 1992, he joined Infosys, which was then embarking on a dramatic growth curve based on offshoring software development. After six years as a project manager with Infosys, Sharma joined PriceWaterhouseCoopers (USA), where he provided technology consulting to Fortune 500 companies. He then earned his MBA at the University of Michigan, and—after receiving his degree in 2004—joined the William Davidson Institute.

Returning to our shared authorial voice, together we have deep theoretical grounding, extensive practical experience, and strong ongoing relationships with many of the most innovative offshoring companies in the world. It's this knowledge base and experience that we bring together in *The Services Shift*.

What You'll Find in This Book

We've already introduced the important distinction between outsourcing and offshoring, mainly talking at the industry level. In Chapter 1, "Globalization of Services: What, Why, and When," we'll dig deeper into these phenomena, giving examples at two levels: industries and companies. We'll provide several tools for you to use as you think about your own company's place in the global services community. We'll explain that the current (and exploding!) wave of services globalization is simply the next logical step in the evolution of international trade, which began with the extraction and exploitation of natural resources, continued through the rationalization of manufacturing around the world—a process that continues today—and now is expanding rapidly into the services sector.

We economists sometimes take for granted certain theories and principles that business practitioners, pundits, and laypeople either don't understand or simply don't buy into. With that potential gulf in mind, we provide some basic economic rationales for why interna-

tional trade and investment are “good,” in the sense of creating comparative advantages for nations, and better returns on capital for individual investors.

Yes, change inevitably causes pain and dislocation for workers in particular industries or sectors. One of the paradoxical aspects of globalization is that the *gains* it creates tend to be spread across large numbers of individuals, whereas the *pain* it generates tends to be localized in smaller groups of workers, companies, or communities. When millions of Wal-Mart shoppers save \$10 each on their running shoes, that’s a huge collective benefit to those shoppers. Meanwhile, a running-shoe factory closes somewhere in the United States, creating dislocations and pain for the people who worked in that factory, and for the surrounding community. When viewed systematically, in almost all cases, the total gains from trade outweigh the losses. It’s just that the losses are more easily identified and observed.

The domestic U.S. press has taken notice, often casting this phenomenon in terms of “American jobs lost.” But this is the wrong lens through which to observe trade. The right question is, *where can and should specific tasks be located to achieve the best combination of cost and performance?* Yes, the jobs that are associated with these tasks might move. But locating *the right tasks in the right place* also leads to faster product development, stronger companies in the “offshoring” nations, better returns for investors in those companies, and rising demand in those nations.

In other words, offshoring—done right—leads to an enhanced standard of living in both developed and developing countries. To be sure, change is uncomfortable, and this provides a ready hook for polemicists. But change is also necessary for growth and improvement.

As we make clear in Chapter 1, managers don’t have the luxury of putting their strategies on hold to await the outcome of a national policy debate. They have to improve their firms *today*, along lines that

have already been proven to work, or they will fall behind to those who *do* make those compelling changes.

Chapter 2, “The Economics and Drivers of Offshoring,” provides a framework for analyzing and understanding offshoring opportunities and discusses why the globalization of services is occurring *now*.

In the first part of Chapter 2, we look briefly at two economic frameworks that are helpful in understanding and assessing offshoring opportunities. The first is the value chain, introduced by Michael Porter in 1985. The value chain framework allows the analyst to look inside the “black box” of a firm—breaking it into a sequence of functions or tasks. Porter’s insight was that competitive advantage arises from capabilities at the *function/task* level, not at the *firm* level.

The second framework is “transaction costs economics,” or TCE, which explains why and where firm boundaries exist. This, in turn, helps shed light on why firms perform some tasks themselves locally, “outsource” some tasks to other firms, and source some from remote locations. As businesses, suppliers, customers, and technologies evolve, the transactions costs involved in moving tasks across firm or geographic boundaries also change, thus affecting the sourcing options and payoffs facing firms.

The chapter then revisits the outsourcing/offshoring decision and, using TCE, discusses the factors that make a task more or less likely to be a candidate for being transferred across a firm or geographic boundary.

In Chapter 1, we explain why trade in services has become more like trade in manufactured goods in recent years (production and consumption have become separable by geography). In Chapter 2, we show how trade in services *differs* in important ways from trade in manufactured goods.

Why? First, services tend to be much more labor intensive than manufacturing. This means that low-wage countries have an even greater advantage in services than they traditionally have had in manufacturing. Second, new (and vocal) categories of workers have become vulnerable to offshoring. Third, trade in services tends to be *synchronous*—that is, happening in real time—which makes this new kind of trade highly visible. And fourth, within the firm, offshoring tends to happen at the task level, and activities sourced remotely remain closely connected to activities retained at home. This means that a service activity that has been offshored—for example, accounting, collections, or product design—still interacts with the company’s remaining employees every day.

Still, not all services lend themselves to offshoring. There are still whole categories of jobs that will remain off limits to offshoring, at least for the time being—and in some cases, forever. (Your local barber, your police officer, and your elementary school teacher are probably immune to offshoring.) Certain kinds of jobs near the beating heart of the company—the core competencies—are probably “safe.” But changing technologies call for a continual reexamination of what is possible. Radiologists once assumed that they were safe, and it’s now clear that they are not.

The chapter concludes with a discussion of what we call the “Five Drivers of Globalization” in the services sector, and explains why those drivers are likely to intensify in the future:

- The economic liberalization in developing countries, which has resulted in 1) lower barriers to economic engagement, 2) higher growth rates in those countries, and 3) increased attention from global firms that are under pressure to generate higher growth rates of their own
- The digitization of business processes, which makes many more business activities “moveable”
- Rapid improvements in quality and reductions in cost across a range of computing and telecom services, which again permit and encourage “task mobility”

- Growing capabilities around the globe
- The emergence of a global business culture, based largely on the practices of leading U.S. and European companies, which makes an ever-larger number of geographic contexts congenial to those companies

In Chapter 3, “Making It Real,” we present a framework intended to help you establish realistic sourcing goals for your organization and to implement these goals. Firms pursue offshoring for a variety of reasons, including efficiency, enhancement, and transformation. The first part of the chapter discusses how these approaches differ and why it is imperative that you be clear and realistic about establishing your offshoring goals. These goals influence the entire offshoring journey—which tasks/processes to start with, the type of sourcing partner to work with, the risks encountered, and the expected benefits.

The chapter then discusses the differences between offshoring tasks (for example, operating a call center and managing accounts payable) and offshoring entire processes (for example, hire-to-retain HR management or purchase-to-pay sourcing operations). Task offshoring tends to be cost and best-practice focused, whereas process offshoring is closely linked with reengineering. In some situations, successful process transformation leads to business performance benefits of 10 to 20 times those from labor cost savings.

The chapter then describes in detail how companies go about identifying, documenting, and migrating activities offshore. We walk you through an eight-step process that takes companies from activity identification to implementation, calling on tools such as detailed process mapping, IT systems implementation, risk mitigation, monitoring, process migration, and post-switchover integration.

Let’s assume you’re interested in offshoring, but you’re not sure of your range of choices in the global marketplace. Chapter 4, “The Supply Side,” explores outsourcing options today. It begins with an overview of the offshoring universe—size, growth rates, types of

activities, and so on. The chapter then discusses how we got here—starting with the Tata Group’s initial software exports in 1973 and continuing (in a milestone format) up to the present.

We then present a typology of offshoring business models:

- The captives of global firms such as Motorola, American Express, and Microsoft
- Organizations affiliated with global outsourcing firms, such as Accenture, IBM, and Convergys
- Firms affiliated with offshore software firms, such as TCS, Infosys, and Wipro
- Independent firms, such as ITTIAM, EvaluateServe, and Telera-diology Solutions, Inc.

Obviously, offshoring involves all different kinds of firms. Yes, you have the huge software firms that have gotten into the back-office business. And you have the U.S. Fortune 100 firms that are rushing over in large numbers, as well. (IBM now has 53,000 people, or 17.6 percent of its global workforce,⁶ in India, and has described India as a linchpin in its strategy to serve the “globally integrated enterprise.”) But you also have a host of very small firms in niche roles—market research, medical transcription, and so on. You also have reconfigurations within this cast of characters—for example, GE’s spin-out of Genpact (from captive to independent), and R.R. Donnelley’s recent acquisition of Office Tiger (from independent to captive).

Today, much of this activity is centered in India. But more and more countries are playing, or trying to play, in the offshoring game. China and the Philippines are already important offshore destinations, and countries such as Hungary, Russia, Morocco, Brazil, South Africa, and Mauritius are gaining ground.

What do these different kinds of firms, in their different geographies, mean for *you*, as a contemporary manager? How do you

choose a partner, and what signals should you look for in a successful offshoring relationship?

Chapter 5, “Shifting Skill Sets,” explores what this all means for how you manage and organize your firm. We start with the fact that offshoring is a *hands-on activity*. Moving tasks from one geography to another creates both enormous challenges and impressive opportunities for companies. Managers need very specific skill sets to make offshoring work—and those skills often differ from those required in the non-outsourced, non-offshored world.

For example, international skills (language skills, cultural awareness, an understanding of how the global business community functions) were once a “nice to have.” Today, for offshoring companies, they are indispensable resources. Where such skills were once confined to the executive suite or in the “international division,” they are now required deep down in many different parts of the offshoring organization. At almost every level, people need to understand how to communicate and manage across cultures. They need to be skilled at anticipating and managing risk, and they need to be effective communicators—enabling them to head off the backlash that is often inherent in offshoring, or to contain and offset that backlash when it does arise.

At the same time, strong IT and industrial engineering skills are needed—not only to reengineer, migrate, and manage far-flung operations, but also to develop and maintain the IT systems that are required to manage a geographically dispersed operation.

The chapter presents a framework with which to consider the types of management responsibilities that lead to success. We then draw on detailed interviews with dozens of offshoring firms to illustrate how the key success factors for managers change when an organization embraces global sourcing.

From the opening chapters of *The Services Shift*, we underscore our political agnosticism about offshoring. Because there’s no point in arguing with the tide—we assert—managers should focus on

understanding and *exploiting* this growing trend. In Chapter 6, “The Services Shift: Policy Implications,” we adopt a broader policy perspective. Offshoring has led to a flurry of policy initiatives, in both developing and developed countries. What are the general approaches, and what do these mean for managers?

In developing countries, policies have focused on investment in education (sometimes primary, and sometimes advanced technical), telecom deregulation, export-processing zones, general incentives for foreign investment, and—in some cases—a broad-based reform of the commercial code. Obviously, these policies are intended to be “offshoring friendly,” and many have proven very successful.

In the developed world, most policy initiatives are aimed at slowing or regulating the offshoring choice. In the United States, for example, at least 33 state legislatures have debated anti-offshoring legislation, and the U.S. Senate has actually passed laws setting limits on offshoring. We argue that for at least three reasons, these policies are generally misguided, in both the short and long term. First, as noted earlier, the savings associated with offshoring tend to be so huge, and companies are under such extraordinary pressure to improve their margins, that managers have little choice but to seek out these opportunities, even when they are frowned upon in the political arena.

Second, the offshore migration of activities is simply too hard to spot to allow for effective regulation. Even when governments try to regulate offshoring, they have almost no ability to monitor, much less enforce, such regulations. Moving a 250-person factory is one thing; moving four customer-care positions or hiring an engineer in China (even though one was available in Michigan) is quite another.

Third, as explained in Chapter 1, all the evidence suggests that for the developed world, inhibiting offshoring only *reduces* long-term incomes. Countries that open up their economies tend to grow faster; countries that throw up protectionist walls tend to grow more slowly. Anti-offshoring policies may be politically appealing in the short

term, but they are a bad economic prescription for long-term growth or high standards of living.

The only feasible policy responses to the pain and dislocations caused by offshoring—we argue—are to focus on 1) minimizing costs to affected workers, and 2) hastening their transition to new sectors. Much has been made in the U.S. media about transition and adjustment programs that haven't worked. We point to examples of adjustment processes that *are* effective and *do* add value.

And finally, in Chapter 7, “Looking Ahead,” we look to the future. What is the next big thing in the globalization of services? And what does that mean for managers today?

First, we reiterate some of the points made in earlier chapters. Offshoring will become a much more truly global activity. Other countries will “gain on” India as they figure out their own unique niches and competitive advantages.

Second, globalization will come to many more services—both high value added (R&D, product design, legal and advisory work) and more personalized services (tutoring for your child, life coaching, personal scheduling).

Third, globalization of services will grow strongly in the non-IT realm. Instead of servicing clients from a distance, new firms will bring clients to the developing world. We are already seeing the beginnings of this trend with so-called “medical tourism” and retirement communities in low-cost countries.

Fourth, business-process multinationals will play an ever more important role. Companies such as Tata Consultancy Services, Infosys, Wipro, and Genpact are growing at astounding rates; all are likely to have more than 100,000 employees within a few years. They will be well positioned to offer the equivalent of “standardized parts” for knowledge work.⁷ As this happens, ever-greater numbers of firms in the developed world will be compelled to

conceive of their traditional back-office processes as standardized utilities.

Introductions have their perils. Boiling down the contents of our book into a few short pages—as we’ve tried to do here, to give you a sense of what’s coming—leads to a pretty dense result. Don’t be daunted; in subsequent chapters, we will do our best to make sometimes-complicated ideas accessible, and *useful*. The services shift is creating an enormously fertile ground of opportunity; our goal is to make you feel at home on that ground.

Endnotes

- ¹ The trade-to-GDP ratio is calculated as (exports + imports) / GDP. It provides a rough measure of the role trade flows play in an economy. Source: Economic Report of the President: 2008, Table B-1.
- ² Peter Koudal, “Growing the Global Corporation: Global Investment Trends of U.S. Manufacturers,” Deloitte Research, 2005.
- ³ Company Facts, VISICU, http://visicu.com/index_flash.asp (accessed on February 21, 2008).
- ⁴ Data from “NASSCOM Strategic Review” (2008) and from “Tata Consultancy Services: High Technology in a Low-Income Country” (2000), by Robert E. Kennedy, Harvard Business School Case # 700-092.
- ⁵ “Nasscom-McKinsey Report 2005: Extending India’s Leadership of the Global IT and BPO Industries,” NASSCOM, December 2005, p. 30, 33.
- ⁶ Paul McDougall, “IBM Head Count In India Tops 50,000,” *InformationWeek* (Feb 2007), www.informationweek.com/story/showArticle.jhtml?articleID=197002525.
- ⁷ I first heard this phrase from John Sviokla, a former colleague at Harvard Business School and currently Vice-Chairman and Director of Innovation and Research for Diamond Management, a leading technology strategy consulting firm.

INDEX

A

AAMT (American Association for Medical Transcription), 25
accent neutralization, 207
accounting processes, 91
accumulation of resources, 235
acquisition, history of offshoring, 155-156
advisory firms, 259
alignment, vendor evaluation, 126
allocation of resources, as managerial role, 177
alternate trade adjustment assistance (ATAA), 232
American Association for Medical Transcription (AAMT), 25
American Express, 152, 160
analysis and strategy formulation process (value chain approach), 52
analysis, as managerial role, 176-177
analytical skills, 183-184
Apollo Hospitals Group, 32
Apple, differentiation strategy, 53
Argentina, 271
AskSunday, 253
asset specificity (TCE transaction variable), 58
ATAA (alternate trade adjustment assistance), 232

B

back office operations, 94, 179-180
backsourcing, 66
bargaining costs, transaction cost economics, 55
benefits
 globalized services, 202-204
 policy initiatives in developed economies, 220-221
Bharti Enterprises, transformational outsourcing, 95
billing processes, 92
Biopolis, 21

biotech research, 20
Biotechnology Ireland, 21
body-shopping, 149
Booz & Company, joint study with Duke University, 259
bounded rationality, 56
BPO (business process outsourcing) services, 5, 22
 BPO-specific firms, 165-166
 Indian BPO industry, 205-206
 potential market, 144
Brainard, Lael, 234
Brazil, 265, 298-301
British Airways, 152, 160
Broadcom, 157
Brookings Institution paper, 234
Brown, Gordon, 82
BTO (business transformation outsourcing) projects, 95
Bulgaria, 269
Burrough Corporation, agreement with TCS, 148-150
business
 culture, 5, 81-83
 models for offshoring, 12-13
 operations risks, 118-119
 processes, 99, 152-153
 tasks, 96
business process outsourcing services. *See* BPO services
business transformation outsourcing (BTO) projects, 95

C

Call Center Outsourcing (EDS), 96
call centers, 165
 accent neutralization, 207
 capital requirements, 202
 contracts, 91
Canada, 266
capability risks, 119-120
Capgemini, 165, 297

- capital, 202
 - captive operations, 19
 - American Express, 152
 - growth, 161
 - multinationals, 159, 162
 - predictions for the future, 248-249
 - CBay, 27
 - challenges
 - cultural challenges, 257-258
 - globalization of services in developed economies, 225-229
 - offshore fatigue, 258
 - improving competitive position*, 260-261
 - managing sourcing complexity*, 259-260
 - policy initiatives for developing economies, 200-201
 - human capital*, 207
 - infrastructure*, 206
 - regulatory environment*, 207-209
 - social repercussions*, 209-210
 - Chile, 301-303
 - China, 264, 284-287
 - Chrysalis Capital, 153
 - clinical trials, 20-22
 - Coase, Ronald, 54
 - Cocuzza, Frank, 184
 - Cogent Road, 117
 - Cohen, Linda, 90
 - collaborative partnering, 124
 - Committee on Prospering in the Global Economy of the 21st Century (National Academies), 238
 - commodity-type processes, 90
 - communication
 - goals/objectives, 176
 - skills, 186
 - competitive advantage, 52
 - Competitive Advantage*, 50
 - computing, as driver of services
 - globalization, 76-77
 - concierge services, 259
 - Conseco, geographical risks due to
 - cultural differences, 116
 - context-specific knowledge,
 - back-office operations, 179
 - continuous improvement provision (SLAs), 141
 - contract research organizations (CROs), 20
 - contracts
 - negotiation, 126
 - service, 91
 - convergence of business culture, 5
 - Convergys, 153
 - coordination of tasks, 100
 - corporate imperatives, 5
 - cost
 - as component of a process, 108
 - differentials, medical tourism, 31
 - minimization (TCE), 58-59
 - Costa Rica, 256, 271
 - “country attractiveness” (Kearney), 171
 - country profiles
 - Brazil, 298-301
 - Chile, 301-303
 - China, 284-287
 - consistent criteria, 171
 - Egypt, 277-280
 - India, 307-310, 314
 - Philippines, 272-276
 - Poland, 294-298
 - Romania, 280-283
 - Russia, 288-291
 - South Africa, 291-293
 - Vietnam, 304-306
 - Croatia, policy measures, 212
 - CROs (contract research organizations), 20
 - cross-border trade and investment
 - flows, 33-37
 - cross-cultural challenges, 257-258
 - cultural challenges, 116, 257-258
 - customer risks, 119-120
 - Cyber Appellate Tribunals, 219
 - “Cyber-City” project (Mauritius), 214
 - Czech Republic, 267
- D**
- data analysis services, 259
 - Data Protection Directive of 1995, 217
 - data security, developing
 - economies, 217
 - database management, 19
 - Days Sales Outstanding (DSO), 92
 - decision variables, 37
 - declining scale of projects, 250-252
 - decoding technology and infrastructure, 111-114

decomposition framework (EquaTerra), 105
 Dell, 61, 161
 Deloitte, 93-94
 Delphi Corporation, 184
 Delta Airlines, 65
 demographic deficit, developed economies, 223-224
 dental tourism, 255
 desktop computing support, 92
 developed economies, policy initiatives, 219
 benefits, 220-221
 challenges, 225-229
 emerging demographic deficit, 223-224
 increased productivity, 221-223
 policy measures, 230-239
 developing economies, policy initiatives, 201
 benefits of globalized services, 202-204
 human capital challenge, 207
 infrastructure challenge, 206
 policy measures, 210-217
 regulatory environment challenge, 207-209
 social repercussions challenge, 209-210
 Diageo, 93-94
 Diamond Consulting, 259
 differentiation strategy, 53
 Digital Signal Processing (DSP) Systems, 166
 digitization of business processes, 74-76
 Dobbs, Lou, 225
 domestic offshoring, 252
 domestic organic growth, 203
 Dreaming the BRICs, "The Path to 2050" study (Goldman Sachs), 42
 drivers of services globalization, 10-11, 73-85
 digitization of business processes, 74-76
 global market liberalization, 74
 growing capabilities around the globe, 78-80
 low-cost, high-speed computing and telecom, 76-77
 rise of global business culture, 81-83
 drug development, 20-22

DSO (Days Sales Outstanding), 92
 DSP (Digital Signal Processing) Systems, 166
 Dubai, Internet City, 214
 due diligence, 19
 Duke University, joint study with Booz & Company, 259
 dynamic nature of offshore market, 171

E

E-Loan, 119
 earn-back windows (SLAs), 141
 Eastman Kodak, 63
 economic frameworks, 9
 transaction cost economics, 54
 bargaining costs, 55
 cost minimization, 58-59
 policing and enforcement costs, 56
 search and information costs, 55
 transaction variables, 57-58
 value chain approach, 50
 analysis and strategy formulation process, 52
 insights, 52-53
 primary activities, 51
 support activities, 51
The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, 55
 economic liberalization, 40
 economic policy initiatives
 developed economies, 219
 benefits, 220-221
 challenges, 225-229
 emerging demographic deficit, 223-224
 increased productivity, 221-223
 policy measures, 230-239
 developing economies
 benefits of globalized services, 202-204
 human capital challenge, 207
 infrastructure challenge, 206
 policy measures, 210-217
 regulatory environment challenge, 207-209
 social repercussions challenge, 209-210

- economic strategies
 - global outsourcing, 195
 - trade and investment flows, 33-37
 - transformation of global economy, 38-43
- EDS (end-to-end Call Center Outsourcing), 96
- education
 - capital and education level, 207
 - management, 79
- effectiveness-focused processes, 135
- efficiency-focused processes, 90-92, 135
- Egypt, 271, 277-280
- eight-step process (outsourcing/offshoring), 104
 - decoding technology and infrastructure, 111-114
 - geography selection, 127-128
 - integration of operations, 131-133
 - migration of operations, 128-129
 - process mapping, 108-111
 - risk identification, 114
 - business operations risks, 118-119*
 - customer, employee, and capability risks, 119-120*
 - geographical/location risks, 115-117*
 - holdup/strategic risks, 120-121*
 - migration risks, 117-118*
 - task identification, 105-108
 - vendor selection, 122-127
- Elanca, 251
- elective reporting, teleradiology, 29
- electronic documentation, IDC survey, 75
- electronic ICUs, 2
- electronic medical records (EMRs), 25
- Eli Lilly, 21
- emerging demographic deficit, developed economies, 223-224
- emerging market growth, 4
- employee risks, 119-120
- employment
 - growth in IT and BPO services, 147
 - India exports, 23
- EMRs (electronic medical records), 25
- end-to-end Call Center Outsourcing (EDS), 96
- Enterprise Resource Planning systems, 111
- Enzor, Jim, 184
- EPZs (export-processing zones), 213-214
- EquaTerra, 105, 185, 259
- equity research, 19
- Ertel, Danny, 184
- European-based captives, 161
- evaluation of vendors, 125
- Evalueserve, 157, 166
- Everest Group, 259
- executives, 178
- expectations (sourcing goals), 89-90
 - efficiency-focused sourcing, 90-92
 - enhancement sourcing efforts, 92-94
 - transformational sourcing, 94-96
- export employment, India, 23
- Export Industry Encouragement Act, 215
- export sectors, India, 23
- export-processing zones (EPZs), 213-214
- Exporting America: Why Corporate Greed Is Shipping American Jobs Overseas*, 225
- F**
- FDI (foreign direct investment), 37, 208, 218-219
- finance processes, 91
- financial incentives, 211-212
- firms (vendor landscape), 158
 - BPO-specific firms, 165-166
 - captives of multinationals, 159-162
 - initiation of offshoring by size, 145
 - multinationals, 164-165
 - offshore-based IT service providers, 162-164
- forces (globalization of services), 4
- foreign direct investment (FDI), 37, 208, 218-219
- foreign investment in services, 210-211
 - data security/intellectual property rights, 217
 - export-processing zones (EPZs), 213-214
 - financial incentives, 211-212
 - human capital/skills development, 216-217

- quality infrastructure and skills, 214-216
 - Forrester Research, 20
 - 2002 report, 225
 - 2004 study, 246
 - free trade zone incentives, 213
 - freeloading outsiders, 209
 - frequency (TCE transaction variable), 57
 - functional level (process mapping), 109
 - future of services shift, 15-16, 245
 - captive operations, 248-249
 - declining scale of projects, 250-252
 - increased globalization, 246-248
 - increased personal services, 252-254
 - rapid growth, 245-246
 - specialized talent overrides cost savings, 249-250
 - two-way travel increases, 254-256
- G**
- Gambia, 212-213
 - Gartner Group
 - approaches to sourcing, 90
 - offshore help desks study, 257
 - GE (General Electric), 61, 152
 - captive operations, 160
 - John F. Welch Technology Centre, 156
 - GECIS, 152
 - General Motors, 250
 - generalized managerial roles, 176-178
 - generic skills, 181
 - generic sources of competitive advantage, 52
 - generic transformation services, 96
 - Genome Valley, 21
 - Genpact, 165, 186, 250
 - outsourcing relationship with Penske Truck, 190-195
 - transformational outsourcing with Wachovia, 95
 - transition toolkit, 129
 - geographic expansion, 153-155, 170-172
 - geographical risks, 115-117
 - Ghana, 212, 270
 - global business culture, 81-83
 - Global Crossing, 76
 - “Global Economic Prospects and the Developing Countries” study, 40
 - global economy, transformation, 38-43
 - Global Initiative (University of Michigan), 6
 - global market liberalization, 74
 - Global Radiology Centre (GRC), 29
 - Global Services Location Index (Kearney), 127
 - global survey of corporate executives (McKinsey), 44
 - globalization of services,
 - drivers of, 10-11, 73
 - digitization of business processes*, 74-76
 - global market liberalization*, 74
 - growing capabilities around the globe*, 78-80
 - low-cost, high-speed computing and telecom*, 76-77
 - rise of global business culture*, 81-83
 - forces, 4
 - future of, 15-16, 246-248
 - market GDP shares, 38
 - safe offshore industries, 18
 - clinical trials*, 20-22
 - drug development*, 20-22
 - equity research*, 19
 - legal research*, 19-20
 - skill sets, 181-182
 - “Globalization of Services” initiative (WDI), 6
 - go live subphase (Six Sigma project, transition phase), 130
 - goals (sourcing), 11, 89-90
 - efficiency-focused sourcing, 90-92
 - enhancement sourcing efforts, 92-94
 - setting, 176
 - transformational sourcing, 94-96
 - Goldman Sachs
 - equity research, 19
 - Dreaming the BRICs, “The Path to 2050” study, 42
 - graduate engineering programs, 80
 - GRC (Global Radiology Centre), Wipro Technologies, 29
 - growth
 - captive operations, 161
 - predictions for the future, 245-246
 - rate, potential offshore market, 145
 - Gupta, Rajat, 78
 - Gupta, Vinay, 183

H

- handoffs, as component of a process, 108
- health tourism, 31
- help desks, Gartner study, 257
- high-speed computing and telecom, 76-77
- history of offshoring, 147
 - early experiments in U.S. and Ireland, 150-151
 - geographic expansion and acquisition, 153-156
 - global talent search, 156-158
 - growth of business process offshoring, 152-153
 - India-based software exports, 151-152
 - TCS agreement with Burroughs Corporation, 148-150
- Hodges, Mark, 185
- holdup risks, 120-121
- human capital, 207, 216-217
- Human Resource (HR) processes, 93
- Hungary, 269

I

- IBM
 - company profile, 297
 - multinational outsourcing firms, 164
 - transformational outsourcing, 95
- IDC surveys, 75
- identification of risks, as step in offshoring process, 114
 - business operations risks, 118-119
 - customer, employee, and capability risks, 119-120
 - geographical/location risks, 115-117
 - holdup/strategic risks, 120-121
 - migration risks, 117-118
- identification of tasks, as step in offshoring process, 105-108
- IGIC (Institutional Group and Information Company), 149
- IIM (Indian Institute of Management), 79
- image-acquisition technology, 3
- imperatives (eight-step offshoring process), 104
 - decoding technology and infrastructure, 111-114
 - geography selection, 127-128
 - integration of operations, 131-133
 - migration of operations, 128-129
 - process mapping, 108-111
 - risk identification, 114
 - business operations risks*, 118-119
 - customer, employee, and capability risks*, 119-120
 - geographical/location risks*, 115-117
 - holdup/strategic risks*, 120-121
 - migration risks*, 117-118
 - task identification, 105-108
 - vendor selection, 122-127
- in-person contact, as factor against offshoring, 72
- India, 264
 - export employment, 23
 - export sectors, 23
 - offshore industries, 22
 - IT/ITES sector*, 23-24
 - medical tourism*, 31-33
 - medical transcription*, 25-27
 - tele-radiology*, 27-30
 - profile, 307-314
 - software exports, 151-152
- Indian BPO industry, 205-206
- Indian Institute of Management (IIM), 79
- Indian School of Business (ISB), 79
- indirect employment, 202
- individual transformations, 196
- induced employment, 202
- Industrial Vocational Training Board (Mauritius), 216
- industries safe for offshoring, 18
 - clinical trials, 20-22
 - drug development, 20-22
 - equity research, 19
 - legal research, 19-20
- industry profiles
 - Brazil, 299-300
 - Chile, 302
 - China, 285
 - Egypt, 278
 - India, 308-309
 - Philippines, 274
 - Poland, 295-296
 - Romania, 282
 - Russia, 289-290
 - South Africa, 292
 - Vietnam, 305

information exchange, as factor against offshoring, 73

Information Technology Act of 2000, 219

Information Technology Action Plan, 218

Information Technology Association of America study, 36

information technology task force, 218

Information Technology/Information Technology Enabled Services (IT/ITES), 23

Infosys Technologies Ltd., 7, 24, 150, 163, 250

infrastructure

- challenges of developing economies, 206
- decoding, 111-114
- policy measures for developing economies, 214-216

innovation, higher standards of living, 236

input, business processes, 100

insights, value chain economic framework, 52-53

Institutional Group and Information Company (IGIC), 149

integration of operations, as step in offshoring process, 131-133

intellectual property rights, 208, 217

InterContinental Hotels Group, 254

internalization/externalization decision, 55

international connectivity, policy measures, 214

International Labor Organization, EPZ database, 213

international trade and investment, 5, 33-37

international trade theory, 200

Internet, as driver of services globalization, 76-77

Internet City (Dubai), 214

investment promotion agencies (IPAs), 210

IPAs (investment promotion agencies), 210

Ireland, 266, 150

ISB (Indian School of Business), 79

Israel, 270

IT services, 162-164

- Gambia, 213
- Jamaica, 215
- potential market, 144

IT/ITES (Information Technology/Information Technology Enabled Services) sector, 23-24

ITTIAM Systems, 166, 248

J-K

Jamaica, IT services, 215

Janeeva, 259

Janeeva Assurance, 133

John F. Welch Technology Centre, 156

JPMorgan Chase, 19

Kanbay, 165

Kearney, A. T.

- "country attractiveness" survey, 171
- Global Services Location Index, 127

key players

- Brazil, 300-301
- Chile, 303
- China, 287
- Egypt, 279-280
- India, 314
- Philippines, 276
- Poland, 296-297
- Romania, 283
- Russia, 291
- South Africa, 293
- Vietnam, 306

Kleiner Perkins Caufield & Byers, 251

knowledge process outsourcing (KPO), 166

knowledge transfer and infrastructure preparation subphase (Six Sigma project, transition phase), 130

knowledge-services industry, Jamaica, 215

KPO (knowledge process outsourcing), 166

L

language, global business culture, 81-82

Larsen, Chris, 119

legal research, 19-20

Lehman Brothers, 118

Litan, Robert E., 234

local resources, 34
 location risks, 115-117
 logic, as component of a process, 108
 low-cost, high-speed computing and telecom, 76-77
 Lucent, 76
 Lund, Morten, 83

M

macro level (process mapping), 109
 macroeconomic gains, offshore industries, 36
 macroeconomic liberalization, 5
 mainframe operations, 92
 make or buy decision (outsourcing), 61
 Malaysia, 268
 Malhotra, Romi, 61
 management responsibilities, 13, 175
 analytical skills, 183-184
 education, 79
 generic process of management, 176-179
 global sourcing operations, 181-182
 negotiation skills, 185-186
 organizational challenges, 186
 availability issues, 189-190
 Penske Truck Leasing example, 190-195
 soft skills, 185-186
 traditional back office operations, 179-180
 Mankiw, N. Gregory, 221
 Mann, Catherine, 36
 mapping processes, as step in offshoring process, 108-111
Market and Hierarchies: Analysis and Antitrust Implications, 55
 market capabilities, as outsourcing factor, 68
 market growth, 4
 market liberalization, as driver of services globalization, 74
 Mauritius
 “Cyber-City” project, 214
 Industrial Vocational Training Board, 216
 policy measures, 211
 McKinsey & Company estimates (potential offshore market), 144
 McKinsey Global Institute (MGI), 219

 global survey of corporate executives, 44
 medical tourism study, 33
 measurement reporting frequency (SLAs), 140
 medical tourism
 economics of, 255
 India, 31-33
 MGI study, 33
Medical Tourism, 254
 medical transcription
 India, 25-27
 Philippines, 27
 Medical Transcription Service Organizations (MTSOs), 25
 Mexico, 265
 MGI (McKinsey Global Institute), 219
 global survey of corporate executives, 44
 medical tourism study, 33
 micro-multinationals, 253
 Microsoft, 248, 259
 middle managers, 178, 196
 migration of operations, as step in offshoring process, 128-129
 migration risks, 117-118
 milestones, as component of a process, 108
 monitoring
 performance, 177
 vendors, 259
 motivation of team members, 177
 Motorola, 298
 Mphasis, 116
 MTSOs (Medical Transcription Service Organizations), 25
 Multimedia Super Corridor (Malaysia), 212
 multinationals, 159, 162-165
 multisourcing, 124

N

NASSCOM, 23
 National Academies, Committee on Prospering in the Global Economy of the 21st Century, 238
 National Telecom Policy, 214
 “The Nature of the Firm” (Coase), 54
 near-shoring options, 248
 negotiation skills, 185-186
 neoIT, 259

network operations, 92
 New Telecom Policy of 1999,
 153, 219
 Nilekani, Nandan, 239
 Novartis, 21

O

OCR (optical character
 recognition), 99

Office Tiger, 166

offshore fatigue, 258

improving competitive position,
 260-261
 managing sourcing complexity,
 259-260

offshore industries, 18

case for the services shift, 43-44
 clinical trials, 20-22
 drug development, 20-22
 equity research, 19
 India, 22

IT/ITES sector, 23-24
medical tourism, 31-33
medical transcription, 25-27
tele-radiology, 27-30

IT service providers, 162-164

legal research, 19-20

macroeconomic gains, 36

offshoring options, 69-73

approaches to, 71
factors that work against
offshoring, 72-73

sourcing options, 60

business importance, 63-64
make or buy decision, 61
process characteristics, 64-69

transformation of global economy, 38-
 43

offshoring, 69

approaches to, 71

business models, 12-13

defined, 3

economic frameworks, 9

eight-step process, 104

decoding technology and
infrastructure, 111-114
geography selection, 127-128
integration of operations,
131-133
migration of operations,
128-129

process mapping, 108-111

risk identification, 114-121

task identification, 105-108

vendor selection, 122-127

factors that work against offshoring,
 72-73

geographic spread, 170-172

history of, 147

early experiments in U.S. and
Ireland, 150-151

geographic expansion and
acquisition, 153-156

global talent search, 156-158

growth of business process
offshoring, 152-153

India-based software exports,
151-152

TCS agreement with Burroughs
Corporation, 148-150

individual transformations, 196

influence of location, tasks, and
 organization type, 166-169

middle managers, 196

patriotism factor, 195

policy initiatives, 14-15, 199

challenges to, 200-201
developed economies, 219-239
developing economies, 201-217

predictions for the future, 245

captive operations, 248-249
declining scale of projects,
250-252

increased globalization,
246-248

increased personal services, 252-
254

rapid growth, 245-246

specialized talent overrides cost
savings, 249-250

two-way travel increases,
254-256

senior managers, 196

skill sets, 13, 175

analytical skills, 183-184

generic process of management,
176-179

global sourcing operations,
181-182

negotiation skills, 185-186

organizational challenges,
186-195

soft skills, 185-186
traditional back office operations,
 179-180
 standard of living enhancements, 8
 tasks versus processes, 96, 99-104
 one-off projects, 253
 operational risks, 118-119
 operational systems, business processes,
 99
 operations integration, as step in
 offshoring process, 131-133
 opportunism, 56
 optical character recognition
 (OCR), 99
 Oracle, 259
 organizational challenges, skill set
 requirements, 186
 availability issues, 189-190
 Penske Truck Leasing example,
 190-195
 organizational/soft issues, as
 outsourcing factor, 68
 output, business processes, 100
 output-oriented schools, 237
 outsourcing, 60
 business importance, 63-64
 defined, 2
 Delta Airlines, 65
 eight-step process, 104
 *decoding technology and
 infrastructure*, 111-114
 geography selection, 127-128
 integration of operations,
 131-133
 migration of operations,
 128-129
 process mapping, 108-111
 risk identification, 114-121
 task identification, 105-108
 vendor selection, 122-127
 make or buy decision, 61
 predictions for the future, 245
 captive operations, 248-249
 declining scale of projects,
 250-252
 increased globalization,
 246-248
 increased personal services, 252-
 254
 rapid growth, 245-246

*specialized talent overrides cost
 savings*, 249-250
two-way travel increases,
 254-256
 process characteristics, 64-69

P

Parry, Cyril, 33
 patent applications, 19
 patriotism factor, 195
 Paul, Steven, 21
 payment processing centers, 165
 penalizing underperformance, as
 managerial role, 177
 Penske Truck Leasing, as outsourcing
 relationship with Genpact, 190-195
 people-dependent processes, 193
 performance monitoring, as managerial
 role, 177
 performance review periods
 (SLAs), 141
 personal services
 concierge services, 259
 predictions for the future, 252-254
 PESTLE (Political, Economic, Social,
 Technological, Legal, and
 Environmental) components, 128
 Pfizer, 248
 pharmaceutical clinical trials, 20
 phases, offshoring history
 early experiments in U.S. and Ireland,
 150-151
 geographic expansion and acquisition,
 153-156
 global talent search, 156-158
 growth of business process offshoring,
 152-153
 India-based software exports,
 151-152
 TCS agreement with Burroughs
 Corporation, 148-150
 Philippines, 264
 medical transcriptions services, 27
 profile, 272-276
 physical proximity, as factor against
 offshoring, 72
 Poland, 267, 294-298
 policing and enforcement costs,
 transaction cost economics, 56
 policy initiatives, 14-15, 199
 challenges to, 200-201

- developed economies, 219
 - benefits*, 220-221
 - challenges*, 225-229
 - emerging demographic deficit*, 223-224
 - globalization of services*, 230-239
 - increased productivity*, 221-223
 - policy measures*, 230-239
 - developing economies, 201
 - benefits of globalized services*, 202-204
 - human capital challenge*, 207
 - infrastructure challenge*, 206
 - policy measures*, 210-217
 - regulatory environment*, 207-209
 - social repercussions*, 209-210
 - policy openness index, 38
 - political repercussions, 227
 - Political, Economic, Social, Technological, Legal, and Environmental (PESTLE) components, 128
 - Porter, Michael, value chain approach, 50
 - power of processes, 101
 - predictions for the future, 245
 - captive operations, 248-249
 - declining scale of projects, 250-252
 - increased globalization, 246-248
 - increased personal services, 252-254
 - rapid growth, 245-246
 - specialized talent overrides cost savings, 249-250
 - two-way travel increases, 254-256
 - President's Council of Economic Advisors, 36
 - PriceWaterhouseCoopers, 7
 - pricing, vendor evaluation, 126
 - primary activities, value chain approach, 51
 - process benchmarking and solution design subphase (Six Sigma project, transition phase), 130
 - process(es)
 - accounting, 91
 - back office, 94
 - billing, 92
 - business, 99, 152-153
 - commodity-type, 90
 - customized, 135-136
 - effectiveness-focused, 135
 - efficiency-focused, 135
 - finance, 91
 - Human Resource (HR), 93
 - management, 181
 - mapping, 98, 108-111, 194
 - outsourcing/offshoring, 104
 - characteristics*, 64-69
 - decoding technology and infrastructure*, 111-114
 - geography selection*, 127-128
 - integration of operations*, 131-133
 - migration of operations*, 128-129
 - process mapping*, 108-111
 - risk identification*, 114-121
 - task identification*, 105-108
 - vendor selection*, 122-127
 - power of, 101
 - skills, 181
 - standardized, 135-136
 - tasks versus, 96, 99-104
 - procure-to-pay process, 102-104
 - procurement services, 165
 - producer-focused schools, 237
 - productivity
 - developed economies, 221, 223
 - growth, 34
 - Progeon (Infosys), 163
 - protectionism, 231
- Q–R**
- quality infrastructure, developing economies, 214-216
 - Quintiles, 21
 - rapid growth, predictions for the future, 245-246
 - reallocation of resources, higher standards of living, 235
 - regulations, developing economies
 - environment challenge, 207-209
 - foreign investment in services, 210-217
 - regulatory requirements, as factor against offshoring, 72
 - relationships
 - as component of a process, 108
 - vendor evaluation, 125
 - remote bedside terminals, 2

remote concierge services, 253, 259
 “rent-a-programmer” business, 149
 reporting performance, as managerial role, 178
 research services, 259
 resources
 allocation, 177
 country profiles, 171
 restrictive regulatory requirements, as factor against offshoring, 72
 retirement communities, 256
 review periods (SLAs), 141
 rewarding performance, as managerial role, 177
 reworked processes, 194
 rise of global business culture, 81-83
 risk identification, as step in offshoring process, 114
 business operations risks, 118-119
 customer, employee, and capability risks, 119-120
 geographical/location risks, 115-117
 holdup/strategic risks, 120-121
 migration risks, 117-118
 Rodrik, Dani, 229
 Romania, 267, 280-283
 Roy, Raman, 17, 153, 203
 Rubin, Brad, 188
 Russia, 266, 288-291

S

safe offshoring industries, 18
 clinical trials, 20-22
 drug development, 20-22
 equity research, 19
 legal research, 19-20
 Samuelson, Paul, 226
 scale (vendors), 158
 scale of projects, predictions for the future, 250-252
 Scott, Tony, 250
 screen process subphase (Six Sigma project, transition phase), 130
 search and information costs (TCE), 55
 sectors
 country profiles, 171
 India exports, 23
 security breaches, 116
 senior executives, 178
 senior managers, 179, 196
 separability, as outsourcing factor, 65
 Serebra Connect, 251
 service contracts, 91
 service level agreements (SLAs), 56, 91, 140-141
 service providers, vendor selection, 124
 services globalization, drivers of, 10-11, 73
 digitization of business processes, 74-76
 global market liberalization, 74
 growing capabilities around the globe, 78-80
 low-cost, high-speed computing and telecom, 76-77
 rise of global business culture, 81-83
 services shift argument, 43-44
 setting goals, as managerial role, 176
 Singapore, 268
 Singapore Airlines, joint ventures with TCS, 163
 Sitel, 153
 Six Sigma project phases, 129
 skill sets for offshoring, 13, 175
 analytical skills, 183-184
 generic process of management, 176-179
 global sourcing operations, 181-182
 negotiation skills, 185-186
 organizational challenges, 186
 availability issues, 189-190
 Penske Truck Leasing example, 190-195
 soft skills, 185-186
 traditional back office operations, 179-180
 skills development, policy measures for developing economies, 216-217
 SLAs (service level agreements), 56, 91, 140-141
 social repercussions challenge, developing economies, 209-210
 soft skills, 185-186
 software development task force, 218
 software exports, India, 151-152
 software technology parks (STPs), 214
 software-specific investments, 152
 sourcing
 goals, 11, 89-90
 efficiency-focused sourcing, 90-92

- enhancement sourcing efforts*, 92-94
 - transformational sourcing*, 94-96
 - landscape, 158
 - BPO-specific firms*, 165-166
 - captives of multinationals*, 159-162
 - multinationals*, 164-165
 - offshore-based IT service providers*, 162-164
 - options, 60
 - business importance*, 63-64
 - make or buy decision*, 61
 - process characteristics*, 64-69
 - South Africa, 265, 291-293
 - specialties
 - Brazil, 300
 - Chile, 302
 - China, 287
 - Egypt, 279
 - India, 310-311
 - Philippines, 275
 - Poland, 296
 - Romania, 283
 - Russia, 290
 - South Africa, 293
 - Vietnam, 306
 - Spectramind, 17, 153, 165
 - speech recognition (SR) field, 25
 - spillovers, 203
 - SR (speech recognition) field, 25
 - Sri Lanka, retirement
 - communities, 256
 - standardized processes, 135-136
 - standards of living
 - accumulation of resources, 235
 - innovation, 236
 - reallocation of resources, 235
 - STPs (software technology parks), 214
 - strategic risks, 120-121
 - strategists (managers), 176
 - strengths, weaknesses, opportunities, and threats (SWOT) analysis, 51, 171
 - subprocesses, 100
 - super-processes, 100
 - supply, 143-147
 - support activities, value chain approach, 51
 - Sutter Health, 3
 - Sutton, Willie, 202
 - SWOT (strengths, weaknesses, opportunities, and threats) analysis, 51, 171
- ## T
- TAA (trade adjustment assistance), 232
 - talent overriding cost savings,
 - predictions for the future, 249-250
 - talents, global talent search, 156-158
 - targets (SLAs), 140
 - task maps (process mapping), 109
 - tasks, offshore process
 - identification of, 105-108
 - influence on offshoring options, 166-169
 - integration of, 131-133
 - migration of, 128
 - processes versus, 96, 99-104
 - reorganization, 36
 - Tata Consultancy Services (TCS), 6, 148-150, 250
 - tax policy, regulatory environment and, 209
 - TCE (transaction cost economics), 9, 54
 - bargaining costs, 55-56
 - cost minimization, 58-59
 - search and information costs, 55
 - transaction variables, 57-58
 - TCS (Tata Consultancy Services), 250
 - agreement with Burrough Corporation, 148-150
 - joint ventures with Singapore Airlines, 163
 - teams, vendor selection, 123
 - technological innovations, 4
 - technology
 - decoding, 111-114
 - services, 215
 - telecom infrastructure
 - as driver of services globalization, 76-77
 - policy measures, 214
 - teleradiology, India, 27-30
 - Teleradiology Solutions, 29
 - Thailand, 270
 - third-party vendors, captive operations, 19
 - toolkits
 - Genpact, 129
 - process mapping, 109

trade adjustment assistance (TAA), 232
 trade and investment flows, 33-37
 trade zone incentives, 213
 trade-to-GDP ratio, 1
 traditional economic models, 56
 traditional office operations, 179-180
 training and control design subphase (Six Sigma project, transition phase), 130
 transaction cost economics (TCE), 9, 54
 bargaining costs, 55-56
 cost minimization, 58-59
 search and information costs, 55
 transaction variables, 57-58
 transferability, as outsourcing factor, 67
 transformation of the global economy, 38-43
 transformational outsourcing, 94-96, 195
 transition phase (Six Sigma projects), 129
 transition toolkit (Genpact), 129
 TransUnion Interactive, 188
 travel anxiety, 193
 true processes, 193
 TutorVista, 252
 two-way travel increases, predictions for the future, 254-256

U

U.N. Center on Trade and Development (UNCTAD) survey, 210
 U.S.-based captives, 161
 Ukraine, 269
 uncertainty (TCE transaction variable), 57
 UNCTAD (U.N. Center on Trade and Development) survey, 210
 user-focused schools, 237

V

value, as component of a process, 108
 value chain approach (economic framework), 9, 50
 analysis and strategy formulation process, 52
 insights, 52-53

 primary activities, 51
 support activities, 51
 Vantage Partners, 184
 variables (TCE and transactions), 57-58
 vendors, 158
 BPO-specific firms, 165-166
 captives of multinationals, 159-162
 multinationals, 164-165
 offshore-based IT service providers, 162-164
 selection, 122-127
 tools for monitoring, 259
 venture capital, 82
 video conferencing, 2
 Vietnam, 268, 304-306
 virtual private networks (VPNs), 28
 VISICU, 3
 VoIP (Voice over Internet Protocol), 77
 VPNs (virtual private networks), 28

W-Z

Wachovia, transformational outsourcing with Genpact, 95
 Wal-Mart, low-cost strategy, 53
 WANs (wide area networks), 28
 Warren, Nicholas, 234
 WDI (William Davidson Institute), 6
 Welch, Jack, 151
 White House Council of Economic Advisers, 221
 wide area networks (WANs), 28
 William Davidson Institute (WDI), 6
 Williamson, Oliver, 54
 Wipro Technologies, 17, 29, 150, 250
 WNS, 165
 Young, Allie, 90