It's Time to Talk Sense about Outsourcing

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Gregory Mankiw, who heads the White House Council of Economic Advisors, ignited a firestorm of debate this month when he said outsourcing of U.S. jobs is probably a good thing in the long run. As tends to happen with hot-button issues in presidential election years, sensible discussion of this question soon was drowned in an uproar of political posturing. John Kerry and John Edwards -- who are seeking the Democratic nomination to take on George W. Bush in November -- denounced the government's so-called conspiracy to ship jobs overseas.

Even Dennis Hastert, the Republican speaker of the House, criticized Mankiw. In the past few days, other respected economists -- such as Columbia University's Jagdish Bhagwati -- have come under fire when they tried to explain the economic rationale behind outsourcing.

Politics apart, the reality is that outsourcing is as old as the corporation. One business arranges with another to make a widget or provide a certain service that it cannot do itself, or does not wish to do, so that it can focus on the parts of the business it does best. The sourcing arrangement is normally seamless, and it matters little to end-use customers who have been paid to perform the outsourced work.

Flash-forward to today, though, and it becomes clear that the phenomenon of outsourcing has taken on a whole new dimension that companies even a decade or two ago would find astonishing. Experts at Wharton and the Boston Consulting Group say sourcing is no longer a tactical option that can help a firm save a few dollars here and there. Rather, it has emerged as a strategic necessity in an era when opportunities offered by "low-cost countries," such as China, India or Mexico, abound. Indeed, these experts say that the sourcing juggernaut will continue to move forward, despite occasional missteps and retrenchment, and transform national economies in both the developed and developing worlds in the process.

"It's the classic 'makes vs. buy' question," says Morris Cohen, professor of manufacturing and logistics at Wharton. "Do I make something internally or buy it in the marketplace, and how do I add value most effectively? This is a problem that's been studied in economics and management for decades. This is not a new issue, and it's not one that will ever go away." What has changed, Cohen says, is that more companies are engaged in more outsourcing than before -- and they are doing it in novel ways. "The idea of moving things offshore and outside the boundary of the firm -- more of that has been happening around processes you would never have thought possible. Having somebody in India answer calls -- who would have ever thought of that?"

Hal Sirkin, senior vice president and director in BCG's Chicago office and head of the firm's global operations practice, emphasizes that "leveraging low-cost countries" is not only about reducing costs. "It

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cuts across a number of dimensions. It doesn't mean your total cost will be cheaper if you can find someone who can make something cheaper. Having a long supply chain is not as cheap [as a short one]. You can't look at leveraging low-cost countries as just finding the purest, lowest cost widget. It affects so much of your business and your customers. You have to take a holistic view."

Ravi Aron, a professor of operations and information management at Wharton, emphasizes the same point. In a new paper, "Rightsourcing Services: Make, Migrate or Outsource?" Aron describes how his field research has determined that for a company to reap dividends beyond operational efficiencies, it is imperative that senior management view sourcing strategically, and not as an operational decision.

"Rightsourcing initiatives that have cost savings as their principal intent do not yield strategic gains easily. Considerable re-architecting of the relationship is needed before strategic gains can be captured," according to the paper. Senior executives who treat sourcing primarily as a cost-cutting maneuver will usually not commit to the major organizational change that is often required to make sourcing produce important strategic benefits. Typical benefits include superior service customization, premium prices for superior service, buyer lock-in, getting to market faster, compression of the product-development cycle and increased market share through competitive pricing.

Jim Hemerling, vice president and director in the Shanghai office of BCG, says the shift of manufacturing and service operations to other nations "is more about leveraging low-cost countries than outsourcing, per se. Increasingly, it's appropriate to define it more broadly than sourcing a physical material component or product. There's a need to think about it so that it includes product development, research and development -- a set of knowledge-related and people-related services and activities in addition to the sourcing of things. Just as there's cost saving in sourcing things, there are savings in sourcing knowledge and talent."

Cohen agrees that, by sourcing, firms can achieve much more than cost savings. "One of the strategic advantages of sourcing is knowledge of technology, access to better processes or efficiencies, or learning about more efficient management procedures. Another company might be a specialist in making types of precision components. By outsourcing, you gain access to that superior knowledge and capability. There are also companies that outsource for capacity. They know how to make a product but don't have capacity, or they don't want to invest in how to make it."

Saving money may not be the only reason for a corporation to cast a strategic eye on low-cost countries, but it is a major impetus. Hemerling notes that the savings can be as high as 50%. Much of the savings is driven by lower wage rates. But other factors also come into play: lower costs for equipment, tooling, raw materials, and real estate, as well as government incentives.

Companies in some sectors – apparel, footwear and consumer electronics – were among the earliest firms to shift many of their operations to low-cost countries, according to BCG research. Nike, for instance, decided a long time ago that its core competency was marketing high-end sneakers, not making them. Other sectors – such as electrical equipment, household appliances and computer equipment – are among the fast-growing segments that are penetrating low-cost countries today. But migration to low-cost countries has only just begun for firms in many other industries, including measuring and controlling devices, heating and ventilation equipment, fabricated metal products and motor-vehicle parts.

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Along the Sourcing Continuum

Companies, as well as individual business units within companies, differ sharply in how advanced they are in taking advantage of low-cost countries. BCG, which has analyzed outsourcing trends in 11 low-cost countries -- Brazil, China, Czech Republic, Hungary, India, Indonesia, Malaysia, Mexico, Poland, Russia and Thailand -- divides companies into five categories:

Some are merely **testing the water**. These firms recognize that sourcing is important. They may even source some basic commodities, but only on a trial basis. There may be incremental benefits from this cautious approach, but no real competitive advantage is gained.

Other firms have advanced to the point where they are **purchasing components or complete products**. Big retailers like America's Wal-Mart and France's Carrefour, for example, purchase billions of dollars worth of goods from China each year. One advantage of such purchases is, of course, reduced costs; another is that the buyers gain knowledge from working with particular suppliers. But these advantages can be easily lost because competitors can readily imitate them.

Some firms find themselves further along the continuum in that they have developed **comprehensive sourcing**. By 2006, Motorola aims to have made $10 billion in accumulated purchases from China and to be producing $10 billion a year in goods there. By that same year, Motorola also wants to have made investments totaling $10 billion inside China, including the construction of a global research and development center and the hiring of 5,000 researchers. This kind of comprehensive sourcing, which involves much more than mere procurement, produces a real competitive edge. Firms can design and make products with higher value added; at the same time, they can reduce their dependence on imports from higher-cost countries and speed up product-development cycles.

Still other firms have reached the stage where they have adopted an **integrated sourcing strategy**. Major auto manufacturers, for example, once viewed countries like China primarily as places to make cars for sale domestically. Today, however, car makers see low-cost countries not just as an important market or as a principal supply base for goods sold elsewhere, but as both. An integrated strategy is required so that each business line can outsource components for products that will be exported and produce goods to be sold in the domestic market. Firms that have reached this stage are reaping major benefits. An integrated approach produces a variety of advantages not easily copied by competitors, such as being able to use plants to realize true economies of scale and broadening the opportunity to increase sales.

Furthest along the sourcing spectrum, BCG says, are those companies – thus far few in number – that recognize they must **capture global advantage**. These firms recognize that if they manage their business across multiple low-cost countries, they can achieve more growth at all levels -- local, regional and global. For example, Toyota outsources vehicle sub-assemblies from many Asian countries, allowing it to keep costs low and achieve just-in-time delivery. Capturing global advantage --achieving the lowest costs while making use of the best people and practices -- is the holy grail of leveraging low-cost countries. It is hard to achieve but it is also difficult for competitors to replicate. To capture global advantage, "You need to think about where you can best source competitive advantage," Hemerling notes. "And you have to do that in a dynamic sense so that you can constantly update your knowledge as to what to source from where, to [know] the risks from any one country, and to balance the exposure of risk in any one country."

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How do firms move toward the goal of achieving global advantage? BCG has identified three steps. Companies must analyze opportunities and determine what should be sourced; establish an infrastructure to support the sourcing operation; and overcome barriers to sourcing.

"We argue that the biggest component is building the sourcing capability," explains Hemerling. "This involves a set of processes, policies, skills, data and supplier relationships. Within each one of those categories, there are things to think about. With policies, say, you have to define the specific policies of how you operate in each country – human rights, legal issues and integrity – and the management of an enormous amount of information."

He adds that one of the major stumbling blocks to leveraging low-cost countries is not the availability of low-cost suppliers or labor, but rather barriers within the organization doing the sourcing. "If you think about a large company with multiple businesses, its functions and procurement are often decentralized down to the business unit and factory level. The organizational complexity of trying to orchestrate things across a global company is really quite extraordinary. To bring together the information and individuals required to make the decisions of where to relocate production and sourcing is a fairly staggering task."

A Shift in Europe

Just how quickly companies are moving to investigate the advantages of low-cost countries can be seen in one type of sourcing – procurement. Pascal Cotte, a vice president and director in BCG's Paris office and the firm's global leader for procurement, says he has witnessed a marked acceleration in sourcing just since mid-2002.

Cotte, whose expertise centers on industrial-goods companies (electrical equipment for power plants, transportation equipment and the like) says these companies have any number of "levers" they can use to reduce costs and achieve efficiencies. One option is to simply reduce the number of suppliers. Another is to engage in transnational partnering, buying from a regional entity so that you do not have 10 German suppliers and 10 French ones. A third option would be for a firm to change its product specifications to simplify the goods purchased so that it can obtain better prices from vendors. A fourth option is to form partnerships with suppliers to simplify the supply chain and reduce paperwork; this is common in the auto industry. If none of these traditional levers is sufficient, a firm can always take the biggest step of all: to move some or all of its operations to a low-cost country.

For years, many companies, mostly in Europe but also in the United States, were reluctant to move to low-cost countries, preferring instead to choose more traditional cost-reduction options that they perceived as safer alternatives, according to Cotte. "They said, 'Why should we bother with the risk of going to eastern European countries or even further to India and China? What's the point?' Some of these companies were ready to try, but many [pilot programs] were big failures, for many reasons. They said, 'Every time we try, it's more costly.' People were happy to say, 'Let's stick to what we know.'"

The reluctance stemmed, in part, from concerns that product quality would suffer if manufacturing were handled by less-skilled workers in less-developed countries. Another factor that kept companies from sourcing: European tariffs and labor laws that protect industries and workers from the kind of abrupt, massive and irrevocable job losses that have become such a controversial topic in the United States. But, just since mid-2002, Cotte has witnessed a startling change: a growing number of European companies

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are demonstrating a willingness to procure goods from low-cost countries and are at least giving consideration to pulling the last lever and moving operations beyond their own borders.

"Companies now feel they've reached a plateau," says Cotte. "They see Eastern European markets and China and India really taking off. Before, because of local content requirements or tariff issues, [European companies] were forced to get goods locally. I know today some companies still source some components from Europe to serve Chinese markets. They use French, German or Italian vendors, which is absolutely strange. It was a vicious circle. But quality and reliability [among producers in low-cost countries] have made major improvements. Now European companies never just think of using local firms. We can observe a real shift."

What is noteworthy, too, is that senior executives are finally getting on board the sourcing bandwagon. "It's now on the CEO and COO [chief operating officer] agenda, not just deep in the organization," says Cotte. "People are rushing to say, 'I want to use my suppliers to import goods back to Europe.' That's a big move. And I can see it mounting almost every week."

Recognizing Risks

As some of the European executives know well, there are risks associated with sourcing that should not be casually dismissed: longer supply chains, political uncertainty, possible difficulties in monitoring a supplier's work, and language and culture issues. Indeed, in recent weeks news reports have described how some U.S. companies have trimmed or eliminated the outsourcing of call centers to India because of cultural snags and customer complaints.

There also is the risk that your supplier could become your competitor. For example, Acer, founded in Taiwan in 1976, was once a supplier of components for personal computers, but over time evolved into one of the world's top PC makers. "Acer realized there was value in making components and in design," Cohen notes. "They said, 'We can put them together better than our customers.' I'd have to believe that the market share they have [today] was at the expense of their customers." In 2000, Acer spun off its manufacturing operation to focus on marketing its brand-name products, which include desktop and mobile PCs.

But Sirkin of BCG points out that it may be more catastrophic for a firm to shun sourcing because of an irrational aversion to risk. The risks associated with inertia and reluctance to change may leave a firm hopelessly behind more nimble competitors willing to tackle risk. "There's a misperception of risk. There's risk you can see and risk you can't see. By allowing yourself to have a cost disadvantage or by forcing yourself to invest in more manufacturing than you have to, you're incurring incredible risk but it's harder to perceive that."

The Next Big Thing

What's next on the horizon for sourcing? Some BCG consultants say that while companies may continue to look at low-cost regions such as Eastern Europe, the major big trend will be capturing global

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advantage. "This means sourcing some R&D and talent from Eastern Europe, some from China, some from India and some from Mexico," says Hemerling. He explains that companies will diversify their sourcing globally while still maintaining some aspects of their operations in Western Europe and the U.S. "Realizing the next big thing requires overcoming many organizational barriers and putting in place global platforms and decision-making mechanisms to enable true global sourcing. That is the next big thing," he adds.

More broadly, the leveraging of low-cost countries will only accelerate in years to come, making deeper inroads into both the manufacturing and service sectors. Despite all of the news media attention given to this topic, sourcing is still in its infancy. “The leveraging of low-cost countries is in its early days, it’s inexorable and it’s a major source of competitive advantage for those companies able to put in place the organizational capabilities to do this on a dynamic, global basis," Hemerling says. "And it’s a huge disadvantage to those who don’t.”

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