

## Chapter 5.3

# Outsourcing and Offshoring: Issues and Impacts on Venture Capital

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### **ABSTRACT**

Recently, outsourcing/offshoring has gained significant exposure in the popular as well as academic publications, with authors arguing the many different facets of the concept and its implications. The ongoing debates have revolved around issues related to cost of operations, benefits for outsourcing countries and countries that are recipients of outsourcing, the types of skills and associated unemployment, the types of industries that are being most effected, and even its political implications. This chapter discusses various issues related to outsourcing/offshoring and presents the findings of a research study (a survey of 364 individuals from 101 San Francisco Bay Area venture capital firms) attempting to validate (or disprove) some of the most widely discussed and presented points of view.

### **INTRODUCTION**

In September 1989, Jack Welch, then General Electric Co.'s chairman, flew to India hoping to sell products like airplane engines and plastics to the Indian government. During a breakfast meeting with top government advisers, Sam Pitroda, chief technology adviser to the late Indian Premier Rajiv Gandhi, surprised Mr. Welch by saying "We want to sell you software." Mr. Welch, by agreeing to start this business relationship, became the impetus that started India on its way to becoming one of the bastions of outsourcing and sparked a global outsourcing revolution (Solomon & Kranhold, 2005). Since then, this revolution has sparked major debates around the issues of operating cost advantages and country benefits, as well as the possible financial, social, and political ramifications of such industry wide practice, on both countries involved in the process.

Even though Jack Welch may have been the impetus that started the revolution, outsourcing is not an U.S. only phenomenon. It is a process that has been used and continues to be used by most developing countries. A recent survey by N. Aggarwal (2004) shows that 40% of Western Europe's 500 largest companies have already begun moving their service operations abroad. According to Forrester Research, the Cambridge, Mass., consulting and research company, European spending on outsourcing is expected to rise to more than Euro 129 billion (U.S.\$156 billion) in 2008 from Euro 82 billion (U.S.\$99.16) in 2002, and the number of firms that spend more than 20% of their outsourcing budget abroad will go from 7% in 2004 to 20% in 2008. Never the less, despite the growing interest, European companies still outsource far less than their U.S. counterparts, of which more than 20% will spend over 20% of their outsourcing budget offshore this year (Campoy, 2004). The primary reason for these differences may be the rigid labor laws in Europe that make relocating jobs a long and costly process. For example, while it's relatively easy for companies in the U.S. to fire employees whose jobs they want to outsource, to lay off an employee in Germany, a company first has to justify its decision to the union and then give its worker a notice period of four weeks to seven months.

## **COST BENEFITS OF OUTSOURCING**

To most executives in the U.S. and Europe, offshoring means cheaper wage rates for labor-intensive activities. Discussions of wage rate differentials between Asia, on the one hand, and the U.S. and Europe, on the other, tend to focus on less skilled jobs. However, even in the more skilled jobs the differentials can be compelling as well. In electronics, the wage rate ratio between the U.S. and China for product engineers is about

10:1. For software developers, the ratio between the U.S. and India is about 8:1. These wage rate differentials, undeniably, generate cost savings. However, the really compelling gains come from pairing savings with top-flight skills. While it is true that only a few Asian countries offer enough English-speaking call-center representatives to deal with U.S. customers, many other skills are more abundant in Asia than in the U.S. China, for example, produces 350,000 graduate engineers every year, compared with 90,000 for U.S. engineering schools. According to a recent GAO report, "despite the widespread belief that global sourcing is driven primarily by companies chasing after low-wage workers, 'low-wage' India ranked only eight in 2002 among countries to which the United States sends business, professional and technical service tasks. Ranking ahead of India were Canada, UK, Japan, Germany, France, Mexico and the Netherlands" (Economic Times, 2004). Other authors also argue and support the position that, as labor arbitrage opportunities begin to disappear, the primary reason for offshoring is becoming strategic rather than cost (Shah, 2004).

Offshoring is not confined to a few manufacturing industries but rather utilized across many industries, even by non-manufacturing industries trying to decrease their operating or support costs. Biotech industry is one such industry. They have recently awakened to an international climate where firms can get qualified workers for as little as a tenth of the U.S. cost and are on the verge of an offshoring wave of its own. A brief look at the companies in the San Francisco Bay Area turned-up biotech companies that are already testing the offshore waters, among which are Stanford University spin-off SRI International signing an outsourcing deal with a research firm in Shanghai and South San Francisco's Genentech Inc., founder of the biotech industry, manufacturing some supplies of an innovative cancer drug in Spain.

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