Communications Workers of America
Local Leaders List

May 19, 2005

To: All Local Presidents

Dear Colleagues:

I want to share with you a letter I received today from Leo Gerard, president of the United Steelworkers. I share his outrage.

SEIU President Andy Stern has repeatedly publicly threatened to take his union out of the AFL-CIO if reforms are not made to his liking.

Apparently one of Stern's reforms is for American workers to embrace outsourcing as an inevitable result of globalization.

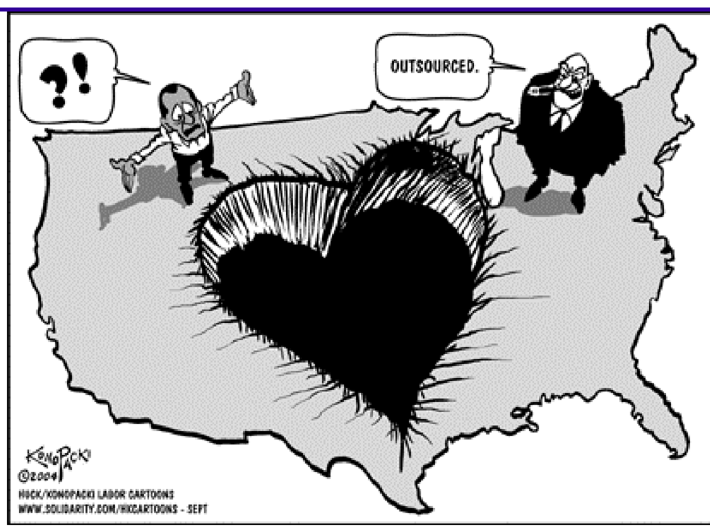
I know I speak for each of you in rejecting that view. We will continue to fight to preserve good jobs here at home.

In Solidarity,

Morton Bahr
President

Attachment

cc: Executive Board
Staff



United Steelworkers

Building Power
USW
Merged April 14, 2005

Leo W. Gerard
International President

May 17, 2005

Mr. Morton Bahr, President
Communications Workers of America
501 3rd Street, NW
Washington, DC 20001

Dear Morty:

I am enclosing a copy of the April issue of HRO Today, a magazine that **promotes outsourcing**. Its cover article features Andy Stern's views on this subject and is entitled, "*Is Outsourcing the New Labor Movement*." I urge you to read it but here's a sample of some of the comments made in this story:

- "...(W)e have 12 or 14 airline unions who do not cooperate, which has helped create airlines' financial problems." (P. 42)
- "The sum total of the wage race to the bottom is that this generation of American workers will be the first ever to have a worse quality of life than their parents. To try to stop the wage drops, unions have been an anti-competitive force, protectionist. But what union wages should be is like electricity, which allows their users [employers] to operate more efficiently with better quality." (P. 44)

In the article, Andy says: "I'm a Farrellist, a big fan of McKinsey economist Diana Farrell's globalization theories." I checked out what she stood for on their web site.

Farrell believes that globalization, with its attendant outsourcing and offshoring, is good for our country. She also believes that globalization is inevitable, and that it is futile and counterproductive for unions, human rights activist, environmentalists and their allies to oppose it. She thinks workers hammered by globalization should get by with retaining, limited healthcare subsidies and partial wage insurance — insurance payable only after workers find another job, not while looking for one.

There's plenty more of this. You can hear Farrell, in her own words by watching her video, "Perspective: Offshoring – Is It A Win/Win Game?" The last segment, number 9, is especially instructive. Go to http://www.mckinsy.com/mgi/rp/offshoring/. Or you can read the enclosed article, *Offshoring and Beyond*, to see what she has to say about the auto industry.

I am sure as hell not a Farrell fan. I am offended and angry.

I have not spent my adult life fighting for the rights of our union members, their jobs and communities to be told outsourcing is good for us by Diana Farrell or Andy Stern.

Do they really think that outsourcing and offshoring are good and inevitable and that good American jobs are not worth fighting for? One of the goals of the IUD and the AFL-CIO must be to help coordinate the fight to save good jobs.

In solidarity,

Leo W. Gerard
International President

LWG/kir

enclosures

HRO Today: April 2005

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Is Outsourcing the New Union Movement?

Andy Stern, President of the SEIU, on why unions can't turn back the clock on outsourcing.

By Jay Whitehead

ANDREW STERN, THE PRESIDENT OF AMERICAS LARGEST AND FASTEST-GROWING UNION, THE 1,800,000-MEMBER SERVICE EMPLOYEES INTERNATIONAL UNION, OR SEIU, IS THE MOST INNOVATIVE UNION LEADER OF OUR GENERATION. (DARE WE SAY EMPLOYER-FRIENDLY? GLOBALIZATION-FRIENDLY? OR EVEN OUTSOURCING-FRIENDLY?) IN THIS HRO TODAY EXCLUSIVE INTERVIEW, STERN HAS ANSWERS FOR THE TRICKIEST QUESTIONS IN MODERN WORKFORCE MANAGEMENT. AND HE STILL HAS ENOUGH ENERGY LEFT TO GIVE HR LEADERS THREE BIG IDEAS.

Here is an HR shocker. If SEIU President Andy Stern were heading HR in a large company rather than the heading the country's largest union, he would outsource a lot more. His outsourcing providers would be unions.

Take the example of what Stern did with New York City janitors Local32BJ. Their pension administration, health plans and operation of health clinic, severance and outplacement administration, training and retraining, employee legal services, and even grief counseling are all outsourced to the SEIU. In handling these functions, one of Andy's clients the employer send up with a far more reliable, trained workforce. And Andy's other clients the employee send up with a higher standard wage, respectable benefits, and a path to portable employment should their employer not need their services any more.

Unions could be this country's largest HR outsourcers, says Stern in an exclusive interview with *HRO Today* following the rancorous AFLCIO (American Federation of Labor - Congress of Industrial Organizations) meeting in Las Vegas in early March during which Stern threatened to sever ties with the mega-syndicate. Remember, we have a huge, huge advantage. Its called collective bargaining, which in any other industry would be an antitrust violation [since collective bargaining agreements, or CBAs, involve setting wage and benefit price standards across multiple employers and industries]. But unions have anti-trust exemption.

A CHANGE AGENT'S RISE

Vision comes to prepared spirits. And if ever one person was well prepped to have a new vision of labor, it is Andy Stern. He started as an activist in SEIU Local 668, the Pennsylvania Social Service Union. He rose quickly up the ranks. At the age of 29, he was named to the SEIU

International Executive Board. By the mid 1990s, Stern had become an aggressive advocate for adapting the union to new market realities, including such vexing mega-trends as globalization and outsourcing. Sterns high-pitched advocacy, however, irked union traditionalists such as his boss, current AFL-CIO head John L. Sweeney, who unceremoniously sacked Stern. Bent but unbroken, Stern got even. In 1996, he came back and was elected President of the SEIU. At 45, he was the youngest president in union history. Since then, Stern has boosted union membership by 500,000-plus people to more than 1,800,000.

Today, Sterns vision of labor is crystal clear. And he is unhappy with what he sees. That is why he has envisioned splitting with the AFL-CIO, an organization he sees as out of touch with today's business reality, which includes the terrible troika of workforce dislocation: globalization, outsourcing, and Wal-Mart. There is a difference between making change and thinking change, says Stern. But the plan that [AFL-CIO leadership] passed in Las Vegas gave more money to politicians. Rather than relying on workers, we are relying on politicians to turn around unions shrinking membership. That's not very smart. The numbers tell the tale of union decline. Since the AFL and the CIO merged in 1955, union membership has fallen from 35 percent of workers to 12.5 percent of all workers, or 13 million employees. And if you look at the private sector alone, membership is only 8 percent. The most dramatic portion of this decline has happened since 1970, a period when the number of U.S. workers has risen an astounding 42 percent to 123.6 million.

DUELING DUELS

At the March AFL-CIO dustup in Las Vegas, Andy Stern fought dual duels. The first was for the right to represent 49,000 childcare workers in Illinois who his union had worked 10 years to attract, only to be undercut at the last minute by the rival AFSCME (The American Federation of State, County, and Municipal Employees). AFSCME claims right to the Illinois contract since 150,000 of its 1.3 million members are childcare workers already. Sweeney refused to make a decision on the issue at the meeting, preferring to hold offline discussions with both unions.

The second and much bigger fight is for control of the AFL-CIO, of which SEIU is part. Five major unionsSEIU, Teamsters, Laborers, United Food and Commercial Workers, and Unite Here representing 40 percent of AFLs membership all side with Stern against AFL-CIO head John L. Sweeney over the syndicates $120 million annual organizing budget. Stern and company wanted Sweeney to return $42 million in dues to the unions for organizing activities, while Sweeney offered only $15 million and proposed boosting political and lobbying spending from $32 million to $45 million annually. Sweeney won this round. But insiders contacted by HRO Today expect that Sweeney's victory will be short-lived, since he stands for re-election in July 2005, and faces major opposition in light of declining membership. Sterns ultimate proposal is to reorganize the AFL-CIO from a patchwork quilt of 58 units into 20, each focusing on specific industry segments. This reorganization, Stern sees, is just one step toward making unions relevant to the modern economy. The rest of his plan is more complex, and a far cry from the traditional semi-Marxist labor versus management dialectic.

STERN'S RADICAL CORPORATE-IZATION

In the 1970s, pro footballs Pittsburgh Steelers won multiple championships with its famous Iron Curtain defense, which featured a unique attack: Rather than targeting just one ball carrier, the Steelers tackled the entire backfield, on every play. Andy Sterns union-organizing technique is Steelers Revisited. Take the example of 10,000 building maintenance personnel in northern New Jersey. Five years ago, the janitors were upset because they earned $10 less per hour than their counterparts 20 miles to their east in New York City. Building owners were also upset because the workers were badly trained and unreliable.

In this situation, a typical union would target one employer, get a CBA in place, and then target other employers in the area. But Stern Steelers Reduxtackled the entire market at once.

He told all the employers that his CBA would be void unless 50 percent of them agreed. In the end, more than 70 percent did. By tackling an entire industry segment, Stern created market-wide wage, benefit, and quality standards, which added significant value for both employers and employees.

In another variant on this theme, Stern tackled the challenges of an Arkansas nursing chain called Beverly Health, which faced problems with cuts in state medical payments. Sterns offer to Beverly was pure Steelers. If Beverly would agree to a contract with SEIU, the union would use its political might to boost state aid. Beverly signed. Then, just as promised, Stern delivered on the payment increases. Stern attacks problems facing his clients entire industries in the same way a corporation would devise a segment-wide marketing strategy. But Sterns union corporate-ization program goes well beyond his organizational technique. He has become a fan of branding as well. In 1996, when he was elected, SEIUs locals were a hodgepodge of locally identified units. Using a corporate consultant to design a package of financial incentives and brand elements, Stern got all the locals to agree to go by one unified brand, indivisible, with one brand color purple. Now, watching union workers come to work in the morning at their 1313 L Street headquarters in Washington, DC, shows an outpouring of purple prideSEIU logo-wear shirts, cups, jackets, hats, sacks, and slacks, and the ubiquitous purple water bottle.

Stern is now also a devotee of a high-tech tactic for spreading his reform message. He is now an inveterate blogger, the term for people who use Web logs, or personal Web pages. (You can find his newest Web log submissions at both the UniteToWin.org and PurpleOcean.org blogs.) In a recent article he put up following that fractious Vegas meeting, he wrote: At the recent AFL-CIO Executive Council meeting in Las Vegas, one of the other union leaders complained to me in exasperation: You keep running around bringing up this worker sh-t. Well, sorry. I thought that's what we were meeting about. Workers.

While some elements of Sterns corporate- ization are mechanical, the real difference between Andy Stern and the legacy union movement is in what he sees as a need for a new strategy to deal with market forces such as globalization, outsourcing and what he calls the Wal-Martization of wages, or in other words, a mad race to the bottom.

Stern uses a private-sector analogy to illustrate how to introduce a new strategy to address the mega-market shifts now facing the AFL-CIO. Several years ago, he explains, IBM faced a moment when its business model no longer worked. It had to change or die. It brought in a new leader [CEO Lou Gerstner] and moved rapidly into services. It changed, rather than continue selling a losing proposition. And now it is once again a leader. Stern sees most of labors value proposition as hopelessly broken. The AFL-CIO's focus on spending more money on public relations and lobbying is horrifyingly wrong, in his mind. Just by spending more on our PR, we are not going to turn the clock back on outsourcing or globalization, Stern says intensely. And we have problems of our own making. For example, there are more people flying on airlines than ever, but we have 12 or 14 airline unions who do not cooperate, which has helped create airlines financial problems. There is no unified plan for portable pensions or healthcare or training. It is a failed strategy of not uniting and not understanding the business realities.

HEALTHCARE HORROR SHOW

While unions own value propositions need revamping, there are other market forces that Stern sees as even more ominous for American business. In Sterns view, healthcare is the 20,000-pound elephant that everyone is afraid of acknowledging. A recent Princeton University study predicts that healthcare, which now represents nearly 17 percent of U.S. gross national product (GNP), compared with 9 percent in Europe, will reach 35 percent of U.S. GNP by 2030 if healthcare costs remain unchecked. If we don't do something about healthcare, well lose Americas competitive advantage, Stern warns. Just look at Detroit, he says. Carmakers can move 15 miles north to Canada and cut their healthcare costs tremendously. (GM reports that it now costs $1,400 per car to provide worker healthcare costs.) The big increase in independent contractors is also distorted by healthcare cost hikes, because employers cannot afford the medical premiums. And the silence on the part of big companies on this topic is deafening.

According to Terence O'Sullivan, head of the Laborers International Union, another AFL-CIO unit, 80 percent of negotiated wage and benefit increases go just to pay for healthcare costs. O'Sullivan has written recently that healthcare and hospital costs are driven up partly by the costs of paying for uninsured employees whose non-union companies fail to offer benefits. In Sterns opinion, our failure to address healthcare cost control has forced companies to shift costs to employees. What makes the situation particularly desperate for unions is that their ability to stanch the bleeding is limited because 84 percent of union members live in 12 states, leaving labor with little organized power in the remaining 38 states. In an ironic sidebar, Andy Stern notes that the healthcare cost climb has helped create some odd winners. The competitive advantage of coffee chain Starbucks, for example, comes largely from its guarantee of health coverage for all employees. That will last for a while, as long as [Starbucks] margins are strong, Stern observes. That is, until the Wal-Mart of coffee comes along and crushes their margins.

MEETING GLOBALIZATION HEAD-ON

While the AFL-CIO will be spending more money on PR and lobbying for protectionist barriers to globalization, Andy Stern will be making lots of international flights, adapting his union to the inexorable trend.

Stern is quite concerned about the impact of Wal-Mart on the plight of American workers. It used to be that what was good for GM was good for America, he says. But now Wal-Mart is the country's biggest employer, and it takes two Wal-Mart jobs to support one family.

While Wal-Mart provides a specific challenge, Stern claims that the bigger threat comes from global Wal-Mart-like players from France and Britain. Companies such as food-service giant Sodexho are largely unionized in France, but in the United States and Canada, where the company has more than 100,000 workers, they have fought union organizing efforts. So Stern went airborne and launched the idea of a global union alliance that would force the company to respect the same workforce standards here as in France. Sodexho, Stern reasons, would be less able to pound down wages here if it faced picket lines in Paris. The tactic has worked. Sodexho has come to the bargaining table.

Stern used the same tactic with U.K.- based First Group, which owns a U.S. school bus company named First Student. While staunchly non-union in the United States, eight out of 10 First Group employees in Britain are union members. Stern hooked up with the transportation union in Britain to put pressure on the company in London and in Parliament. Before and after Sterns planned Keynote speech at NY HR Week and HRO World in New York in April, he will be in London and Australia on similar missions. He recently went to Beijing, China for talks with union leaders there, and talks openly about going to India on an information gathering tour to address companies that are outsourcing work there. But unlike his AFL-CIO counterparts, Stern is not waving a flag of protectionism. His message is about standards. I'm no Marxist, he says. I'm a Farrellista big fan of McKinsey economist Diana Farrell's globalization theories.

In a 2004 edition of The McKinsey Quarterly, Farrell, the head of the McKinsey Global Institute, wrote: *But understandable as the protectionist reaction [to the hardships of globalization] might be, it is misguided, since it would forestall not only the problems but also the benefits of offshoring. Less understandable, perhaps, is the failure of corporations and governments to do more to ease the suffering of its victims in healthy economies; companies create new jobs often with higher wages and higher value added to the economy for most of the people who lose their old ones. Companies can make it easer for their workers* *to adjust by committing themselves to continual on-the-job learning and retraining programs. Policy makers can assist them by offering tax credits or other incentives for companies that hire and train displaced workers. Generous severance and relocation packages can help as well. So too can wage insurance the McKinsey Global Institute estimates that for as little as 4 to 5 percent of the savings gained from offshoring, companies could insure most full-time workers for up to 70 percent of any difference between the wages they received on jobs they lost and the wages they might receive on their new jobs if indeed these jobs paid less. Companies could also offer health care subsidies for up to two years.*

Stern wholly endorses Farrell's concept of helping companies share the risk of worker dislocation. Why can't a high tech company operating in Silicon Valley or Bangalore have set-asides for worker health, training, and transition? He asks. The truth is that a union could do this. This could be a risk-sharing partnership. The union could be an intermediate force in an industry to make these increasingly rapid changes less painful. Stern thinks for a moment, then proclaims, Yes, this is a winning strategy.

Does that mean that Stern, the leader of the country's biggest union, is actually a fan of outsourcing? Hey, we represent lots of outsourced workers, he smiles. Janitors, security officers, healthcare workers, they are all doing outsourced work. To us, the question is whether [the outsourcing] is all about paying less wages and rewarding campaign contributors [in the case of public-sector outsourcing], or about quality and efficiency.

Stern pauses, knowing he is on to a big thought. We can't reward work with a race to the bottom on wages, he says, slowing his pace and deepening his voice for emphasis. That is not the American Dream. [HRO]

ANDY STERN'S 3 BIG IDEAS FOR HR LEADERS

As the leader of a 1,800,000 union, the nations largest, Andy Stern is as much a Human Resource leader as any reader of this or any other HR publication. And he has Three Big Ideas that just might inspire you to look at your job a bit differently.

IDEA 1: DEEDS ARE BETTER THAN WORDS.
Think about how to reward workers rather than stockholders. When you say we are investing in people, is that just empty words? There is a role for an intermediate organization that helps you truly invest in your people.

IDEA 2: ARE UNIONS AN ANTI-COMPETITIVE FORCE OR ELECTRICITY?
The sum total of the wage race to the bottom is that this generation of American workers will be the first ever to have a worse quality of life than their parents. To try to stop the wage drops, unions have been an anti-competitive force, protectionist. But what union wages should be is like electricity, which allows their users [employers] to operate more efficiently with better quality.

IDEA 3: PRIVATE RETIREMENT ACCOUNTS SIDE-BY-SIDE WITH SOCIAL SECURITY.
Maybe the only interesting part of President Bush's proposals on Social Security reform is to have workers put money in an account as an add-on for retirement setting up a national annuity system in addition to Social Security that is portable from employer to employer. It would take a portion of employee's retirement investment and outsource it with some [principle] guarantee. Unions could play a role in helping administer this.

Jay Whitehead is President & Publisher of Outsourcing Today LLC, the owners of HRO Today and HRO Europe magazines. He can be reached at jwhitehead@outsourcingtoday.com.

THE McKinsey Quarterly

19 May 2005| **Visitor Edition**

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Strategy: **Globalization**

Tools

Offshoring and beyond

Cheap labor is the beginning, not the end.

Vivek Agrawal, Diana Farrell, and Jaana K. Remes

The McKinsey Quarterly, 2003 Special Edition: Global directions

The enticement to companies of a worker who earns $2 an hour in India as against ten times that amount for a worker in the United States is obvious. For years, such wage differentials have attracted leading manufacturing companies to low-wage nations. More recently, businesses of all kinds have also exported back-office functions such as data entry, payroll processing, and call centers. Business-process offshoring is all the rage, and the hundreds of companies that have taken this route often cut their costs by as much as half.

Yet as impressive as these achievements may appear, new research by the McKinsey Global Institute (MGI) finds that companies are leaving billions of dollars in savings behind when they offshore back-office functions and service jobs.[1] Such companies are merely replicating what they do at home, where labor is expensive and capital is relatively cheap, in countries in which the reverse is true. What is needed? Nothing less than a total transformation of business processes to harness the new environment's potential. And by undertaking such a transformation, many companies will find that the resulting lower cost structure releases massive new revenue opportunities even more valuable than the savings.

Halfway to global

The first wave of globalization began a hundred or more years ago, when companies were lured abroad by the prospect of new markets. Even today, we estimate, the age-old motivation of reaching vast new customer pools explains perhaps 80 percent of cross-border investments. Many of them, such as Wal-Mart Stores' operations in Mexico and HSBC's in Malaysia, are in service sectors that require a local presence by definition. Others are in industries such as automotive, in which high tariffs and other trade barriers effectively force foreign companies to set up shop locally if they want to do business.

Despite the fits and starts of progress in world trade talks, the policy barriers that limit foreign investment and trade have fallen significantly over the past ten years. The result has been a second wave of globalization, in which companies from North America, Europe, and Japan build plants in low-wage countries to take advantage of enormous wage differentials and then export the finished goods back to the home market. These companies have substantially cut their costs for a variety of products, particularly labor-intensive ones such as textiles and toys, even taking into account the extra expense of transportation and overseas management and training.

Companies in a few industries have gone further, specializing in component production and final assembly in the countries or regions with the strongest comparative advantage. Nowhere is this third wave of globalization more evident than in consumer electronics (*see* sidebar, "How far can it go?"). Business-process offshoring, made possible by the dramatic fall in telecommunications costs and the ability to transform paper-based activities into digital ones requiring only a telephone and a computer, is just the next logical step. A broad

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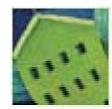


The real benefits of offshoring

Offshore outsourcing is about more than cheap labor.

Exploding the myths of offshoring

Offshoring goes on the offensive F

Innovation blowback: Disruptive management practices from Asia F

Offshoring and beyond

The next wave in US offshoring

range of service jobs and back-office functions can now be performed remotely in India, for example, or in the Philippines. Low-skill work such as data entry and transaction processing, real-time customer support, and research services are obvious candidates. But even high-skill activities such as customized software development, the design of automotive and aerospace components (CAD/CAM), and pharmaceutical research are increasingly undertaken outside the United States.

Many of the jobs sent offshore may be considered undesirable and lacking in prestige in developed countries yet are highly attractive in developing ones. So offshore workers not only cost far less but also are often more highly motivated, which means that they perform better. One British bank's call-center agents in India, for instance, process 20 percent more transactions, with 3 percent more accuracy, than their counterparts do in the United Kingdom. Some companies set up their own "captive" operations in offshore locations to take advantage of these benefits, while others outsource to local companies, particularly in India.

Companies in the United States and Britain account for roughly 70 percent of the business-process-offshoring market. Relatively liberal employment and labor laws give such companies flexibility in reassigning their activities and eliminating jobs, and they can take advantage of the sizable English-speaking populations in many low-wage countries, such as India, Ireland, the Philippines, and South Africa. With a shared language, errors are far less likely and functions that require voice interaction or text-based work are straightforward. The opportunities for Continental European and Japanese companies are thus more limited.

Business-process offshoring is still a nascent industry. By our estimates, in 2002 it was worth \$32 billion to \$35 billion, just 1 percent of the \$3 trillion worth of business functions that could be performed remotely. Because of the significant benefits already being realized through offshoring, the market is projected to grow by 30 to 40 percent annually over the next five years.[2] This prospect may cause consternation over job losses in the United States (*see* Vivek Agrawal and Diana Farrell, "Who wins in offshoring," *The McKinsey Quarterly*, 2003 Number 4 Global directions, pp. 36–41), but it will make offshoring an industry with well over \$100 billion in annual revenues by 2008.

Getting more from offshoring

Merely replicating processes developed at home, however, is not the way to realize offshoring's full potential. Wages represent 70 percent of call-center costs in the United States, for instance, so these operations are designed to minimize labor by using all available technology. But in low-wage India, that makes little sense, since wages represent only 30 percent of costs, and capital equipment (to provide telecom bandwidth, for example) is often more expensive than it is at home.

The way to reduce the cost of offshore operations even further (Exhibit 1) is to reorganize and reengineer operations to take full advantage of these differences. In a low-wage country, the capital infrastructure—including office space, telecommunications lines, and computer hardware and software—should be used as intensively as possible. For a call center, this approach can reduce costs by an additional 30 to 40 percent, boosting total savings to as much as 70 percent of the cost of onshore operations (Exhibit 2). The potential value for other offshored functions, like data entry, payroll processing, and financial accounting, is similar.

Companies can boost their capital productivity in low-wage environments in three ways:

EXHIBIT 1

Pushing the envelope

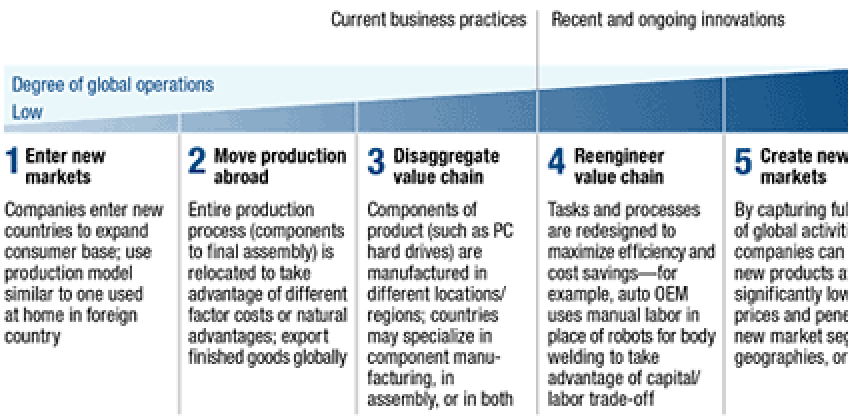
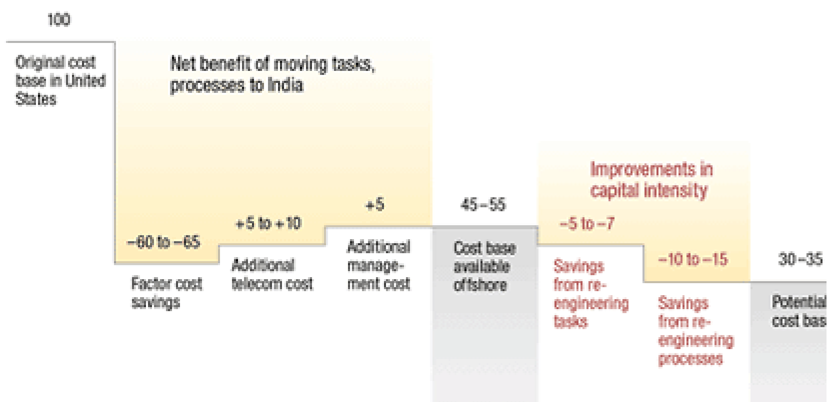


EXHIBIT 2

Capital intensity is the key

Economics for typical offshore call center in India; index: original cost base in United States = 100



Round-the-clock shifts. The most obvious way to use the capital infrastructure more intensively is to run round-the-clock shifts, even if they mean higher wages for odd hours. This option simply wouldn't exist in a high-wage environment, where wage premiums offset any capital savings. We estimate that just by increasing the number of shifts, companies can reduce their operating costs by 30 to 44 percent for many types of offshore work, including financial accounting, procurement, call centers, transaction processing, and more complex functions such as knowledge services and R&D (Exhibit 3). But in India, we found that even the most efficient third-party providers run only two shifts a day, and most of the captive operations set up by multinational corporations are running only one.

- ***Cheaper capital equipment***. Some service providers in India are using cheap local labor to develop their own software instead of purchasing more expensive branded products from the global software giants. American Express, for instance, hired programmers to write software to reconcile accounts, and the software now reconciles over three-quarters of them, or more than half a million every day. The company, which paid only $5,000 to develop this solution, estimates that licensing more sophisticated

EXHIBIT 3

Rock around the clock

Effects of additional shifts on operating costs, $ per billable seat per hour

Level of skills required →

	Data entry, verification[1]				Rules-based decision making[1]				Knowledge-based services[1]		
	Fixed costs	Variable costs[2]	Total cost		Fixed costs	Variable costs[2]	Total cost		Fixed costs	Variable costs[2]	Total cost
Voice services[3]											
1 shift a day	7.8	4.0	11.8		7.8	4.6	12.4		7.8	6.8	14.6
2 shifts a day	3.9	4.0	7.9		3.9	4.6	8.5		3.9	6.8	10.7
3 shifts a day	2.6	4.0	6.6	–44%	2.6	4.6	7.2	–42%	2.6	6.8	9.4
Nonvoice services[3]											
1 shift a day	6.3	3.8	10.1		6.3	4.3	10.6		6.3	8.0	14.3
2 shifts a day	3.1	3.8	6.9		3.1	4.3	7.4		3.1	8.0	11.1
3 shifts a day	2.1	3.8	5.9	–42%	2.1	4.3	6.4	–40%	2.1	8.0	10.1

[1]Data entry, verification include simple manual processes that don't require decision making; rules-based decision making includes services that don't require managerial judgment, can be performed with mechanical rules-based directions, and require minimal supe knowledge-based services require skilled, knowledge-based professionals, such as engineers, MBAs, scientists.
[2]Additional shifts in this example are daytime shifts and therefore require no wage premium.
[3]Voice services include multipurpose, multichannel interactions serving needs of many constituencies, including customers, distributo employees, prospects, suppliers; nonvoice services include processing of back-office functions with turnaround time >4 hours.

database software would have cost several million dollars. The Indian carmaker Maruti Udyog developed its own robots for its assembly lines; the robots, on average, cost a small fraction of what similar ones cost its partner Suzuki in Japan. In this way, companies maintain the level of automation that prevails in high-wage countries, but at a distinctly lower capital cost.

- ***Reduced automation***. Some companies have gone a step further and used workers for tasks that would normally be automated at home. A payments processor, for example, might employ people to input checks manually into a computer system instead of using expensive imaging software. A telemarketing firm that would use expensive automatic dialers in a high-wage country might have workers make their own calls instead.

Manufacturers too can use this approach. Certain automotive original-equipment manufacturers (OEMs) in China use robots for only 30 percent of the welding in car assembly, as compared with 90 percent or more in US or European operations. (BMW's plant in South Africa employs the same line of attack.) In India, domestic car companies have reduced the need for automation throughout the manufacturing process: they use more manual labor to load and change dies in pressing, body welding, materials handling, and other functions—while suffering no discernible loss of quality in the finished product. In this way, these companies manage to cut their assembly costs by 4 to 5 percent or even more and save themselves millions of dollars annually.

Ultimately, companies might completely redesign the sequence in which tasks are performed, in order to leverage the opportunities above more fully. Consider the simple example of a call-center agent who manages customer accounts. In high-wage countries, each customer call is routed to an agent who listens to the request, opens up a computer database, and updates the account in real time. Neither the computer nor the telephone is used efficiently, since the agent is either talking or typing but not both.

Offshore, an agent equipped with only a telephone could write the customer request by hand into a tracking log and move on to the next call. Telecom costs are reduced because the agent spends less time on calls and customers less time on hold. Another agent, working at a computer station used around the clock, could enter the information into the database. While the new process requires more agents to handle requests, expensive computer hardware and software and telephone lines are used more intensively. Added wages are more than offset by savings on computers, software licenses, and telephone connections (Exhibit 4). The economics of an Indian call center suggest that this simple change could actually boost current profit margins for offshoring vendors by as much as 50 percent.

EXHIBIT 4

Process reengineering lowers costs

Change in operating costs for typical call center in India,[1] $ per billable seat per hour

Decrease in labor productivity		Cost of increased transaction-processing time and additional labor	+$1.20
Increase in capital productivity	Process reengineering	Savings from increased capital intensity (more efficient use of computers, telephones)	–$2.60
	Task reengineering	Savings from reduced software-licensing costs	–$0.20
	Net effect on operating costs		–$1.60

[1] In this example, agent equipped with only a telephone writes customer requests by hand into tracking log; agent spends less time per call, customers spend less time on hold; second agent working second or third shift enters information into database.

Reengineering offshore functions makes sense only if wages stay low. Over time, they will rise and technology costs will continue to fall. As this happens, companies can adjust their operations to reflect changing factor costs. But in most low-wage countries, labor is so cheap and the labor pool so large that rising wages are unlikely to be a problem for decades. India each year produces 2,000,000 college graduates—more than 80 percent of them English speakers—while China produces 850,000, though with minimal English skills. Even a small country like the Philippines annually produces 290,000 college graduates, all English speakers.

Beyond cost savings

By reaping offshoring's full potential, companies will find that their new, lower-cost structures open up a variety of opportunities to boost revenue growth. These opportunities will often far exceed the annual cost savings.

Some companies, for instance, can now chase delinquent accounts receivable they formerly had to ignore: one airline carrier is capturing $75 million in previously lost receivables on top of the $50 million it saves each year by operating its accounts-receivable department in India. Meanwhile, a leading US personal-computer manufacturer created telephone- and e-mail-based customer service centers in India to provide technical support. In addition to saving more than $100 million annually, it has significantly increased the proportion of customer problems it resolves. The company thereby reduces the number of follow-up calls it receives and the amount of merchandise it must replace while simultaneously boosting its customer satisfaction levels. And a financial-services firm has extended to customers with lower account balances services previously limited to high-net-worth clients, thus opening up large new customer segments in its home market.

The new cost position can also be used to develop cheaper products for consumers in emerging markets. Consider the experience of one of their own local companies. The Indian automaker Tata Motors (formerly Telco) designed the low-cost Indica car for the domestic market. The Indica sells for roughly 10 percent less than cars from global OEMs and breaks even on a volume of 150,000 units, a fraction of the number global companies need. That Indicas have fewer features accounts for a small part of the cost savings. Most of the savings come from a lower level of automation in assembly, a reengineered process, and the use of very low cost local labor to develop the car (at a quarter of what a global OEM would have spent to develop something similar). As a result, the company has grown from virtually nothing to capture a quarter of the Indian market in its segment during the past four years—displacing Suzuki Motor, Hyundai, and other global brands—and is now under contract to export 100,000 Indicas to the United Kingdom and Continental Europe.

As companies go further down the road to globalization, the potential to create new markets and redefine industries is enormous. Consider how the dramatic price reductions made possible by globalizing production have changed the market for televisions in the United States. Just 25 years ago, almost a quarter of US households had no color TV. Since then, prices have declined by roughly 40 percent in real terms. Now 98 percent of US households have at least one, and many families have three or more. At the new price point, color televisions have been transformed from luxury items into nearly disposable goods that most of the population considers a necessity. And as color TVs have proliferated, they have given rise to an industry that produces television content and television-based games worth more than $30 billion. Although the detractors of globalization fear that it has already gone too far, we believe that it has barely begun.

How far can it go?

The personal computer on your desk today may have been designed in Taiwan and assembled in Mexico, with memory chips from South Korea, a motherboard from China, and a hard drive from Thailand. Not surprisingly, the value of world trade in consumer electronics components and final goods is 180 percent of the value of industry sales each year, and the industry has been completely restructured. Many companies around the world are now specializing in quite narrow segments of the value chain—for example, as innovators and designers of goods, low-cost producers, specialized assemblers, or marketers and distributors.

Countries too are starting to specialize: Mexico and Eastern Europe take advantage of their location to assemble goods destined for the United States and Europe, respectively, and China uses its huge labor pool to become a global base for low-cost manufacturing. Although companies have benefited from lower costs and consumers have enjoyed dramatically lower prices and more choice, few nonmanufacturing industries have moved so decisively.

Clearly, not every industry could go as far as consumer electronics along the road to globalization: steel, for instance, is heavy and bulky to transport, while services such as retailing, banking, and entertainment must of necessity remain largely local. The interplay between the physical nature of any industry, its organizational environment, and the legal, regulatory, and policy barriers to its globalization determines its potential for restructuring.

The barriers to globalization are real, and many may not come down. But as an experiment, we looked at how much value could be created in the automotive industry if they did. We found that it could capture a staggering $150 billion annually in cost savings and an additional $170 billion annually in new revenues—a combination that would boost industry revenues by more than 25 percent from current levels. What stands in the way of achieving this increase?

Most people think that the industry is already global, largely because of the popularity of foreign cars. Few realize that of the 55 million vehicles produced each year, more than 90 percent are sold where they are made. Although the leading OEMs have all built plants in low-wage countries, these facilities were built to meet local or regional demand. Very few cars move from one geographic region to another, and until very recently only about 100,000 cars produced in low-wage countries were subsequently exported to high-wage ones.[1]

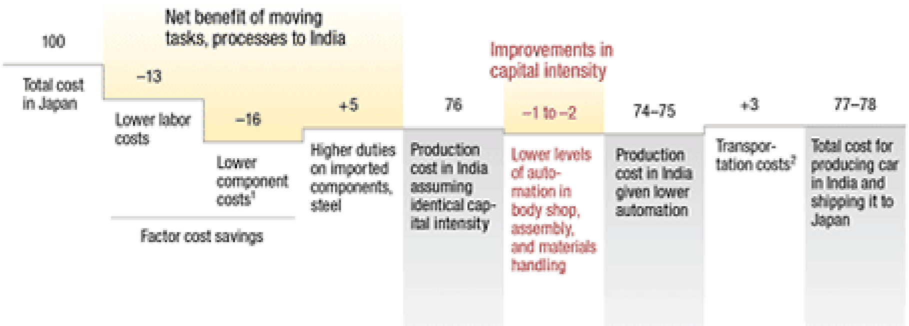
Yet there are few good reasons for this pattern. After all, it costs only $500 and takes only three weeks to ship an automobile anywhere in the world, and both the cost and the time are diminishing. More important, cars can be produced in low-wage countries for at least 20 percent less than in high-wage ones, even after shipping costs and tariffs are factored in (exhibit). The resulting boon to the world's consumers could be enormous.

Furthermore, experience has shown that quality standards can be maintained in low-wage countries. BMW's South African plant, which exports to Europe and North America, is even slightly better than the German plant.[2] Volkswagen produces all of its popular New Beetles in Mexico. Operating in these countries often requires extra training for workers—BMW spends three to five times

EXHIBIT

From India with love

Economics of producing car in India for shipment to Japan; index: total cost of comparable car in Japan = 100



[1]Assumes 90% of all components are sourced indigenously, with equivalent or superior quality.
[2]$300 for small car, $500 for large car; there are no tariffs on car imports to Japan.

more on training in South Africa than it does in its other plants—but wage differences more than offset that cost.

Moreover, many analysts believe that overcapacity in the global automotive industry is now 30 percent or even higher. Much of the overcapacity is in emerging markets, where governments granted lucrative incentives to global OEMs during the 1990s but local demand failed to materialize. These factories could be supplying developed countries with lower-cost cars. Confronted by idle plants in countries from Thailand to Brazil, a few OEMs are now moving in this direction.

The barriers to globalization are government policies and some of the industry's organizational features. Apart from Japan, virtually every country has car tariffs, which range from 2.5 percent in the United States to 10 percent in Europe and to over 100 percent in some developing countries. What's more, strong unions mount stiff resistance to moving production offshore. Many auto parts are proprietary and there is very little standardization across manufacturers. So the complex supply chain—which can include hundreds of direct suppliers, each relying on hundreds of subsuppliers—is still relatively fragmented despite current perceptions of rampant consolidation. And since assembly plants can cost up to half a billion dollars to build, OEMs have enormous sunk costs in their existing manufacturing facilities.

If the industry found ways to overcome these barriers, it could capture up to $320 billion annually in cost savings and new revenues. The first step would be to use existing plants in low-wage countries more efficiently. By cutting the current overcapacity in half, the industry could reap $10 billion annually.[3] By building all additional production capacity in low-wage countries, it could save a further $40 billion annually after five years. Over time, if OEMs migrated 70 percent of their assembly and components sourcing in high-wage countries to low-wage ones, they could realize savings in the neighborhood of $150 billion a year. (For most OEMs, as much as 30 percent of demand is variable and 70 percent stable and predictable. Moving 70 percent offshore is thus potentially feasible without making consumers wait longer to get their cars or building large inventories to compensate for fluctuating demand.)

But the benefits don't stop at cost savings. By taking advantage of low-cost labor and disaggregating supply chains, automakers could produce cars at least 20 to 25 percent more cheaply. If tariffs on parts were also to fall, these companies could, by conservative estimates, cut prices by 30 percent and unleash massive new demand. In emerging markets, where consumers are highly price sensitive and there is significant unmet demand for low-cost cars, we estimate that the industry could increase its sales by up to $100 billion a year.

In developed countries, where most consumers already own cars, cutting the price of the lowest-cost models by 30 percent (to $7,000, from $10,500) could produce roughly $70 billion in additional sales. Some of this demand would come from low-income households that currently don't own cars. But part of the opportunity would be generated by changing the way consumers view them: instead of having only one or two, households might opt for three or four, with some purchased just for fun. Parents might be more inclined to buy cars for their children, and young people might enter the market as well.

The potential value at stake in the auto industry is eye-popping but hardly unique. As the barriers to globalization continue to erode, many other industries could be restructured and capture similar value.

Notes

1This estimate doesn't include production within the countries adhering to the North American Free Trade Agreement (NAFTA).

2"Two-way street: Automakers get even more mileage from the Third World," *Wall Street Journal*, July 31, 2002.

3For details on these calculations, *see* the October 2003 MGI report *New Horizons: Multinational Company Investment in Developing Economies*, available free of charge.

Return to reference

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Notes

1*See* the October 2003 MGI report *New Horizons: Multinational Company Investment in Developing Economies*, available free of charge. During the yearlong research project leading up to this report, we conducted in-depth case studies of foreign direct investment in five sectors (automotive, consumer electronics, retail banking, retailing, and the offshoring of information technology and business processes) in four major developing economies (Brazil, China, India, and Mexico). These cases generated the basis of our findings and conclusions.

2Consensus estimates of the market research firms Aberdeen Group, Gartner, and IDC.