

## Institutional factors affecting offshore business process and information technology outsourcing

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### **Abstract:**

Micro and macro level impacts of offshore outsourcing are far from clear. Thus there are some well-founded rationales for and against offshore outsourcing as well as a number of misinformed and ill guided viewpoints. Using institutional theory as a lens, this paper analyzes the drivers of offshore business process and information technology outsourcing. We examine the mechanisms by which regulative rules, social rules, culturally supported habits and subconsciously accepted rules and customs influence assessment, selection as well as continuation of outsourcing projects. Managerial and policy implications are discussed and directions for future research have been suggested.

**Keywords:** Offshore outsourcing; Institutions; Privacy laws; Rule of law; Codes of conduct

### **Article:**

#### ***1. Introduction***

The global offshore outsourcing market is rising exponentially. One estimate suggested that the annual global market for business process (BP) and information technology (IT) outsourcing will cross \$100 billion by 2008 (Babcock, 2004)<sup>1</sup>. Micro and macro level impacts of offshore outsourcing are, however, far from clear (Kotabe and Murray, 2004). Because of a lack of a systematic framework, there has been substantial debate about the long-term consequences of offshore outsourcing (Lacity and Willcocks, 1998). There have been some well-founded rationales for and against offshore outsourcing as well as a number of misinformed and ill guided viewpoints.

At the micro level, the existing literature provides very little guidance in selecting outsourcing service suppliers (Kotabe, 2001). Thus offshore outsourcing decisions related to the optimum level, activities and destinations are accomplished through the use of common sense, accumulated experience and rough judgment (Kshetri and Williamson, 2004). Notwithstanding a substantial potential savings, a number of firms are reluctant to outsource offshore. Some firms engaged in offshore outsourcing, on the other hand, have been unable to reap the benefits. A Gartner analyst predicted that during 2005-2008, 60% of organizations outsourcing customer services will face customer defections and incur hidden costs that will cancel or even exceed savings (Alster, 2005). Another study indicated that half the firms that shift processes offshore fail to generate expected financial benefits (Aron and Singh, 2005).

Next, let's consider macro-level effects. Some studies have indicated that if properly implemented, offshore outsourcing creates more jobs than those sent overseas. Nonetheless, offshore outsourcing has been a controversial issue in business and political circles (Human Resource Management International Digest, 2005). Fears related to offshore outsourcing have generated confrontational reactions and raised a public outcry in outsourcing origin countries. Domestic lobbies such as labor unions, members of affected industries and professionals losing jobs are pushing for protectionism (Pfannenstein and Tsai, 2004). Negative media coverage has further intensified the debate about the justifiability of offshore outsourcing (Rottman and Lacity, 2004). Job losses associated with outsourcing became a major issue during recent EU constitution referendums and in the 2004 U.S. presidential campaign (Kaka and Sinha, 2005).

Advancement of the art and science of offshore outsourcing will facilitate to speed up the learning curve (Rottman and Lacity, 2004) for firms engaged in outsourcing relations. It will also help policy makers in outsourcing destinations devise strategy to attract outsourcing jobs. Such an understanding will also assist policy makers in an outsourcing origin country (e.g., U.S.) assess broader impacts of outsourcing. To fill these research gaps, this paper draws upon institutional theory to develop an understanding of factors affecting the pattern of the global flow of offshore IT and BP outsourcing.

Before proceeding, we offer some clarifying definitions. IT outsourcing is defined as subcontracting a company's IT functions to an external vendors (Cheon et al., 1995; Lacity and Willcocks, 2001; Loh and Venkataraman, 1992; Sengupta and Zviran, 1997). Similarly, BPO is defined as long-term contracting of a firm's (hereafter: the client firm) non-core business processes to an external service provider (hereafter: the outsourcing firm) (Romberg, 1998). These are non-IT business processes but in most cases are IT-intensive or are facilitated by IT. Some examples include customer service call centers, tax preparation, medical transcription, finance and accounting, human resources, design and engineering, etc. (The Economist, 2005a). In offshore IT or offshore BP outsourcing, the outsourcing firm and the client firm are located in different nations. The remainder of the paper is structured as follows: The next section provides an overview of institutional theory. Then, we develop some propositions that relate institutions in the origin and the destination countries with the global flow of offshore BP and IT outsourcing patterns. Finally, we provide discussions and implications.

## **2. Institutions and offshore outsourcing**

At the broadest level, the concept of "social co-evolving ecosystem" (Mitleton-Kelly, 2004) can be used to analyze the institution-offshore outsourcing nexus. An organization influences and is influenced by the social ecosystem. Institutions can be considered as a conceptual subset of the social ecosystem. An economic system, on the other hand, is a "coordinated set of formal and informal institutions" (Dallago, 2002) influencing economic agents' behavior (Matutinoviæ, 2005). Put differently, all economic phenomena have institutional components and implications (Parto, 2005).

As an economic phenomenon, offshore outsourcing is deeply embedded in a diverse set of institutions. For instance, in an outsourcing agreement, regulatory controls such as legal documents, policies, formal systems, standards and procedures may establish the relationship between the two parties and specify boundaries (Das and Teng, 2001). Yet they represent only "incomplete contracting" (Grossman and Helpman, 2005) and hence cannot be exhaustive. To resolve ambiguities and make outcomes more predictable, it is necessary to understand social, interpersonal and informal infrastructures related to norms, shared values, internalization and beliefs (Eisenhardt, 1985; Kanter, 1994; Parker and Russell, 2004; Read, 2004). Such an understanding can help firms win and maintain legitimacy and thus exert more control over the environment (George et al., 2006, p. 352).

Approaching offshore outsourcing from the standpoint of institutions, we can capture complex causes and roots discussed above (Ang and Cummings, 1997; Hu et al., 1997; Lacity and Hirschheim, 1993; Levina and Ross, 2003; Loh and Venkataraman, 1992). North (1990) defines institutions as "macro-level rules of the game" (p. 27). For offshore outsourcing projects, institutions guide behaviors of concerned parties by mediating the relationships among various stakeholders and enabling technologies (Russo, 2001).

Now, let's consider how an organization's responses, structure and practices are related to institutions. Early works of institutionalists indicated that organizational structure and practices tend to be isomorphic, that is, consistent with regulatory, cognitive and normative institutions (Meyer and Rowan, 1977; Powell and DiMaggio, 1991) and those of other actors (George et al., 2006, p. 353). Subsequent theoretical and empirical evidence suggested that organizations do not always engage in predictable and isomorphic actions (George et al., 2006; Hoffman, 1999). They often face pressures for non-isomorphic responses that "involve departure from established structures, practices, and utterances of other actors in the environment" (George et al., 2006, p. 353). Table 1 provides some examples of isomorphic and non-isomorphic responses related to offshore outsourcing.

Here is why organizations involved in outsourcing sometimes can engage in non-isomorphic responses. Like other organizational fields, outsourcing activities can be viewed as “arenas of power relations” (Brint and Karabel, 1991, p. 355) in which various players engage in institutional war (Hoffman, 1999; White, 1992). Although, organizational isomorphism is positively related with legitimacy (Deephouse, 1996), when an organization is seeking legitimacy from different sources with conflicting demands, its responses are likely to be non-isomorphic with respect to some of the sources. The degree of isomorphism/non-isomorphism of a response is a function of organizational perception of gain or loss of control and/or resources associated with the response (George et al., 2006).

Following the analogy of social ecosystem and pressures for non-isomorphic responses discussed above, we can argue that outsourcing activities may bring institutional changes. Notwithstanding their connotation of inertia and resistance to change (Hoffman, 1999) persistence (Parto, 2005), durability (Hodgson, 2003) and stability (Scott, 2001, p.48), institutions are subject to change in evolutionary time (Parto, 2005). One way in which institutional change takes place is through institutional war discussed above (Hoffman, 1999; Selznick, 1949). Zucker (1988, p. 26) draws an analogy from physics to describe institutional changes mechanisms. He argues that institutions continuously undergo change due to entropy, a tendency toward disorder or disorganization (p. 26). An implication of the entropy-like characteristics is that people and organizations can modify and reproduce institutions (Scott, 2001). Institutional changes take place incrementally (North, 1990) as well as in discontinuous fashions (Scott, 2001, 48). Offshore outsourcing is thus likely to change institutional structure of outsourcing origin and destination countries. Such changes, in turn, are likely to affect offshore BP and IT outsourcing.

Table 1  
Some examples of isomorphic and non-isomorphic responses

Institutions associated with	Isomorphic response	Non-isomorphic response
Outsourcing origination country (e.g., the U.S.)	Firms select an outsourcing firm that is culturally compatible.  Firms are quiet and sensitive about revealing their offshore outsourcing plans. Firms take measures (e.g., employing encryption technology to communicate) to protect customers' privacy.	Unions are challenging firms' profit maximization motives and are raising issues related to social obligation requirement (challenge on capitalism).
Outsourcing destination country (e.g., India)	Outsourcing firms adhere to professional codes of conduct.  Outsourcing firms take measures to understand a client firm's culture and respond accordingly.	Call center employees have to undergo "undignified" security checks.  Call centers are breaking the taboos of the society by making young men and women work together during nights.

In this article, we use Scott's (1995, 2001)<sup>2</sup> approach as the framework for analyzing BP and IT outsourcing. Scott has conceptualized institutions as composed of three pillars: regulatory, normative and cognitive. These three pillars can be mapped with DiMaggio and Powell's (1983) coercive, normative and mimetic pressures respectively. Scott's pillar model is an umbrella concept and integrates various institutional theories and approaches from a wide variety of research disciplines such as economics, sociology and anthropology.

At this point, it must be emphasized that each institutional pillar both reflects as well as determines the nature of other pillars. For instance, political scientist Robert Axelrod (1997) comments on the relationship between regulative and normative institutions:

Social norms and laws are often mutually supporting. This is true because social norms can become formalized into laws and because laws provide external validation of norms<sup>3</sup>.

### 3. Institution-offshore Outsourcing Nexus: Some Propositions

We employ three sources of reasoning to develop propositions (Webster and Watson, 2002, Whetten, 1989, p.

491). First, we provide theoretical explanations for "whys" and "hows" of offshore outsourcing. Such explanations tie together structures and causal mechanisms in the outsourcing industry. Second, we use past empirical findings such as survey results related to the outsourcing industry. Lastly, practices and experiences of companies engaged in outsourcing relations (e.g., Dell, Mphasis, Daksh, etc.) and measures taken by professional associations (e.g., the American Association for Medical Transcription (AAMT), the Organization for the Rights of American Workers (TORAW), the Business Processing Association of the Philippines (BPAP) and India's National Association of Software and Services Companies (NASSCOM)) to influence offshore outsourcing have also contributed to our theory development process.

### ***3.1. Regulative institutions and offshore BP and IT outsourcing***

Regulative institutions consist of "explicit regulative processes: rule setting, monitoring, and sanctioning activities" (Scott, 1995, 35). They are related to regulatory bodies and the existing laws and rules that influence offshore outsourcing. These institutions focus on pragmatic legitimacy concerns in managing the demands of regulators and governments (Kelman, 1987). Individuals and organizations adhere to them so that they would not suffer the penalty for noncompliance (Hoffman, 1999).

#### **3.1.1. Privacy laws in the origin country**

A large proportion of offshore outsourcing entails significant information flows. An estimate of the Gartner group indicated that offshore BPO services, which typically require the transfer of personal data, grew by 38 percent in 2003 to reach \$2 billion (Swartz, 2004a,b). Privacy, thus, has been a major concern in offshore outsourcing activities because of difficulties related to enforcing privacy laws in foreign countries' courts (Lucas, 2004).

Some analysts argue that privacy rules have become a form of disguised protectionism in offshore outsourcing (Davis, 2004). Some business sectors (e.g., health-related services) are more protected than others (The Economist, 2001). For instance, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) requires firms providing services to healthcare organizations (e.g., outsourcing vendors) to maintain confidentiality of the information they receive (Hazelwood et al., 2005)<sup>4</sup>. In 2004, two bills were introduced in the U.S. Congress that would limit offshore outsourcing of radiology (Piotrowski, 2005)<sup>5</sup>.

Countries across the world also vary in terms of the strictness of privacy laws. The U.S., for instance, has stricter privacy laws than economies in Eastern Europe and Latin America (Shaw, 1993). As of the mid-2004, there were 186 bills pending in the U.S. Congress and 40 state legislatures that aimed to limit offshore outsourcing (Engardio et al., 2004; Solomon, 2004). To take one example, U.S. Senator Liz Figueroa (California) filed a bill in 2004 seeking to ban offshore outsourcing of works involving confidential information such as medical and financial records (Estavillo, 2005)<sup>6</sup>. A member of the Telecommunications and Internet Subcommittee said:

There is no assurance that privacy will be protected when personal data is transferred to offshore companies that are beyond the reach of US law enforcement, and the federal government needs to wake up to the risks that this presents... The implications for identity theft by gangs, breaches of homeland security by al-Quida, and criminal misuse and abuse by multinational corporations are frightening (Ravindran, 2004).

The European Union (EU) is considered to have stricter privacy laws than in the U.S. Whereas the U.S. has a more relaxed approach to privacy and in an attempt to encourage marketing innovations, prefers to rely on voluntary self-regulation, the EU tends to enforce privacy rights through legislation (The Economist, 1999). The EU Privacy Directive 1998, for instance, aims to protect the privacy of citizens when their personal data is being processed. The data covered by the directive include sensitive employee or customer-related data (Balaji, 2004). To summarize, because of these regulations, less data based information will be allowed into the hands of other companies which means less outsourcing will take place. The discussion in this section is summarized as:

Proposition 1. *Ceteris paribus*<sup>7</sup>, the strictness of privacy laws in an originating country is negatively related to outsourcing outflow from the country.

### **3.1.2. Rule of law in the destination country**

Theoretically security, privacy, or identity breaches could happen within as well as outside the U. S. Nonetheless, the prospect of civil and criminal prosecution is weaker when such breaches take place in a country with a weak rule of law (Lowes, 2004). Perceived or real security, privacy, or identity breaches can diminish the value created by offshore outsourcing (PR Newswire Europe, 2005).

Some of the fears are well-founded. As discussed in the last section, there have been a number of well-publicized security breaches and concerns about service quality (Kaka and Sinha, 2005). If a U.S. customer becomes a victim of such breaches, the U.S. company that outsourced work is legally responsible (Engardio et al., 2004). Theoretically, the U.S. company can shift the liability to its offshore outsourcing partner<sup>8</sup>. Contracts are, however, difficult to enforce in countries that have a weak legislative environment.

A country with a strong rule of law has “sound political institutions, a strong court system” and citizens that are “willing to accept the established institutions and to make and implement laws and adjudicate disputes” (International Country Risk Guide 1996). On the contrary, in a number of countries, it is very tough to operate due to weak rule of law (Human Resource Management International Digest, 2005). Difficulties associated with contract enforcement in such countries diminish the perceived value of offshore outsourcing (Welfens, 1999).

U.S. and European companies are concerned about a weak legislative environment and difficulties related to contract and privacy enforcements in India<sup>9</sup> (Engardio et al., 2004; Ravindran, 2004) and China (Murphy, 2004). Some U.S. medical transcription firms are unwilling to outsource work to India notwithstanding a potential savings of up to 50% (The Economist, 2001). Commenting on offshore outsourcing by banks, Virginia Garcia of TowerGroup financial services argues:

Banks will continue to weigh the advantages and disadvantages of outsourcing to India, and in fact, continue to send more processes overseas. But they'll ask harder questions. They will make their contracts more airtight, and the regulators are going to be there (Fest, 2005).

Rules in origin countries also influence the extent to which outsourcing can be undertaken in a particular destination. For instance, Article 25 of the EU Privacy Directive 1998 states that EU members can transfer personal data to a country outside the EU only if that country ensures an adequate level of data protection (Balaji, 2004)<sup>10</sup>. Many U.K. banks insist on compliance with this directive (Fest, 2005).

Countries with weak rule of law also lack standard identifier like the U.S. social security number, which makes it difficult to check potential employees' background. In some countries, it costs up to \$1000 per employee for a detailed background check (Schwartz, 2005).

Developing countries are likely to strengthen the rule of law to attract offshore outsourcing. For instance, Pakistan's Foreign Data security and Protection Act of 2004 aims at providing protection and safety of foreign data processed within the country (Hazelwood et al., 2005)<sup>11</sup>. In India, as of 2004, Bombay's police department established a cybercrime unit and many other cities had similar plans (Engardio et al., 2004). The Indian Ministry of Information Technology has drafted data protection and data-privacy laws to respond to privacy concerns of offshore clients (Hazelwood et al., 2005; Engardio et al., 2004). We propose that:

Proposition 2a. *A lack of strong rule of law is negatively related to outsourcing inflow in a destination country.*

Proposition 2b. *A developing economy interested in developing the outsourcing industry is likely to take measures to strengthen the rule of law related to this industry.*

### ***3.2. Normative institutions and offshore BP and IT outsourcing***

While regulative rules are parts of regulative institutions, social rules are components of normative institutions. Normative components introduce "a prescriptive, evaluative, and obligatory dimension into social life" (Scott, 1995, 37). Practices that are consistent with and take into account different assumptions and value systems of national cultures are likely to be successful (Schneider, 1999). Elements of normative institutions include trade associations or professional associations (e.g., The Organization for the Rights of American Workers, and NASSCOM, a lobby for the software and services industry) that can use social obligation as a tool to induce certain behavior within the outsourcing industry. Labor institutions such as educational establishments, labor certification, training agencies and, professional norms, trade unions and labor-relations are also components of normative institutions in the destination country. Normative institutions are concerned with procedural legitimacy and outsourcees and clients to embrace socially accepted norms and behaviors (Selznick, 1984). The basis of compliance in this case derives from social and professional obligations and non-compliance can result in societal and professional sanctions (Grewal and Dharwadkar, 2002).

#### ***3.2.1. The union and public pressures against offshore outsourcing in the origin country***

In most industrialized countries, public views on outsourcing are more negative than on international trade and investment (Kuttner, 1997). For instance, a study conducted by the University of Maryland among people with income over \$100,000 indicated that proportion of U.S. population that actively supported free trade declined from 57% in 1999 to 28% in January 2004 (Amiti and Wei, 2004). Similarly, in a recent British survey one in three respondents said they would not do business with a bank if it relocates its call centers overseas. Another study conducted in 2004 reported that only 5% of the U.K. population is satisfied with offshore call centers (Alster, 2005)<sup>12</sup>.

Social norms affect the substitutability between offshore outsourcing and domestic labor (Rodrik, 1997). Social obligation is being used as a lever for pressuring companies that send jobs overseas. For this reason, as a measure of "strategic isomorphism" (Deephouse, 1996), many U.S. firms have been quiet and sensitive about revealing their offshore outsourcing plans (Fest, 2005). They are afraid of the possibility of a hostile reaction by staff, loss of morale, disaffection, etc. (Vowler, 2003).

A union-backed survey released in August 2005 revealed "increasing pessimism" among U.S.- based technology workers, who perceive declining demand for their skills (Koprowski, 2005)<sup>13</sup>. This finding reflects negative feelings over layoffs associated with offshore outsourcing (Appleton, 1996). Ironically, truth and falsify of such fear is less relevant than the fear itself, which could lead to vigorous opposition to outsourcing. Unions are putting together moral and ethical arguments against offshore outsourcing. They argue that firms in the U.S. have social obligation that goes beyond profit maximization (Figart, 2001). Offshore outsourcing is also being attacked on the ground that it is unethical for executives to award themselves large bonuses and outsourcing jobs to overseas contractors that don't pay health benefits to their employees (O'Toole, 2005).

Rapid increase in offshore outsourcing is fueling IT workers' unionization (Koprowski, 2005). For instance, a group of displaced workers laid off by Connecticut insurance and financial services companies have established The Organization for the Rights of American Workers (TORAW). In June 2002, TORAW and similar groups organized a demonstration outside the Strategic Outsourcing Conference held in New York City (Koch, 2003)<sup>14</sup>. Similarly, in the U.K. unions have warned of strikes if outsourcing deals lead to job cuts in the U.K. (Vowler, 2003). Likewise, there have been concerns about outsourcing medical transcription services to developing countries. The American Association for Medical Transcription (AAMT) raised the issues of documentation quality and patients' rights to privacy and confidentiality that arise from offshore transcription (Wall Street Journal, April 6, 2000)<sup>15</sup>. In the same vein, in August 2004, a trade union at the U.K.'s Lloyds TSB bank challenged the bank's right to send sensitive customer information offshore (Balaji, 2004). The discussion above is summarized as:

*Proposition 3a. The union and public pressures against offshore outsourcing in the origin country increase with the increase in such outsourcing.*

Proposition 3b. *In response to increased union and public pressures against offshore outsourcing, companies engage in "strategic isomorphism" measures by reducing (or slowing the growth rate of) such outsourcing.*

### **3.2.2. Professional organizations in the destination country**

Difficulties related to integrity and accountability and distance of the workforce co-vary positively (Printing World, 2005). Offshore outsourcing provides firms in foreign countries with an opportunity for engaging in unethical and/or deceptive practices. Client firms often become skeptical about the honesty and ethicality of outsourcing firms. To some extent, the enforcement of professional ethics and codes of conduct can mitigate such skepticism.

Savan (1989) defines "the professions" as groups that apply "special knowledge in the service of a client" (p. 179). A profession is also self-regulated by a code of ethics (Claypool et al., 1990; Cohen and Pant, 1991) and is characterized by its role as a moral community (Camenisch, 1983). The codes of conduct generally require members to maintain higher standards of conduct than required by law (Backoff and Martin, 1991). The codes also help make professional norms visible (Frankel, 1989) and act as a vehicle to assure the public and clients that members are competent, have integrity, and maintain and enforce high standards (Ward et al., 1993). Apart from convincing external parties of the integrity of the profession, codes play an important role in forcing members of a profession to question their values (Meyer, 1987). Codes also act as a support system against improper demands and serve as a basis for resolving disputes (Frankel, 1989).

In some developing countries, active trade or professional associations are enforcing ethics and codes of conduct thus overcoming adverse impacts of the weak legislative environment. For instance, medical transcription companies in Karnataka state of India have formed the Indian Medical Transcription Industry Association (IMTIA). IMTIA aims to shape industry related policies and standards including data protection, security and privacy of confidential information, and share best practices in medical transcription, human resources and training initiatives (Businessline, 2004). The Business Processing Association of the Philippines (BPAP) is similarly an information and advocacy gateway for the country's IT-enabled services<sup>16</sup>. Likewise, NASSCOM intends to have security practices of its 860 members audited by international accounting firms (Engardio et al., 2004).

NASSCOM is also introducing an "assessment and certification" program for would-be employees, which are expected to cut costs, ease wage pressures and discourage illegal and unethical behaviors (The Economist, 2005b). Industry leaders have also been advocating the adoption of certification under the information security management systems (ISMS) evolved by the British Standards Institution to provide guidance on organizational aspects of risk assessment and control (Ravindran, 2004). The certification covers security related issues such as network security, data sanctity and terms of data utilization.

Another mechanism by which professional associations influence outsourcing industry is by strengthening the rule of law. In India, for instance, firms are backing NASSCOM's proposal to launch a program for background checks that entails the development of criminal and public records databases (Fest, 2005). NASSCOM also offered to work with authorities in the U.K. and India to investigate a number of cases involving identity theft ([tribuneindia.com](http://tribuneindia.com), 2005). NASSCOM also helped Bombay's police department establish a cybercrime unit and training officers to investigate data theft. Similar units are planned for nine other cities (Engardio et al., 2004). In addition, NASSCOM has partnered with the Indian Ministry of Information Technology to draft data protection and data-privacy laws (Hazelwood et al., 2005; Engardio et al., 2004).

Still another mechanism by which trade or professional associations influence the development of the outsourcing industry is by signaling quality to outside parties. Since an outsourcing firm in a developing country faces difficulty to prove quality and other attributes of inputs to potential client firms (Grossman and Helpman, 2002), these associations can assure the latter about competence and integrity of the former (Ward et al., 1993). The next proposition is:

Proposition 4. *In an outsourcing destination country, the existence of active trade or professional associations that enforce ethics and codes of conduct is positively related to the amount of outsourcing inflow in that country.*

### **3.3. Cognitive institutions and offshore BP and IT outsourcing**

Although all components of institutions are intertwined with culture (Neale, 1994, 404), cognitive institutions are arguably most closely associated with culture (Jepperson, 1991). These components represent culturally supported habits that influence offshore outsourcing. In most cases, they are associated with cognitive legitimacy concerns that are based on subconsciously accepted rules and customs as well as some taken-for-granted cultural account related to offshore outsourcing (Berger and Luckmann, 1967).

Scott (1995, 40) suggests that “cognitive elements constitute the nature of reality and the frames through which meaning is made”. Although carried by individuals, cognitive programs are elements of the social environment (Berger and Luckmann, 1967). Various stakeholders related to outsourcing (e.g., labor unions, members of affected industries and professionals in outsourcing origin countries, and potential workers in outsourcing destination countries), however, have varied cognitive programs that influence the lens through which they view offshore outsourcing.

#### **3.3.1. Culture of modern (Western) management**

From the outsourcing firm's perspective, nowhere is this more evident than in the field of outsourcing where there is a need to build a culture of modern and professional management. The lack of modern management has been a major barrier to attract BP and IT outsourcing for developing country-based firms. Modern (Western) management is defined as a set of “scientific, systematic, quantifiable and operational methods” of running an organization and creating value (Branine, 1996). Developing countries lack economic (e.g., modern banking, transportation, and telecommunications) and organizational (consultants, capitalist economics, and management) infrastructures needed to implement modern management (Waddock, 1997).

In India, for instance, there are a few professionally run companies such as Wipro, Infosys (Larkin and Bellman, 2004). Yet the country's management is highly traditional (Heller, 1995). To attract BP and IT outsourcing, a firm requires to be ‘process-driven and detail-oriented’ — characteristics that are virtually absent in the Indian work culture (Piramal, 2004). In the same vein, whereas Western countries have the time-is-money culture, Indians have more flexible approach to deadlines (Slater, 2003). Experts argue that the country needs to make a significant progress before a culture of modern and professional management emerges (Bellman, 2005). Similarly, product quality, reliability and on-time delivery often vary greatly in China (Murphy, 2004).

In an attempt to address their clients' fear that customer data will be stolen and even sold to criminals (Lucas, 2004)<sup>17</sup>, a number of Indian firms have started instilling the culture of modern management. As noted above, organizations engage in non-isomorphic responses if they perceive that such responses are likely to minimize a potential loss of resources (George et al., 2006). For outsourcing firms in developing countries relationships with clients are important resources that can provide long-term returns on investment. To win and maintain legitimacy from their clients, structures and practices of Indian outsourcing firms are becoming non-isomorphic with respect to the local culture. For instance, call center employees have to undergo security checks which are considered to be “undignified” (The Economist, 2005b). Firms have established biometric authentication controls for workers and banned cell phones, pens, paper and Internet/e-mail access for employees (Fest, 2005). Similarly, computer terminals at Mphasis lack hard drives, e-mail, CD-ROM drives, or other ways to store, copy, or forward data<sup>18</sup> (Engardio et al., 2004). Indian outsourcing firms also extensively monitor and analyze employee logs (Fest, 2005). Call centers are also breaking the taboos of the society by making young men and women work together during nights (Sparks, 2006).

As people in developing countries aspire to improve their living standards (Tomlinson, 1991), a certain degree of non-isomorphism is acceptable to them. Yet a high degree of non-isomorphism jeopardizes full cooperation of employees. An illustrative example makes this concept clearer. For instance, the Indian outsourcing firm,

OfficeTiger used a motivation strategy that involved on-the-spot cash awards for employees meeting deadlines. The employees felt that “it was demeaning to accept handfuls of money in front of others” (Slater, 2003). Likewise, Dell faced difficulties in retaining its employees in its Indian call centers when the company attempted to emulate its headquarters model in treating the local employees (Kaka, 2006). The above leads to the following:

Proposition 5a. *The culture of modern management is positively associated with outsourcing inflow in a destination country.*

Proposition 5b. *In an attempt to instill the culture of modern management to attract more outsourcing jobs, outsourcing firms in developing countries are likely to engage in responses that are non-isomorphism with respect to the local culture. The degree of non-isomorphism, however, has an upper limit.*

### **3.3.2. Cultural compatibility**

As noted above, institutions create coercive, normative and mimetic pressures for isomorphism (DiMaggio and Powell, 1983). The dominant group's power tends to become culturally embedded (Fligstein, 1987, 1990) in outsourcing relationships, which creates a pressure for isomorphism to less powerful groups. An outsourcing relationship can be conceptualized as an extension of the client company's (the dominant group) culture (Bailor, 2005). Pressures for isomorphism require the outsourcing firm to “walk and talk the same cultural language” as the client firm (Building Operating Management, 2005).

Cultural compatibility is thus tightly linked with outsourcing flow between two countries. For this reason, some developing economies are employing cultural compatibility or a higher degree of isomorphism as a selling proposition to attract outsourcing businesses. The Offshore Romania 2003 report, for instance, points out that Romanian workers have a better understanding of Western European culture than their Asian counterparts (Ravindran, 2004). Similarly, some Indian outsourcing firms have shifted parts of their operations in Eastern Europe to respond to client firms' pressure for isomorphism. For instance, Indian outsourcing firm, Infosys, has opened an outsourcing center in the Czech Republic with 100 people working in 13 languages. Multilingual workers and cultural affinity with Western Europe were among major factors in the decision to relocate its outsourcing operations in the Eastern European country (The Economist, 2005c).

Assessment of cultural compatibility, however, requires in-depth and detailed analysis of the two cultures. For instance, although some argue that Indians “eat, drink and sleep American culture” because of the pervasiveness of media (Zammit, 2005), a number of outsourcing projects failed in India because of the lack of cultural compatibility. To win and maintain legitimacy from a client firm, an outsourcing firm is required to have in-depth knowledge of the client firm's culture as well as its national culture.

Language similarity is also a critical component of cultural compatibility. In terms of language, what is intended to be respectful in one culture becomes annoying in another (Schelmetic, 2005). There are also difficulties related to accents and implied meaning. Customers' complaints regarding difficulties to understand the operators forced some companies to relocate call centers from India to the Philippines (Fairell et al., 2005). In this regard, it is important to note that some Indian outsourcing firms are responding to pressures for isomorphism by hiring foreign employees that speak native languages of the client firm's customers. The Indian company, Tecnovate, for instance, has launched a successful nine-language model that employs workers from a number of European countries (Overdorf, 2005)<sup>19</sup>. Many other companies are emulating this model.

Even those with good command of English may not understand cultural contexts and business practices of the client firm<sup>20,21</sup>. For Indian outsourcing operations, some U.S. companies send employees of Indian descent who understand both the corporate and local culture (Bank Technology News, 2004).

Ethnic linkage between the managers of origin and destination countries increases cultural compatibility and hence individuals' inclination to do things for each other. Such linkage hence enhances social capital (Willcocks

et al., 2004). For instance, over 32,000 Indian doctors practicing in the U.S. have created networks of contacts for Indian medical-transcription services (Dhume, 1999).

Cultural differences, on the other hand, increase difficulties related with managing employees. For instance, the approach to managing U.K. or U.S. employees may not work for Chinese or Indian employees (Vowler, 2003). Cultural compatibility is also associated with customer satisfaction and retention problems (Read, 2004). For instance, following U.S. customers' complaints about difficulty in communicating with Indian technical-support personnel because of "thick accents and scripted responses", Dell stopped using a technical support center in India ([CNN.com](http://CNN.com), 2003). The credit card giant Capital One and insurer Conesco also shifted some customer-support operations back to the U.S. (Alster, 2005). Some customers feel uncomfortable being served by offshore firms.

Measures taken by outsourcing firms to understand client firms' culture also indicate the importance of cultural compatibility. Consider Daksh, an Indian outsourcing firm. After signing up a contract, the firm sends a team to learn the client's procedures and study its culture (The Economist, 2001). In some Asian centers, agents are trained to conceal their real names and adopt American names (Alster, 2005). Likewise, Indian teleworkers pick up American accents by watching Baywatch, Friends etc. (Dhume, 1999). Indian companies also provide training on the Western approach to time and other concepts related to culture. For instance, OfficeTiger, an Indian outsourcing firm, explains its employees that "five minutes really means five minutes" (Slater, 2003). They also teach their employees attitudes to deal with U.S. customers (Sparks, 2006.). Thus, we propose that:

*Proposition 6a. The degree of cultural compatibility between the origin and the destination countries is positively related to the amount of outsourcing flow between the two countries.*

*Proposition 6b. Outsourcing firms are likely to take measures to make their responses more isomorphic with respect to the client firm's culture.*

#### **4. Discussion and implications**

This paper has contributed to the conceptual and some empirical understanding of the patterns of global flows of offshore BP and IT outsourcing. The theoretical contribution of this paper is to develop propositions that explain the 'hows' and 'whys' (Whetten, 1989) of offshore BP and IT outsourcing. The analyses of the paper indicated that the nature of regulative, normative and cognitive institutions in origin and destination countries influence the amount and types of jobs that are outsourced. In outsourcing origin countries, well-founded fears as well as messy and ill-guided political schemes have produced pressures against offshore outsourcing. Developing countries, on the other hand, have been undergoing significant institutional changes to increase the inflow of BP and IT outsourcing.

Although some of the factors (e.g., rule of law in an outsourcing destination country) discussed above are also applicable to other forms of international trade or investment, offshore outsourcing has distinct mechanisms. Its uniqueness stems from a number of sources. First, offshore outsourcing is relatively new. The newness is associated with a lack of rules and laws as well as codes of conduct, especially in developing countries. Second, unlike traditional forms of international trade and investment, offshore outsourcing in industrialized countries is perceived as a more direct substitute for jobs in the home country (e.g., the U.S.). This has led to negative public views of offshore outsourcing. Third, compared to other forms of international trade and investment, offshore outsourcing, especially BPO, entails a higher degree of interaction among people of different cultures. In most BPOs, employees of an outsourcing firm interact with the client firm as well as with the latter's customers. Institutional compatibility is thus of paramount importance for the success of outsourcing relations.

The discussion above also sheds some light on degrees of dominance of various players involved in the institutional war associated with offshore outsourcing. Client firms are more powerful than outsourcing firms. Professional organizations and the public in industrialized countries (e.g., the U.S.) seem to be among the most dominant groups. They have been able to bring changes in regulative institutions in their home country (e.g.,

bills seeking to ban offshore outsourcing of certain works) as well as in developing countries (e.g., strengthening rule of laws). Isomorphism pressure from client firms as well as professional organizations and the public in industrialized countries have brought significant institutional changes in developing countries (Table 1).

This paper has important managerial and policy implications:

***Implication 1. Maximizing legitimacy by relocating activities in different economies***

In order to maximize legitimacy from different sources, outsourcing firms can relocate their activities in a number of economies worldwide. For instance, Indian outsourcing firms serving Western European clients can shift some activities, especially those requiring direct interaction with customers, in Eastern European countries. Cultural compatibility associated with ethnic linkages and other elements will result in a higher degree of isomorphism and hence legitimacy from Western European clients.

***Implication 2. Dynamic and fluid structure***

To compete successfully, an outsourcing company is required to be fast-moving and dynamic. Such a structure allows the company to change its structure or take some non-isomorphic actions as new demands arise from clients and customers. As noted above, dynamic and fluid structures allowed a number of Indian outsourcing firms to introduce a culture of modern management and enhance cultural compatibility with the client firms and customers.

***Implication 3. Effects of institutional changes associated with globalization***

Fundamental shifts brought by globalization and market integration will have complex influence on offshore outsourcing. Consider, for instance, the enlarging EU. The new and candidate countries are required to ensure the stability of institutions guaranteeing democracy, the rule of law, respect for human rights, and the promotion of free market economy. Newly joined and candidate countries have already experienced a by-product of fulfilling the minimum requirements in these domains (Zielonka, 2004). Eastern and Central European countries that joined the EU in 2004 are likely to capture a bigger share of offshore outsourcing, especially those originated from Western Europe. Similarly, some analysts think that since Central American countries are introducing business-friendly policies and actively promoting their outsourcing industry, with the progress of Central American Free Trade Agreement (CAFTA), they are likely to capture a growing share of the offshore outsourcing jobs originating from the U.S. (Harman, 2005). For Asian outsourcing firms, these developments provide more pressures to move outsourcing operations to Eastern Europe and Latin America.

***Implication 4. Proper communication and education***

Customers' and employees' skepticism is reinforced by the negative images of offshore outsourcing that is projected in the mass media. Outsourcers can minimize public and union pressures against offshore outsourcing by proper communication and education to their employees and the public. For instance, there is evidence that proper implementation of offshore outsourcing in fact creates new jobs at home. To take one example, in 2003, Delta Airlines saved \$25 million by outsourcing 1000 call-center jobs to India, which allowed the company to add 1200 reservation and sales positions in the U.S. (Drezner, 2004). Other advantages include opportunities for employees in the home country to promote to more challenging jobs requiring higher skill sets (Bank Technology News, 2004). Companies should also consider investing some proportion of the savings from outsourcing into retraining programs for displaced workers in the home country (Bank Technology News, 2004). There are also additional benefits such as U.S. consumers receiving services from 24-hour-a-day call centers that have become more efficient because of supports in other time zones (Pfannenstein and Tsai, 2004).

***Implication 5. Variation of institutional pressure across service sectors***

The effects of institutions on offshore outsourcing vary across sectors. In the U.S., for instance, some jobs are regulated more closely than others. For instance, federal laws require that anyone interpreting X-rays and other images for U.S. hospitals be trained and licensed in the U.S. (Maher, 2004). Likewise, government and societal pressures are weaker for IT outsourcing driven by the scarcity of skills compared to BPO.

### ***Implication 6. Technological deployment to win legitimacy***

In some cases, deployment of appropriate technology helps win and maintain legitimacy from regulators and the public. For instance, outsourcing and client firms can employ a sophisticated encryption technology to communicate safely, which reduces the fear related to security breach.

### ***Implication 7. (Policy makers in industrialized countries): Devising outsourcing policies to ensuring economic and non-economic cooperation from other countries***

Governments in outsourcing origin countries should also consider other economic and noneconomic implications associated with offshore outsourcing. For instance, the level of barrier erected to offshore outsourcing may influence other countries' level of economic (e.g., willingness to reduce trade and investment related barriers) and non-economic cooperation (e.g., cooperation in the war against terrorism)<sup>22</sup>.

### ***Implication 8. (Policy makers in developing countries): Developing outsourcing-friendly manpower***

A developing country's share in the global outsourcing pie is a function of the existence of outsourcing-friendly manpower in the country. Outsourcing readiness of a country's workforce depends upon a proper combination of cultural, linguistic and technological expertise. Consider, for instance, the linguistic skill. Although English is an official language in India and there has been a widely held belief that India's huge English-speaking population will give it an edge over China and other rising nations in doing business with Western corporations (Mehta, 2005), only a small proportion of graduates meet the level required to interact with foreigners (Fairell et al., 2005)<sup>23</sup>. An estimate suggests that Indian outsourcing industry will face a shortfall of about 260,000 qualified personnel by 2009 (The Economist, 2005b). Educational system geared towards preparing the workforce with broad skills and knowledge needed for attracting outsourcing related jobs is needed to compete globally.

An important area of future research concerns conducting in-depth case studies of selected outsourcing relationships from the standpoint of institutions. Institutionalists have recognized that whereas regulative institutions have economic impacts, normative and cognitive institutions are social, cultural, and habitual in nature (Scott, 1995, 2001). Compared to other research methods, relative efficacy of case studies is especially greater in exploring how normative and cognitive institutions affect outsourcing activities. Such a study can thus provide insights into how and to what extent institutions determine the success or failure of outsourcing projects.

Another fruitful avenue for future research would be to employ survey research to compare institutional characteristics of successful and unsuccessful outsourcing relations. Surveys can be used to capture client firms' perceptions of their outsourcing partners' institutional characteristics. These characteristics can be analyzed by using binary outcome models such as logit and probit to predict success/failure of outsourcing projects.

We also encourage researchers to examine deeply how institutions are affected by outsourcing activities. As noted above, offshore outsourcing activities have generated confrontational reactions and raised a public outcry in industrialized countries such as the U.S. We, however, know very little about the exact nature of mechanisms in such responses.

Another area of exploration is the nature of institutional war discussed above. Evidence presented above indicates that isomorphism pressure from players in the industrialized countries force outsourcing firms to take responses that are non-isomorphic with respect to local culture. But the degree of non-isomorphism seems to have an upper limit. Further research is needed to gain an understanding of the determinants of such an upper limit.

### **Notes:**

1 The annual growth rate is expected to be 30-40% during 2004-08. Another study conducted by Gartner indicated that the European offshore outsourcing market grew by 40% in 2003 (Vowler, 2003).

2 Hodgson (2003) has defined institutions along similar lines.

3 Hayek (1979) has provided similar argument.

4 HIPAA was enacted to provide federal regulations for the security and confidentiality of health related information. HIPAA's privacy regulation also requires contracts with business associates to contain specific provisions related to disclosures and permitted uses of information (Hazelwood et al., 2005).

5 Both bills require patients to give consent for the use of their radiology readings outside the U.S.

6 Another bill requires transcription companies to disclose whether they send files offshore. A third bill forces companies doing business in California to agree to heed state privacy laws and come under the jurisdiction of state courts (Lowes, 2004). Still another bill filed by Edward Markey requires businesses seeking to transfer a customer's personal information to a foreign country would first be required to notify the consumer (Swartz, 2005).

7 All propositions are stated on a *ceteris paribus* – other things being equal – basis. The phrase “*Ceteris paribus*” is implicit at the beginning of each proposition, and has not been explicitly stated.

8 For instance, HIPAA requires that the business associate does not disclose the information unless permitted by law. Moreover, if an associate uses a subcontractor, the subcontractor must abide by the same provisions as the original business associate (Hazelwood et al., 2005).

9 Indian law on computer hacking is also considered to be fuzzy.

10 The EU has not approved India as a destination that complies with the EU privacy rules (Balaji, 2004).

11 Gartner called on the Indian government to pass stringent data-security laws (Fest, 2005). Experts argue that to foster this industry, the Information Technology Act 2000 and the modified Copyright Act enacted the same year need to be strengthened and intellectual property rights laws have to be enforced (Ravindran, 2004).

12 The Irish arm of Sweden's Tele2AG shifted its call center operations out of India back to Ireland, citing consumer preference.

13 The problem is compounded by media's coverage of outsourcing focusing on perceived costs and thus dismissing the benefits (Drezner, 2004).

14 Similarly, Save American Manufacturing (SAM) has been formed by two small manufacturing-company owners in Wisconsin to protest Chinese trade practices (Schroeder and Aepfel, 2003).

15 Consumer-advocacy groups in the U.S. are also concerned that foreign debt collectors maybe violating existing laws (e.g., the Fair Credit Reporting Act designed to promote accuracy in registering debts and to ensure privacy of information used in consumer reports) (Solomon, 2004).

16 Business Processing Association of the Philippines (BPA/P),

[http://www.johnclements.com/articles/article\\_BPAP.htm](http://www.johnclements.com/articles/article_BPAP.htm).

17 A number of examples provided earlier indicate that these concerns are not greatly exaggerated.

18 And since data theft is often committed by disgruntled former employees, Mphasis can lock a staffer out and cut access to PCs and phones three minutes after a resignation. A year ago that process took three days (Engardio et al., 2004).

19 Although the Europeans get about 25% of what they would earn at home, the employment package includes housing, a housekeeper, and time off to travel (Overdorf, 2005). By the early 2005, Tecnovate attracted over 200 European workers since testing the program in 2002.

20 Alster (2005) quotes a posting on [www.complaints.com](http://www.complaints.com): A traveler described losing his luggage on a Delta flight from Florida to Las Vegas. To report the loss, he called an 800 number and told the offshore agent that he was staying at New York Hotel and Casino in Las Vegas. His baggage did not arrive and he called back to find that it had been sent to the Casino Hotel in New York. An American call agent would be less likely to make such an error.

21 To take an example of the understanding of business practice, in the case of medical transcription services, for instance, compared to India, the Philippines, seems to have lower socio-cultural distance with the U.S. Many Filipino doctors and nurses have studied or worked in the U.S. and are thus familiar with the latter's healthcare system.

22 For instance, a number of outsourcing destination countries (e.g., India, Poland, and the Philippines) are U.S. allies in the war against terrorism (Drezner, 2004).

23 Even HR managers in software and IT services firms rank language problems as one of the top three handicaps of engineering applicants (Fairell et al., 2005).

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