



The Services Shift

Seizing the Ultimate Offshore Opportunity

THE SUMMARY IN BRIEF

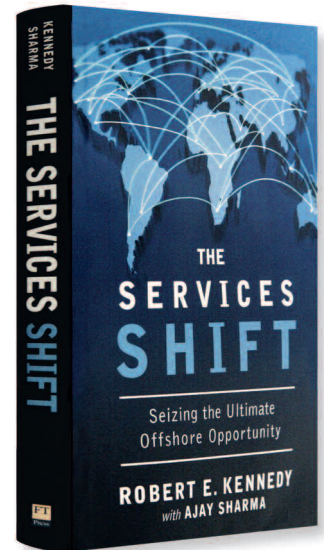
By now, most businesspeople, pundits and politicians in the United States and other developed nations have come to grips with the phenomenon of manufacturing jobs moving offshore. The process is variously referred to as “outsourcing” or “offshoring.” But a far bigger wave of change is approaching the shores of those same developed nations: the globalization of services.

In *The Services Shift*, two leading researchers show how services offshoring works in both industries and individual companies, and they show how to define and implement realistic services-sourcing goals for your organization. You’ll learn who’s involved in services offshoring, understand leading business models and discover the main geographical centers.

The Services Shift previews the enormous wave of services offshoring that is now building — and helps you understand what it will mean for you, your company and the world. It also tours today’s emerging centers of services offshoring, revealing what can be offshored and introducing powerful strategies and tactics for businesses that want to purchase services offshore.

IN THIS SUMMARY, YOU WILL LEARN:

- How to embrace the new revolution in services offshoring.
- Where services offshoring is happening today, what’s coming next and how to profit from key trends.
- How to prepare for the massive financial and political implications of services offshoring.
- How to define the right global-sourcing strategies for your service business.
- How to thrive in the world of services offshoring, where everything from HR management to emergency medicine can be provided from half a world away.



by Robert E. Kennedy
with Ajay Sharma

CONTENTS

Fundamental Reorganization
Page 2

The Economics and Drivers of Offshoring
Page 3

The Value Chain
Page 4

Making It Real
Page 5

Shifting Skill Sets
Page 6

The Services Shift: Policy Implications
Page 7

A Game You May Have to Play
Page 8

THE COMPLETE SUMMARY: THE SERVICES SHIFT

by Robert E. Kennedy with Ajay Sharma

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The Services Shift: Seizing the Ultimate Offshore Opportunity by Robert E. Kennedy with Ajay Sharma.

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For additional information on the authors, go to <http://www.summary.com>.

Introduction

If you're an active manager in the first decade of the 21st century, you already know about the phenomenon of globalization in the manufacturing sector. By any measure, it's enormous.

In 2006, the U.S. trade-to-GDP ratio was 28.0 percent, compared with 11.1 percent in 1970 and 20.4 percent in 1990. In 2006, U.S. companies committed \$60 billion to new manufacturing foreign direct investment (FDI): a jump of 66 percent over the previous year.

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

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

This is “the services shift.”

Outsourcing and Offshoring

Outsourcing means moving a particular task outside an organization's boundaries. When a company decides to eliminate its in-house food service department and hire an outside contractor to run its cafeteria, it is “outsourcing” that function. For lots of “non-core” practical activities — such as staffing the cafeteria and cleaning the headquarters building — outsourcing means buying

the service fairly close to home.

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

Offshoring, as the name implies, means moving a function and its associated jobs to another part of the world. Offshoring comprises a wide range of relationships between the “parent” company and remote service providers. Sometimes those providers stay within the corporate boundary, but operate at a geographic distance. Sometimes they are outside the corporate boundaries (they are “outsourced offshorers”). Here, we focus mainly on the offshoring phenomenon, although certainly domestic outsourcing is another important kind of “services shift.”

Fundamental Reorganization

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

Tomorrow's managers will have to become more flexible, more versatile and more broad-gauge. You



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need to understand the offshoring options that are available to you, because — without a doubt — your strongest competitors will certainly understand and exploit them. ●

Globalization of Services: What, Why and When

The global economy is in the midst of a vast transformation. Globalization can be measured in many ways — in terms of government policies, actual trade and investment flows, and so on — and nearly every measure shows that economic linkages among countries have become more extensive. Three measures illustrate this change.

The first measure is a country's "openness" to international trade and investment. In 1994, and later in 2000, seven factors were used to calculate a "policy openness" index in 192 countries. These factors included average tariff rates, regulatory restrictions on FDI, the presence or absence of a two-tiered foreign exchange system and others.

Research results show that the share of the global population living in open economies remained fairly steady from the early 1960s through the mid-1980s. Then, starting around 1986 and accelerating in the early 1990s, dozens of countries implemented programs of economic liberalization that deregulated domestic markets and lowered barriers to trade and investment.

The Bottom Line

What's the bottom line for managers today? The global economy has undergone substantial changes in the past 20 years. It is likely to change *even more* over the next 50 years. The engines of growth in the new global economy are increasingly located in developing countries. How managers seize these opportunities and manage the challenges these trends create will determine the success or failure of their companies and careers.

The Compelling Case for the Services Shift

Today's business environment is one of increasing competitive intensity, on a global scale, creating staggering new challenges for managers.

It's an environment characterized by *increased volatility* and *greater uncertainty*. The average product life cycle is shrinking, meaning that companies need to bring more products to market, and do it faster. Consumers are becoming more demanding, insisting on more value at lower price points. There is a growing need to continually come up with something *new* (product or service or

You and Your Vendor

Transformational outsourcing requires a very close partnership and assumes the most complex kind of relationship between the service provider and the service recipient. You and your vendor will have to interact intensively, invest in each other extensively, renegotiate the contract(s) continuously and trust each other intimately. You have to be prepared to engage in a long-term relationship, most likely based on gain-sharing, equity-sharing or a joint-venture model.

market) or something *better* (efficiencies, product features, customization, personalization, etc.).

Meanwhile, new technologies and business models are lowering barriers to entry, introducing disruptive changes and creating asymmetric competition. Competitive intensity has increased as technological innovation has accelerated.

Meanwhile, the speed, efficiency and global nature of financial markets generate a steady drumbeat of demand for greater shareholder value, trimmer balance sheets and stronger bottom lines.

Better, Cheaper and Faster

In short, companies are compelled to deliver along multiple and seemingly contradictory dimensions. They have to be better *and* cheaper *and* faster — all at the same time!

Here's where the phenomenon that we refer to as the "services shift" can, and should, come into play.

Most of these forces compel companies to look offshore for solutions to at least some of their problems. From a defensive standpoint, they need to lower their costs to compete — and offshoring certainly offers that prospect. But offshoring also allows companies to be proactive in shaping their futures: by improving the quality of products and services, developing new offerings and — over the long term — creating toeholds in the economies and markets that will be most important years and decades down the road. ●

The Economics and Drivers of Offshoring

When we begin contemplating moving some aspect of our enterprise offshore, it's important to focus more closely on the process of value creation.

Summary: THE SERVICES SHIFT

One way to think about how firms create and capture value is by using a framework originally developed by Harvard Professor Michael Porter. The value chain approach was first presented in Porter's 1985 book, *Competitive Advantage*.

Porter's central insight was that a firm is actually a system of interconnected activities, with both physical and informational linkages. A firm's competitive position in the marketplace results from superior or inferior performance in specific activities. With this perspective as a starting point, activity-level performance can be explored analytically and strategies can be formulated to improve the firm's position.

The Value Chain

Primary activities are the steps that directly impact the product/service that customers care about. In a manufacturing firm, these include inbound logistics, operations, outbound logistics (distribution), marketing and sales, and service. Support activities are those that provide the background necessary for the effective and efficient operation of the firm but do not impact the main product/service directly. Support activities typically include human resources, information technology and accounting.

Value chain analysis posits that competitive advantage occurs at the activity (or functional) level. The analysis and strategy formulation process consists of three distinct steps:

- Breaking down the firm's key functions into primary and support activities.
- Assessing the potential for adding value in each activity.
- Formulating strategies that focus on key activities that enable companies to sustain a competitive advantage.

Superior Performance

The value chain framework provides several insights. First, *competitive advantage results from superior performance in specific activities*. In most industries, one or a few activities are "core" — that is, they are the keys to competitive advantage. The value-chain approach argues that managers should *focus their efforts on improving performance in core activities*, meanwhile making sure that other, non-core activities are performed at an acceptable level. These non-core activities are good candidates for outsourcing, particularly if there are outside firms that specialize in these non-core activities (for example, ADP in payroll processing, EDS in running data centers and Hewitt Associates in managing human resources processes).

A second insight is that *there are two generic sources of competitive advantage: low cost and differentiation*. Firms can win in the marketplace either by offering standard products at the lowest cost or by distinguishing their products in such

a way that customers are willing to pay a premium for them. Again, cost strategies and differentiation take place at the activity level.

Digging Deeper

Companies don't have to perform all the activities that ultimately are required to create value for their customers. Firms can partner with other companies (very often, established vendors) and *outsource* some of these activities to them.

Firms are no longer constrained to perform all value-creating activities within the borders of their home countries. Some of these activities can be located *offshore* (outside the national borders of the firm's home country) in places where they can be carried out most effectively. Phrased slightly differently, for many service companies, *new sources of value are likely to be found outside the boundaries of the firm and the nation*.

Firms that decide to pursue those new sources of value generally face two key decisions. The first is the "make or buy" decision: Do you perform the activity within the firm or do you outsource it to another firm? The second relates to the geographic location: Should the activity be located "locally" (that is, within the same country) or remotely (abroad)?

Five Key Drivers of Services Globalization

What's driving services globalization today? We can point to five such "drivers":

Driver #1: An ongoing global market liberalization. In only 13 years, the percentage of people around the world living in "open" economies rose dramatically, from 23 percent in 1985 to 78 percent in 1998.

Driver #2: The digitization of business processes. The explosion in outsourcing and offshoring is in large part the result of the digitization of a wide range of business processes, including payroll, procurement, customer support and many others.

Driver #3: The low cost and high speed of computing and telecom. It's worth reminding ourselves that no modern technological advance has ever been embraced as quickly.

Driver #4: Growing capabilities around the globe. The 2005 MBA rankings by the Economist Intelligence Unit identified a Spanish school as the world's top MBA program, and 10 out of the top 25 MBA programs in that particular ranking were located outside the United States.

Driver #5: The rise of a global business culture. Since the mid-1990s, schoolchildren in China have been required to learn English starting in primary school. The

Summary: THE SERVICES SHIFT

British Council estimates that by 2015, 3 billion people — in other words, almost half of the world's total population — will speak more or less fluent English.

Re-evaluating Boundaries

The five drivers exert a powerful influence on global business, and they are only going to increase in importance.

For service companies, the drivers of globalization — especially technology and economic liberalization — have led to serious re-evaluation of the boundaries of the firm.

Is the globalization of services simply a fad, or is it likely to be a permanent and growing phenomenon? The answer to that question grows directly out of the five drivers. Of those five, only the first (ongoing global market liberalization) can be considered “reversible” in any significant way. Yes, it's conceivable that one or more of the recently liberalized economies — put under some sort of serious social or political strain — could slip back into the kind of static, centralized economic model that characterized their past. This is conceivable, but unlikely, because liberalization creates its own momentum.

The other four drivers exist more or less outside the realm of public policy and legislative fiat. The first two are technology-focused, and history suggests that once a technology genie is let out of the bottle, it can't be stuffed back in.

The second two are people-focused, and once people have acquired skills and a new (self-interested) way of looking at the world, they are unlikely to be led back into the old, unproductive ways of doing things.

In short, the globalization of services is here to stay and is only likely to accelerate in the future. ●

Making It Real

As you start your sourcing journey, it is important to define your goals and expectations. This may sound self-evident, but establishing a clear definition of what you hope to achieve through offshoring may be more elusive than you might think.

Three Offshoring Goals

There are three distinctive (but interrelated) goals you may choose to pursue through offshoring: efficiency, enhancement and transformation.

- **Efficiency.** The goal of efficiency-focused sourcing is to maintain existing service quality, availability and consistency while cutting costs, commonly through labor arbitrage (that is, buying your labor more cheaply elsewhere).

- **Enhancement.** By moving to a better technology platform, re-engineering existing business processes or otherwise embracing ways to do things better, you can improve your operational performance and outcomes. Here, your primary focus is not on cost reduction, but on process improvement — which often leads to reduced costs, along with higher quality, increased availability and other good outcomes.

- **Transformation.** This is aimed at achieving rapid, sustainable step-change in enterprise-level performance, often through bundling technology, consulting and outsourcing. The point is to dramatically improve the competitiveness of the organization by creating new value and new revenues, outmaneuvering the competition and changing the very basis on which your corporation operates.

Effective Outsourcing/Offshoring

Here is an eight-step process for effective outsourcing/offshoring:

1. **Identify the tasks.** Consider whether the tasks are routine and repetitive in nature — and are thereby *efficiency* focused — or whether they require knowledge and skills and are thus *effectiveness* focused.

2. **Map the process(es).** Visually display exactly what happens across the collection of activities that together create value.

3. **Decode the relevant technology and infrastructure.** As you consider outsourcing or offshoring your business processes, you need to confirm that your underlying information technology applications and infrastructure can support this strategy.

4. **Identify and mitigate risks.** These risks include geographic and location risks; migration risks; business operations risk; customer, employee and capabilities risks; and the risk of “holdup” by a vendor under the guise of a renegotiation due to “unforeseen circumstances.”

5. **Select a vendor.** Assess vendors thoroughly on the “Three C's” of outsourcing: capabilities, culture and commitment. Most companies in search of an outsourcing vendor follow these four steps: Create a vendor selection team, short-list appropriate service providers and reach out to them, evaluate these potential providers, and negotiate the contract.

6. **Select a geography.** While India has long been the leader in IT and IT-enabled services, the phenomenon is no longer India-centric. China, Southeast Asia, Central and Eastern Europe, and Latin America have emerged as attractive destinations for global service delivery.

Summary: THE SERVICES SHIFT

7. Migrate your operations. The *migration* of tasks — along with knowledge, systems and capabilities — is the phase when tasks that are currently being run in-house/onshore are handed over to an external vendor or moved offshore.

8. Integrate your operations. Even as processes move outside a firm's boundaries, companies need to ensure control of overall cost, risk and quality. This can be achieved by ensuring continued operations integration. ●

The Supply Side

Offshoring follows the fundamental rules of economics and incorporates most of the lessons learned in the fast-growing universe of global trade. These include the following:

- **The need to strike appropriate balances.** Firms must balance cost savings against the investment required to achieve those savings. At the same time, they must weigh the risks inherent in offshoring (including loss of control, exposure to macroeconomic risks, public perception, the distribution of sensitive data and intellectual property, and so on) against the likely benefits.

- **The need to achieve scale.** For many basic operations, the key is to gain sufficient scale in order to minimize costs. Large firms can achieve this internally. Small firms generally go to outside vendors, which gain scale by aggregating across many customers.

- **The need to build and control an expertise.** Some businesses involve specific skills — for example, in fields such as radiology, genomics research and so on. This creates the need to gain access to specific people, who by and large tend to have bargaining power and mobility. In some cases, multinational corporations — for example, large pharmaceutical firms — can successfully hire and retain these people. In others, the talent bands together and acts as a group (for example, paralegals and radiologists) that offers its services as independent vendors.

- **The need to create or embrace appropriate business structures.** Higher perceived risks (to business processes, intellectual property, outsiders or data) make it more likely that a particular process or task will be kept in-house.

Types of Vendors

Many types of vendors and corporations are delivering global IT and IT-enabled services from offshore. These organizations employ a variety of business models for providing offshore services, which can be grouped into four categories:

- **Captives of multinationals.** “Captives” are wholly owned subsidiaries of multinationals, and this business model is used by many prominent companies today, including American Express, Microsoft, Oracle and Motorola.

- **Offshore IT vendors.** Offshore-based IT service providers, such as TCS, Infosys, Wipro, Satyam and Mphasis, have grown aggressively and matured substantially in recent years.

- **Multinational outsourcing firms.** Leading multinational service firms (such as IBM, HP and EDS in data systems; Convergys and Sitel in call centers; and Accenture and Siemens in business services consulting) now have a sizeable offshore presence.

- **Offshore BPO-specific firms.** Along with the increase in volume and value being delivered from offshore, there has been an expansion in the types of activities being offered, resulting in more and more processes in a greater number of industries being serviced from offshore. This has led to increased fragmentation and specialization, and the emergence of different types of offshore BPO-specific firms.

As you consider your offshoring options, think about how location, task and organization can be made to intersect to your advantage. At the same time, scrutinize the likely transaction costs associated with your options. ●

Shifting Skill Sets

While the services shift creates many new possibilities to create value in your organization, it also requires the development of new and different skill sets in your management team. Simply put, instead of directly managing people and outcomes, the global sourcing manager generally exerts influence indirectly, through negotiations, mutually agreed-upon goals and the intelligent design of incentive systems for vendors.

These new functions require global managers to draw on a very different toolkit. Some of these skills are obvious — for example, analytical skills, IT solutions and structured root-cause analysis all play an important role in managing offshore operations. But some of the changes are less obvious. The global operations manager has to step up his or her game on both the analytical and the soft-skills ends of the spectrum.

What This Means for Your Company

This shift in management roles has broad implications for your company, assuming you seek to capitalize on the opportunities offered by global sourcing. First, you will need to seek new skill sets in middle-manage-

ment positions, with an emphasis on both analytical and soft skills. Second, you will need to revisit and reconceptualize basic organizational issues. Finally, you will have to communicate a new working culture to your employees. Gone are the days of “9 to 5, Monday through Friday.”

Today’s managers need to keep their passports in their desk drawer and their immunizations up to date. They need to be ready to catch an overseas flight at the drop of a hat. They need to keep their BlackBerrys and cell phones charged up and on at all times — almost literally.

Transformation

Going forward, the easy gains from labor arbitrage will be available to most firms. Once that happens, the source of advantage will shift to accessing talent and tapping into global resources to facilitate transformation.

That transformation has to extend to individuals and individual jobs. Among middle managers, it seems, the success rate is somewhat higher — but in the process of succeeding, their work lives change dramatically. They live in the world of service level agreements (SLAs), intercontinental travel and root-cause analysis.

What about senior management? Senior managers may be in the best possible position to take advantage of organizational transitions. If you chart the right course and invest wisely in your people — and, yes, disinvest when necessary — you are likely to see productivity increase as costs decrease. You are likely to know *more* about your organization — thanks to improved reporting — even as your resources become more dispersed geographically. And perhaps most rewarding of all, you’re likely to get the benefit of great business ideas bubbling up from the virtual trenches. ●

The Services Shift: Policy Implications

In most countries today, services account for the largest share of economic activity. In the United States, for example, services account for 67 percent of both GDP and employment if we exclude government from our definition of “service.” These are staggering figures from almost any perspective. And because the manufacturing sector itself has a steadily growing component of services — such as R&D, design, logistics, marketing and servicing — even these huge percentages tend to understate the importance of services.

So the policy implications that grow out of the

Four Challenges for Developing Economies

Developing economies face multiple challenges as they seek to attract and grow global services industries. These can be considered in four “buckets”:

- **Infrastructure.** This plays a critical role in a country’s competitive position.
- **Human capital.** General education levels are critically important.
- **The regulatory environment.** Tax policy is a particularly important component of the regulatory environment.
- **Social repercussions.** Multinationals can crowd out existing domestic firms.

expanding globalization of services are both far ranging and complex. In recent decades, many restrictions to trade in manufacturing have been removed via trade agreements and the World Trade Organization process. The demand for a corresponding liberalization in the services sector has become more and more insistent — and is already well under way.

Globalization

Globalization has come to the services sector. In the long run, and taken in the aggregate, it is a vital element of growing productivity and living standards. Over time, many clever approaches have been proposed to mitigate or stop trade flows, but history shows that countries that embrace trade prosper, and those that don’t, don’t.

But trade in services differs in some important ways from what we have traditionally seen in manufacturing and/or natural resources. It affects huge new areas of the economy. Many of the tasks and processes that move are not “low end,” but rather affect people “like us.” As the old economist’s joke puts it, “A recession is when your neighbor loses his job. A depression is when you lose yours.”

The good news is that the policies that made sense to deal with globalization in manufacturing largely apply to the services shift. Think long term, invest in accumulation, allow reallocation and promote innovation. And most of all, *don’t throw sand in the wheels of commerce.* It’s expensive and it doesn’t work. Instead, look for the lubricant. ●

Summary: THE SERVICES SHIFT

Looking Ahead

Here are seven predictions about the future of the services shift:

- 1. Global sourcing will continue to grow — rapidly.** There is still plenty of room for growth in global sourcing.
- 2. The key word will be “global.”** Expect global sourcing to become steadily more global.
- 3. Global services sources will keep moving “up the food chain.”** Today, we see firms such as ITTIAM (chip design in India), Microsoft (graphics research in China) and Pfizer (genomics research in India) moving some of their most sophisticated jobs to low-income countries.
- 4. Talent will become more important than cost.** A recent survey of civil engineers in the United States revealed that about 20 percent of CE firms had experience with offshoring. Among those firms, 47 percent had ventured overseas in search of lower labor costs — but another 40 percent went to procure more capacity or specialized talent.
- 5. The scale will decline dramatically.** “Scale” here is the scale of the projects that are likely to be serviced globally in the coming years. Suppliers will come up with increasingly specific competencies that will service increasingly specialized market segments.
- 6. Global sourcing will become increasingly personal.** We are almost certain to see a dramatic rise in personal services: tutoring, concierge services, schedule management and so on.
- 7. We will see more two-way travel.** Almost certainly, we will see customers traveling to the suppliers for some outsourced services. The economics of medical tourism can be compelling. The knee replacement that might cost \$40,000 in the United States costs \$18,000 in Singapore and \$8,500 in India. With insurance companies and global hotel chains working together to promote medical tourism, the industry is almost certain to grow exponentially — from \$60 billion in 2006 to \$100 billion by 2012, according to McKinsey.

Complex Landscape

For most companies, making the services shift isn't easy. Even assuming that infrastructure-related issues don't cause problems for you — and in more and more parts of the world, the technological and physical infrastructure is coming up to world standards — you will almost certainly find that cross-cultural challenges persist. Among 200 U.S. business executives polled in a recent Accenture survey, for example, two-thirds said that their companies had experi-

enced problems offshoring because of cultural differences.

In addition to more countries and more firms, there are more and more types of firms participating in the global sourcing landscape. The broad-line providers are all rapidly growing their geographic footprint.

There are also hundreds, possibly thousands, of new specialty firms, offering everything from personal concierge services to sophisticated data analysis and research services. These generally small, focused vendors tend to deliver higher-value services, and they account for a growing share of the sector.

A more complex landscape is the natural result of the sector's maturing. As a customer, you face more and more options to meet your global sourcing needs. Yes, greater complexity creates confusion in the short run, but it also gives you the potential to create and harvest greater value through your operations in the longer term.

A Game You May Have to Play

If the services shift is so difficult, why are companies doing it? There are many reasons, but in the end, companies are doing it because they have to.

The business environment is constantly changing, and forward-looking firms are always searching for and seizing new options. The past decade has seen the sequential removal of various barriers to globalization in the service sector. These include economic liberalization, technological innovation, improvements in education in low-income countries and the emergence (some might say triumph) of an American-style global business culture.

Some pundits and polemicists would prefer to ignore these new options and insist that “responsible” firms not pursue them. But this is simply head-in-the-sand logic. Think of the British Army marching in formation (in bright red jackets) during the Revolutionary War, being picked off by the ragtag American colonists. Those who cling to the past — those who rush into battle with the wrong weapons or the wrong strategy — will be ground down. Eventually, they will lose the war. ●

RECOMMENDED READING LIST

If you liked *The Services Shift*, you'll also like:

- 1. *Intelligent M&A* by Scott Moeller and Chris Brady.** Moeller and Brady set forth a solid strategy for thriving in the high-stakes, high-stress environment of mergers and acquisitions.
- 2. *The New Age of Innovation* by C.K. Prahalad and M.S. Krishnan.** This successful title presents a better method for business processes to smoothly connect consumers and resources.
- 3. *Wikinomics* by Don Tapscott and Anthony D. Williams.** The authors address how the Internet's social network offers new, decentralized ways to produce content, goods, services and profit.