

## Australian SME micro-offshoring in the Philippines: Opportunities and challenges

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The practice of offshoring former in-house work to countries with relatively cheaper wages has been well documented (Dunning 1988; Agrawal and Kamakura 1999). Unfortunately, small and medium enterprises (SMEs) in industrialized countries suffer from resource constraints despite the potential for offshoring strategies to reduce labor costs. They lack the time, capacity, and/or expertise to engage in the processes required to acquire knowledge of the local context and internationalize their staffing requirements (Dana et al. 2007).

An increasing number of Philippine-based business process outsourcing (BPO) centers, however, are targeting Australian SME clients by offering micro-offshoring services that reduce the transaction costs. This *Policy Note* examines the BPO sector and considers the potential economic and social gains of this

expanding niche market. Such gains include entrepreneurial opportunities for local firms and overseas investors and the creation of new relatively well-paid jobs for Filipino professional workers and graduates. These developments are expected to foster the growth of the Filipino middle class.

This *Note* is based on a research conducted in 2016 on the BPO sector in Metro Manila and Clark Freeport Zone in Angeles City, Pampanga. Data were obtained through interviews and discussions with BPO managers, Australian SME clients, and other relevant persons. The paper is further supported by the long-term industry experience and knowledge of one of the authors.

*PIDS Policy Notes* are observations/analyses written by researchers of the Philippine Institute for Development Studies (PIDS) on certain policy issues. The treatise is holistic in approach and aims to provide useful inputs for decisionmaking.

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The views expressed are those of the authors and do not necessarily reflect those of the PIDS or any of the study's sponsors.



*An increasing number of local BPO centers are tapping Australian SMEs by offering micro-offshoring services that are cost effective and not constrained by regulations imposed on traditional outsourcing. (Photo by Magellan Solutions 2015, <http://www.magellan-solutions.com/call-center-industry/>)*

### **Traditional outsourcing/offshoring versus micro-offshoring**

Traditional outsourcing models are characterized by firms contracting out their work to third parties, which then perform the work subject to service agreements often linked to key performance indicators (KPIs). Under this model, someone else does this work for the firm. Meanwhile, offshoring involves relocating a business process or function to another country. It can include outsourced and captive governance approaches. The former includes nonequity arms-length outsourcing, while the latter includes joint ventures and wholly owned foreign subsidiaries (e.g., incorporation in the host country) (Roza et al. 2011). Firms utilizing BPO redeploy business processes and competencies to foreign locations as a

new wave of international outsourcing and offshoring activities (Lewin and Volberda 2011; Roza et al. 2011).

However, traditional offshoring governance approaches are often not suitable for SMEs. International outsourcing contracts, for example, often require economies of scale and rigid agreements and processes. Large-scale outsourcing contracts are also associated with detailed service agreements and KPIs. In contrast, SMEs lack economies of scale and require greater flexibility in their day-to-day operations.

Captive governance approaches to offshoring, such as employing host-country workers directly via a host-country-based subsidiary, may also not be suitable for SMEs. First,

incorporation in another country requires substantial time, investment, and risk, including sunk costs that SMEs will not be able to retrieve if the investment does not work out as planned. Second, SMEs suffer from resource constraints and may not have the ability or desire to cover associated costs, such as sourcing overseas-based workers, locating and renting office space in the host country, dealing with host-country legal issues (including incorporation, taxation and labor laws), and addressing cross-cultural challenges.

However, an increasing number of often smaller BPO centers are addressing these SME challenges through what can be described as *micro-offshoring*. Operating under the guise of *staff leasing arrangements, comanaged services, or comanaged operations*, micro-offshoring services include:

- the sourcing, vetting, and employing of local professional workers on behalf of their clients;
  - provision of desk space and Internet facilities for workers (generally in a shared open office environment); and
  - provision of ongoing follow-up client support.
- The BPO then charges the client a monthly fee to cover these services. Decreasing telecommunication costs and the advent of relatively cheap cloud-based collaborative workplace tools, such as Skype, email, Dropbox, Windows 365, and Xero, further support these arrangements.

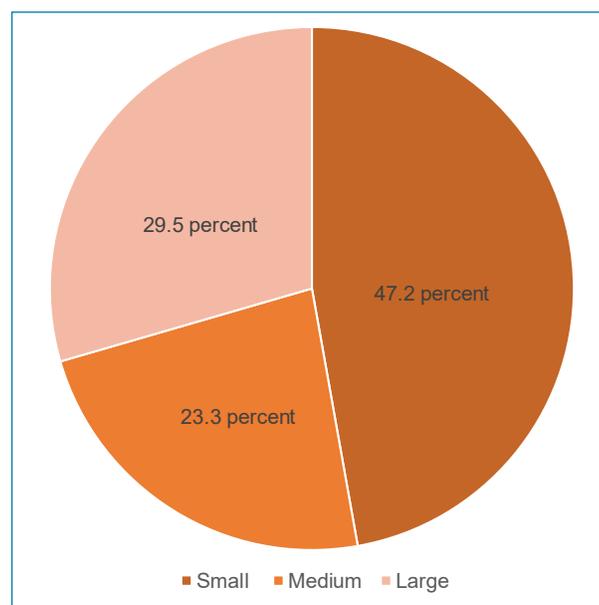
Micro-offshoring produces a third-way offshoring governance mode that lies between the

outsourced and captive governance models. Importantly, *the Filipino-based BPO worker is technically 'employed' by the BPO center*, which covers all legal requirements, as in the case of the Philippines where local workers must be employed by Philippine-registered firms. The BPO also provides advice and support to the client in relation to staffing matters and human resource management issues.

### The Australian SME context

Australia has a dynamic and highly competitive SME sector, which comprises 99 percent of their businesses (DIISR 2011). This sector likewise employs the highest percentage of Australian workforce at 70 percent. Specifically, the small business sector, or firms that have less than 20 workers, employs almost half of the workforce (Figure 1).

**Figure 1. Australian employment by business size in 2010**



Source: Department of Innovation, Industry, Science, and Research (2011)

Micro-offshoring services, in this context, provide a possible competitive edge for Australian SMEs by allowing them to cut costs (i.e., through lower labor costs) and access skills and services they could not previously afford (i.e., augment rather than simply replace Australian staff). This, in turn, may help Australian SMEs to increase their competitiveness and growth.

The Australian-based SME client manages its foreign staff similar to a traditional employer-employee relationship, although technologically rather than geographically mediated (Ross 2015).

The potential benefits of the micro-offshoring model for Australian-based SMEs include the following:

- It is a relatively cheap way to initially embark on offshoring strategies and access overseas-based professional services. It likewise allows the SME to develop offshoring expertise and knowledge before shifting to a captive offshoring governance model, such as incorporation.
- It lowers transaction costs because there is no need to find and vet local staff and locate office space nor incorporate in the country of BPO.

*The Philippines has a highly literate and well-educated workforce currently increasing by around 600,000 tertiary graduates, including more than 3,000 public accountants annually. The variety of Filipino tertiary graduates also provides the varied skills that Australian SMEs need, such as the ability to speak in English fluently.*

- BPO looks after labor law issues. As in the case of the Philippines, its labor law is quite extensive and is enforced across the BPO sector.
- SMEs can begin the offshoring process with a relatively small number of workers.
- It reduces risk, given that the BPO firm shares the risk with the client.
- It allows firms to maintain control. SME owners are used to being in control and micromanaging their operations. Directly managing overseas-based worker helps SMEs to maintain this control.

### **Competitive advantages of the Philippine BPO sector for Australian firms**

Feedback from interviews suggests that Australian managers felt more comfortable going to the Philippines to explore offshoring opportunities, as opposed to other rival potential BPO destinations in the region, such as India, given the following advantages.

#### *Top-ranking BPO sector*

The Philippines now ranks as one of the top BPO destinations, with Metro Manila and Cebu City ranking second and seventh, respectively, in the world in 2014 (Tholons 2016). According to the IT and Business Process Association of the Philippines (IBPAP), the value of the Filipino BPO sector had increased from USD 3.4 billion to USD 18.9 billion, employing around 1.2 million workers from 2006 to 2014 (IBPAP 2015). However, these figures only cover those enterprises that are member of IBPAP. They, therefore, underestimate the full value and employment of this sector,

which suggests the need for more extensive quantitative research to determine the full potential of this emerging niche micro-offshoring market sector.

### *Favorable geographical time zone*

The time zone in the Philippines also favors Australian firms. It is the same as Perth, Western Australia, while there is only a two-hour difference to the Australian Eastern Standard time. This allows Australia-based SME managers to work with their Philippine-based staff in real time. Australian shifts are also popular with Metro Manila-based BPO workers, as the time difference allows them to arrive and leave work two hours before the main peak traffic times.

In terms of geography, the two countries' proximity makes it easier for Australian managers to commute to and from the Philippines with less resources.

### *Highly literate workforce*

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### *Competitive labor rates*

Median labor rates in the Philippines for call center type of work are around eight times lower than in Australia (Table 1). This accords

**Table 1. Comparative annual labor rates in call centers in 2016**

Country	Bottom 10 Percentile	Median	Top 10 Percentile
Australia	AUD 37,641 (PHP 1.38 million)	AUD 43,180 (PHP 1.58 million)	AUD 55,883 (PHP 2.05 million)
Philippines	AUD 2,825 (PHP 103,630)	AUD 5,241 (PHP 192,241)	AUD 8,423 (PHP 308,963)

Source: Payscale: Human Capital, <http://www.payscale.com/>

with the BPOs that were visited during the course of this research, which suggested that salaries for new workers began at around AUD 360 to AUD 480 per month. Salaries and pay relativities between the two countries naturally vary according to the type of job, including the required skill set, and worker experience.

Base wage levels, however, do not tell the whole story. The total cost of micro-offshoring models, such as staff leasing arrangements, typically includes a fixed fee per employee per month (which covers base salary, benefits, taxes, and insurances) plus a services fee (which covers office arrangements, including access to shared office space, desks, computers, and ongoing BPO client support services). While BPO rates are confidential and vary depending on client requirements and the employee's role and experience, evidence from this research suggests that the full cost of an administrative or customer service worker would be around AUD 15,000 to AUD 20,000 per year, less than half of the Australian salary for an equivalent job.

The Australian salary outlined in Table 1 also does not include employee overhead

and office and equipment costs. Taking these overhead and other labor expenses into account, a widely quoted statistic across many Filipino BPO sites suggests that Australian firms can secure up to 70 percent labor cost savings.

### **Challenges confronting the Philippine BPO sector**

Despite these advantages, the BPO sector in the Philippines has to address the following challenges.

#### *Government red tape*

Many respondents said incorporating a subsidiary in the Philippines takes a lot longer than the target period of government agencies. They further spend a long time queuing in government offices to get recurring requirements approved and/or paid. Some have even hired an employee merely assigned to do the queuing. A certain BPO manager had to set up an Uber taxi account just to facilitate the process for his workers tasked to queue.

#### *Conflicting government requirements*

Many respondents also expressed disapproval about the overlapping and sometimes conflicting requirements from different levels of government.

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#### *Poor infrastructure, traffic congestion*

Both the lack of transport infrastructure and the high traffic congestion make commuting around Metro Manila time consuming. In fact, many workers are spending three to four hours per day traveling to and from their workplace. Frequent flooding of Metro Manila roads compounds this problem.

The World Economic Forum (2013) further outlines the challenges the Philippines is facing in improving its infrastructure, ranking it second from the bottom in the region after Viet Nam in terms of infrastructure. While research suggests that infrastructure investment in the Philippines is improving (KPMG 2015), this is obviously a long-term project.

#### *Expensive, unreliable utilities*

BPO managers added that utilities in the Philippines are expensive and not always reliable. Most Metro Manila BPOs have to operate with back-up electricity generators to cover breaks in the electricity supply. A certain Australian BPO manager also decried the excessive Internet and electricity fees relative to what he would be paying for similar services in Australia.

#### *Biased adjudication of labor cases*

The country's extensive labor law provisions are strictly enforced in the BPO sector, primarily because the workers themselves are cognizant of their rights. This makes it relatively difficult to sack a Filipino worker. Firms, therefore, need to document all employee activities in case they need

to manage someone out. However, some respondents felt the adjudication of labor cases before the National Labor Relations Commission tends to be biased in favor of employees. Nonetheless, most respondents advised that the Labor Law could be navigated but firms needed to be aware of and abide by its provisions.

### Conclusion

Trying to get an exact figure of the growing number of Australian SMEs engaging in micro-offshoring strategies represents a policy challenge. IBPAP (2015) estimates that 150,000 Filipino workers, or 12 percent of the total Filipino BPO workforce, are now employed by Australian firms in the Philippines through such arrangements. However, as mentioned above, these figures only include firms that are IBPAP members.

The data obtained in this research, however, suggest that micro-offshoring services are supporting a paradigm shift in the ability of Australian SMEs to engage in such activities. The micro-offshoring model allows Australian SMEs to offshore former in-house professional services to the Philippines without having to address many of the traditional transaction costs associated with offshoring strategies. Likewise, it allows Australian SMEs to gain expertise in operating in the Filipino context, with relatively few upfront costs. This knowledge may encourage Australian SMEs to shift to more long-term captive offshoring models, such as local incorporation, over time.

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Australian firms represent an important and growing BPO market. Specifically, the Australian SME sector provides a relatively large existing and potential market for the kind of micro-offshoring services being offered by Philippine-based BPO firms. The extent and competitive nature of the Australian SME sector also suggest that the growth of Australian SME clients is likely to continue. This provides entrepreneurial opportunities for local Filipino SMEs looking to enter and tap this market.

The Australian SME micro-offshoring market also provides potential job opportunities for Filipino graduates and professional workers as the nature of the jobs often includes higher-level professional services. This provides higher value-added job opportunities in comparison to lower value-added traditional call center BPO work.

This is an important consideration given that while labor productivity in the BPO sector is higher than the Filipino services sector as a whole, it still lags the labor productivity

levels found in Filipino industry and manufacturing by around 33 percent (Usui 2012). It is advisable for the Filipino BPO sector to move up the value-added chain by providing more sophisticated services in order to generate greater labor productivity growth and longer-term lift in living standards (Usui 2012). 📄

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