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Australian SME Micro-offshoring Opportunities in the Philippines: An Expanding Niche Market?

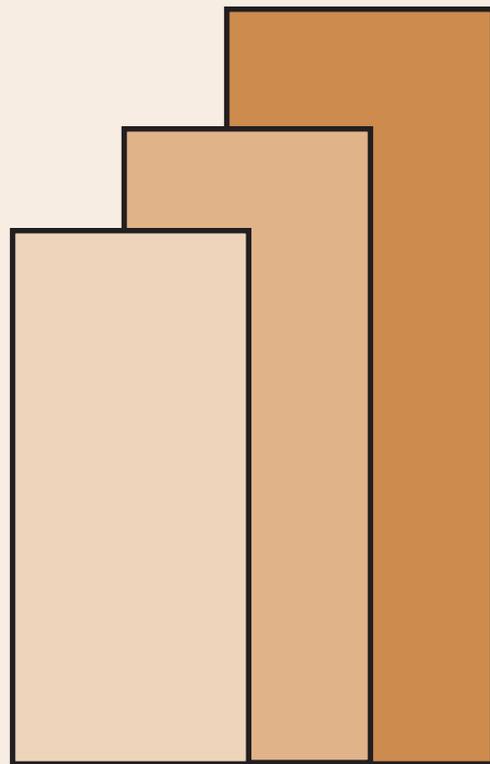
Peter K. Ross

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For comments, suggestions or further inquiries please contact:

The Research Information Staff, Philippine Institute for Development Studies
18th Floor, Three Cyberpod Centris - North Tower, EDSA corner Quezon Avenue, 1100 Quezon City, Philippines
Telephone Numbers: (63-2) 3721291 and 3721292; E-mail: publications@mail.pids.gov.ph
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AUSTRALIAN SME MICRO-OFFSHORING OPPORTUNITIES IN THE PHILIPPINES: AN EXPANDING NICHE MARKET?

Peter K. Ross, Griffith Asia Institute (GAI), Griffith University

Email: p.ross@griffith.edu.au

Introduction

This paper examines how Filipino BPOs are providing ‘micro-offshoring’ services that are encouraging Australian small and medium size enterprises (SMEs) to offshore former in-house professional work to the Philippines. It further considers the potential for further growth in this expanding niche market. The paper is supported by research that was conducted by the author in the Metro Manila and Clark BPOs sectors in 2016. This included the author visiting BPO centres, attending BPO presentations to prospective clients and conducting follow up interviews and discussions with BPO managers, Australian SME clients and other related persons in the field.

The practice of offshoring former in-house work to countries with relatively cheaper wages has been well documented (Dunning 1988; Agrawal & Kamakura 1999). Baker further suggests that the “simple iron law of economics dictates that where labour is fungible”, that is, where it is possible to transfer the work process to another person who can perform the same job at a similar level, “then the available employment will go to the relatively lower paid worker” (2007:25).

However, despite the potential for offshoring strategies to reduce labour costs, SMEs suffer from resource constraints and often don’t have the time, capacity and/or expertise to engage in the processes required to internationalise their staffing requirements (Dana, Hamilton & Pauwels 2007). In this regard, SMEs generally don’t know the local context nor have the time nor resources to acquire this knowledge.

An increasing number of Filipino-based BPO centres, however, are targeting Australian SME clients by offering micro-offshoring services that reduce the above offshoring transaction costs, as outlined below.

Traditional BPO Outsourcing/Offshoring versus Micro-offshoring

Traditional *outsourcing* models are characterised by firms contracting out their work to third parties, who then perform the work on behalf of the firms subject to service agreements that are often linked to key performance indicators (KPIs). Under this model *someone else* now does this work for the firm. Strategic outsourcing then allows firms to leverage suppliers' competencies and technical capabilities at relatively low costs (Kotabe et al. 2012:230).

Offshoring involves relocating a business process or function to another country. Offshoring modes include *outsourced* and *captive* governance approaches. The former includes non-equity arms-length outsourcing (as outlined above), while the latter includes joint ventures and wholly owned foreign subsidiaries (e.g. incorporation in the host country) (Rosa et al. 2011: 314). Offshoring drivers include lower costs, access to resources (including human resources) and specialist knowledge. The rapid development of ICT technologies, including cloud-based tools, has further reduced the costs of managing and coordinating offshore activities (Ross & Blumenstein 2013; 2014).

Offshoring strategies are being driven by cost pressures brought about by increasingly competitive global markets. Firms in industrialised countries, for example, initially shifted labour intensive manufacturing processes to overseas locations in order to exploit relatively cheap unskilled and semi-skilled labour. However, the ability to access alternative sources of skilled *professional* workers, as opposed to low skilled labour, at reduced costs, is increasingly driving offshoring strategies (Lahiri & Kedia 2011). Similarly, Ellram and Cousins suggest that Business Process Outsourcing (BPO), whereby firms redeploy business processes and competencies to foreign locations (Lewin and Volberda 2011:241; Rosa et al. 2011: 314) represents the new wave of international outsourcing and offshoring activities.

Despite these trends, 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. Call centres for instance provide relatively low value-added work. Host country-based third party providers therefore require relatively large contracts and associated staffing levels to make the contract worthwhile, as the value-added per staff member may be relatively low. Large scale outsourcing contracts are also associated with detailed service agreements and KPIs. SMEs in contrast, 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 the SME will not be able to retrieve if the investment does not work out as planned. Second, as outlined above, SMEs suffer from resource constraints and may not have the ability or desire to cover associated subsidiary transaction costs, such as, sourcing and vetting overseas-based workers, locating and renting office space in the host country, dealing with host country legal issues (including incorporation, taxation and labour laws) and addressing cross-cultural challenges.

However, an increasing number of often smaller Filipino-based BPO centres are addressing these SME challenges through the operation of what can be described as *micro-offshoring* models. Operating under the guise of ‘staff leasing arrangements’, ‘co-managed services’ or ‘co-managed operations’ these services include:

- the sourcing, vetting and employing of local professional workers on behalf of their Australian-based clients;
- provision of desk space and internet facilities for the Filipino-based workers (generally in a shared open office environment); and
- provision of ongoing follow up client support.

The Filipino-based 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 (e.g. IP telephony, Skype, email, Dropbox, Windows 365 and accounting packages such as Xero) further support these arrangements.

This approach produces an offshoring governance mode that lies somewhere between the outsourced versus captive governance models outlined above. Importantly, *the Filipino-based BPO worker is technically ‘employed’ by the BPO centre*, which covers local legal requirements, as Filipino workers must be employed by Filipino registered firms. The BPO also looks after legal issues and provides advice and support to the client in relation to staffing issues (i.e. to help sort out any client/worker management issues). However, on a day-to-day basis the Australian client ‘manages’ their Filipino-based staff similar to a traditional

employer/employee relationship, except that the employment relationship becomes technologically-, rather than geographically-mediated (Ross 2015).

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

1. A relatively cheap way to initially embark on offshoring strategies and access overseas based professional services at relatively cheap costs;
 - i.e. a way for firms to ‘dip their toe in the water’;
 - allows the SME to develop offshoring expertise and knowledge before shifting to a ‘captive’ offshoring governance model such as incorporation;
2. Lowers transaction costs;
 - e.g. no need to find and vet local staff, locate office space nor incorporate in the Philippines;
3. BPO looks after labour law issues;
 - Filipino Labour Law is quite extensive and is enforced across the BPO sector;
4. SMEs can begin the offshoring process with a relatively small number of workers in the Philippines (i.e. 1+);
 - traditional offshoring arrangements in contrast generally operate with far greater economies of scale;
5. Reduces risk;
 - ‘Pay as you go’ model reduces risk through low ‘sunk’ costs;
 - BPO firm shares the risk with the client;
6. Maintain control;
 - SME owners are used to being in control and micro-managing their operations (i.e. it’s their firm and they run it). Directly managing the overseas-based worker helps SMEs to maintain this control.

The Australian SME Context

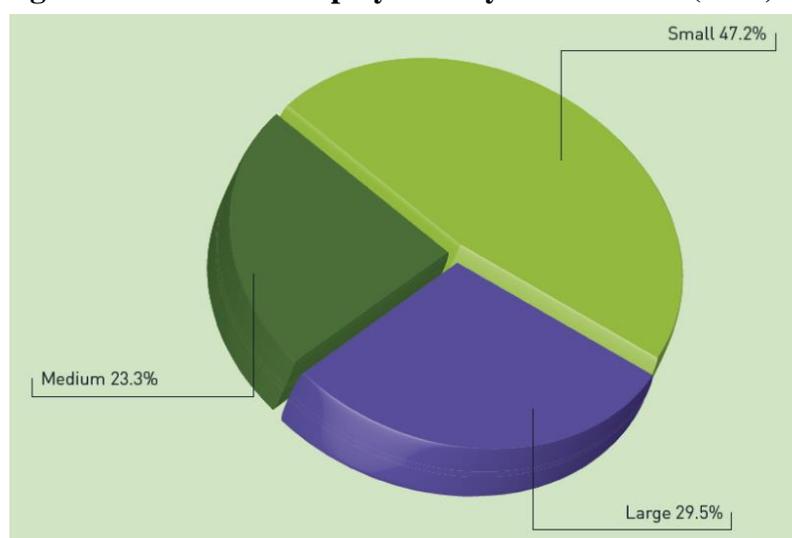
The recent upsurge in interest from Australian SMEs in relation to offshoring services to the Philippines is supported by the Australian SME context. As outlined in Table 1, SMEs are the predominate type of Australian business with 99 per cent of Australian businesses having less than 200 employees. The figures also suggest that Australian businesses with less than 20 workers also comprise 97 per cent of the business sector, although, this figure includes 61 per cent of registered firms that have no workers at all.

Table 1: Australian SME context

Business Definition	No. of employees	Percentage of firms
Small Business	0 to 19	97%
	Zero	61%
	1-4	28%
	5 to 19	
Medium-sized business	20 to 199	2%
Large business	200+	1%

Figure 1 further shows that SMEs employ the highest percentage of Australian workers, with small and medium size businesses employing more than 70 per cent of the Australian workforce. Further, the small businesses sector (i.e. firms that employ less than 20 workers) employs almost half of the workforce.

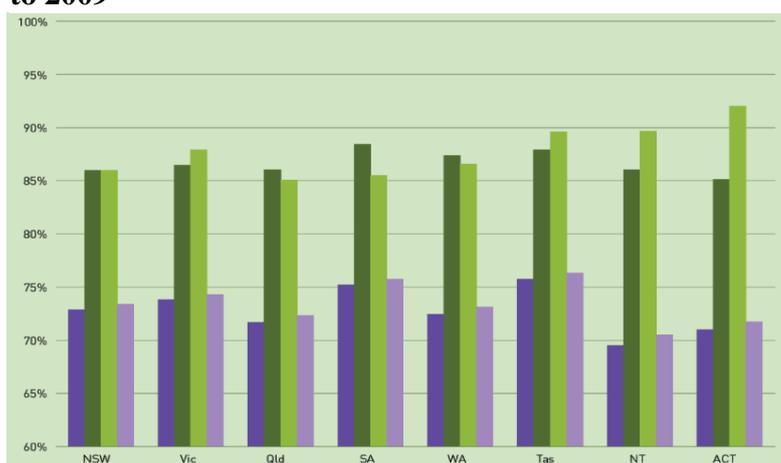
Figure 1: Australian employment by business size (2010)



Source: DIISR (2011)

Figure 2 also shows that smaller firms have the highest entry and exit rates, with firm survival rates being lowest for Australian firms with annual turnovers under AU\$50,000 and highest for businesses with annual turnovers of AU\$2 million or more. The figures therefore indicate that Australia has a dynamic and highly competitive SME sector. Further, SMEs that don't grow have a lower chance of longer term survival in this competitive environment.

Figure 2: Firm survival rates by Australian State: 2007 to 2009



Source: DIISR (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 labour costs) and access skills and services that the SMEs 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 ‘grow the business’.

Filipino BPO Sector: Competitive advantages for Australian firms?

The Philippines has developed a large and growing BPO sector and now ranks as one of the top BPO destinations in the world. In 2014 Metro Manila achieved the number two ranking in the Tholons global “Top 100 outsourcing destinations” (ahead of Indian cities such as Mumbai, Delhi, Chennai and Hyderabad) with Cebu City ranked in seventh place (Tholons 2016). The peak Filipino BPO industry association, the ‘IT and Business Process Association of the Philippines’ (IBPAP), advises that between 2006 and 2014, the value of the Filipino BPO sector increased from US\$3.4 billion to US\$18.9 billion dollars, with the sector now employing around 1.2 million workers. The Filipino BPO sector therefore has demonstrated BPO skills and experience. Interview feedback further suggested 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.

The above BPO figures are based on IBPAP membership and therefore may further underestimate the full value and employment of this sector as some Filipino-based BPO firms are not IBPAP members. Many of the smaller BPOs that were visited during the course of this research that were offering micro-offshoring type services, for example, were not IBPAP members. This suggests the need for more extensive quantitative research into this area to ascertain the full value and employment of this emerging niche micro-offshoring market sector.

The time zone in the Philippines and its relative geographical closeness also favours Australian firms. In this regard the Filipino time zone is the same as Perth, Western Australia, while there is only two hours difference to Australian Eastern Standard time (AEST). The geographical proximity makes it relatively easy for Australian managers to commute between the two countries if required, while the minimal time difference allows Australian-based SME managers to work with their Filipino-based staff in synchronous (i.e. ‘real’) time. Australian shifts are also popular with Metro Manila-based workers, as the time difference allows them to arrive and leave work two hours before the main peak traffic times.



Supply-side factors further favour the Filipino BPO sector. As outlined in Table 2, the Philippines has a highly literate well educated workforce that is currently producing around 600,000 tertiary graduates (including more than 3,000 CPAs) annually, while English is widely spoken. A hallmark of this study has been the wide and varied types of jobs that Australian SMEs are offshoring to the Philippines. The number and variety of Filipino tertiary graduates therefore provides the varied skills (and the ability to learn new skills) that Australian SMEs are demanding. It further provides a potential labour market for Filipino tertiary graduates.

Table 2: Graduate Labour Market

Number of college degree graduates	2013	2016
Medical and natural sciences, allied fields	158,159	183,459
Business, accounting, and related fields	119,526	129,168
Social and behavioral sciences, education	67,474	65,558
Engineering and architecture	57,799	63,191
ICT-related and mathematics	57,921	65,420
Fine arts, mass com, humanities	13,549	14,673
TOTAL Tertiary level	533,273	584,474

Source: IBPAP Presentation: 2016 Industry Outlook Prospects

A proviso here is the ICT and mathematics related graduate cohort. Interview feedback suggested that many higher-skilled ICT technical workers left the Philippines to work in countries such as Singapore, where there was a high demand for their services, supported by relatively high wages. BPO managers advised that while it was possible to get these skills in the Philippines, they were relatively more difficult to locate. Research further suggests that the Philippines still lags behind the Indian BPO sector in relation to the provision of ICT technical skills, with 80 per cent of Filipino BPO revenue coming from voice related communication services rather than ICT technical work (Maddineni 2015).

Table 3 is based on labour market surveys and provides an example of the competitive salaries that Filipino call centre BPOs can offer in comparison to their Australian counterparts, with median pay rates in Australia around eight time higher than in the Philippines. This accords with the BPOs that were visited during the course of this research which suggested that salaries for new workers began at around AU\$360 to AU\$480 per month. Salaries and pay *relativities* between the two countries will of course vary according to the type of job and worker experience. For example, a BPO manager advised that a DevOps (development and operations) ICT worker in Australia would earn around AU\$120,000 a year, while a similar person in the Philippines would earn around AU\$35,000. In this example the pay rate in Australia is less than four times the Filipino equivalent, however, the lower pay relativity in this case could also reflect the relative scarcity of higher level ICT technical skills in the Philippines (as outlined above), compared to the relative abundance of administrative and customer service type labour market skills. The differences in pay levels, however, was still substantial.

Table 3: Comparative Call Centre rates: Annual Salaries (2016)

Call centre worker: annual salary	Bottom 10% percentile	Median	Top 10% percentile
Australia	AU\$37,641	AU\$43,180	AU\$55,883
The Philippines	AU\$2,825 (PHP 103,630)	AU\$5,241 (PHP 192,241)	AU\$8,423 (PHP 308,963)

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

Base wage levels however do not tell the whole story. As discussed earlier, the total cost of micro-offshoring models, such as staff leasing arrangements, typically includes a fixed fee per employee per month (which includes base salary, benefits, taxes and insurances) plus a services

fee (which covers office arrangements, including access to shared office space, desks, computers, and on-going 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 suggested that the full cost of an administrative or customer service worker would be around AU\$15,000 to \$20,000 a year, which is still less than half of the above Australian salary. Further, the Australian salary outlined in Table 3 does not include employee overheads (such as, workcover insurance, superannuation and holiday pay) and office and equipment costs. Taking these overheads and other labour expenses into account, a widely quoted statistic across many Filipino BPO sites suggests that Australian firms can gain up to 70 per cent labour cost savings. While this research has not been able to verify the source of this figure, simple arithmetic points to substantial potential savings for Australian SMEs.

Australian SME issues and challenges

This research elicited a number of issues and challenges that Australian SMEs need to address when managing Filipino workers. As could be expected these include cultural issues. While the history of the Philippines, including the influence of US culture, has helped to make Filipinos more open to Western culture than many other countries in the region, differing cultural and work practices remain.

Issues and challenges
• Culture & work practices
• US cultural influence
• Labour turnover
• Training
• Australian Accent/Slang
• Filipino Labour law
• Managing SME expectations

Table 4 outlines Hofstede’s well known four cultural dimensions, Power Distance, Individualism, Masculinity and Uncertainty Avoidance, and his analysis of these dimensions in the Australian and Filipino context. The table shows the two main areas of cultural difference to be in the power distance and individualism dimensions.

Table 4: Hofstede’s Cultural Dimensions

Countries	CULTURAL DIMENSIONS			
	Power Distance	Individualism	Masculinity	Uncertainty Avoidance
Australia	36	90	61	51
The Philippines	94	32	64	44

Source: Hofstede, G. *Geert Hofstede cultural dimensions*, [online] <http://www.clearlycultural.com/geert-hofstede-cultural-dimensions/>

Notes: The above rankings are out of a maximum of 100

Power distance refers to the way in which power is distributed and the extent to which the less powerful (e.g. lower level workers) accept how that power is distributed (Hofstede 2010). In a work context it therefore relates to the distribution and acceptance of authority amongst employees. Australia exhibits a fairly low power distance (see Table 4) and Australian workers therefore tend to be forthright and informal with their supervisors. This may include taking complaints directly to their supervisors and/or publicly disagreeing with a supervisor's direction or statement. Filipinos in contrast exhibit a relatively high power distance which suggests a greater acceptance of authority, which may include an unwillingness to publically disagree with their manager. BPO managers concur that Filipino workers tend to be more formal, polite and non-confrontational than their Australian counterparts. While the desire to please others and not make waves makes Filipino workers excellent customer service representatives, it may frustrate Australian managers who are looking for more forthright (including negative) responses rather than continual agreement.

Interview feedback further suggested that Filipino workers were reticent to advise their supervisor when they did not understand a request or work process. Rather, when asked if they understood something they would tend to say yes, whether they understood the subject matter or not. While this can also occur with Australian workers, this issue appeared to be more pronounced in the Filipino context.

During the course of this research interview feedback further suggested that while Filipino workers learnt new skills and processes quickly and competently (i.e. fast as or faster than Australian workers), they were more reticent to initiate new practices on their own initiative (i.e. outside of set processes) than their Australian counterparts. This again could be linked to the above relatively high acceptance of authority, with workers not wanting to be seen as doing something outside of what they were told to do and/or not wanting to be seen as going behind the bosses back.

Filipinos also score much lower on Hofstede's individualism dimension than Australians, which suggests that Filipino workers feel more comfortable when they are part of a group. In this regard, BPO managers advised that developing a group 'family' type work environment was an important part of developing and maintaining Filipino worker loyalty. Further, virtually every BPO that was studied during the course of this research conducted extensive regular employee group activities.

Because family lies at the heart of Filipino culture, Australian SMEs also need to be more cognisant of employee family issues and needs than in the Australian context. One BPO manager advised that if an employee mentioned that they had a family issue or problem, then as a manager you were expected to follow up and ask them about this. Many Australian workers in contrast would find this to be an invasion of their personal privacy.

The BPO sector is further impacted by relatively high annual turnover rates. Because many workers send much of their money home, non-monetary rewards then become an important component in developing employee loyalty. This is not to say that wages are unimportant. Rather, a good working environment coupled with appropriate non-monetary rewards and employee recognition can help to prevent Filipino workers leaving in order to earn a relatively small pay increase elsewhere.

The US is also The Philippines' default Western Culture. From an Australian firm perspective this US cultural influence has both positive and negative influences. As outlined above, it provides Filipino workers with an affinity with Western culture and English is widely spoken. However English is spoken with a US accent and vocabulary and BPO managers advised that it can take time for Filipino workers to adjust to an Australian accent and associated slang.

This research further suggested that Filipino BPO workers like to operate under set processes and KPIs, to a greater extent than Australian workers. This is not borne out by Hofstede's study which shows both countries as operating under relatively low levels of uncertainty avoidance, which in turn suggests that both cultures feel relatively comfortable in unstructured situations. Hofstede of course may have simply been wrong in this aspect of Filipino work culture, but the apparent need for set processes and KPIs could also reflect the BPO sector itself. First, traditional outsourcing was built on the need for detailed service agreements and processes. Second, managing an overseas worker from another country through micro-offshoring type arrangements may require more set processes, at least in the earlier stages of the employment relationship. Third, being able to monitor and document Filipino worker activity is a necessary part of dealing with Filipino Labor Law.

In this regard, the Philippines has extensive labour law provisions that are enforced relatively strictly across the BPO sector. BPO workers are also quite cognisant of their rights under the

law. One BPO manager for example advised, “if you want to find a Labour Law expert, ask a call centre worker!”. While the BPO, and not the Australian client, technically ‘employs’ their Filipino-based worker under micro-offshoring models, Australian SMEs still need to be aware of Labour Law issues (especially if they are considering incorporating in the Philippines at a later date). In particular, Australian SMEs need to understand that Filipino Labor Law can make it relatively difficult to sack a Filipino worker. Firms, therefore, need to document all employee activity if they want to manage someone out. As one interviewee advised, “If it’s not documented it won’t happen!”. Some respondents also thought that the adjudication of labour cases before the National Labor Relations Commission tended to be biased in favour of the employee. Despite these potential issues, most respondents advised that the Labour law could be navigated but firms needed to be aware of and abide by its provisions.

A further recurring theme from BPO managers were the challenges associated with effectively managing Australian SME manager *expectations*. This included an apparent expectation amongst many Australian managers that Filipino workers should be able to immediately pick up the required skills to do the job. However all workers need adequate time and training to acquire the firm-specific skills and knowledge required to master any new position, whether in the Philippines or Australia. Despite this seemingly obvious requirement, BPO managers regularly advised that the number one reason for Australian client/Filipino worker failure was a lack of adequate training from Australian SMEs in relation to their Filipino worker(s). Successful Australian SMEs in contrast were those that were prepared to put in the required time and effort into training. Some Australian SMEs also flew their Filipino workers to Australia for on-the-job training. This was very popular with Filipino workers, who could then also be used to train other workers after they returned to the Philippines.

BPO Issues

The major issues raised by locally-based BPO owners and managers were directed at Government ‘Red tape’, infrastructure and utilities. Many respondents further advised that incorporating a subsidiary in the Philippines took a lot longer than Government agencies advised, while there were overlapping and sometimes conflicting requirements from different levels of government.

In relation to government bureaucratic challenges, some BPO respondents advised that they had had to spend so much time waiting in government offices trying to get government

requirements approved and/or paid (such as paying business registrations) that they now employed permanent ‘queue standers’ to do this work. These workers then spent their entire day travelling between different government departments and agencies and standing in queues. One BPO manager had even set up an uber taxi account to help facilitate this process for his ‘queue stander’ workers.

A lack of transport infrastructure and high traffic congestion also makes commuting around Metro Manila a time consuming process. From an employee perspective it further impacts on the time it takes for them to get to work, with many workers spending three to four hours per day commuting to and from their workplace. Frequent flooding of Metro Manila roads compounds this problem.

BPO managers further advised that utilities in the Philippines were expensive and not always reliable. Most Metro Manila BPOs therefore operated in purpose built areas where their office buildings had back-up electricity generators to cover breaks in the electricity supply. One Australian BPO manager also advised that his Filipino internet and electricity bills were in excess of what he would be paying for similar services in Australia.

Table 5: Global Infrastructure Competitive Ranking

Indicator	Philippines	Singapore	Malaysia	Thailand	Indonesia	Vietnam
Quality of Roads	87	7	23	42	78	102
Quality of railroad infrastructure	89	10	18	72	44	58
Quality of Port Infrastructure	116	2	24	56	89	98
Quality of air infrastructure	113	1	20	34	68	92
Quality of electricity supply	93	8	37	58	89	95
Fixed telephone connectivity	109	29	79	96	82	88
Mobile telephone connectivity	81	18	27	49	62	21
Overall	98	5	25	61	82	110

Source: World Economic Forum (WEF) Global Competitive Report 2013-2014

Table 5 is based on a World Economic Forum (WEF) Global Competitive Report and compares infrastructure across the region. It outlines the challenges that the Philippines faces in improving its infrastructure, with its overall regional ranking being second from the bottom after Vietnam. While research suggests that infrastructure investment in the Philippines is improving (see KPMG 2015), this is obviously a long-term project.

Conclusion/Future Directions?

Trying to get an exact figure on the growing number of Australian SMEs engaging in micro-offshoring strategies represents a policy challenge. IBPAP estimates that 150,000 Filipino workers are now employed by Australian firms in the Philippines through offshoring arrangements, which represents around 12 per cent of the estimated total Filipino BPO workforce. However, as outlined above, these figures may not include Australian SMEs that are engaging in micro-offshoring strategies with Filipino-based BPO firms that are not IBPAP members.

This data obtained in this research, however, suggests that micro-offshoring services are supporting a paradigm shift in the ability of Australian SMEs to engage in offshoring activities. In this regard, 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. It further allows Australian SMEs to gain expertise in operating in the Filipino context, with relatively few upfront or sunk costs. This in turn may encourage Australian SMEs to shift to more long-term captive offshoring models, such as, the local incorporation, over time (i.e. provide a source of FDI).

Australian firms therefore represent an important and growing BPO market, while the Australian SME sector provides a relatively large existing and potential market for the kind of micro-offshoring services being offered by Filipino-based BPO firms. The extent and competitive nature of the Australian SME sector also suggests that the growth of Australian SME clients is likely to continue. Researchers have dubbed this the third wave of global offshoring (Jones & Jones 2013). This in turn 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 the large number of Filipino tertiary students who graduate annually. The nature of the jobs being

sort by Australian SMEs, which often includes higher level professional services, also provides higher-value added job opportunities in comparison to lower value-added traditional call centre BPO work. This is an important consideration given that while labour productivity in the BPO sector is higher than the Filipino services sector as a whole, it still lags the labour productivity levels found in Filipino industry and manufacturing by around 33 per cent (Usui 2012). Usui therefore advises that the Filipino BPO sector needs to move up the value-added chain by providing more sophisticated services in order to generate greater labour productivity growth and an associated longer-term lift in living standards (Usui 2012: 42).

To conclude, the results of this project suggests the need for further research into this area, which in turn could help to better develop policies that can encourage and support the further development and growth of the Australian SME micro-offshoring market.

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