

Área temática: **Internacionalização**

## **OFFSHORING OF SERVICES:**

### **GETTING MORE VALUE AT LOWER COST IN EMERGING MARKETS**

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**Abstract:** Offshoring production and services is changing business models in many industries. In a first moment, a first wave can be identified based on offshoring manufacturing low aggregated value goods to emerging countries, while main activities and final assembly remain in mother country. However, a new wave is being detected and worrying developed countries because it means loss of white-collar jobs to emerging countries. Jobs in financial, engineering, IT, telecommunication, and customer care areas are moving abroad not only due to low cost workforce but also because the emerging countries are improving their workforce and a yellow alarm is blinking in developed countries. The bibliographical search done shows that developed countries are worried and it can be a good opportunity for emerging countries. It is a preliminary and for discussion paper for a better process understanding and how Brazil could be a good player in this new scenario. This study is not conclusive and it is not based on an extensive survey on service sector in Brazil or worldwide but shows a worry of some developed countries with this movement of white-collar jobs and if they are worried, it can be good for emerging countries.

**Key-words:** **Internationalization, offshoring of services, emerging countries.**

**Resumo:** A terceirização para outros países de produtos e serviços está mudando os modelos de negócios em muitas indústrias. Uma primeira onda pode ser identificada baseada na manufatura de produtos de baixo valor agregado em outros países, enquanto as principais atividades e a montagem final permanecem no país sede. No entanto, uma nova onda está sendo detectada e preocupando os países desenvolvidos porque isso significa a perda de empregos de colarinho branco para países emergentes. Empregos nas áreas de finanças, engenharia, TI, telecomunicações, atendimento ao cliente estão mudado para o exterior, não somente devido à mão de obra de baixo custo, mas também porque os países emergentes estão melhorando sua força de trabalho e uma luz amarela de alerta está piscando nos países desenvolvidos. A pesquisa bibliográfica feita mostra que os países desenvolvidos estão preocupados e isso pode ser uma boa oportunidade para os países emergentes. Este é um artigo preliminar para discussão para um melhor entendimento e como o Brasil poderia tirar proveito deste novo cenário. Este estudo não é conclusivo mas mostra que alguns países desenvolvidos estão preocupados com a migração de empregos qualificados e, se eles estão preocupados, isso pode ser uma oportunidade para os países emergentes.

**Palavras-chaves:** **Internacionalização, terceirização de serviços, países emergentes.**

## Introduction

In-house, outsourced and offshoring production are changing business models in many industries and creating a new perspective for developed and emerging economies. Maybe based on Prahalad and Hamel (1990) distinction between core and non-core competencies and/or Porter (1986) cost leadership management strategies, the organizations are outsourcing part of their business to third-party providers and, with the globalization process, not only outsourcing but offshoring activities to keep or acquire more competitive advantage against new competitors from any place in the world.

In a first moment (first wave), outsourcing of manufacturing especially regarding parts or components less critical or with low aggregated value goods were transferred to emerging countries as China, Taiwan, South Korea and Malaysia. Only blue-collar activities were outsourced and main activities of a company, management, marketing, R&D, finance have been retained in home country (Bardhan and Kroll, 2003)

However, a second wave was detected based on service providers and with a main driver the low cost labor in emerging countries. Many works has been done worldwide studying this new process especially in United States where many white collar jobs are disappearing and migrating abroad. Table 1 presents many cases of companies' migration jobs from U.S. to India.

Table 1 – Examples of job migration

Citigroup (1)	500	Citigroup cut 500 U.S. call center workers at the same time it acquired an Indian outsourcing firm. (Phoenix Business Journal, April 23, 2004)
Bank of America (1)	1,500	Bank of America had sent 1,500 technology jobs to India by March 2003 (BusinessWeek, Feb. 2, 2003)
Morgan Stanley (1)	1,000	Morgan Stanley has sent portions of its IT work to offshore outsourcers to Canada, India and Philippines (Information Week, Sept. 22, 2003)
HSBC USA (1)	768	HSBC has transferred 768 customer service, collections and back-office positions to India during the last three years. (Buffalo News, Feb 22, 2004)
Sun Microsystems (2)	N.A.	Unknown number of software, Web developer and engineer jobs have gone to undisclosed offshore locations.
Dell Inc. (2)	5.700	Dell eliminated 5.700 jobs. At same time it opened a call center in India. (Austin American-Statesman, Oct. 21, 2002)
HP (2)	1.200	HP shifted 1.200 Compaq customer-service jobs from Florida to HP center in India (Forth Worth Star-Telegram, July 21, 2003)
Microsoft Corp. (2)	900	In India, Microsoft employs 900 software developers, IT staff and customer service calls (Several newspaper and magazines)
Intel Corp. (2)	3,000	Intel announced plans to cut 4,000 jobs in US and is tripling its number of engineers in India to more than 3,000 (Austin American Statesman, 2002)
Sprint FON Group (3)	4.500	Sprint has given contracts to IBM and EDS to outsource hundreds of IT and call center jobs. It expected to go overseas. (Kansas City Star, Feb. 14, 2004)
SBC Comm. (3)	4.520	SBC hired Indian contractors to handle inquiries about its high-speed Internet service at the same time that it eliminated thousands of U.S. jobs.

Source: Adapted from Public Citizens, 2004.

(1) Financial services (2) Computer products & services (3) Telecommunications Services

In table 2, there is a comparison among some occupations and wages in U.S. and India. It is important to observe in tables 1 and 2 that not only low skill jobs as telephone operators but college occupations are in danger from developed countries to emerging countries, not only to India.

China and others as OEM producers and India as English speaking service providers, especially IT, are now producing their own brands and products with quality and reliability

and competing worldwide. So, emerging countries are learning how to produce and how to play the global game of international trade using their capabilities to be a good player. All this movement is also happening in call center industry and as India is being a destiny for many call centers.

Table 2 – US and India wages comparison

Hourly wages for selected occupations US and India (2002-03)		
Occupation	US wage	India wage
Telephone operator	\$ 12.57	< \$ 1.00
Legal Assistant	\$ 17.86	\$ 6.00 – \$ 8.00
Accountant	\$ 23.35	\$ 6.00 – \$ 15.00
Financial researcher / Analyst	\$ 33.00 – \$ 35.00	\$ 6.00 – \$ 15.00

Source: Adapted from [http://www.berkeley.edu/news/media/releases/2003/10/29\\_outsource.shtml](http://www.berkeley.edu/news/media/releases/2003/10/29_outsource.shtml)

It is a yellow alarm for developed countries but good opportunities for emerging economies, which one with their capabilities and of course, Brazil can be a good player in some of those industries, and, as will be presented bellow for instance in call center sector.

### Research Problem and Objectives

Robinson and Kalakota (2004) present a large number of examples showing offshore outsourcing and define offshoring as the migration of part or all of the value chain to a low-cost location. Offshoring hinges on cost management through labor and skill arbitrage. It is dependent on the dramatic advances in telecommunications technology that have made it possible to situate back-office operations in a variety of locations and to benefit from significantly lower labor costs. Besides that, Abramovsky et al. (2004) presents, as can be seen in Figure 1, a scheme to differentiate all possibilities into the supply chain.

		Location Decision	
		Domestic	Overseas
Corporate Boundary Decision	Insource	Domestic Divisions/ Affiliates	Establishing Foreign Affiliates (FDI and trade)
	Outsource	Source from Domestic Suppliers	Source from Foreign Suppliers (International Trade)

Source: Adapted from Abramovsky (2004, p.5)  
Figure 1 – Corporate Boundary and Location Decision

Offshoring (overseas) possibilities involve insource and outsource options. The first one occurs when it is done to a subsidiary in another country, while offshore outsourcing represents an outsourcing to a supplier outside the corporate structure. Bie (2005, p.5) says that there is no official definition for outsourcing, offshoring or offshore outsourcing but presents a similar definition as presented in Figure 1: outsourcing is the relocation of a

function to a third party producer; that is domestic or abroad. Offshoring is the relocation to an own affiliate abroad, whereas offshore outsourcing is the relocation to a third party abroad.

There are distinct parallels that can be drawn between the offshore outsourcing trend and development that took place in industries during the last century. In the 1960s, the apparel industry started to move production from West countries to Asia and Latin America to take advantage of lower labor costs, while the design remained in the West. Although, much of the research and development also is moving particularly for countries in Asia and the movement of production facilities and call centers to locations such as Ireland during the 1990s (Kolding, 2003).

This article handles with offshoring of services state of art, the differences with traditional manufacturing internationalization process theory, what is happening in this world and if emerging countries can take advantage of that.

## **Theoretical Background**

Bardhan and Kroll (2003) proposed two waves for outsourcing in U.S. market, the first one regarding manufacturing and the second one called "white collar jobs". The foreign outsourcing in U.S. manufacturing and the associated loss of "blue-collar jobs" in many industrial sectors is attributed to globalization of activities for offshore production of intermediate inputs, usually in low-cost developing countries, such as Taiwan, China, South Korea and Malaysia. However, the software sector was the first service sector to transfer significant activity to foreign locations as white collar jobs, especially to India. The rapid dissemination of the Internet, the transnational networks set up by immigrants in the U.S., and liberalization of emerging markets economies created the conditions for a major burst of outsourcing in 1990s. Several major differences distinguish services outsourcing from the previous wave of outsourcing of manufacturing jobs. Services outsourcing is structurally simpler than manufacturing in terms of resources, space and equipments requirements and thus may proceed much more quickly. They presented a special warning sign: the occupational mix of a sector may determine its vulnerability in Business Process/Services Outsourcing (BPO/BSO) circles it is said that any job that involves mostly "... sitting at a desk, talking on the phone and working on a computer..." is a job under potential threat.

International business specialists, who came to the subject from an economics perspective, tend to see merit in trying to merge the economics and business strategy perspectives. Most notable in this respect are, perhaps, the works of Porter (1998) and Dunning (1988). In Porter, the approach is firmly based on economic principles. The central construction of Porter (1998) is his "diamond" analysis of the competitive advantage of nations. Competitive advantage, in Porter's sense, means the ability of firms in a nation to use their location-bound resources to compete successfully in international markets (Reid, 2003).

Porter (1998) with his diamond model shows how a nation can or is competitive in international business. The diamond has four determinant aspects to analyze a nation, or, of course, it can be applied to a company also. Factors conditions are related to production factors as skilled labor and infrastructure countries capabilities. Home demand conditions represent the internal market competitive environment. If a company acts in a competitive in its country, it is a good premise to be competitive in a global perspective. Related and supporting industries indicate the existence or not of international partners in its supply chain. Firm strategy, structure and rivalry represent how companies are established, organized and managed based on the characteristics of domestic competition.

From the economic point of view, the main approach is the eclectic paradigm of internationalization. The reasons for internationalizing explained through three advantages (Dunning, 1988) (i) due to the property abroad; (ii) exploring the location advantages (for low

wage labor, for instance); (iii) adapting current advantages of the internalization of activities to facilitate the knowledge transfer.

In addition to Porter and Dunning points of view, some other business strategy authors propose different alternatives for strategic positioning involving different perspectives on how to define a strategy. Prahalad and Hamel (1990) with core competencies, Hax and Wilde II (2001) with Delta model and, more recently Kim and Mauborgne (2004) with the blue ocean interpretation. Another concept that can not be forgone when handling with final customers, especially when call centers are involved is relationship marketing as defended by Grönroos (2003) and in Bateson (1995) words, this is the marketing term for 90's.

The purpose of outsourcing or offshoring is to transfer a business process or function, typically not a core function, to an organization that have expertise in the area based on saving costs (labor costs, economies of scale) or to improve the quality of production or service. At the bottom line it will reflect in better results.

All these strategic options are important instead in internal market environment or in internationalization process, through outsourcing and/or offshoring part or all of your operations to third-party companies.

In international business area, the Uppsala model suggests company's knowledge is accumulated through conduction of international operations. The model focuses on acquisition, integration and gradual use of knowledge on international operations and markets (Johansson and Vahlne, 1977; Eriksson et al., 1997). The central hypothesis is that, in internationalization processes, companies gradually increase their international commitment as they expand their knowledge on operations in international markets. This approach includes among factors to be considered, psychological aspects of the company's main executives (psychic distance relative to other markets), and the environment external to the company and also its characteristics.

Other authors in behavioral perspective (Wright and Ricks, 1994) presented international entrepreneurship as a newly emerging research direction and include comparisons of entrepreneurial behavior in multiple countries and cultures and organization behavior that extends across national borders and is entrepreneurial. Authors presented how the internationalization can be done but not the main reasons to do that.

The roots of offshore outsourcing can be traced on Ronald Coase, a Nobel Prize winning economist. In 1932, Ronald Coase explained why businesses exist as they do, why, for instance, they choose to produce some goods themselves and contract with outside companies to provide the rest. In 1937, published "The Nature of the Firm" in the journal *Economica* and it is considered by many to be the foundation of modern outsourcing (Robinson and Kalakota, 2004).

In the early 1990s, pricing pressure for basic IT services and call centers maintenance pushed the industry into low wage countries. India became a symbol of this migration in addition to fluent English-speaking. Pushed by its customers and a quest to improved margins, IT services vendors started to establish offshore presence through a variety of strategies including organic build-outs, partnerships, joint ventures or acquisitions (Langerling and Roman, 2005).

Robinson and Kalakota (2004) ask: Why has offshoring become more prevalent? Why now? They answer themselves: the reduction of transaction costs associated with finding vendors, monitoring their works, and sending work overseas is helping to reshape the modern company.. Those costs, Coase theorized, frequently determine whether a company uses internal or external resources for products or services.

Despite some worries that are happening in developed countries, specially in U.S. and UK, around emerging offshore outsourcing, most of them focusing on jobs losses, the

advantage of using offshore locations is basically cost savings – 25%-50% - mostly due to cheaper labor (Kolding, 2003)

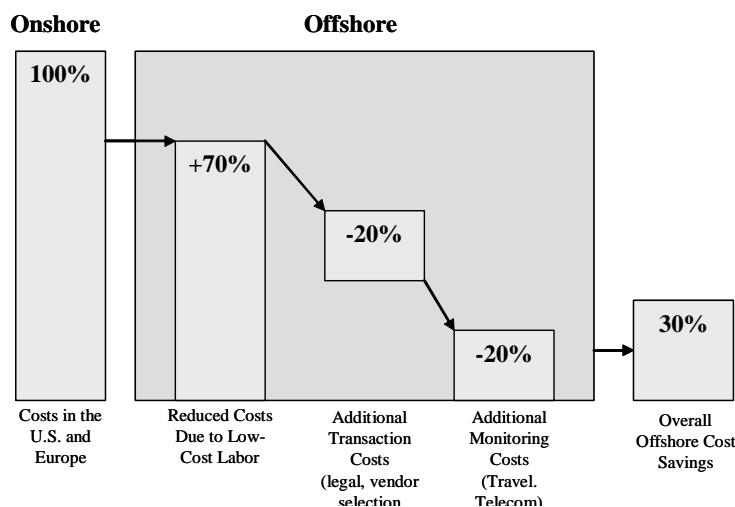
A summarization of the drivers for this rapid offshore outsourcing growth is presented by Robinson and Kalakota (2004): Continuous cost pressure on U.S. and European companies; rapid decline in communication and computing costs; dramatic improvements in Internet reliability and functionality; more offshore suppliers with better capabilities; high-quality onshore suppliers offering offshore services; access to low-cost, high-quality employees, especially for labor-intensive tasks; and a business model for offshoring that has been proven by successful pioneers such GE and American Express. These drivers represent opportunities in many service areas as detached by Bardhan and Kroll but from now on the attention of this paper will concentrate in call centers perspectives, threats and opportunities.

The offshore service market is becoming a great segment to be explored by companies and countries. Based on Langerling and Roman (2005) offshore market for IT is growing rapidly. NASSCOM (India’s National Association of Software and Service Companies) forecasts that Indian software and services exports to grown from US\$ 9.5bn in revenues in 2003 to US\$ 56.1bn in 2008, an average annual growth rate of 42%.

Regarding IT and call centers, in 2003, \$696 million of the global contact center budget was spent on workforce optimization technologies, according to research firm Datamonitor. This technology component is expected to grow to \$1.3 billion by 2008, as contact centers are seeking software tools to streamline agent performance and effectively capture, record, and analyze telephone and data interactions to gather customer intelligence (FBR, January, 2005, p.5).

Offshoring and VoIP go hand-in-hand in our opinion, as having customer service agents in third-world countries (i.e. India, Vietnam) is markedly more efficient with this technology medium FBR (January, 2005, p.13). It is confirmed by Kolding (2003) saying that IP solutions facilitate management control, flexibility, cost reduction and geographic independence. According to Servcik and Forbath (1998), call centers are one of the first applications to take advantage of the convergence – the merging of data, voice, and video communications over a common network infrastructure – in business and encouraging customer self-service and enhance the user experience.

The presented graphics of figure 2 from Robinson and Kalakota (2004) gives a good idea of the difference of onshore and offshore operations. Instead the additional costs with transactions and monitoring, the gains with the reduction in labor costs means a, overall cost savings at 30%.



Source: Robinson and Kalakota (2004)

Figure 2 – The Economics of Offshore Outsourcing

The jobs being created in India and elsewhere are in a wide range of service sectors such as geographic information systems services for insurance companies, stock marketing research for financial firms, medical transcription services, legal online database research, and data analysis for consulting firms, in addition to customer service call centers, payroll and other back-office related activities (Bardhan and Kroll 2003, p.1).

Naturally if new jobs are being created in many developing countries, a threat in developed countries can be reflected. Some papers show that. The problem of offshoring in service sectors in U.S. is being observed and handling by non-profit organizations and US Senate. In aftermath of the blue-collar jobs meltdown, offshoring now has gained momentum among service sector companies seeking lower employment costs and higher profit margins. This job migration began with lower-age, "back office" operations, such as telemarketing, reservations and data processing and now high-skilled jobs are at risk. Large swaths of the US labor force – from factory workers to Ph.D engineers to computer scientists – must now compete with developing country wages. The result is a hollowing out of the middle class (Public Citizens, 2004, p.4).

Some quotations of Public Citizens are dramatically for U.S.: 14 millions highly skilled, white-collar jobs paying an annual average salary of \$40,000 are vulnerable to being offshored (Bardhan and Kroll, 2003); A widely cited projection by Forrest Research estimates that 3,4 million white-collar jobs will move offshore by 2015; a Goldman Sachs study estimates that as many as 6 million U.S. service jobs could move overseas in the next decade; A.T.Kearney predicts 500,000 financial jobs (8% of all U.S. jobs in banking brokerage and insurance) will be shipped overseas by May 2008.

Otherwise, if the developed countries are losing jobs, it is an opportunity for developing countries focusing on policy changes, tax incentives, and infrastructure support. In a study of A.T Kearney (2004) consulting company, an offshore location attractiveness index was defined based on 1) people skills and availability; 2) business environment and 3) financial structure; and Brazil occupies the 7<sup>th</sup> place after India, China, Malaysia, Czech Republic, Singapore and Philippines. But of course it is based in a more complete study involving more complex job skills as IT professionals, R&D engineers and not only for call center operations.

Kolding (2003) based on IDC's European BPO and IT Outsourcing Survey 2003 presents priorities for selecting an outsourcer. The priorities follow the order: security of company information, cost predictability, operational flexibility during lifetime of contract, cost reduction, access to process or technology expertise, access to the latest technology and automation of administrative tasks.

Based on that and following PEG (2005, p.13) opinion,

Call centers are perhaps the most common form of BPO services outsourced to offshore locations. Offshore call centers are attractive because of the low telecommunications costs in countries like India, Jamaica, the Philippines, South Africa, and Mexico as well as lower wages offered to workers offshore. (...) Based on a recent study conducted by market research firm Datamonitor, call center agents in India earn 10% of what U.S. and UK-based call center agents earn per hour.

All presented theories about strategy and internationalization in case of call centers are extremely impacted by technological evolution and the kind of service offered by them. With globalization and advances in telecommunications, distances are not so important for call center interactions and many of presented theory need to be complemented and the cost saving appears as the most important factor for outsourcing and outsourcing operations to continue competitive in a global economy. As presented in some studies about IT outsourcing as Lagerling and Roman (2005) and Keane and Seok (2005), the cost savings advantages in

India can reach, respectively, 60-80% and 70-75% on average employee's salaries in comparison with U.S. and UK. However Brazilian IT wages are 60% up to Indian IT wages.

## **Methodology**

This study is based on a bibliographical analysis of offshoring of services and its impact in developed and in developing countries. A great amount of articles, reports, and documents were surveyed for process understanding and to identify threats and opportunities for countries.

## **Final Considerations**

Offshoring of services is opening new opportunities for emerging countries. The provision of services is easier than for manufacturing production when plants need to be implanted. For services, simple installations based on networked workstations with headsets and chairs to provide services to any place in the world.

It is a reality as presented by Kraemer and Dedrick (2004) survey with 301 firms in Orange County (USA). 20% of them are engaged in some kind of offshore activity. Among this 20%, 21% have no previous international experience! Besides product manufacturing offshoring, a variety of services activities are being offshoring: software development or maintenance (7%), IT services (5.5%), R&D activities (5%), business process outsourcing (3.5%) and call center activities (3%).

All presented services above are exactly those ones which Garner (2004) say that can be performed abroad because of lower foreign labor costs, reduced telecommunications costs, and technological advances that allow more services to be produced at remote locations and concluded that policymakers should not be complacent and choose the right policy actions. Bivens (2004, p.16) agree with Garner and say:

The issue of offshoring demands a careful response by policy makers, with the great challenge being to make sure any potential benefits are equitably distributed among firms and workers. Any policy response must therefore be well informed about the costs and benefits of offshoring. Proponents of offshoring and many economists have claimed that its negative impact on the U.S. economy over the past four years has been exaggerated by politicians and others. Even if true, this ignores the fact that offshoring is likely to grow rapidly in the future and could well have large effects on the U.S. economy in years to come.

Maybe, in a first moment, the intention of the first wave was to explore the low cost manufacturing in developing countries, keeping the project and the intelligence in home country and with that, maintaining the control of the high aggregated value manufacturing process.

However, the low skill works could be a bridge or a learning process to develop new skills, talents, knowledge and capabilities for the second wave in developing countries. It is an important new movement in globalization, maybe unexpected in developed countries and now with unpredictable impact in their high skill jobs. Bednarzik (2005, p.20) has a good comment about that:

The conventional view is that trade replaces bad jobs with good jobs, but does this view hold for services where some good jobs are indeed being displaced? Some job losers have higher skills that help them get a new job, but they also demand higher wages that limit their re-employment possibilities.

Abramovsky et al. (2004, p.31) propose an agenda for future research in United Kingdom for policy debate and management practice:



- a) Understand the outsourcing and productivity process;
- b) Impact of offshoring on the skill content in UK jobs;
- c) Impact of outsourcing and offshoring on the regional distribution of jobs;
- d) How do companies make a decision on what business services to outsource and what to offshore;
- e) What is the impact of outsourcing and offshoring on innovation in services?

Of course it is a natural worry of a developed country in understanding and tries to protect at least their main jobs. However, it is a good agenda for emerging countries also on how to take advantage of their weakness.

So, for analysis purposes, researchers have three merged starting points: point 1: developed countries are losing high skill jobs; point 2: is it an opportunity for emerging countries to catch those jobs?; point 3: Can Brazil be a great player in this new scenario?

This study is not conclusive and it is not based on an extensive survey on service sector in Brazil or worldwide but shows a worry of some developed countries with this movement of white-collar jobs and if they are worried, it can be good for emerging countries.

It is a preliminary and for discussion work about the second wave of internationalization based on a bibliographic search from a different point of view, not based on expensive FDI but in service sector built on people, tables and computers in a networked world.

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