OFFSHORING

The High Cost of Cheap Chinese Labor

by PAUL W. BEAMISH

It's well known that low-skilled Chinese labor is abundant. Over the past two decades, some 140 million low-skilled workers have either moved off the payrolls of state-owned enterprises into the private sector or migrated out of rural areas into the cities to seek their fortunes.

What's less well known is that the average worker earns just 75 cents an hour. Migrant workers – who account for one-fifth of the 750 million people in China's labor market – typically earn less than $130 a month. When you are making that kind of money, a five-cent-an-hour raise is a significant increase. No wonder, then, that Chinese workers leave their employers in droves. Turnover rates among low-skilled workers are frequently in the range of 30% to 40% annually – and sometimes rise above 100%. Compare those figures with industrialized countries, in which annual employee turnover rates in manufacturing are roughly 5%.

Companies that seek to exploit cheap Chinese labor may be penny-wise, but some are pound-foolish. If your head of manufacturing in China can't even hang on to a low-skilled workforce, he will certainly not be able to help you if you need more value-added work done. Companies such as GE have acknowledged the difficulty of finding mid- and senior-level managers. L'Oréal China reports that it loses almost all the new Chinese university grads it hires within three years.

When Chinese employees leave for work that pays better, the costs to companies are high. These include the same problems that plague any firm with high turnover – higher HR management and training costs, greater quality control problems, increased chances of competitive disruption, and more difficulty establishing a stable corporate culture.

The lesson in all this? The costs of labor churn should be taken into account when assessing the costs of doing business in China.

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Reprint F0606D

TEAMS

When to Let Them Duke It Out

by TONY SIMONS AND RANDALL S. PETERSON

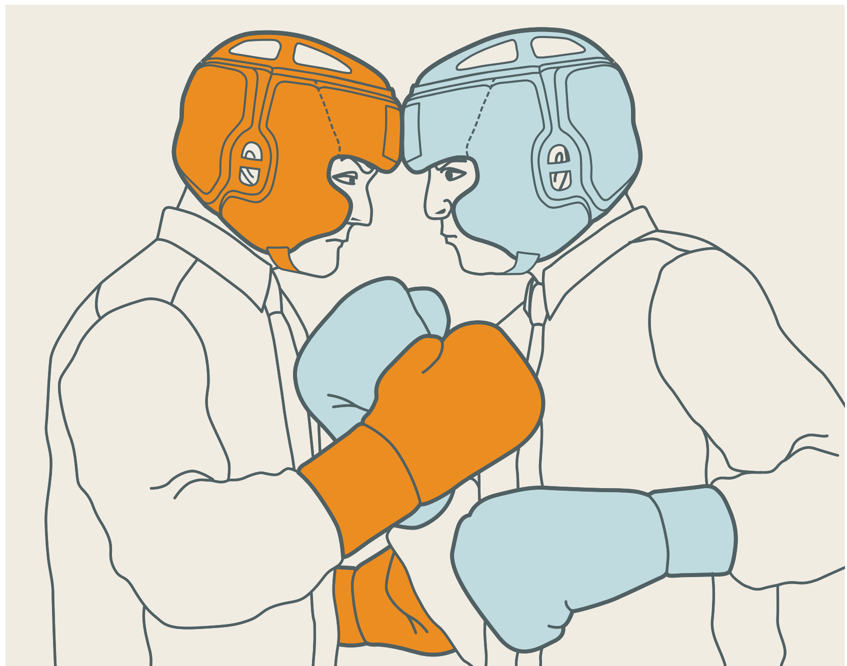
When a top management team gets argumentative or political, it is tempting for the CEO or other executives to cut off debate by simply making the decision. Sometimes, stopping the discussion short is necessary. But when the source of the conflict is mistrust among group members, a unilateral decision can be a costly mistake.

We interviewed 100 CEOs of multisite-hotel companies about the level of trust within their top management teams and about the teams' most important recent strategic decisions. We asked how strongly the CEOs felt their teams endorsed the final decisions and how smoothly the implementation ran. We then sent surveys to the members of these top management teams and asked them the same questions. We ended up with information on 78 strategic decisions, each described by an average of five executives.

The first finding came as no surprise: Teams whose members mistrust one another are less effective at implementing their strategic decisions. That lack of trust, we found, manifests itself in two ways – one, mistrustful groups are less effective at collaborating and, two, they endorse their strategic decisions less strongly, which affects implementation.

We then grouped the decisions into those made by full consensus and those where one or more members reported that the decision was made by the CEO or by a subgroup of executives. Our analysis showed that group mistrust damaged implementation only half as much when the decision was made by consensus than when it was imposed by the CEO or a subgroup. What's more, these executives often did not even realize they were imposing their decisions.

It turns out that the critical factor here is buy-in. When a group operates with a low level of trust and a decision is forced on members, they rebel. And the rebellion shows up as weak endorsement of



the decision, which in turn gums up implementation. If trust is high, then imposing a decision does not cause this problem.

So, when the top management team operates with a low level of trust, or is political in its operation, it's wise to try hard for consensus, even where it seems elusive.

If, as a CEO, you read this recommendation and think it doesn't apply to your top management team, think again. To our surprise and theirs, the vast majority of CEOs in our study couldn't accurately describe the level of trust among their fellow team members. It's as if they were describing a different team and did not realize it.

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STRATEGY

Profiting from the Long Tail

by DANIEL G. GOLDSTEIN AND DOMINIQUE C. GOLDSTEIN

As digital content is increasingly delivered electronically and "all-you-can-eat" pricing plans are more and more common, marketing managers are finding themselves in a struggle to decrease, rather than increase, consumption. Netflix, Blockbuster, and now Amazon.com are in the subscription business, delivering digital content by mail and broadband with no late fees and various unlimited-pricing models. There is no such thing as a free lunch, however, so all unlimited plans must, in fact, be limited in some way to keep costs in check. Accordingly, Netflix restricts the number of DVDs subscribers can order at one time, and Amazon caps the number of rentals per month.

Digital content providers can reduce costs in a variety of ways, all of which relate to recommendation engines and the concept of "long-tailed distributions." These distributions, in which a few products are in very high demand while most are in very low demand, describe endless-inventory e-businesses like Amazon and Netflix. (Chris Anderson's book on the topic, *The Long Tail,* is due out from Hyperion this summer.) Following are three such cost-control strategies.

Promote the back catalog. First, companies can encourage the consumption of lower-cost units. New-release DVDs, for example, are more costly than items from the back catalog because of higher up-front fees and revenue-share arrangements with film studios. Ranking films by demand forms a long-tailed distribution in which expensive new releases make up the front end and the cheaper back-catalog items constitute the tail. However, as companies like Amazon have discovered, the total sales volume of the worst sellers can exceed those of the best sellers. By using recommendation engines to encourage customers to rent inexpensive back-catalog DVDs chosen to please individual tastes, providers can increase profits and maintain customer satisfaction. Through recommendations and other promotions, Netflix ensures that just 30% of rentals are new releases, compared with 75% at Blockbuster outlets. Our analysis of one online recommendation engine found that 90% to 95% of titles suggested were from the back catalog, even when we indicated a strict preference for new releases.

Slow consumption. Second, companies can recommend items that take longer to consume. Someone spending several nights watching a DVD containing an entire season of the TV show *The Office* is not renting and returning many features in succession, which saves the provider acquisition and postage costs. Our analysis of recommendations found that, intentionally or not, recommended DVDs were significantly longer than top new releases, and many contained discrete episodes, which encourages viewing across many nights.

Encourage procrastination. Third, companies can reduce costs by encouraging customers to put off using their products. Research from economics and psychology into how people make choices speaks of two selves, one who predicts "wants" in the future, and one who evaluates them in the present. As anyone who has neglected a gym membership knows, the future-looking self can make virtuous choices that the present self wants little to do with. Recommendation engines can remind customers of products they've always wanted but have never gotten around to using. Movie classics offer a good example. When the DVDs arrive in the mail, customers' present selves are likely to prefer light fare like *Meet the Fockers* over a demanding classic like *The Seventh Seal,* especially after a long day at the office. When, as a result, they postpone returning, say, just one of three DVDs, this creates a bottleneck that reduces the costs of fulfilling a subscription. Customers' virtuous choices then become management's reward.

As more companies offer unlimited subscription models for licensed content, we can expect to see recommendation engines and long-tailed distributions paired in these and other creative ways. Netflix has recently ruffled some feathers

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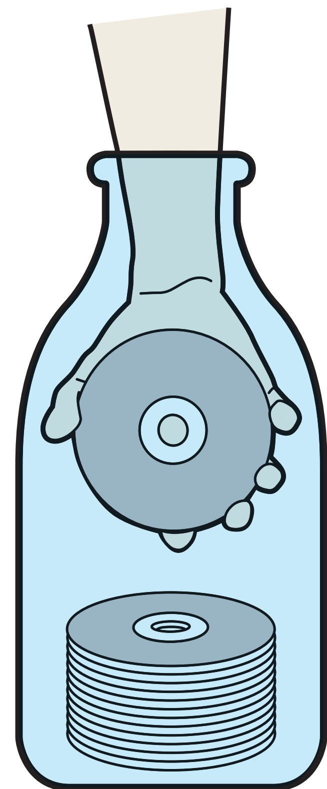

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