

ippr Seminar:

“Offshoring practices in the UK – Where are the Limits?”

Background paper

Introduction

Outsourcing is the term commonly used for the practice of companies to subcontract work to third parties. This way, a company can focus on its core business and leave non-core activities to providers that can perform them to a higher standard or more cheaply.

Outsourcing by itself is nothing new. For years, companies have made use of subcontractors to provide everything from cleaning services to data processing and consultancy. What has changed is the international scope of outsourcing. Thanks to the technological improvements made in telecommunication services, automation of most services throughout the world and decreasing communication costs, it is now possible to outsource work to far away places such as India, South Africa and the Philippines.

In some industries, such as consumer electronics, production of goods can even become scattered into an international network of suppliers. In these instances, Information and Communication Technology (ICT) not only enables firms to conduct relationships over great distance, it enables them to manage a far greater complexity of relationships than would be possible in its absence. In either case, pursuit of market competitiveness may be the driver of offshoring, but ICT is indisputably the enabler.

The offshore outsourcing trend has, up until a decade ago, affected mainly the manufacturing sector. But as communication services have become so much faster and cheaper over the past two decades, more and more companies decide nowadays to move service-sector jobs abroad as well. Especially offshore Business Process Outsourcing (BPO), back-office activity such as call-centre jobs and HR administration, is becoming increasingly popular.

The dominant argument for companies to move business processes offshore are lower production costs caused mainly by low wages in countries outside of Europe, the US and Japan. An average ICT worker in India earns one-seventh of the amount earned by his British counterpart, and a call centre agent even less. (Financial Times, 13-05-'03) According to the McKinsey Global Institute, companies can save over 45% on production costs when moving business segments offshore. (McKinsey, 2003)

But offshoring can offer additional commercial advantages, beyond simply cheaper labour. India, the country that profits of 90% of the revenues of all IT and service offshore activity, produces two million university graduates per year. Global companies can recruit the most talented employees out of this pool, for jobs that are – in contrast to their image in Europe and the US – considered high profile and desirable. “The issue now was not finding good people; it was filtering the excellent from the good,” states Mark Kobayashi-Hillary, who went to Bangalore to open a software facility and author of *Outsourcing to India: the Offshore Advantage*. (Observer, 04-04-'04)

Compared to businesses in mainland Europe, UK companies are more inclined to make use of offshore opportunities. Wipro, India's most successful outsourcing consultant, gets 12 % of its work from British companies, versus 20% from other Europeans. (The Economist, 04-03-'04) Given that the UK economy represents only one sixth of the west-European total, this demonstrates the unusually high propensity of British firms to off-shore business services. Britain's flexible labour laws partly explain the difference, as they make it relatively easy for UK companies to relocate jobs offshore. A second significant factor is the availability of an English-speaking population in countries as India, South-Africa and the Philippines, which makes it possible to outsource customer service activity such as call-centres.

Impact of offshore outsourcing on the UK economy

US market analyst Forrester has predicted that the number of American jobs outsourced offshore will grow to 3.3 million in 2015, compared to 315.000 in 2003. The number of ICT and back-office jobs relocated abroad will rise to 830.000 by 2005. (Forrester, 2004)

Although the scale of offshore outsourcing in the UK is much smaller than in the US, similar trends may be expected with regards to the British economy. Unfortunately there still exists a considerable lack of data regarding the scale of offshoring in the UK, due mainly to the negative image of offshoring and the sensitivity of the issue in business terms. A rough estimate was recently given by the Chancellor who stated that between 2 and 3 per cent (up to 5 million) of American and European service-sector jobs would possibly be outsourced offshore by 2015. (Speech Gordon Brown, 25-01-'04) A report of Evalueserve for NASSCOM, India's National Association of Software and Service Companies, estimated that 275.000 British jobs would be lost as a result of offshoring by 2010, of which 219.000 ICT and call-centre jobs. (Evalueserve, 2003)

What kinds of jobs are likely to be offshored? Apart from ICT and call centre jobs Britain may also expect to see a greater number of back-office jobs - such as HR administration, airline travel bookings and internal auditing - being

relocated overseas. Looking at trends in the United States, we might anticipate the same occurring for web-design and content, insurance claim processing, medical transcription, deposition summary (for legal firms) and geographical information systems (digital mapping of roads and townships). (ILO World Employment Record, 2001)

Classical economic theory preaches that offshore outsourcing by British companies in the context of free global trade will ultimately be to the advantage of everyone. From this perspective, it makes sense for businesses to compete internationally on the basis of cost effectiveness. According to the theory of comparative advantage, national economies should produce those products and services that they can produce most cheaply and effectively. This suggests that national or regional specialisation plays an important role in the international marketplace, and enabling national economies to compete on quality as well as cost.

If a UK firm moves part of its business to India to reduce production costs this should ultimately lead to cheaper products for British consumers, economic growth for both the host country and the UK, and eventually more jobs within the UK. A recent study by the McKinsey Global Institute broadly supports this argument. According to McKinsey, offshoring is ultimately a win-win situation, as every American dollar invested in offshore activity abroad leads to a return of \$1.12-1.14 to the US economy and a profit of \$0.33 to the Indian economy. (McKinsey, 2003)

However, McKinsey does acknowledge that offshoring results in job losses, at least in the short run. Job losses as a result of offshoring will be mostly felt on the regional level, particularly in areas that are dependent on the types of employment mentioned above. The South-East and London, the West Midlands and the North-West have the largest share of call centres in the country and are – if we believe the forecasts - likely to be affected by transitional unemployment in this sector over the next few years.

The public debate about offshoring

Public discourse about global offshoring has been predominantly negative. In the United States, the economy most affected by offshore outsourcing, the public debate has been focused on the loss of American jobs and its impact on the ICT and service sector. The federal government has been pressured by professional organisations and unions to put a legal stop to offshore outsourcing of American jobs. In response the US government recently passed a bill that forbids certain agencies of the Federal Government, including the departments of Treasury and Transportation, to subcontract work that has not previously been outsourced overseas outside of the United States. A number of American States plan to do the same.

Although the public debate about offshoring in the UK has not yet reached the same levels of intensity as in the United States, fears that British jobs would be 'stolen' by workers in low-wage countries are very much present. Stories about sweatshops run by multinationals in developing countries have added to the negative image of offshoring in Britain. A short analysis of the views of the key-players in the political debate is given below.

The position of the **Trade Union Congress (TUC)** in the offshoring debate is "practical and non-protectionist". In a recent paper on the issue (*Global Offshoring*, March 2004) the TUC states that a significant number of jobs are at risk of being offshored. Basing its figures on the predictions of the 2001 World Employment Report of the International Labour Organisation (ILO), and official statistics of workers in the private sector, the TUC states that between 150.000 and 750.000 British jobs (1 to 5 per cent of the total) could be affected by the offshoring trend. However, the TUC emphasizes the importance of valuing these numbers in context. The service sector is continuing to create jobs in the UK, with almost 800.000 created over the past three years; the UK records a £15 billion trade surplus in services ; and a recent study by Glasgow University has shown that offshoring has only marginally inhibited the growth of the Scottish call centre industry. According to the TUC, part of the hype around offshoring has been created by greedy consultants and commercial consultants wanting to drive up the numbers.

Despite some misgivings about the predicted scale of offshoring, the TUC accepts that it represents a significant trend, but that much depends on the response of government and industry. A lack of strategy and direction during the industrial transformations of the 1980s and 90s has, according to the TUC, led to long-term unemployment in certain traditional industrial regions. In order to avoid a similar scenario today, the TUC demands that the government draws up a strategy statement in cooperation with the main stakeholders. This document should include policies to help improve companies' global competitiveness and stimulate different kinds of employment at the local level. The TUC also requests more government support for local businesses in terms of staff upskilling and extra training and a 'code of best practice', drawn up by government and other parties involved to encourage fair and transparent conduct when a company is planning to move business offshore.

The TUC wants businesses to ensure that the decision to offshore is made on the basis of a clear assessment of the advantages and disadvantages, as well as a consultation round with staff and trade unions. Companies should make sure that jobs lost as a result of offshoring are replaced by others and should offer training opportunities for staff to upgrade their skills so that they can move up to high value added jobs.

Amicus, the union for the financial services industry, has been one of the more critical members of the TUC. Amicus recently launched a national campaign to call attention to the negative impacts of offshoring jobs. According to Amicus, 15.000 jobs were offshored between October 2003 and the February 2004, while 200.000 jobs will have been lost by 2010. Offshoring of call centre jobs is for Amicus “the least of our worries”. According to Amicus, ICT means that nearly any job is now at risk of being offshored.

Together with a number of MEPs, Amicus launched a European campaign to raise awareness about the risks of global data traffic without sufficient protection this April. David Fleming, National Secretary for Amicus declared: “Offshoring is an accident waiting to happen. It is only a matter of time before a serious crime is committed, which ruins the reputation of the British financial services industry.” (Statement Amicus, April 2004)

Amicus has also criticized British companies for not doing enough to protect their employees against the effects of offshoring. Companies should, according to Amicus, incorporate the risks that offshoring poses to their employees in their social responsibility strategy. They should hold consultation processes if planning to move jobs offshore, provide in-house training to offer employees to update their skills and avoid compulsory lay-offs wherever possible. (Roger Lyons, Amicus Joint Secretary/ President of the TUC in a presentation for the Foreign Policy Centre, 04-03-'04)

According to the **Institute of Directors (IoD)** offshoring should be beneficial to both the UK and the host country in the long run. However offshoring can only have a positive effect if the UK moves further up in the value-added chain. At the moment, cost efficiency is not the sole reason for companies move business offshore. Certain skills are difficult to find in the UK and easily available abroad. Only if Britain makes up for its skills deficiencies can offshoring have a positive effect on the British economy. The IoD finds that the government has reacted well to the dynamics of the current debate. Protectionism is out of the question, given that the government seeks to facilitate an environment in which business can flourish. But addressing issues such as skills shortages is part of that role. The IoD plans to launch report on offshoring during the course of the summer.

The **Confederation of British Industry (CBI)** takes a similar position in the debate on offshoring. According to the CBI offshoring is a natural result of the development of the global market place and offers British companies opportunities to stay competitive, which is ultimately to the benefit of the UK economy.

Current fears that offshoring might lead to large-scale job losses in the UK are, according to the CBI, not always justified. Certain companies might have relocated a part of their call-centres to India recently, however we should not forget that most jobs, even those in the call centre sector, remain in the UK. It

is important to keep this in perspective. Also, the CBI has its doubts about forecasts and predictions about the scale of offshoring. Tracing the business activities of an international firm is extremely complicated and jobs lost overseas might be compensated for by new jobs created at home that the figures do not take into account.

The CBI does not see a specific role for government in the debate on offshoring. Government should acknowledge the impact of offshoring on the UK economy, but it should refrain from posing legal restrictions, as seems to be the trend in the US.

The CBI plans to hold a survey among its members in autumn 2004 to collect first-hand stories, as so little is known about British companies' experiences in the offshoring business. It will also pay attention to the issue at its yearly conference in November.

So far, the **Department of Trade and Industry (DTI)** has issued two key documents on offshoring:

In the consultation document, *Services and Offshoring: The Impact of Increasing International Competition in Services* (December 2003), the DTI gives a first analysis of the effect of offshoring on the British service industry and identifies areas of further research. The DTI acknowledges and regrets the job losses that have followed offshore relocation of service-sector activity. However the Department emphasizes that it is important to look at the whole picture. According to international figures (official statistics for the British service industry are still not available), British service imports and exports have both increased rapidly, but in a similar pace, between 1990 and 2002. What's more, British service imports are today worth £15 billion less than British exports and Britain is still the number two exporter of services in the world. Thus the DTI underlines that offshoring is not a "zero-sum game": it can drive up productivity and total employment in the long run, and allows UK industry to remain a competitive player on the global market.

The DTI clearly denounces protectionism, stating that its effects on the British economy would be entirely negative. Trade barriers are very costly and could force British companies leaving the country if doing business from abroad would become more profitable. "We cannot compete on low wages and nor should we try to", the DTI writes, instead "we have to do even more to build strong, sustainable economies in all the regions of the UK. To raise the business birth-rate, to forge strong partnerships between regional universities and business, develop the skills that the regional economy needs, to attract more inward investors and improve the local infrastructure - in other words, to create a virtuous circle of better skills, better jobs and better, more profitable businesses." To areas that are particularly affected by the offshoring trend the DTI will focus on the creation of new jobs and new skills.

The paper calls for contributions of employers, employees and interest groups to add their views. The consultation round closed on January 30 2004 and is awaiting a government response.

The most recent report of the DTI on offshoring, *The UK Contact Centre Industry – A Study* (May 2004) assesses the competitiveness of British call centres and makes some forecasts for the future. The call centre industry is an important branch of the service sector, accounting for 790.000 jobs. The sector has grown rapidly since the 1990s and is expected to grow by another 70.000 jobs in 2004.

As an increasing number of call centre jobs are being relocated offshore, concerns among call centre workers have risen. But the exact impact of offshoring on the call centre industry is, according to the DTI, difficult to measure. Figures on the scale of offshoring of UK businesses are not that easy to find, not least because of the commercial sensitivity of such numbers. And because offshoring as a trend is relatively new, making predictions about future developments is tricky. The future of offshoring depends on a number of factors. For instance, technological developments, such as voice self-service machines, might further drive back the need for low-skilled call centre jobs in Britain. Call centres offshore are likely to make improvements in the quality of their work, while wages are expected to stay low for at least the immediate period ahead. This makes offshoring as a long-term investment for companies more attractive. But then there are many factors that count against offshoring - hidden costs, cultural differences, links with the local area – that are keeping companies from moving business offshore, and will continue to do so in the future. And much depends on the attitude of the British consumer. A survey of Contact Babel (April 2004), a UK analyst focusing on the contact centre industry, found that 26% of British consumers are planning to change supplier because of negative feelings towards their current supplier's offshoring activities.

The DTI states that what's happening to the call-centre industry now is very different from what happened to the British manufacturing industry. Whereas offshoring of manufacturing activity is generally to the direct benefit of the consumer (because they pay a lower price for the same product), there are no visible consumer advantages to moving call centres offshore. Equally, the nature of the call-centre industry – the 'product' cannot simply be replaced if something is wrong with it – makes calls received by a call-centre agent in India more vulnerable to customer dissatisfaction than was ever the case with manufactured products.

However trends in offshoring develop, it is clear that the future of the British call centre industry lies in high value added jobs, such as those in sales and maintaining customer relations. Whereas UK call centres cannot compete on

low wages, they can compete on quality and skills. If the industry wants to keep its competitive advantage in the long run, call centres will have to invest in skills, training and qualifications, thus creating opportunities for personal growth, more value-added positions and better service to customers.

Conclusion

From nearly any perspective, offshoring is a social and economic fact of our times. The globalisation of production is a trend that has been on the rise for decades, and one which has always benefited from technological innovations such as containerisation in shipping. What ICT enables for the first time is the globalisation of services, which causes understandable anxiety in an economy that is ever more dependent on service sector jobs. Government has few policy tools to affect offshoring, and we lack decent evidence on how much of it we can expect to see over the next few years. All of this can contribute to a sense of fatalism.

The economic rationale for offshoring has not been disputed. Critics of the practise stress the social rather than the economic arguments against it. So the question for the foreseeable future is where the limits of offshoring lie, and how those limits will come about. Consumers' loss of patience with ever more detached companies may provide the break. Meanwhile, the UK must continue its pursuit of a high road to full employment, based around high value-added jobs which can't be provided competitively elsewhere.

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