

Offshoring, a threat for the UK's knowledge jobs?

the work foundation



Globalisation and the extent and impact of offshore outsourcing

A working paper prepared for the Knowledge Economy Programme

Katerina Rüdiger

June 2007



Contents

Preface	3
1: Offshore outsourcing: the India phenomenon	4
2: Myths and perceptions	11
3: The extent and impact of offshoring	14
Conclusion	27
Contact details	30

Preface

Global changes in the location of production and the outsourcing of tasks to low-wage countries have dominated the public discourse for some time. Especially the relatively recent IT boom in India, which has led to some media hype, nurturing a fear in high income countries such as the UK that even relatively high-skilled, well-paid jobs are now also under threat by this next wave of technology driven globalisation.

This paper aims to provide a big picture account of this phenomenon by examining the extent and the nature of offshore outsourcing as well as its impact on the UK labour market.

It aims to provide a reasoned critique of existing literature on the topic, based on official trade data and interviews with business experts carried out in India in May 2007.

1: Offshore outsourcing: the India phenomenon

A flat world?

Gurgaon, a business quarter like any other, with high, modern office buildings, bustling with smart office workers, could be found anywhere in the developed world. Yet, this hub of activity is located 30km South-East of New Delhi, in a country that figures on rank 126th out of 177 countries on the Human Development Index; a third of the population still lives below the poverty line and salaries are a fraction of those in OECD countries¹.

This new business area is home to Evalueserve, a *Knowledge Process Outsourcing* (KPO) company, specialising in a range of knowledge intensive business services. For a few thousand dollars, Evalueserve's team of Indian patent attorneys, engineers, and business analysts provide an independent appraisal and market research for new products in the US and Europe.

According to its COO, Ashish Gupta, the company, founded three years ago by a former director at IBM and a former partner at McKinsey's, is one of the pioneers leading a growing trend of offshore outsourcing of knowledge services².

'It is already happening' Mr Gupta claims, when asked to comment on Western fears of the future offshoring of knowledge intensive service jobs, 'anything which does not involve customer face-to-face relations can and will be offshored'. In this sense he echoes Alan Blinder's prediction, which caused a stir on both sides of the Atlantic, that a tidal wave of offshoring will sweep away high quality knowledge intensive jobs in the developed world³.

Indeed, according to Mr Gupta geographical and even cultural differences are less important, 'the world is flat' he says, quoting another famous American commentator, as more and more service jobs are becoming tradable thanks to advances in technology⁴.

'India shining'

The case of Evalueserve ably demonstrates the changes that have taken place in the Indian economy since its liberalisation in 1991. This phenomenon has been promoted as 'India shining', a slogan used by the then ruling Bharatiya Janata Party (BJP) in the 2004 general elections, fuelling talk about India as an emerging global economic superpower.

¹ See *Human Development Index 2006* and The World Bank's India data fact sheet

² Interview with Ashish Gupta, carried out on 3 May 2007

³ Alan S. Blinder 'Offshoring: The Next Industrial Revolution?' *Foreign Affairs*, March/April 2006

⁴ See Thomas L. Friedman, 'The World is Flat: A Brief History of the Twenty-First Century', 2005

The emergence of the IT sector in India has captured the world's attention. One of the world's poorer countries became almost over night a global hub for information technology industries and business services.

A new wave of globalisation?

However, even though anecdotes may tell us something about change in the world they do not constitute an adequate basis for policy making, nor do they provide accurate information about the extent of offshoring.

Indeed, information about the extent of offshoring and outsourcing can be patchy and the 'evidence' often has an ulterior purpose.

The questions we should therefore ask are: can these individual cases be extrapolated into a worldwide trend and are the consequences irretrievably damaging for Europe and the UK?

In the absence of official statistics on offshoring, this paper aims to address some of these questions, looking at the true picture beyond the myths and misconceptions.

In the recent past the policy response to 'globalisation', offshoring and outsourcing has focused on the importance of the knowledge economy. The EU's Lisbon strategy is decisively oriented towards the development of human capital and the encouragement of research and innovation. It is said that this is the only way that Europe can remain prosperous in the future.

However, in the light of the perceived threat of offshoring of knowledge jobs, some commentators have started to question whether this remains an adequate policy response, or whether this has already been overtaken by the next wave of technology driven globalisation that will see more high skilled and well paid jobs – for example, in areas such as law, medicine and IT – migrating to the developing world.

Will we all find ourselves as hairdressers, cleaners and carers in the future just because these jobs cannot be contested in global markets?

We believe the answer to these questions is no, as we will further explain in the remainder of this paper.

We also think that a debate focused on winners and loser *between* countries is wrong and misleading. Policy-makers should rather focus on the losers of structural change *within* a country, creating a new narrative and adequate policy choices for the knowledge economy and globalisation.

The concept of outsourcing....

The concept of outsourcing draws on David Ricardo's well-known theory of comparative advantage which states that even if a country could produce everything more efficiently than another country, it would still reap gains from specialising in what it was best at producing and trading with other nations.

But the meaning of the term has changed over the years. Today 'outsourcing' means that another company is made responsible for the implementation of a business process or a specific task, albeit under strict guidelines from the outsourcing company.

This is said to allow the outsourcer to optimise expertise and competencies, but also to reduce cost, especially when the sub-contracting company operates in another country – offshore – where labour cost and general expenses are lower.

'Outsourcing' and 'offshoring' are often used interchangeably in public discourse. 'Offshoring' describes the transfer of a business process to another country, regardless of whether the work stays within the same corporation or not, ie the task could also just be transferred to one of the company's offices abroad.

.....and the reasons for doing it offshore

To this date, the phenomenon of labour arbitrage – the huge wage gap between industrialised and developing countries – has played an important role in offshore outsourcing. This is why Alan Blinder has called the phenomenon of offshore outsourcing 'the migration of jobs, but not the people who perform them, from rich countries to poor ones'.⁵

⁵ Alan S. Blinder, 'Offshoring: The Next Industrial Revolution?', *Foreign Affairs*, March/April 2006

Offshore outsourcing: the India phenomenon

Change of location	Change of ownership	
	No change – own company	Change to another company
Same country	Internal relocation	Outsourced
Other EU country	Offshored	Offshored and outsourced
Outside the EU	Offshored	Offshored and outsourced

Source: Restructuring and employment in the EU: Concepts, measurements, and evidence, The European Foundation for the Improvement of Living and Working Conditions.

Developing countries such as China, Vietnam, South Africa, Malaysia and the Philippines are increasingly getting involved at the lower end of offshore activities, but India has been to date the biggest beneficiary of offshore outsourcing.

The Information Technology Enabled Services (ITES) or the business process outsourcing (BPO) industry arrived in India with the first wave of call centres in 1999. India's advantage was its abundance of English speaking, relatively high skilled, low cost workers.

Services are, by nature, highly labour intensive which makes human capital the highest cost factor. Relocating part of their business process to low labour cost countries is thus for companies financially very attractive.⁶

For example, as shown below, the salary for an experienced IT professional in India is at \$36,000, only 13% of what employers would have to pay their staff in the US or the UK.

On the demand side, the sectors which have been involved in offshore outsourcing are predominantly banking and financial services in general, as well as legal services and utilities (for instance billing). On the supply side, service providers include IT services companies, international consultancy firms, specialist BPO companies, and IT/BPO divisions of large groups (for instance Lufthansa or British Airways).

⁶ Corporate Partners Research Programme: 'Outsourcing and Offshoring, Implications for organisational capacity', The Work Foundation, January 2004

Comparative pay rates in India and UK/USA

Occupation	Salary in India	% of UK/US salary
Call Centre Operators	60p to £1.25 per hour	13-20%
Software Engineers	£5,000 to £15,000	15-17%
Experienced IT Manager	\$36,000	15%
Accountant	\$5,000	12%
Market Research Analyst	\$12,000	13%
HSBC average	£2,500	14%

Source: Corporate Partners Research Programme: Outsourcing and Offshoring, Implications for organisational capacity, The Work Foundation, January 2004

Moving up the value chain: from call centers to market research

Today, Indian companies are increasingly offering a variety of outsourced services ranging from customer care, transcription, billing services and database marketing, to web sales, marketing, accounting, tax processing, transaction document management, telesales/telemarketing, HR hiring and biotech research.

Indeed, increasing demand meant that even already big IT companies in India integrated BPO in their business model, explains Anand Dalmia from Avendus Advisors an Investment bank specialised in the ICT sector⁷. BPO has thus become a very important part of the export-oriented IT software and services environment. It initially began as an activity confined to multinational companies, but this, as well as the spectrum of services offered by Indian companies has evolved substantially.

This does not seem to be the only shift underway, as Indian business insiders think that the labour cost arbitrage factor will become less and less important over time. Indeed, in future the emphasis will more and more lie in the quality and variety of the services available: 'offering a platter of services enables BPOs to get more profit and better contracts⁸'.

The reasons why companies offshore are increasingly complex too. Some companies want to liberate expensive analysts, engineers, and salesmen from routine tasks, so they can spend more time innovating and dealing with customers.

⁷ Interview with Anand Dalmia on 2 April 2007 in Mumbai

⁸ Information collected during interviews

However, for other companies it might be an issue of survival, claimed Ashish Gupta. One of his company's clients for example, a relatively small company, offshored twenty jobs to India, in order to save the remaining eighty employees, as global competition increased pressure on profit margins.

Offshoring, it is said, allows companies to work round-the-clock shifts, sending data back and forth from one place to another and thus to increase their productivity.

Towards a global service delivery model

UK companies do not solely have the simple option of outsourcing to a purely Indian service company, or to a purely UK service company. Most outsourcers can offer a mix of different locations in both the UK and India (or elsewhere), which can combine the cost advantages of cheaper labour in the offshore location with the control advantages and client interface possibilities of a UK presence.

Vakul Sharma, an Indian lawyer mainly dealing with outsourcing contracts and author of a forthcoming book on outsourcing models, agrees that there is a new outsourcing model emerging, as the current system is not sustainable in India.

He believes that there will be some offshoring of knowledge jobs but not on a large scale and that the new outsourcing model will be different.

For example, an Indian IT company may well have a base in that country but may also operate a number of satellite operations overseas and invest directly in operations in the European or US market. Wipro are already showing that this new model can work as illustrated by their 'string of pearls' strategy of targeted overseas acquisitions.

A further conclusion that we might draw from this experience is that cultural differences matter after all. Further support for this can be found in the phenomenon of 'nearshoring', where companies that are uncomfortable with distant offshoring, go for an option closer to the home market⁹.

Companies can still secure substantial cost savings if they locate in North or South-eastern European countries such as Estonia or Romania. Both countries

⁹The Economist Intelligence Unit, 'The new face of offshoring, closer to home?', The Economist, 2006

offer high skilled low-cost labour, cultural understanding and a proximity to affluent Western European markets. Distance still seems to matter – geographical closeness allows the outsourcing company to manage their supply chain effectively and exercise more control over the process.

However, Anand Dalmia argues that 'nearshoring is not the future of offshoring'.

The future is likely to be more complex, with companies combining packages of nearshore and offshore activities to meet their specific demands and making use of the advantages of different locations to ultimately optimise their business models.

Cost arbitrage will thus be less important, with companies applying models like 'dualshore', when a company has for example operations in India and the US, or 'bestshore', a combination of nearshore, offshore and operations in the country of origin.

More than forty per cent of the companies involved have already an element of global service delivery. Although companies are planning to increase their use of offshoring, they are also re-adjusting their division between onshore and offshore operations, a survey by the sourcing advisory firm TPI found out. Half of the survey respondents expect to bring some functions back to the UK in the next five years as their global sourcing strategy develops.¹⁰

Indeed, companies are definitely 'moving towards a global service delivery model'. A good example for this is TransWorks, one of India's leading outsourcing companies, which has operations in forty countries with a third of its revenues coming from outside India¹¹.

¹⁰ British Computer Society, 'Embracing the challenge, exploiting the opportunities: Building a world class IT profession in the era of global sourcing', Second Report, May 2006

¹¹ Interview with Anand Dalmia, Avendus Advisors, carried out on the 1 May 2007

2: Myths and perceptions

If outsourcing tasks makes companies more competitive by increasing productivity and providing better service to consumers, surely offshoring is, on balance, beneficial for our economy? So, why does offshore outsourcing get such a bad press?

**Job creation
abroad = job
destruction at
home?**

The clue, of course, lies in the meaning of the word 'offshore'. According to the Oxford Dictionary this means: 'made, registered or situated abroad' or, if taken literally 'away from a distance from the coast' – describing the feelings of distance and loss of control often associated with offshore activities.

Technological advances combined with foreign direct investment in developing countries like India contribute to a record economic growth (9.2% in 2006 for India) helping on balance to improve the situation for many poor people. But this causes anxiety in developed countries, where people associate job creation abroad with domestic job destruction.

Winners and losers

As long as jobs are outsourced within the same country, people do not feel threatened, however, if these jobs move abroad, there is the feeling that somehow the national economy and workforce must be losing out.

This is based on the idea, that there is only a limited quantity of prosperity in the world and, following this logic, the improvement of the economic situation of developing countries automatically implies a worsening of our situation.

Indeed, bestselling books like 'Weltkrieg um Wohlstand' (Global War on Wealth) which caused a sensation in Germany last year, instigate and exacerbate those fears and misconceptions. 'Winners and losers have traded roles in the war for wealth. The new strengthening of Asia leads to a weakening of the West' claims Gabor Steingart, the author and chief of the Berlin bureau of the German weekly newspaper.¹²

Some of the fears are, of course, not entirely unreasonable. The processes accompanying economic globalisation can create winners and losers by accelerating structural change and one of the big political questions is how to address this seriously.¹³

¹² Gabor Steingart, 'Weltkrieg um Wohlstand (war for wealth): wie Macht und Reichtum neu verteilt werden', Piper, September 2007

¹³ See Joseph E. Stiglitz, 'Making Globalisation work', W.W Norton, September 2006

But limiting the debate to winners and losers between countries is not only unhelpful but also allows racism to raise its ugly head.

Populist publications may claim that they are advancing well-supported arguments, but the 'evidence' they adduce, more often than not, consists of statistics taken out of context, anecdotes generalised as trends or the aggressive public relations material of outsourcing companies and management consultants.

There is plenty of rhetoric to nurture the myth that the near future will see millions of jobs move abroad, leaving displaced workers at home struggling to sustain their lifestyle.

Politics of fear

Politicians, taking protectionist stance, are also partially responsible for the negative media attention offshoring has received within the last few years. This is particularly true in continental Europe, where blaming domestic problems on external forces is easier to sell to the electorate, than advocating the need for drastic and often painful reforms to address home-grown ills. Emotions such as fear are universal and a lot easier to manipulate than reality and figures.

This was amply demonstrated during the recent French election campaign, where both presidential candidates resorted to protectionist rhetoric. Ségolène Royale threatened to tax companies who offshored activities and Nicolas Sarkozy promised to 'protect' workers from job losses due to 'delocalisation'. Indeed, his winning strategy was to portray himself as 'President protecteur', appealing to the masses.¹⁴

In the US, the Senate has already tried, albeit unsuccessfully, to impose restrictions on the offshoring of federal contracts. In the UK the debate has been more subdued than the discussion in continental Europe or US. Indeed the British government has made it clear that it will not pass protectionist legislation¹⁵.

Nevertheless, a recent survey conducted in the UK by Deloitte and YouGov revealed that the fear of job losses to offshore countries is not only limited to the US or continental Europe, where unemployment is higher. According to the result of the survey, the UK public perceive offshoring as an 'increasing threat'. 82% of

¹⁴ Editorial, 'Changer', Le Monde, 07.05.2007

¹⁵ IMF Working Paper, 'Fear of Service Outsourcing: Is it Justified?', Mary Amiti and Shang-Jin Wei, 2004

the people questioned believed that 'enough jobs have moved offshore already'. One in three people went even further, saying that UK companies should 'be forced to bring jobs back to the UK'.

Those fears are further fuelled by the management consultants themselves, with a partner at Deloitte's claiming that 'we can expect a massive increase in offshoring in the financial services sector alone'¹⁶. In 2003, Deloitte and Touche had already predicted that 2 million jobs could move from Western economies to low-wage countries by 2008.¹⁷

¹⁶ Deloitte UK, 'UK population feels increasingly threatened by offshoring', News release, Deloitte November 2006

¹⁷ Corporate Partners Research Programme: 'Outsourcing and Offshoring, Implications for organisational capacity', The Work Foundation, January 2004

3: The extent and impact of offshoring

The current debate on the shift of high skilled service jobs to low-cost countries is not solely limited to the media and the political realm. Well-known economists world wide are struggling to agree when it comes to the extent and the impact of the phenomenon.

A recent paper by the Economic Council of Finland prepared for the Finnish Presidency suggests that the rapid increase in world trade since the mid 1990s has been associated with what is called the 'great unbundling'. This means that commercial activity is being dispersed around the globe as part of complex integrated production systems within multi-nationals¹⁸.

So for example, high value added parts and components are shipped from the US, EU and Japan to low cost routine assembly operations in non-OECD Asia, they are then returned to Western markets where the final high value added marketing, design and servicing elements are added. As a result, international trade becomes even more dominated by intra-company trade in intermediate goods.

The paper argues that the fall in the cost of trade and the development of enabling ICT technologies were the triggers for the unbundling of manufacturing in the North. The effect was to increase the differentials in wages and productivity between locations in the North and South as productivity enhancing ICT could now be combined with cheap skilled labour in locations remote from consumers of the final product.

These changes weakened the agglomeration forces that conventionally limited the distance between producers and consumers.

Moreover, the fall in trade costs reduced 'home market magnification' – the ability of firms in large home markets to exploit economies of scale to sustain a dominant position. As trade costs and other barriers fall firms find it easier to move, more competitors are able to enter domestic markets and the home advantage declines.

It seemed clear that the likely winners from this process would be educated high skill workers in higher valued industries and the losers would be less educated,

¹⁸ Richard Baldwin, 'Globalisation: the great unbundling (s)', Prime Minister's Office, Economic Council of Finland, September 2006

low skill workers in low value added industries. The associated restructuring was taking place primarily at the sectoral level.

EU governments saw the response as more investment in education and a continued push towards knowledge based economies that would be less vulnerable to increased North-South trade.

However, the second great unbundling outlined in the paper for the Finnish presidency, is one where tasks rather than industries are moved to low wage locations, reflecting falling costs and advances in information and communication sectors.

The offshoring and outsourcing of service tasks, the paper argues, are cross sectoral, unpredictable, and do not respect educational levels. Individuals within firms rather than firms within sectors bear the impact.

However, the evidence suggests that most of the job losses in European manufacturing so far are as a result of productivity improvements driven by new technologies and shifts in market growth as consumers in richer economies switch from spending on goods to services. Bob Rowthorn and Ken Coutts from Cambridge University estimate that between 10 and 30 per cent of jobs lost in US and European manufacturing can be attributed to trade (including both North-North and North-South)¹⁹.

In other words, even if China had remained a closed economy, manufacturing across the OECD would have experienced significant falls in employment.

Will we all be 'Bangalored'?

The current economic debate on the topic was triggered by a study carried out in 2002 by a US research group called Forrester. The study claimed that within the next 15 years, 3.3m American white-collar service jobs (500,000 of them in IT) would move offshore to countries such as India, leading to an 'overseas exodus'.²⁰

Two years later the research group released a study with similar disastrous predictions for Europe. By 2015, Europe will lose a collective number of 1.2 million

¹⁹ Ken Coutts and Robert Rowthorn, 'Growth and The Balance of Payments: The Role of Manufacturing', Paper for The Cambridge-MIT (CMI) Conference, Manufacturing Matters, New Hall, Cambridge, July 2002

²⁰ John McCarthy, '3.3m US Services Jobs To Go Offshore', Forrester Research, November 2002

jobs to offshore locations, the report stated, as European firms increasingly rely on offshore service providers. This trend will predominantly be driven by financial firms in the UK, displacing employees from their current roles.²¹

Alan Blinder, the US economist and former advisor to Bill Clinton, has supported this apocalyptic prediction with his provocative thesis that offshoring of service sector jobs will lead to a 'third Industrial Revolution'.

A third of American jobs will be shipped abroad, he argues, triggering a deep transformation comparable to the transitions from agricultural production to industrial manufacturing and the subsequent shift from manufacturing to services.

According to Blinder, we have so far 'barely seen the tip of the offshoring iceberg, the eventual dimensions of which may be staggering.'²²

For him, offshoring is not just an extension of trade but symbolises the new 'man-made comparative advantages' that have nothing in common with the comparative advantage of the past shaped by natural conditions, such as resources. Whereas in the past a comparative advantage would shift back and forth, today's advances in technology will constantly increase the tradability of services previously thought of as non-tradable, regardless of whether they require high levels of education or not.

According to Blinder, this will have very disruptive consequences for wealthy societies because of the sheer number of jobs involved. Governments and societies must thus adapt rapidly to those new realities to avoid a decline in real wages as more workers have to seek employment in personal services which remain non-tradable.

Conspiracy or a theory based on facts?

The media frenzy created by these predictions easily conveys the impression that offshore outsourcing in the service sector has exploded over the recent years. All stakeholders involved seem to agree that this is either a 'fact' or an irresistible 'trend' or both.

²¹ Andrew Parker, 'Two-Speed Europe: Why 1 Million Jobs Will Move Offshore' Forrester Research, 18 August 2004

²² Alan Blinder, 'Offshoring: The Next Industrial Revolution' Foreign Affairs, March/April 2006

Management consultants claim that their clients offshore more and more jobs, business insiders and BPO companies in offshore locations confirm this. Overall economic growth and a boom in the IT sector in countries like India seemed to show the results and future trends of offshoring. Politicians in developed countries promise to 'protect' us from jobs being shipped abroad; NGOs and trade unions lobby against offshoring and economists provide gloomy forecasts.

The absence of official statistics on offshore outsourcing leaves a lot of room for speculation, supported by the interpretation of various indirect measurements and 'evidence'.

First, evidence collected through case studies often provides a distorted picture. The experience of individual companies may or may not reflect a trend in a specific sector but it cannot allow us to draw conclusions for the economy as a whole – to do so would hugely exaggerate the scale of offshoring.

Second, management consultants have conducted most studies on services offshoring and employment effects. Their objectivity and ability to reflect a broader trend is again somewhat limited.

Thirdly, visitors who go to place like Bangalore, dubbed the Indian 'Silicon Valley'²³, where the main activity in the Indian IT sector takes place, might forget that two thirds of the Indian population still work in agriculture. The New York Times columnist and writer Thomas L. Friedman falls into this trap when he visits the campus of Infosys Technologies and notes that 'the world is flat' meaning that knowledge work can be produced anywhere in the world as the global competitive playing field is starting to level.²⁴

Friedman lists the end of the cold war, the development of global supply chains and advances in technologies amongst the factors which, according to him, work as 'flatteners'.

This might be true for mundane tasks, the World Bank concludes in their recent Global Economic Prospects forecasts, but otherwise they disagree with Friedman's

²³ 'Boomtown Bangalore', Le Monde, 25/04/07

²⁴ Thomas L. Friedman, 'It's a Flat World, After All', The New York Times, 3 April 2005

view of the world: the landscape is still 'hill and mountains', where endowment, human capital and policy still matter'²⁵.

Knowledge itself is a unique factor of production in the sense that its value does not diminish, but it also distinguishes itself from information by empowering actors for intellectual and physical capacity. As a great deal of knowledge is tacit, and therefore difficult to transfer, its reproduction can be extremely costly²⁶. It also needs an environment in which it can be harnessed effectively.

Despite having a relatively highly skilled workforce, low-cost offshore locations like India still have a long way to go in creating a knowledge based economy and strong basic education systems are a necessary pre-condition for that. Today, fractionally more than 1 in 2 people are able to read and write and the pool of skilled labour is almost exhausted. According to a recent World Bank publication, India is at the bottom end (rank 98 out of 128 countries) of an index that measures the ability to create, absorb and diffuse knowledge.²⁷

BPO companies in offshore locations often have very aggressive business PR in order to portray a specific image of their country that might not correspond to the reality. So appearances can, in this case, be deceiving.

The truth, in fact, is much more complicated and rather less exciting.

Measurement problems

There is a clear problem when it comes to the measurement of offshoring. It is generally difficult to capture information from within a company and data on business processes that are contracted out is not readily available.

In order to try and measure the scale of offshoring we therefore need to rely on indirect measures, such as trade in services and foreign direct investment.

Offshoring activities are therefore best measured in the patterns of cross-border trade in services. Economy-wide measures such as a country's balance of payments can help us to understand patterns of cross-border trade. Only by using those measures, can we make any judgment about the scale of offshoring.

²⁵ 'Global Economic Prospects, Managing the next wave of Globalisation', The World Bank, 2007

²⁶ Dominique Foray, 'The Economics of Knowledge' MIT Press, September 2006

²⁷ Carl Dahlman and Anuja Utz, 'India and the Knowledge Economy: Leveraging Strengths and Opportunities, Overview', WBI Development Studies, The World Bank Institute, April 2005

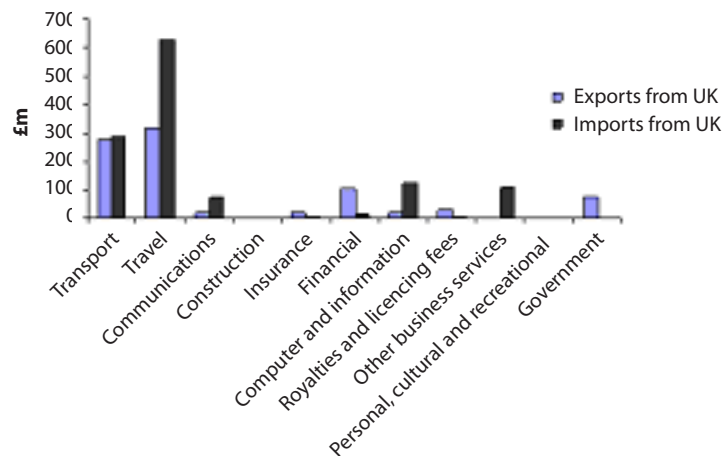
The impact on trade

If the outsourcing of tasks by UK-based companies to offshore locations such as India is soaring, then the UK should be importing more of these services from India.

An analysis of the UK's current account shows that in 2005, UK imports of computer and information services from India, were £122 million in current terms. Indeed, this figure appears to be more than six times higher than the UK's export of those services to India (£20 million).

This, however, is a good example, of quoted trade figures, taken out of context failing to give the whole picture. Looking at the total value of the UK's service imports from India the figure of £1,247 million is not significantly higher than the UK's services exports to India (£1,102 million) and perhaps most importantly, computer and information and other business services are not the largest share of services imported. Travel (£626 million) followed by transportation (£289 million) are the UK's biggest imports from India²⁸.

Export and Import in Services



Note: there is no data readily available for country to country export of other business services, personal, cultural and recreational and construction. For the imports from India there is no data break down available for construction, personal, cultural and recreational and government services.

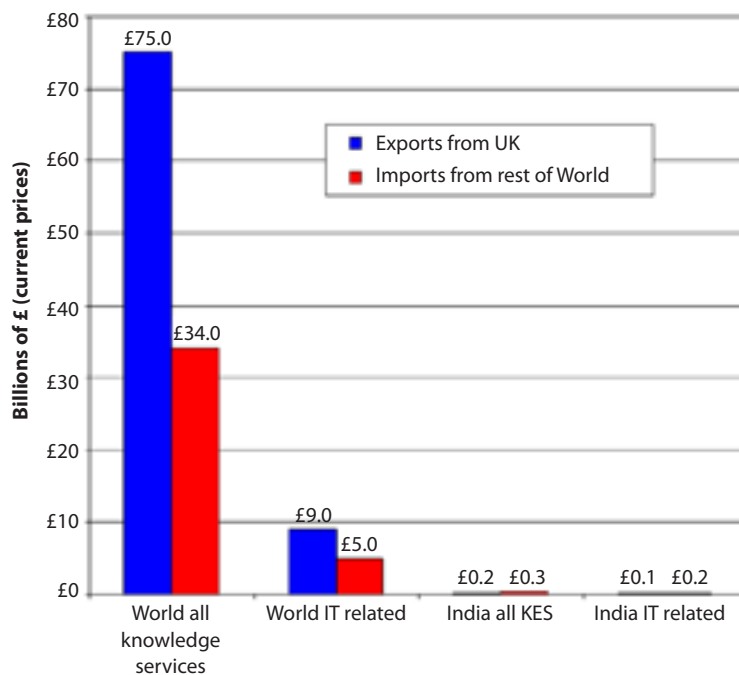
Source: Pink Book: 2006 edition, Office of National Statistics

²⁸ Table 9.11, Chapter 9: Geographical breakdown of current account, The Pink Book: 2006 edition, Office of National Statistics

The extent and impact of offshoring

If compared with services imports from other countries, the small scale of these imports becomes even more visible. The UK imports almost four times more computer and information services and over sixteen times more other business services from Germany. This is why India only rates 15th in the ranks of service exporters to the UK.

UK-India knowledge services trade in 2004



Source: Pink Book, 2006 edition.

Financial, business, high tech, cultural services and royalties and licence fees. IT related are computer, information, and communication services.

This is not to deny of course that there has been an increase in the import of services from India over time. However, the scale is small (an increase from 1995 to 2004 of about 1.2% of imports) and the overall percentage of trade in services is still not significant enough to speak of as an explosion of offshore outsourcing activities.

There are, however, as mentioned above certain, caveats when using these indirect measures to establish the scale of offshoring.

Trade figures can only serve as an indicator and they have a certain weakness, as they might not be able to capture some of the movements within firms. They can also lead to underestimation of the value of offshoring, as the cost of importing services is likely to be lower than the cost of purchasing them domestically. Unfortunately, there is no data on the quantity of the imports of the UK available, as they would most likely reflect a more accurate picture than the value of imports expressed in currency (Million GBP).²⁹

As seen earlier, labour cost and production costs are much cheaper in India compared to the UK, which could mean that imports expressed in current currency might not give us the right impression of the actual amount of services imported to the UK.

But on balance, even when taking into account those weaknesses, the figures provide a good picture of the scale of offshoring and its complexity.

A more important phenomenon is a general increase in trade in services – in other words a rise in both imports and exports of services.

For example, the UK has emerged as the world leader in 'knowledge services', mainly financial services, and business and computer services. Between 1995 and 2005, exports of these services grew by over 100% in current terms compared with just over 50% for more traditional service exports such as transport and travel. In current terms, knowledge based service exports were worth £76 billion in 2005³⁰.

As the International Monetary Fund (IMF) observes, trade in services is a two-way street, just like trade in goods. Indeed, their trade data analysis shows that most outsourcing countries also receive outsourcing of services from other countries. Their data furthermore shows that the top recipients of global service outsourcing tend to be rich, industrialised countries, rather than poor developing countries. It ranks India as sixth for global 'insourcing', behind the US, UK, Germany, France and the Netherlands who appear to be the top recipients of offshore outsourcing³¹.

²⁹ Mary Amiti and Shang-Jin Wei, 'Fear of Service Outsourcing: is it justified?', IMF Working Paper, October 2004

³⁰ Ian Brinkley, 'Defining the knowledge Economy', The Work Foundation, 2006

³¹ Mary Amiti and Shang-Jin Wei, 'Fear of Service Outsourcing: Is It Justified?', IMF Working Paper WP/04/186, October 2004

Knowledge economies are by nature open economies, trading in knowledge and ideas, which is why we might see an increase in outsourcing and offshoring activities. This has been reflected in an increase in foreign direct investment (FDI) in services, in the UK from 10.8% in 1995 to 42.3% in 2003.³² Obviously, FDI creates new jobs in the receiving country without moving existing jobs abroad.

At the same time, flows of FDI no longer go only in one direction. Indeed, indigenous Indian firms are now globalising (through reverse FDI).

Sixty-two of the Fortune 500 companies are from the developing world, and the number is growing fast³³. Cross-border acquisitions help these companies to enter markets, acquire well-known brands, take advantage of a high skilled workforce and apply modern management techniques³⁴.

The impact on jobs

The reason why public opinion is so wary of offshore outsourcing is that it automatically associates this phenomenon with job losses at home. Measuring the impact of offshoring or even estimating the potential impact on employment is even more difficult than measuring the scale of offshoring.

The most obvious means of collecting information on the extent of jobs lost due to restructuring is through national labour market statistics like the UK's Labour Force Survey. However, this is a rather inadequate source of data on restructuring in the UK – and the same argument applies to other EU member states. We are therefore better advised to refer to redundancy notification data, based on EU legislation, which gives a more accurate picture.

Jobs potentially affected by offshoring....

Most estimates of the employment impact of offshoring are based on macro-economic estimations of aggregate data. The OECD has attempted to develop a typology of the occupations most vulnerable to offshoring and concluded as follows: the jobs most at risk are those with an intensive use of ICT, generating outputs that can be traded and transmitted by ICT, with a highly codifiable knowledge content (i.e. the opposite of tacit knowledge) and low face-to-face contact requirements.

³² Desiree van Welsum and Xavier Reif, 'We can work it out – The globalisation of ICT-enabled services', OECD, Directorate for Science, Technology and Industry

³³ 'Move over Fortune 500' by Kunal Kumar Kundu, Asia Times online, 5 August 2006

³⁴ Rebecca Bream and Joe Leahy, 'Tata Steel wins Corus with £6.2bn offer' Financial Times; 31 January 2007

An analysis of occupational employment data leads the OECD to conclude that 20% of employment in OECD countries could *potentially* be affected by international services outsourcing³⁵. Financial, insurance and computer and information services are the services most likely to be moved abroad.

The potential share is calculated as a function of international trade and investment, the industrial structure of the economy, a technology adoption variable, product market regulations indicator, an employment indicator and human capital. However, there is no empirical testing for this theoretical model, so the results should be interpreted carefully. The study concludes that ICT-enabled service offshoring has not yet led to a relative decline in the occupational share of tradable services.

Calculating the share of jobs potentially affected only makes sense if all the jobs that are susceptible to be offshored will actually be offshored. This implies that the future pattern of offshoring would be very different from the one today. Most jobs at risk of offshoring today or in the near future are likely to be at risk in twenty years, while jobs not at risk today are likely not be at risk in the future.³⁶

Equally, not all jobs created offshore by UK companies automatically translate to job losses at home. The lower prices make it possible for instance to offer services which would not be available otherwise, like 24 hour call centres. Consumers in developing countries are increasingly demanding services – like banking or travel bookings – around the clock, which is why time difference also plays a role in offshoring and allows companies to offer extended services to their clients.

**...versus the
actual number of
jobs offshored**

Evidence collected by the European Restructuring Monitor (ERM) shows that job loss due to offshoring is in fact very small.

The ERM records announcements reported in the press involving the reduction or creation of at least 100 jobs, or affecting 10% of the workforce in sites employing 250 or more in specific countries.

³⁵ OECD, 'The share of employment potentially affected by offshoring', 23 Feb 2006

³⁶ Robert D. Atkinson 'Apocalypse Soon? Why Alan Blinder Gets it Wrong on Offshoring', The Information Technology and Innovation Foundation, July 2006

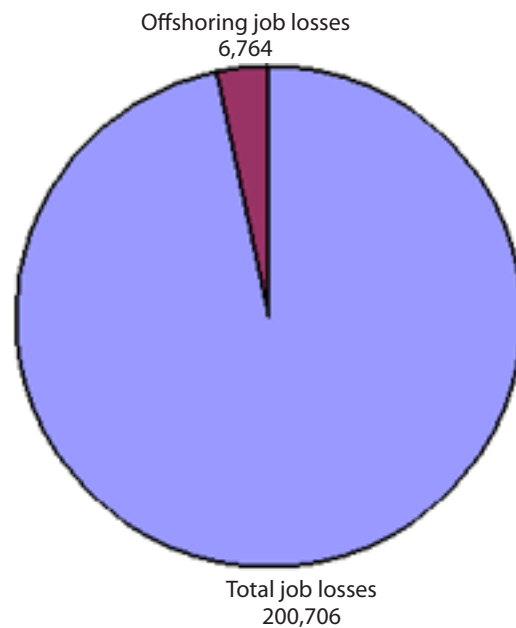
The extent and impact of offshoring

During the first quarter in 2007, the ERM recorded 420 restructuring cases in Europe. These cases announced 132,762 jobs losses and 184,511 job gains. Only 5.5% of all jobs lost were lost due to offshoring activities.³⁷

For the year 2005 the percentage of job losses due to offshoring was only 3.4 percent of the total jobs lost.³⁸

However, there are again certain limitations to the accuracy of the figures recorded by the ERM as it bases its data on lay offs announced in the daily newspapers and business press. It would indeed be beneficial to also rely on other sources, by adding a few questions into the European Labour Force Survey (ELFS) which would give a better estimation of how many workers are affected and what sort of jobs these are.

Total job losses and job losses due to offshoring in the UK in 2005



Source: Based on figures from the European Restructuring Monitor for 2005

³⁷ European restructuring monitor quarterly, Issue 1, Spring 2007, European Foundation for the Improvement of Living and Working conditions

³⁸ 'Restructuring and employment in the EU: Concepts, measurements and evidence', European Foundation for the Improvement of Living and Working Conditions, 2006

But similarly low numbers have also been found in the US, where the US Department of Labor 'Mass Layoff Survey' in 2004 found that only 3% of layoffs could be attributed to offshoring. A recent Brookings Institute paper³⁹ pointed out that the survey only covered a small number of total displaced workers. The same paper noted, however, that the Forrester projections on losses from offshoring implied an annual loss of about 2% of the 15 million involuntary resignations by US workers each year.

In France, the National Institute for Statistics and Economic Studies (INSEE) estimates in its 2007 report on the French economy that offshoring has been responsible for the destruction of 15,000 jobs per year between 2000 and 2003. This is to contrast with a job creation in the private sector of 200,000 per year.⁴⁰

It is remarkably difficult to see a clear offshoring impact on the UK labour market. We would expect the impacts of offshoring to show up most clearly amongst industries and occupations most vulnerable to offshoring. However, studies in the UK have found no overall decline in call-centre employment in the 1990s. A more recent study of IT and call centre jobs associated most with offshoring between 2001 and 2004 could also find no impact.⁴¹ The study concluded:

'Employment growth in the occupations considered susceptible to offshoring has been very strong. The redundancy levels for these occupations, although high relative to the whole economy, have been falling in the last four years. The overall reemployment rate for these occupations has also shown an increase, showing the cost of moving low-skilled jobs abroad is either falling or positive job creation is highly prevalent in these IT-enabled occupations.'

This does not mean that jobs are not being offshored, and it is entirely possible that in the absence of offshoring, employment in these areas might have been higher. But the adverse impact is entirely offset by much larger changes in domestic demand for such services. Moreover, as shown above, the UK in particular has been extremely successful in developing as a world leader in knowledge based international trade. Jobs created through the expansion of

³⁹ Brainard and Litan, 'Services Offshoring, US Jobs and the Global Economy, Brookings 2005

⁴⁰ INSEE, L'Economie Francaise, Comptes et dossier 2007, Rapport sur le comptes de la nation 2006' June 2007

⁴¹ Offshoring and the labour market: the IT and call centre occupations considered, Gaiwan Heckley, ONS, Labour Market Trends September 2005

exports of services are likely to outweigh the contraction of jobs caused by the import of services.

Industry based studies offer different and somewhat contradictory assessments of offshoring. In 2006 a report prepared for the DTI by Ovum predicted that UK employment in the IT and software sector would fall as a result of offshoring between 2005 and 2008, based on interviews with the major employers in the sector.⁴² However, a DTI sponsored study of the UK call centre industry published in 2004 predicted total employment in the industry would continue to grow strongly, with only a limited impact from offshoring.⁴³ One underlying problem is the lack of consistent definitions between the studies.

The most authoritative review of the evidence set out is the 2007 OECD employment outlook which states that offshoring has no effect or even a positive effect on sectoral employment.

Furthermore it argues that offshoring generates new jobs by increasing the scale of production as firms become more competitive.⁴⁴

The report concludes, however, that even though the actual impacts of an increase in trade and the expansion of global sourcing have been quite modest to date, offshoring can change the skills structure of labour demand, increasing the vulnerability of low-skilled workers in particular.

⁴² The Impact of Global Sourcing on the UK Software and IT services sector, Ovum June 2006

⁴³ The UK Contact Centre Industry: A Study, DTI May 2004

⁴⁴ European Employment Outlook 2007, OECD, June 2007

Conclusion

Offshoring in the service sector has received a lot of media attention, despite or perhaps because of, the lack of solid evidence when it comes to the scale of the phenomenon.

Commentators are quick to link offshoring to trade, rather than to explore the more complex relationship between economic and structural developments, such as the shift to knowledge intensive sectors in mature capitalist economies.

When it comes to the alleged future offshoring of knowledge jobs, there is no data confirming this, even though the supply side of the BPO market argues that it is 'most definitely moving towards high value added, knowledge intensive tasks'.⁴⁵

But most of the workers in offshore locations are 'information workers' not 'knowledge workers', the services provided by BPO companies are solutions to existing problems, but 'they do not pose problems themselves'.⁴⁶

High value knowledge intensive services are still principally located in developed countries. Despite the media frenzy, India's growth in services has, in large measure been driven by an expansion of more routine support services. Progress towards higher end knowledge intensive services has, so far, been rather slow.

Indian business insiders see future offshore outsourcing as an advantage for Europe enabling it to focus on the 'thinking part of the job', providing opportunities for 'better jobs' and 'knowledge work' in Europe.

For Jayant Pendharkar from Tata Consultancy Services it is a 'no-brainer': Europe should further invest in education and skills and 'continue to do what it does best: product design, creative work and patents'.

The benefits of service offshoring will, in the long run, outweigh the cost as long as policy-makers focus their efforts on the adjustment process in the short run. Increases in trade in knowledge based services will overall benefit all economies involved.

⁴⁵ Based on interviews with BPO firms

⁴⁶ Interview with Vakul Sharma

To the rest of the world it seemed perfectly obvious that Europe's comparative advantage is its 'high skilled work force', its 'ability to provide research, science and design'.

The fear of 'jobs moving abroad' is often linked to less specific, more general structural change, particularly when this is taking place against a background of high unemployment. The shift towards a knowledge based economy seems to increase, sometimes carefully manufactured, perceptions of fear.

The tradeability of knowledge jobs might increase, but this does not automatically mean that all jobs that are tradeable will be offshored.

Distance and lack of control may harm the flexibility and speed of delivery due to practical implications of language, time, cultural difference and the lack of face-to-face interaction often needed to resolve complex problems. Some services can be done anywhere in the world in theory, but even multinationals rely in practice on local delivery of services with a global brand image supported by global expertise.

Whether offshoring is going to increase slightly or stay the same, policy-makers should not shy away from the real questions of adjustment and compensation as the pace of structural change, driven by markets and technology speeds up. The key policy issues are still how to equip people for change, especially within the industries most affected.

We would therefore like to warn against simple extrapolation. Any attempt to forecast what the future might hold is of course a speculation and the world could indeed change in unexpected ways. But meanwhile, on the basis of the evidence, we can say that the scale and the impact of the phenomenon have often been exaggerated. This means that the future pattern of offshoring would need to be very different from the one today if it was going to affect knowledge jobs on a large scale.

It also shows that our economies are able to cope with all sorts of change when combining competitive markets with social networks in order to manage transitions.

The debate should thus focus on (a) consolidating the UK's and Europe's strength in higher value added knowledge services where investment in human capital will prove decisive. The Prime Minister has for example suggested that advanced industrialised countries will have to invest at least 10 percent of GDG in education and skills. And (b) it should focus on domestic policy choices for the losers of rapid structural change within countries rather than on the winner and loser debate between countries.

Contact details

Prepared by:

Katerina Rüdiger
The Work Foundation
21 Palmer Street
London
SW1H 0AD

Tel: +44 (0) 20 7976 3617

krudiger@theworkfoundation.com

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording and/or otherwise without the prior written permission of the publishers. This publication may not be lent, resold, hired out or otherwise disposed of by way of trade in any form, binding or cover other than that in which it is published, without the prior consent of the publishers.