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Offshoring: Saviour or Value Destroyer?

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"Industrialisation" of services has seen service-based businesses follow their manufacturing cousins in offshoring jobs, as technology allows workers in different locations to interact seamlessly. US companies and the US economy have benefited from offshoring. But will the same be true for UK companies? UK executives – whose own jobs could soon be offshored – should find out more before following their US colleagues.

In recent years, offshoring and outsourcing have become political issues, troubling politicians, trade unions, lobbyists and employers with their implications for national economies. In these debates, the terms are often conflated and used to refer simply to the transfer of high-paying, white-collar jobs to relatively well-trained but less expensive workers in India and other overseas locations. Yet the loss of all kinds of service jobs, which currently account for over 80% of private sector employment in developed countries, to outsourcers and offshorers is not an inexplicable development but a consequence of wider long-term economic, technical and social trends.

The reason behind many of these moves is pure economics: costs of employment in the UK are high and rising. For example, in 2003 the UK operations of HSBC, the second biggest bank in the world, contributed around 25% of HSBC's overall annual pretax profit of £6.8bn; however, the UK operations accounted for 33% of its total cost. (1) It is no wonder that in June 2004, HSBC announced the loss of 3,500 jobs in the UK. Nearly 15% of these jobs, which include bankers and management and head office staff as well as technical programming and call centre operatives, will be offshored to India, where HSBC has a significant operational presence. HSBC had already cut more than 5,000 jobs in the UK in 2003, many of which were offshored to India, Malaysia, and China.

Similar management decisions have been made by many other companies in the UK and in the US. And the loss of services jobs is not the result of some whimsical and unprecedented love affair with the "O" words. Outsourcing has been part of the standard repertory of business practice as long as there have been shopkeepers selling goods produced by others.

Information technology, market research, accounting, tax returns, billing, and customer services have been at the forefront of this new move to outsourcing and offshoring. Other information-sensitive areas, such as publishing, medical science and healthcare, are not far behind. Service sector jobs at all levels, including management are at risk in every developed country.

However, worry focused on offshoring and outsourcing misses the point. We are in the middle of a process of fundamental *social* and *economic* reform in which services are being *industrialised* in the same way as the manufacturing industry has been revolutionised in the recent past. The transformation process is closely intertwined with technological innovation and is also related to changes in attitude about how business can be conducted. China and India are leading this transformation, with China focused on manufacturing and India on services. Together, they could usher in a broader and more powerful strain of industrialisation that will put pressure on senior executives in developed countries. In short, senior managers in all types of service industry must start thinking about defending themselves and their operations, just as their manufacturing cousins did a generation ago (see *Offshoring practices in European financial services companies* by Pal).

Technology drives services industrialisation

The primary driver behind the services industrialisation is technology. A good example is the development of telemedicine. In the past, when a patient needed an X-ray, his General Practitioner (GP) would refer him to a hospital where a radiographer would perform the scan. The film image would then be passed to a radiologist, who would record her report on audio-tape. The tape would be passed to a medical transcriber who would turn it into a printed report, while the X-ray film was sent to a medical records store somewhere in the hospital. The report would be faxed or mailed to both the patient's GP and the hospital doctor overseeing the patient's care in the hospital.

Using today's technology, the entire process can be redesigned. The patient can be scanned at a location convenient for him: in the GP's surgery or a "cottage hospital", perhaps, or in a mobile unit brought to a local library or supermarket car park. The image then can be sent electronically to the radiologist, who may be in a specialist centre many thousands of miles away, as well as to the hospital doctor and GP. Voice recognition technology can transcribe the radiologist's report as she makes it, or the audio report can be recorded as a computer file and sent offshore for transcription in a country, such as India, where there are many highly-qualified medical transcribers available at rates which are a fraction of the cost in the developed world. Even the skills of the radiologist may be replaced by intelligent systems currently under development which can diagnose certain conditions automatically.

Who wins in this industrialisation of services? The patient enjoys greater convenience and lower cost; the hospital saves money by offshoring an expensive service to a lower-cost economy; and the offshore company which wins business based on economics of scale. Who loses? The local transcriber and all but the very best radiologists in the developed world.

US economy and companies benefit from offshoring. Will the UK?

US companies have pioneered the movement to offshore service jobs to low-wage countries. A recent analysis by McKinsey Global Institute (MGI) reported that every dollar US companies offshore to India generates as much as $1.14 in new wealth for the US economy [2]. In other words, offshoring leads to cost savings and revenue gains for individual companies, along with increased exports and creation of new, higher value jobs that generate greater wealth for the US economy as a whole. This is a win-win situation for the US economy, US companies, offshore countries and offshore companies.

We've applied the same analysis to the UK to understand the impact of offshoring on UK companies and the UK economy. We have identified that UK companies save less than their US cousins because of inferior organisational practices, such as lack of "end-to-end" sourcing strategies, outdated supply chain management, poor management decision making, and flawed implementation of offshoring deals, compounded by lower productivity from UK workers compared with their counterparts in the US [3] (see Figure 1). All of this adds extra management costs to offshoring projects.

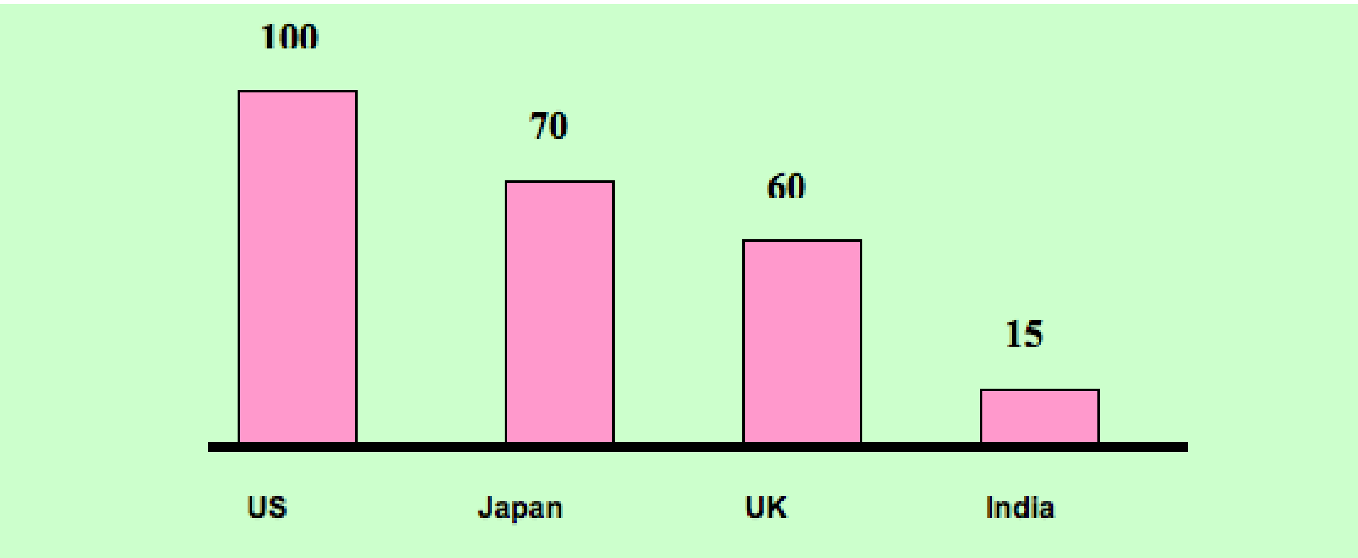

Figure 1: *Comparative Labour Productivity Rates*
[Source: Goldman Sachs Global Economics Paper No: 99, October 2003, Sirius & Co analysis]

On top of that, the UK economy doesn't reap the same benefjts as the US when it comes to making high technology exports to offshorers, because US companies dominate the market for the technologies that underpin offshoring. The UK also misses out on repatriation of earnings from offshoring companies, while UK workers are less successful at finding new jobs compared with their US colleagues. If the rate of re-employment in the UK matched that in the US – nearly 70% – we calculate offshoring would create £1.05 of value for the UK economy for every pound sterling of corporate spending transferred offshore. However, Using MGI's approach, we estimate that re-employment rates for UK workers could be as low as 30%. That means that the UK economy recaptures only £0.70 worth of value for every pound sterling of corporate spending moved offshore (see Figure 2).

In short, our findings suggest that while both US companies and the US economy enjoy savings from offshoring, the UK economy loses out as a result of current offshoring practices. And while UK companies may benefit financially in the short term, the long term picture may not be so rosy, with offshoring failing to deliver lasting value. However, protectionism is not the solution, although countries benefiting from offshoring trends, such as India, are highly protective themselves.

What does it mean for policy makers and UK business leaders?

The UK's economy grew at its slowest annual rate for 12 years in the second quarter of 2005, according to official figures from the Office for National Statistics (ONS). People are facing increasing pressure on their disposable incomes and they are reluctant to spend because of higher fuel bills, the slowing housing market and a reluctance to take on more debt. The ONS revised down its annual growth rate for the second quarter of 2005 from 1.8% to 1.5%. It was the weakest rate of annual expansion since the first quarter of 1993 (see Figure 3).

The official figures also showed that the savings ratio - the amount of disposable income people saved - rose to 5% in the second quarter of 2005, from 4.5% in the previous quarter. What happens to the savings ratio is one of the most important factors determining the course of the UK economy in the near future. If the ratio continues to rise, growth will struggle to exceed 2% in the next couple of years.

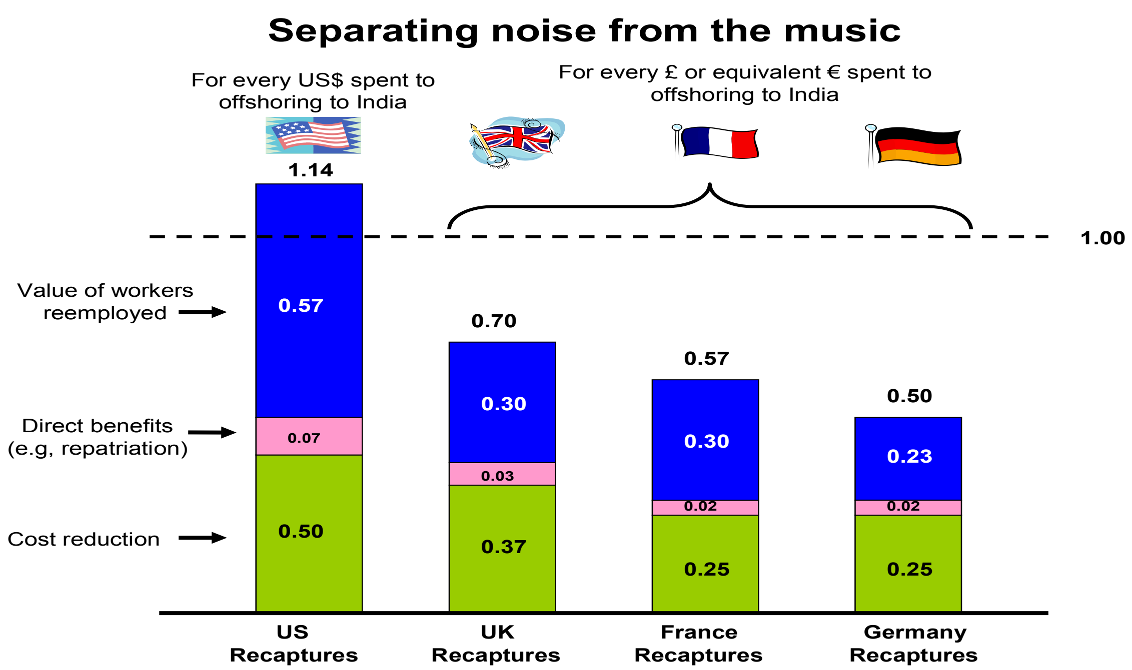

Figure 2: *Offshoring to India and what it means to the UK [Source: Sirius & Co analysis]*

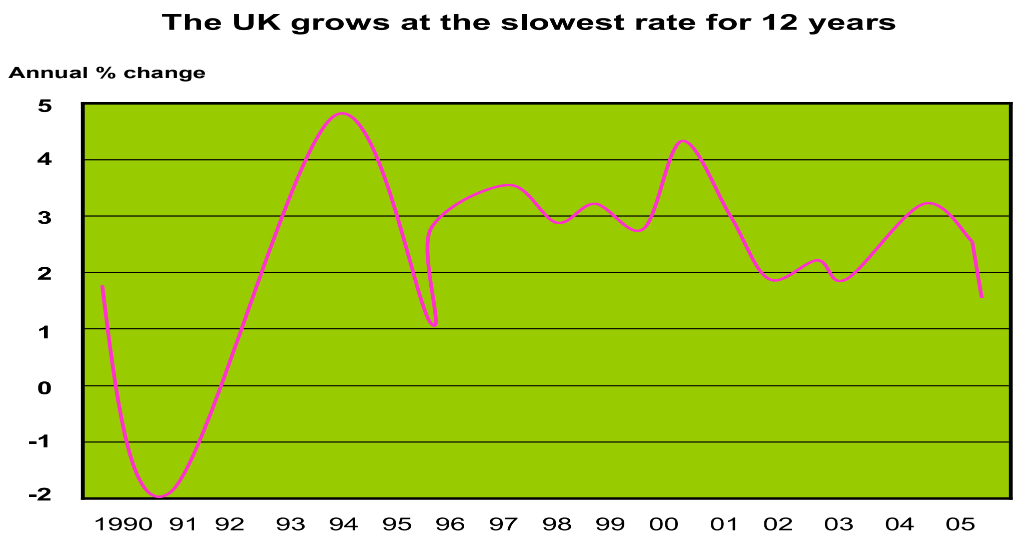

Figure 3: *The UK's Real GDP growth over last 15 years (source: Thompson Dtatastream, ONS)*

The UK's business and political leaders must use offshoring as the catalyst for undertaking long-overdue structural reforms to the UK economy. Productivity in the UK is lagging and has hobbled GDP growth and reduced the competitiveness of UK companies. On top of that, the UK's aging population and low birth rates will reduce the total number of workers in the coming decades. To ensure developed countries benefit from offshoring and are not disadvantaged by it, policymakers must make labour markets more flexible, improve the national productivity rate and reform regulations that stifle competition and innovation.

For the UK companies, prudent offshoring to low-wage countries would reduce costs, increase productivity, enhance their flexibility and ability to innovative and introduce new products and services, while pre-empting and sidestepping recruitment crises resulting from a shortage of labour. Alongside careful use of offshoring, UK companies must also recognise that, in the highly customer-centric age ushered in by the industrialisation of services, they must focus on customer preference, quality and value, not just price, and look for ways to find new value from existing and unfamiliar sources by unbundling and re-bundling their offerings (see *Why integrate, when you can aggregate* by Pal).

A clear understanding of basic economic indicators is a pre-requisite to a meaningful cost reduction programme. If senior managers in the UK continue to view offshoring as a threat, and at the same time carry on avoiding implementing next practices, they may find their own jobs are threatened by offshoring.

Notes

1. HSBC Annual Report 2003.
2. "Who wins in offshoring", The McKinsey Quarterly, 2003 Special Edition.
3. "EU Productivity and Competitiveness: An Industry Perspective"; Mary O'Mahony – National Institute of Economic and Social Research.

About the author

Sukhendu Pal is the CEO & Managing Partner of Sirius & Company.