

# 3 Recent Developments in Offshoring

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As experience grows, companies are devising more sophisticated sourcing strategies that use offshoring selectively to complement the strengths of onshore IT professional staff. Recent research by sourcing advisory firm TPI found that 81 per cent of senior UK executives responsible for outsourcing within large companies expect to increase their offshore outsourcing over the next 2–3 years (TPI, 2005a). There was, however, a marked shift away from outsourcing towards the use of captive sites set up by organizations overseas in preference to relying on external service providers. Fifteen of the FTSE 100 companies now have captive operations in India (TPI, 2005a).

Global sourcing is also having an impact on the size of new outsourcing contracts awarded. TPI found that the average value of larger contracts signed worldwide in 2005 was down by about one-quarter compared with 2004. However, the number of outsourcing contracts continues to rise and in 2005 was around 10 per cent higher than a year before (TPI, 2005b). A key factor is the increased use of offshore resources and companies' growing expertise in combining the services of different providers each skilled in specific areas. There are little data available on the split between onshore and offshore outsourcing operations, but TPI found that more than 40 per cent involved an element of global service delivery. More business process outsourcing (BPO) than IT outsourcing deals now have offshore components.

TPI's research also showed that although companies are planning to increase their use of offshoring, they are also re-adjusting the split between onshore and offshore operations. Half of the survey respondents expect to bring some functions back to the UK in the next 5 years as their global sourcing strategy develops.

Offshoring occurs in almost all developed countries. A study by Frost & Sullivan looked at the use of offshoring (both through offshore outsourcing and the use of captive sites offshore) in the USA, UK, France, Germany, Japan and Hong Kong between 2002 and 2004 (Rosenthal, 2005). The number of IT jobs exported during this period is illustrated in Figure 3.1.

One surprising result from the Frost & Sullivan study (Rosenthal, 2005) was that Poland was the fastest growing offshore location for IT outsourcing, although India remains the single largest recipient of IT job imports. Different countries are developing their own niche markets. Brazil is particularly attractive to Japanese companies because there has been a significant level of Japanese immigration to Brazil. Russians are developing a reputation as IT problem solvers. French companies choose French-speaking outsourcing companies in Tunisia and Mauritius. German organizations are choosing nearshore destinations such as Poland and Romania.

Suppliers are moving up the value chain and offering more complex services. The increased nature of global competition and subsequent impact on profitability has forced many service companies to expand their range of services, with a gradual move to offering more complex tasks being the natural next step. Analysts use the term knowledge process outsourcing (KPO) for the next tranche of services that might be offshored. KPO is therefore a continuation of BPO, although with rather more business complexity. The defining difference is that KPO is usually focused on

knowledge-intensive business processes that require significant domain expertise. An offshore team servicing a KPO contract cannot be easily hired overnight as the members will be highly educated and trained and trusted to take decisions on behalf of the client.

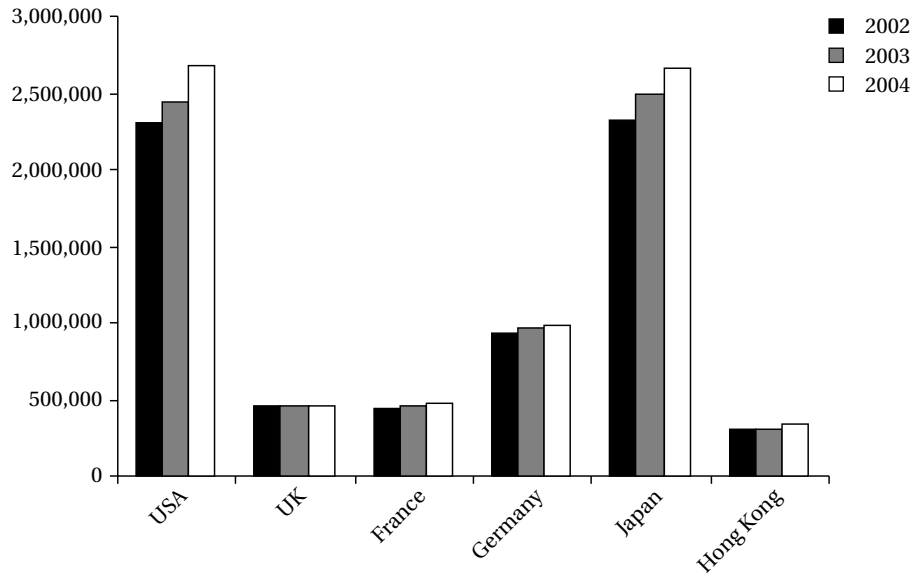


FIGURE 3.1 Total number of IT jobs exported (offshore outsourcing and offshore subsidiaries), 2002–2004 (Source: derived from Rosenthal, 2005)

KPO delivers higher value to organizations that offshore their domain-based processes, thereby enhancing the traditional cost-quality arguments for BPO. The central theme of KPO is to create value for the client by providing business rather than process expertise. So KPO involves a shift from standardized processes to advanced analytical thinking, technical skills and decisive judgement based on experience. These services include financial research, customer data analysis and patent work.

The leading Indian IT service companies are developing into major global players and are recruiting staff around the world to provide local services to their clients. They are also acquiring companies to expand into specialist areas and offer higher value services, as the description of Tata Consultancy Services in Box 3.1 illustrates. With annual revenue increases around 30 per cent, the major Indian companies are growing faster than American and European suppliers and are becoming world leaders in the IT services market.

**BOX 3.1 EVOLUTION FROM INDIAN TO GLOBAL IT SERVICES COMPANY: TATA CONSULTANCY SERVICES (TCS)**

Natarajan Chandrasekaran, Executive Vice-President, writes about the development of TCS into an international company. Chandra is a member of the BCS Working Party on Offshoring.

In 1968 the IT industry as we know it did not exist. That year Tata Consultancy Services (TCS) commenced operations with a handful of employees in India and embarked

*(Continued)*

on an exciting journey. Today, with over 60,000 employees, TCS is a truly global company with 158 offices in 43 countries across six continents. TCS' Network Delivery Model (NDM™) provides business value to clients using global delivery centres, regional development centres, nearshore centres and several niche solution centres in various countries. This ensures that the full service capability can be brought to our customers from the most appropriate destinations, at the fastest possible speed, the lowest possible risk and with the best available expertise. With 33 centres in a Network Delivery Model across six continents, TCS has one of the strongest delivery networks in the world.

TCS' vision is to be a top 10 IT services company by 2010. In order to deliver on this vision and to further increase its global footprint and capabilities, TCS has looked beyond its traditional organic growth by way of acquisitions. Most notable are the acquisitions of Chilean business process outsourcing firm Comicro for £15 million and the £13 million acquisition of Australian banking solutions firm FNS. These deals provide the platform for our larger customer base to process their business transactions with a high degree of precision and at an optimal cost.

Another aspect of TCS' globalization is its ability to serve its international customers locally. This is a very key characteristic that enables our customers as they enter into new territories to expand their global footprint. For the Dutch bank ABN AMRO, TCS is delivering from Luxembourg, Amsterdam and Brazil in addition to our centres in India. This has provided the necessary balance between the cost optimization objective and the nearshore customer comfort needs. With the UK insurance company Pearl, TCS has built a strong platform for the life and pensions domain.

TCS was first established in Europe in 1975 and now has 23 offices across the European continent. In addition to ABN AMRO and Pearl, European clients include Aviva, British Airways, BNP Paribas, Ferrari, Nokia, Rabobank and Somerfield. As a leading IT and consultancy firm in Europe, TCS is very much a part of the business and social fabric across the 14 European countries in which it operates. In September 2005 the company received a Special Recognition Award for Outstanding Contribution to the UK Knowledge Economy. While presenting the award Rt Hon. Tony Blair concluded, 'Blending the best of British and Indian know-how and technology, TCS has developed innovative, world-beating techniques to develop high-quality services that add value to business plans and efficiency to government service delivery alike.' From a small Indian IT company to a global IT services player praised by Britain's Prime Minister, an exciting journey indeed.

Wealthier nations also benefit from the global trade in IT services. An article by researchers from the International Monetary Fund (IMF) points out that trade in services is a two-way street. In addition to importing services, the UK is also a large exporter of services. The UK and the USA both have large net trade surpluses in business services while Ireland and Germany import significantly more services than they export (Amiti and Shang-Jin, 2004).

Trade statistics indicate that the offshoring of services is quite small compared with that in manufacturing. Research at the Said Business School, Oxford (Sako, 2005), has shown that:

- only 10 per cent of services output enters international trade, whereas 50 per cent of manufacturing does, indicating that offshoring of services is small relative to outsourcing within national boundaries;
- the top two exporters of computer services are Ireland and India, but the two top exporters of other business services are the USA and the UK.

Although the USA and the UK are known as major users of global IT resources, they are in fact both major net exporters of computer and information services. The three largest net importers of computer services are Japan, Brazil and Germany (World Trade Organization, 2005b). Figure 3.2 illustrates the balance of trade in computer and information services across the world.

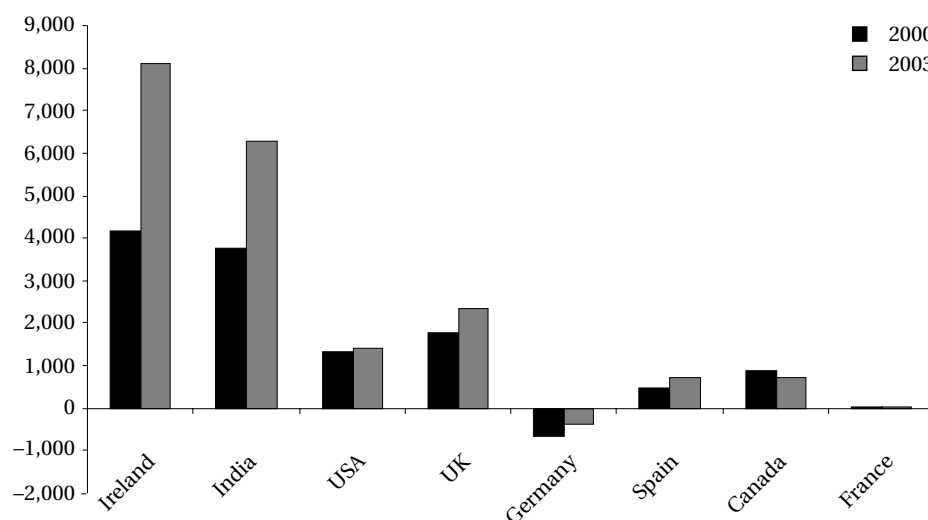


FIGURE 3.2 Major traders in computer and information services, 2000 and 2003  
(Source: derived from World Trade Organization, 2005b)

UK productivity in high-tech business services is catching up with other countries. We have substantially closed the productivity gap with the USA, Germany and France in this sector while, at the same time, increasing numbers in employment (Advanced Institute of Management Research, 2004).

## RESEARCH AND ANALYSIS REPORTS

Since the BCS Working Party's report on offshoring was published (BCS Working Party on Offshoring, 2004), a number of new reports have appeared offering different perspectives and analyses of the offshoring trend.

### Advanced Institute of Management (AIM) Research

#### *Offshoring of Business Services and its Impact on the UK Economy*

The AIM community includes more than 150 academics and is the largest management initiative in the UK. This paper (Abramovsky *et al.*, 2004) considers recent trends in specialization, outsourcing and offshoring of business services and identifies four key findings:

- business services have accounted for more than 50 per cent of job growth in the UK over the past two decades;
- more business services are purchased from the UK than the UK purchases from overseas, i.e. we have a trade surplus in business services, and it has been growing;
- most business service industries in the UK have experienced continued job growth;

- UK productivity in business services has caught up with other leading economies.

## Association for Computing Machinery (ACM)

### *Globalization and Offshoring of Software*

ACM is an educational and scientific society uniting the world's computing educators, researchers and professionals to inspire dialogue, share resources and address the field's challenges. A taskforce was established to look at the issues surrounding the migration of jobs worldwide within the computing and IT field and industry. The key findings and recommendations (Aspray *et al.*, 2006) are outlined below.

- Globalization of, and offshoring within, the software industry are deeply connected and both will continue to grow. Key enablers of this growth are IT itself, the evolution of work and business processes, education and national policies.
- Both anecdotal evidence and economic theory indicate that offshoring between developed and developing countries can, as a whole, benefit both, but competition is intensifying.
- While offshoring will increase, determining the specifics of this increase are difficult given the current quantity, quality and objectivity of data available. Scepticism is warranted regarding claims about the number of jobs to be offshored and the projected growth of software industries in developing nations.
- Standardized jobs are more easily moved from developed to developing countries than are higher skill jobs. These standardized jobs were the initial focus of offshoring. Today, global competition in higher end skills such as research is increasing. These trends have implications for individuals, companies and countries.
- Offshoring magnifies existing risks and creates new and often poorly understood or addressed threats to national security, business property and processes, and individuals' privacy. While it is unlikely these risks will deter the growth of offshoring, businesses and nations should employ strategies to mitigate them.
- To stay competitive in a global IT environment and industry, countries must adopt policies that foster innovation. To this end, policies that improve a country's ability to attract, educate and retain the best IT talent are critical. Educational policy and investment is at the core.

## Global Insight

### *The Comprehensive Impact of Offshore Software and IT Services Outsourcing on the US Economy and the IT Industry*

The Information Technology Association of America (ITAA) provides global public policy, business networking and leadership for its 325-plus corporate members in the USA and its global network of IT associations in 70 countries. The ITAA sponsored this analysis and its key findings (Global Insight, 2005) include:

- while global software and IT service outsourcing displaces some workers, total employment in the USA increases as the benefits ripple through the economy;

- cost savings and use of offshore resources lower inflation, increase productivity and lower interest rates. This boosts business and consumer spending and increases economic activity;
- spending on global sourcing of computer software and services is expected to grow at a compound annual rate of just over 20 per cent;
- the USA has a large and rapidly growing trade surplus in services and the expected increase in offshore software and IT services outsourcing will not reverse this trend.

## **McKinsey Global Institute**

### *US Offshoring: Rethinking the Response*

The McKinsey Global Institute was founded in 1990 as an independent economics think-tank within McKinsey & Company. Its research (Farrell and Rosenfeld, 2005) found that many fewer jobs can be performed remotely than is commonly assumed. In theory 11 per cent of all USA services jobs could possibly be performed offshore. A large percentage of service jobs require face-to-face customer interactions or a worker's physical presence. Moreover, only a small fraction of the service jobs that could theoretically be performed offshore actually will be. By 2008, offshoring will affect less than 2 per cent of all service jobs. Offshoring generates substantial benefits but historical data show that not all workers who lose their jobs will find new ones and many that do will have to accept pay cuts. Policies are needed to ease the transition for displaced workers. Globalization is producing more frequent and dramatic shifts in companies' demand for labour and it is vital to prepare people to work in such an economy. This will require changes to the USA educational system and a new approach to career changes.

## **Office for National Statistics**

### *Offshoring and the Labour Market: the IT and Call Centre Occupations Considered*

The Office for National Statistics is the government department that provides UK statistical and registration services. This article (Heckley, 2005) places offshoring in the context of the economics of international trade, both in theory and practice. It then examines the evidence of recent labour market impacts using official UK labour market data. The key findings (Heckley, 2005) are:

- the UK is a net exporter of IT-enabled services;
- the trend in both exports and imports of these services is increasing, but this rise is in line with the rise in UK output;
- employment growth over the last 4 years in relevant occupations has been three times (8.8 per cent) the overall UK employment growth (3.2 per cent);
- redundancy rates are higher and re-employment rates have been lower in relevant occupations compared with the overall UK figures;
- the overall re-employment rate for these occupations is increasing.

## **Organization for Economic Cooperation and Development (OECD)**

### *Growth in Services: Fostering Employment, Productivity and Innovation*

The 30 member countries within OECD share a commitment to democratic government and the market economy. The services sector now accounts for more than 70 per cent of total employment and value-added in OECD economies. Productivity growth in services, however, has been slow in many OECD countries and the share of the working-age population employed in services remains low in many countries. Addressing the challenges of global competition and strengthening the potential of services to foster employment, productivity and innovation will need to build on sound macroeconomic fundamentals and involve a combination of structural policies (OECD, 2005).

## **OECD Working Party on the Information Economy**

### *Potential Offshoring of the ICT-Intensive Using Occupations*

Even though there are no official statistics measuring the extent of offshoring, anecdotal evidence suggests that the international sourcing of IT and ICT-enabled services is growing rapidly. However, even the largest estimates of jobs likely to be lost through offshoring are relatively small compared with the general job turnover numbers. Results from an analysis of occupational employment data (OECD Working Party on the Information Economy, 2005a) suggest that nearly 20 per cent of total employment in the European Union, USA, Canada and Australia could potentially be affected by global sourcing. The adjustment process could be costly, especially for those who have lost their jobs. Education and training programmes should be adapted to enable people to take advantage of new employment opportunities. Life-long learning and skills upgrades will become increasingly important. A change in mentality will be needed, as people are increasingly likely to have multiple jobs and even careers. Countries should remain committed to liberalizing trade in services and avoid a protectionist response.

## **OECD Working Party on the Information Economy**

### *The Share of Employment Potentially Affected by Offshoring*

This report (OECD Working Party on the Information Economy, 2005b) examines the relationship between the share of employment potentially affected by ICT-enabled offshoring of services and other economic and structural indicators. Estimates are provided of the statistical association between this share, trade in business services and foreign direct investment. Contrary to popular belief, the analysis in this paper does not find any systematic evidence that net outward investment or imports of business services are associated with significant declines in the share of potentially offshorable occupations at the aggregate level. Exports of business services are found to have a positive statistical association with the share of employment potentially affected by ICT-enabled offshoring of services, suggesting that increases in demand and production have also raised demand for these types of ICT-using occupations. Other key factors positively associated with the share of potentially offshorable occupations are found to be the comparative size of the service sector, the growing share of ICT investment in total fixed investment, and human capital.

## **Professional Contractors Group (PCG)**

### *The Offshoring of IT Work and the Government's New Immigration Strategy*

PCG is a not-for-profit professional body for freelance contractors and consultants, with more than 12,000 members in a wide variety of sectors. This paper (Professional Contractors Group, 2005) presents an empirical analysis of the advantages and disadvantages of offshoring IT work and suggests that the widely predicted benefits of this strategy seldom, if ever, emerge. Economic theory predicts that offshoring will result in large cost savings, which will be sufficient to offset the short-term damage to the economy caused by the loss of work in the UK. This study (Professional Contractors Group, 2005) suggests that this theory is wrong and that companies who offshore their IT operations usually fail to make the anticipated savings and have no clear advantage compared with those who do not offshore. They are in fact often out-performed by their non-offshoring competitors.

## **United States Government Accountability Office (GAO)**

### *Offshoring of Services: An Overview of the Issues*

The GAO is an independent, non-partisan agency that studies how the federal government spends taxpayer dollars and advises Congress and the heads of executive agencies. In response to widespread congressional interest, the GAO carried out a study (United States Government Accountability Office, 2005) to help policy makers better understand the potential impacts and policy implications of services offshoring. Analysts expressed a range of views on four broad areas: the average US standard of living; employment and job loss; distribution of income; and security and consumer privacy. The different perspectives reflected the fact that services offshoring is a relatively recent development the impact of which is not fully known; the limitations of available data on offshoring; and different theoretical expectations about how services offshoring will affect the USA economy.

## **World Trade Organization**

### *Offshoring Services: Recent Developments and Prospects, World Trade Report*

The World Trade Organization is the only global international organization dealing with the rules of trade between nations. This essay (World Trade Organization, 2005a) appears in the 2005 World Trade Report (World Trade Organization, 2005b). Offshoring services are not new, the report states, and are in fact no different from other forms of trade driven by comparative advantage. It concludes that the impact of offshoring services jobs is far stronger in the popular perception than on actual production, employment and trade patterns. The number of jobs affected today by offshoring IT services is small if related to the overall employment levels in the developed countries most affected. In 10 years' time, the impact of service globalization will be compared with previous revolutions such as ecommerce. Offshoring of IT and IT-enabled services will increase significantly in size in the coming years without upsetting national employment levels in the countries that offshore, given the normal turnover rates in labour markets. Nor will it dramatically change the overall employment situation in the countries providing the offshored services, given their large labour force growth in the years ahead.

## **RESPONDING TO OFFSHORING**

The BCS Working Party on Offshoring, and many of the publications described above, have highlighted the impact of increased globalization on the UK's IT profession. The scale of our ICT service exports demonstrates the competitive edge we now enjoy. Our aims now must be to anticipate future business needs, enhance professional standards, redesign IT career patterns, develop appropriate skills, encourage creativity and innovation and celebrate excellence.