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OUTSOURCING CHALLENGE TO THE LABOUR MARKET - THE RISE OF AN OPEN-SOURCE WORKFORCE

Abstract

Over the last 25-30 years the manufacturers of textile, automobile, steel and services have outsourced work to foreign countries. The outsourcing has become one of the main response to new competitive and technological realities of the global market, not only labour market. It is unquestionable a revolutionary development which changes not only the structure of enterprise but also its culture. Because human resources constitute 65% to 70% of average business in Europe and North America, there will be a great pressure for labour-intensive work to migrate from high-labour cost to low labour-cost countries. An increasing competition in a single global marketplace for labour-intensive products and services will gradually drive all labour markets around the world to pay comparable wages for comparable work. This will be the most visible effect of the globalization process and outsourcing (or rather open sourcing) strategies of enterprises from both developed and developing countries.

Key words: outsourcing of manufactures and services, offshoring, offshore outsourcing, job losses on labour markets, costs and benefits of outsourcing, increasing competition on the global marketplace.

Introduction

In recent times the outsourcing of both products and services has been discussed in the scholarly literature as well as in the mass media. For many readers of various articles outsourcing appears to be equal with job losses and an increasing competition for jobs between the individual countries. The aim of this paper is to present the nature of outsourcing, especially offshore outsourcing, its costs and benefits and to describe the challenge of that phenomenon to the labor market. The main argument of the following remarks will be that outsourcing does not only lead to net job losses, because jobs lost in one industry often are offset by jobs created in other expanding, new industries and especially services.

The term outsourcing is not understood and interpreted in the same way. In some dictionaries this term is defined as "the procuring of services or products ... from an outside supplier or manufacturer in order to cut costs" (Macmillan Dictionary, 1992). This can be interpreted both as outside the firm and also outside the country. The majority of authors focus attention on international outsourcing (Krugman, 1992). Some authors use the terms of offshore outsourcing to describe a normal part of international trade consisting of "exporting jobs" from developed countries to developing, low cost countries (Erber and Sayed-Ahmed, 2005). They widely use the term of offshoring which can be defined as the relocation of business processes (including production, distribution and business services, as well as core activities like research and development) to lower-cost locations outside national borders. This term

assumes the perspective of the country of origin. Offshoring can refer either to the production of goods or services (Erber and Sayed-Ahmed, 2005, p. 100).

Sometimes the literature distinguishes between offshoring and nearshoring, when the location of the first destination is at a closer proximity to the country of origin. Major nearshoring destinations are, Mexico and Canada for US businesses, while Central and Eastern Europe are nearshoring sites of European companies.

In recent times the outsourcing of services has become the most visible phenomenon in the business activity of many companies. The offshore outsourcing has also become very important for many global industries and services as it secure to cost optimisation in the global scale. For example the expected cost savings of up to 50% by offshore outsourcing information technology services (IT) are too compelling to be ignored in today's increasingly global economy. For many companies the use of offshore outsourcing is the main strategy aimed at both the labor cost reduction and greater productivity. There are many examples confirming the fact that increases in service outsourcing in U.S. manufacturing and services sectors go hand in hand with greater labor productivity (M.Amiti and Shan-Jin Wei, 2004). By comparing the costs of the internal supply of a particular task of service with the external market costs of the same task or service, managers and entrepreneurs could decide about the efficiency of internal or external production by making internal/external cost comparisons.

The advances in technology, especially in information processing, communication, and transportation, are increasingly making it possible to trade services that previously were too costly to trade. Although, for a typical industrial economy, the international outsourcing of material inputs is still far greater than that of services, the current wave of anxiety is largely about service.

Main body

The growing outsourcing of services in industrial countries is simply a reflection of the benefits from the greater division of labor and trade. With improvements in communication technology, such as the Internet, services can cross political borders. Jobs in fields ranging from architecture to radiology consequently seem much more at risk. Although firms were able to relocate abroad in the past, they had to give something up-their closeness to important markets, for example. With the new technologies, they can retain these links, while also obtaining access to cheap but well trained labor. Moreover by splitting the value chain of a company's production process into a sequence of tasks, its comparative advantages over competitors could be utilised to increase the company's profitability. By focusing each company on its own core competencies, it was able to achieve major improvements in efficiency and profitability. Additionally, outsourcing reduces the amount of sunk costs in fixed investments which, with a volatile demand, could lead to significant underutilisation of production factors. By outsourcing some of the production capacity to subcontractors, a company might gain sufficient flexibility to be able to utilise its own capacity at a consistently higher level.

On the other hand outsourcing involves transferring a significant amount of management control to the supplier. This creates the risk of diminished control over the supply chain. A typical outsourcing relationship seeks to reduce this risk through a higher degree of coordination than between totally independent buyers and sellers. Buying products from another entity is not outsourcing or out-tasking, but merely a pure vendor relationship. Likewise, buying services from a provider is not necessarily outsourcing or out-tasking. Outsourcing always involves a considerable degree of two-way information exchange, coordination and trust.

It should be noted that the outsourcing company usually encounters costs when it

changes even one single component of its offshore outsourcing system. In other words, the company is to some extent locked in by an offshore relationship and faces switching costs when moving from one service provider to another, changing the offshore destination, or bringing outsourced activities back home. Some experts point out that switching costs are the norm in the business relations of an information economy. They distinguish between several types of lock-in and associated switching costs. One type of lock-in effect concerns information and databases, which with regard to IT offshore outsourcing means huge investments in IT technology to store and manage the transferred information. If offshore service providers arrange upgrades or convert data into new formats, the outsourcing company might face incompatibilities or high switching costs if it changes to another supplier of such services. Switching costs can therefore create significant barriers to exiting from contracts (Shapiro, Varian, 1999, p. 23).

Other types of lock-in mentioned by Varian and Shapiro are specialised suppliers and search costs. The search costs range from selecting and testing new vendors to identifying alternative offshore countries. In complex mass markets, these costs are often very substantial and the associated switching costs include productivity interruptions when changing ingrained habits in current business relations.

Among outsourcing contracts, lock-in effects can emerge if organisations change their offshore vendor or even the offshore destination, e.g. from India to China. Choosing one single service provider today will make the company more dependent in the future. Therefore, companies should maintain alternative sources of supply, which can be called a multiple sourcing strategy. By holding multiple offshore outsourcing service providers, the ability to switch vendors later on at comparatively low switching costs gives outsourcing companies a higher bargaining power. This is a strategy of risk insurance against otherwise high switching costs by keeping the amount of value at risk - associated with a particular contract partner - under control.

If we consider only wage differentials of IT workers as a benchmark so they suggest that companies save up to 80 per cent of wage costs by moving IT work offshore. This should, however, not be interpreted to mean that a cost advantage of this dimension can be translated into higher net profits of the same dimension for the outsourcing company. United Technologies, an acknowledged leader in developing offshore practices, currently saves only just over 20 per cent even when wage differentials are as high as 80 per cent (Overby, 2003). In order to realise such substantial cost savings, companies have always to consider the total costs of offshore activities.

In the era of globalization offshore outsourcing of both production and services is increasingly taking the form of business process outsourcing, where whole business processes (or are outsourced. The client is usually free to choose who provides the outsourced business processes. Pressure from the stock market to do more for less requires managers to take the cheapest offer they can get. It is known that globalization in production and services is driven by cost optimisation. The managers of companies are under pressure from the side of shareholders to do more with less and therefore they are looking for various ways which enable them to cut labor costs. In some branches like for example in IT outsourcing of work and payments to low-cost countries can reduce fixed R&D costs. In addition, the substitution of fixed costs by variable costs gives the outsourcing company greater flexibility in reallocating its capital. Moreover outsourced work conforms to companies' needs over a longer timeframe, whereas contracts with offshore service providers are made more on a short-term, case-by-case basis. Thus in the case of the IT sector cutting costs through offshore outsourcing can cut the IT budget by as much as 50 per cent, enabling the company to provide new market services faster, by optimising its process chain and improving customer perception. This adds up to a reduced time-to-market. It should be mentioned that also quality

criteria are another incentive for offshore outsourcing. The ideal outsourcing partner assures high quality work at low prices and a modern IT infrastructure, and guarantees international quality standards. The most visible advantage that from the outsourcing processes outside its core business is an enterprise can devote itself entirely to value-added activities within its core competencies. This can help to unlock internal resources (Erber and Sayed-Ahmed, 2005, p. 102-103).

Table 1. Comparison of the costs of labour-force: an average pay per hour in US dollars

	USA	INDIA
Operator call-center	12,57	1,00
Office clerk	15,17	1,50-2,00
Accountant	23,35	6,00-15,00
Financial analyst	33,00 USA	6,00-15,00 CHINA
Worker in a factory	21,11	0,64*

* Estimated.

Source: Newsweek Polska 5.06.2005.

The crucial issue connected with offshore outsourcing is the question of jobs disappearance as a result of outsourcing. The findings of the IMF experts confirm that increases in service outsourcing in U.S. manufacturing and services sectors go hand in hand with greater labor productivity. This is likely due to firms relocating their least efficient parts of production to cheaper destinations. For manufacturing, firms, the largest category of outsourced services is, indeed, business services. Even if outsourcing leads to some shedding of labor, the increased efficiency could lead to higher production and an expansion of employment in other lines of work. For example, a firm might let some employees go because it imports its information technology services but then, as it becomes more efficient, it may decide to expand its research and development department, thereby creating new jobs (Amiti and Wei, 2004, Fear of Outsourcing, p. 8). Moreover, when jobs in one sector are outsourced, other sectors could also be affected. As firms that outsource become more efficient, they produce more cheaply and, hence, can provide inputs to other sectors at lower prices. This, in turn, lowers other firms' costs, reducing their prices and leading to higher demand for their products. This higher demand could be met by the increased productivity of existing staff, or, if demand growth is sufficiently strong, it could lead to further job creation, which could, in principle, offset the direct job losses caused by outsourcing. However in practice such "neutral" changes due to the offshore outsourcing are not too frequently observed. On the contrary, due to the enormous differences in the labor costs (see table 1) very often jobs are being exported from industrial countries to developing countries. Much depends on the range and sophistication of business processes that are sent offshore. Activities relocated to India are often portrayed as outsourced call-center functions. This is a popular misconception. The research of some experts from Deloitte Company indicates that IT is the cornerstone of offshoring. Staff employed if offshored IT outnumber call-centre staff by ten to one (Gentle, 2005, p. 16).

It should be stressed that labor skills, not volumes, are the key issue. To make offshoring sustainable, firms will have to invest more in management skills. Rather than hopping backwards and forwards on short visits, key management talent (and their families) will have to be relocated to lower-cost markets. As was mentioned earlier the pressure on costs in the West's markets looks set to increase. Services such as banking, insurance and

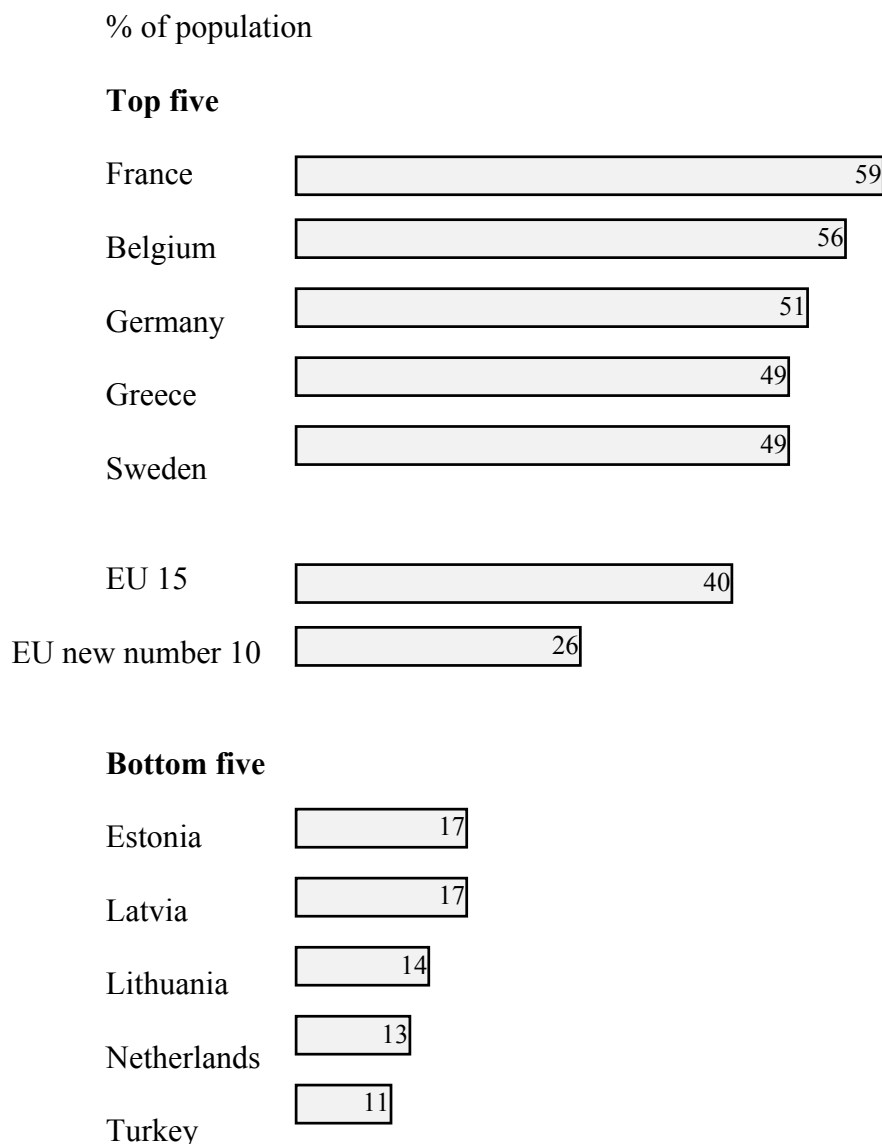
telecoms are very mature. In some cases, the relocation of processing activities into emerging markets will go hand in hand with market-entry strategies. Manufacturing took 20 years to make its operations global. Services are just starting along this path and offshoring is likely to play a profound role in reshaping the operations of its businesses. It should be added that offshore outsourcing is a completely new area for IT. According to a CIO Research Report when 101 IT executives were surveyed in 2003, the majority (67%) said their company began outsourcing after 2000 (Cosgrove-Ware, 2003, p. 4).

It should also be mentioned that there are not only benefits but also risks connected the offshore outsourcing. Therefore many economically attractive labour pools abroad carry location-specific risks that must be balanced against the expected cost savings. Cost savings that make a location attractive at one point in time are sometimes significantly reduced by new taxes, exchange-rate volatility and rapid increases in local wage rates. Companies must therefore balance high potential returns against higher country-specific risks that depend on potentially shifting political, regulatory and economic conditions. One possible way for companies to address this problem is locational and/or vendor diversification. If a company uses only one location or a single vendor, this can be compared with investing in only one stock. Investing capital in several different companies or countries provides risk-reducing portfolio effects on invested capital. This is why analysts or consultants often advise managers to create significant outsourcing portfolios to hedge against business risks and high volatility of returns to capital.

Another problem that should not be underestimated are the cultural differences, which may result in productivity lags. Companies have to face totally different attitudes when comparing American to Indian workers, for example.

The fact is however that despite all those risks connected with offshore outsourcing the cost savings is currently listed as the number one reason global companies outsource both production and service work. Some economists call it globalization and creation of an opensource workforce, but white and blue-collar workers from many sectors call it unemployment due to job exports (Stiglitz, 2004, p. 13). Of all the consequences of globalization, the relocation of jobs to countries where labour is cheaper is what worries European citizens most. The extent of the concern varies sharply between countries - with the French topping the list - and is on the increase. Across Europe, and allowing for "don't knows", the pessimists about globalization outnumber the optimists by two to one (see chart 1).

Draw 1. EU residents who fear jobs moving to other countries



Sources: Eurobarometer 63; European Commission. Percentage of the population that thinks first of corporate relocation to lower wage countries when the world "globalization" is mentioned.

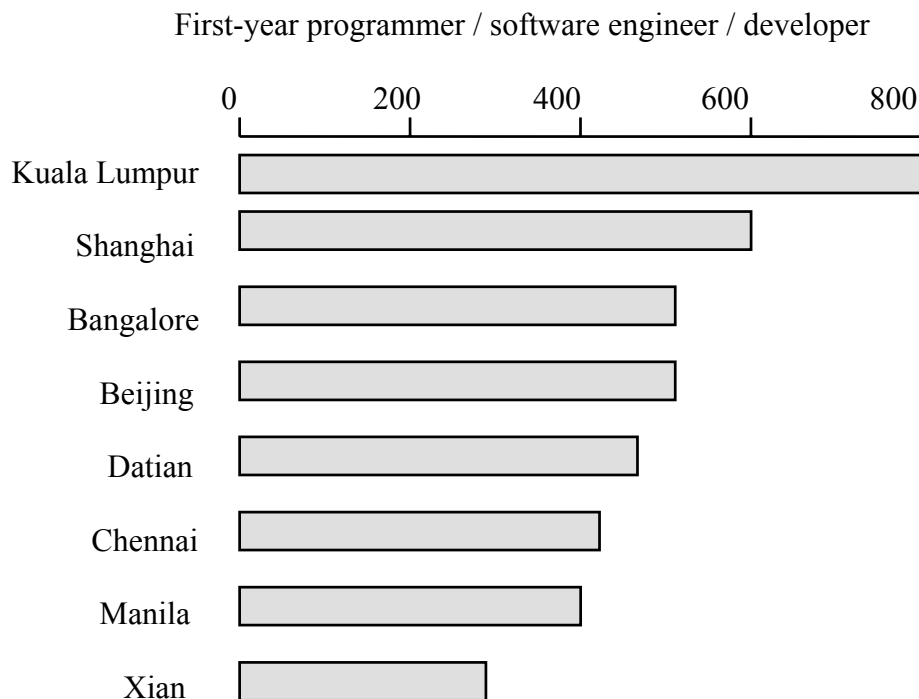
Such opinions should be taken into account when we evaluate and compare costs and benefits of globalization or only of offshore outsourcing. There are both winners and losers in those two processes. The same holds true to trade which often produces losers as well as winners. The accelerated pace of globalization means more losers as well as more winners; workers' fear that they will lose their jobs to Chinese factories and Indian call centers aren't irrational (Krugman 2004).

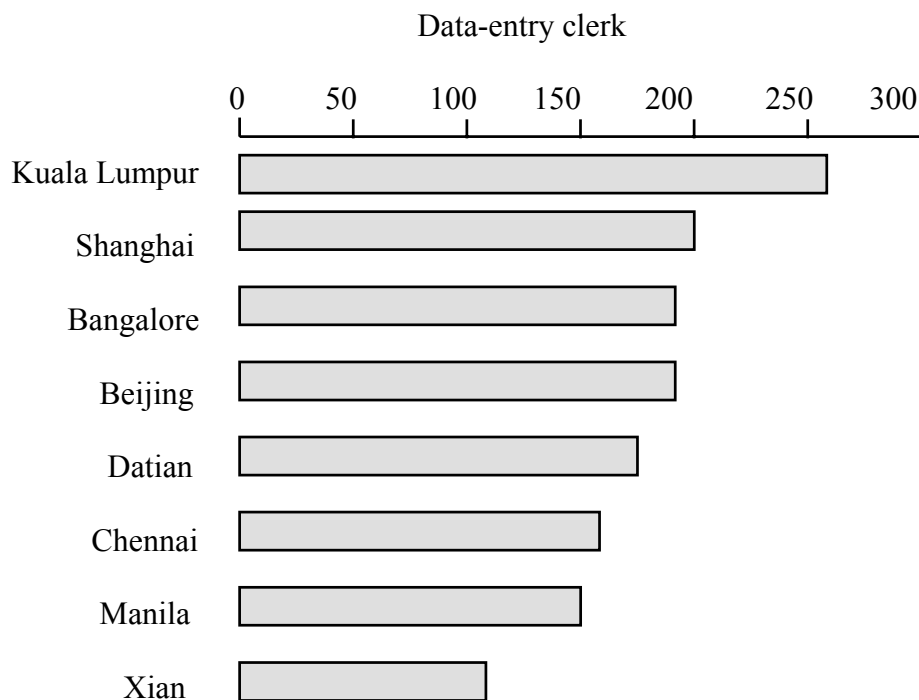
For the time being China is way behind India in the business of outsourced services, but it has now started to catch up. The latest example is the opening of The Xian High-Tech Industries Development Zone, which comprises 35-square-kilometres and houses 7,500 companies. This Zone is also supported by more than 100 universities that churn out 120,000 graduates a year, half in computer sciences alone. And that is just the start. The Xian High-Tech Industries Development Zone will eventually span 90 square kilometres at a cost of 100 billion yuan (\$ 12 billion) (Outsourcing).

The sheer size of this undertaking betrays China's ambition to become a global power in software and services to match its pre-eminence in manufacturing. Attracting outsourced business is central to this. The worldwide market for offshore spending on IT services for (predominantly) Western companies will reach \$ 50 billion by 2007, and is growing in double digits. The market for business-process outsourcing, BPO, which encompasses processing bills and credit-card applications to managing entire humanresources operations, should be worth another \$ 24 billion by next year, and is expanding even faster (Gartner, 2005).

However India has captured the bulk of this work. While China is the world's top location for contracting out manufacturing, it has just \$ 2 billion of the outsourced-services market. But China has plenty of potential. Its workers are well educated in basic computing and mathematics. They may lack creativity, but they are disciplined and readily trained, making them better at tedious jobs than most Indians are. This suits the BPO business. These are repetitive, rules-based tasks which you can train an army of people to do. They are not tasks that require innovation. In other words this business needs millions of low-cost workers, and China has them. India used to be cheaper, but salaries for graduates, engineers and programmers have been climbing fast and staff turnover at IT companies can reach 30-40% year. China, where an entry-level BPO staffer is paid around \$ 300 a month, one-tenth of the comparable American wage, is now very competitive.

Draw 2: Typical monthly salary in April 2006 in US dollars





Source: Tamasys International.

As was mentioned earlier for the potential foreign investor it is also important - apart from relatively low salaries - what are the other incentives which a given state offers such as tax breaks, strong support from the state and well or poorly developed infrastructure. Both countries offer generous tax breaks, but China is still five to ten years behind India, say most observers. It has two big disadvantages. First, although many Chinese can read English, they speak and write it badly. That's a problem in services that require frequent communication with overseas offices. Moreover few Chinese engineering and computer graduates are as good as their qualifications suggest. While they often have a more solid grasp of theory than their European counterparts, few leave university able to apply it to real-life problems, such as developing software. One reason is a lack of vocational training and few links between business and academia. In Europe and India, by contrast, engineering degrees demand work experience - but not in China.

As a result, foreign companies in China are spending a small fortune "subsidising China's education system". For example Fujitsu Company has put some 40 Chinese workers through intensive training in Japan, at a cost of \$ 30,000 a year each. They need two years of full-time training just to become a middle-level engineer and four years to get to be a project manager according to the managers of the Fujitsu Company (Outsourcing in China, 2006, p. 76). The same holds true to the rest of the China's educated labour force. The fact is that China has so many colleges and so many graduates, but the degrees are not as good as they sound. The same can be true for China's infrastructure. There is also fear about piracy of intellectual property, which is more common in China than in India. This factor also may hinder the inflow of foreign investments and outsourcing contracts into China, although copying sophisticated IT processes is difficult and can be thwarted by relatively simple safeguards. However the perception that sensitive business information is at risk is likely to slow development. It seems that, for the moment, China is likely to capture an increasing share of low-level BPO tasks, such as data entry, form processing and software testing, while India continues to dominate higher-value functions, such as research and design, which require greater creativity and language skills. However, this will change as more western

firms demand support in China and domestic opportunities grow. Such expansion of foreign companies, especially multi- and transnational corporations not only in India and China but in many other countries is being driven by burgeoning demand from overseas clients who want lower costs, a better spread of risk and local support for their growing outsourcing operations.

Conclusions

It is difficult to assess fully the economic challenge of offshore outsourcing. As was discussed in the main body of this article some research confirm that jobs are being exported, on net, from industrial countries to developing countries. Thus, the evidence suggests that job losses in one industry are often offset by jobs created in other growing industries. The findings of other experts confirm the fact that the cost saving motivation is a driving force for offshore outsourcing and this process leads to unemployment in industrial countries, where wages and salaries are very high. It seems that further research is needed to examine all possible consequences of outsourcing. There are yet still other conjectures that cannot be verified without more detailed firm level data on employment and output, as well as details of which parts of the production stage have been outsourced to other countries. The fact is that in the era of globalization there will be a steady increase in the mobility of capital and to much lesser extent of labor. The whole sectors of labor-intensive production will be transferred from the high-wage countries to the low-wage countries. An increasing number of labor-force will have to live under the new conditions created by the globalization and more mobile enterprises which are free to move the production to almost every country in the world.

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