

Global Outsourcing of Services: Issues and Implications

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Contemporary international trade flows are increasingly characterized by “production sharing” which essentially refers to the cross-border multi-staged production and trade in parts, components and accessories (PCAs). This process has been facilitated immensely by major advancements in transportation and information communication technologies. Production sharing is not just limited to trade in goods, as companies have also fragmented and dispersed various services and functions worldwide to take advantage of marginal differences in costs, resources, and markets. This has led to a rapid increase in the off-shore outsourcing of and international trade in many service activities that may have been considered non-tradable in the recent past. The often repeated mantra nowadays is “anything that one can send over the wire is up for grabs!”

Many times outsourcing is defined on the basis of organizational control (intra-firm versus arms-length). With regard to international trade, what is important is not so much organizational control, but rather the location of economic activity. The focus of this paper is on all forms of global outsourcing (i.e. “offshoring”), as opposed to any type of domestic outsourcing. Global outsourcing involving arms-length transactions with no direct interface requirement between the consumer and producer comes under the rubric of Mode 1 services trade. This category needs to be distinguished from captive outsourcing that involves establishing a commercial presence by foreign providers in another country, as represented under Mode 3 of the General Agreement on Trade in Services (GATS).

EXTENT OF GLOBAL OUTSOURCING

To date the offshored service activities have typically been highly commoditizable and labor-intensive (semi-skilled) in nature. The most commonly outsourced activities are IT-enabled “Business Processing Outsourcing” (BPO) services. Activities under this category have included call centre support and other back-end business process operations such as data entry and handling, coding, medical, and legal transcription transcriptions and testing. However, global outsourcing is also increasingly taking place in higher end activities or so-called “Knowledge Process Outsourcing” (KPOs) that include valuation

and investment analysis, market research, consulting, legal and insurance claims processing, software design, architecture, drafting and filing of patent applications, drug discovery and other types of R&D activities, chip design and embedded systems, analytics and inventory management, and so forth. The KPO business is only at its infancy and is set to take off in the next few years, just as the BPO business has done in the last few (1).

However, measuring the extent of global outsourcing activity is an extremely difficult task in view of the acute lack of comprehensive and internationally harmonized data. Although data on computer and information services and other business services reported in the *IMF Balance of Payments* provides some broad indication of the magnitude of international cross-border trade in some services, not all such service transactions can necessarily be characterized as being “global outsourcing.” As an indication of the severe measurement difficulties noted above, the OECD has estimated the volume of the global outsourcing market in 2003 to have been anywhere between US\$ 10 billion on the low end, to US\$ 50 billion on the high end (2).

Tables 1 and 2 offer an indication of the top destination countries (i.e. the so-called top “insourcing” countries) and “outsourcing” countries, respectively. Interestingly, while the industrial countries like US, Germany and Japan are the top outsourcers, the top insourcers, such as India in particular but also China and Russia, are also among the top twenty outsourcing countries. In other words, outsourcing is not a one-way street from developed to developing countries. India is clearly the leading destination for outsourcing of BPO and IT services (Table 3). This is so for a number of reasons, including the widespread use of English, relatively low wages, large pool of science and engineering graduates (see Table 4), and the presence of strong indigenous service sector enterprises.

Apart from India, China and Russia, countries like Ireland, Hungary, Israel, South Africa, Philippines, Poland, and Russia are also emerging as important players. Many of the countries that are witnessing an outsourcing wave have inevitably experienced rapid growth in exports of business services and computer and information services (3). Interestingly, a number of Indian outsourcing

operations are focusing on mid and higher margin activities in India (i.e. higher end BPO as well as KPO activities) and have moved some lower end activities to China and some Southeast Asia countries like the Philippines (due to costs), while others have chosen to set up parallel (higher-end) bases in countries like Singapore, partly as an insurance policy (for instance, in the event that operations in India or other places are disrupted for whatever reason).

ECONOMIC BENEFITS OF GLOBAL OUTSOURCING

From an economy-wide perspective, global outsourcing of service activities from developed to developing countries will inevitably lead to some white collar job losses in the former, just as production sharing has been leading to the displacement of certain blue collar workers. Such domestic adjustments are an inescapable outcome of resource reallocation to their more productive uses following international trade (which is the reason motivating such trade in the first instance). However, this in no way justifies embracing archaic protectionist attitudes or policies that prevent the optimal allocation of resources globally (4). Rather, the focus of well-meaning labor unions and policy makers should be to empower people to take advantage of—rather than hinder and lament—the process of economic globalization and inter-related forces. Indeed, global outsourcing is responsible for only a small portion of recent job losses in the US, with the general business cycle and rapid machine automation being the main reasons behind sluggish job creation and concomitant job insecurities that have gripped the country (5).

In addition, international trade lowers the costs of final goods and services available to the consumers. This so-called consumer “surplus” will far outweigh the job losses faced by a select group of workers in developed countries. Thus, even in a simple *static* sense, outsourcing and production sharing will be beneficial on a net basis to society as a whole, though there will inevitably be some transitional costs.

There is a small but growing body of analytical work indicating that both industrial and developing countries stand to reap substantial gains because of global outsourcing in services (6). Specifically, global outsourcing ought to lead to efficiency gains for industrial countries by allowing them the opportunity to specialize in areas of their core competencies. According to McKinsey Global Institute (2003), for every US\$ 1 offshored by the US to India, the former gains US\$1.12 to US\$ 1.14, while the latter gains US\$ 0.33. While such estimates should be taken with a pinch of salt, they are indicative of the static gains to be reaped from global outsourcing (7). Many multinationals are beginning to routinely outsource a number of their services activities. They have come to appreciate that if they do not out-

source to reduce costs, while their competitors continue to do so aggressively, they stand to lose global and local market shares to their foreign rivals. The resultant stagnant corporate profit growth will limit the creation of new capital and re-investment in domestic technology. The cost savings from outsourcing has emerged as one of the most obvious source of value for U.S companies in particular.

Global outsourcing also presents significant benefits for developing countries by opening up new export, growth and employment opportunities in various tradable service activities. In a more *dynamic* sense, the trade-induced growth in income levels in developing countries will have further positive feedback effects for the rest of the world in terms of rising exports and increased tourism inflows. This is the age-old global-wealth-creation story which is a win-win game. There are already signs of this happening, with rapid growth in China and India leading to sharp increase in imports by these countries as well as increases in outbound tourism from them.

CONCLUSION

Global outsourcing has clearly made the structure of international competition and consequent labor market adjustments more intense. However, it is not a new phenomenon. Rather, it is a continuation of the process of globalization that began in the 1950s and 1960s which has led to net wealth creation globally (as opposed to mere wealth transfer between countries) (8). While global service outsourcing is not a zero-sum game, there will inevitably be adjustment costs and job losses that need to be addressed in a timely and effective manner by all countries involved in the international division of labor. Liber-

alization of services through Mode 4 (temporary movement of natural persons) which facilitates movement of skilled professionals across developed and developing countries can accelerate the process of global outsourcing (9). The same is true with regard to the liberalization of service via

Mode 3 (commercial presence through FDI), especially in higher-end outsourcing activities. For developing countries, it is also imperative that they undertake appropriate domestic policy reforms in the form of upgrading Internet security and data protection laws, privacy safeguards, and intellectual property rights protection if they are to remain attractive insourcers.

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