Outsourcing/Offshoring: Myth versus Reality

Technology and Economics have already revolutionized manufacturing. The industrial complex that Henry Ford built in the early 20^{th} Century in Dearborn, Michigan was the beginning of the age of **'mass mechanisation'**. This was the beginning of exploiting the labor saving properties of machines. In those early stages, Dearborn was handling every step of the production cycle – from rolling steel to making springs and axles as well as casting engine blocks. As automation lowered production costs, profits grew rapidly and these profits were then re-invested to deliver better products for the consumer. As products grew more and more complex, manufacturers managed the growing complexity of their requirements by outsourcing – by sharing the work with others who specialized in specific parts. These part companies in turn depended on other suppliers who specialized in individual components. For example, the first Ford Model T which rolled of the assembly lines in Dearborn had about 700 parts – a modern car today has more than such parts in its audio entertainment system alone! As a result, at each level of production, outsourcing divided growing level of complexity into manageable pieces.

Fast forward to the latter part of the 20^{th} century – the tool used to automate office work was the **'Computer'**. Like assembly line machinery, computers saved labor, reduced costs and thus increased a company's profits. Using the power of technology, firms began to offer 'bells and whistles' to give their customers improved products - eg from providing basic mortgages, Banks began offering 'floaters, caps, collars' etc. to tailor the mortgage to the individual customer's risk appetite.

Just as in manufacturing, the solution to the growing complexity of office work (or more commonly known as 'white collar' work) was to outsource to companies who specialized in specific processes. Companies began outsourcing the work of their IT departments – from managing the physical hardware to maintaining and upgrading business software. Once companies became comfortable in outsourcing their business systems, they soon realized they could do the same with the workers who operate them. Thus was born the phrase **"business process outsourcing" - BPO**. Accounting departments began farming out tasks such as Invoice processing and collecting Receivables; HR departments began shedding payroll work and so on.

Towards the beginning of the 21^{st} century, with the cost of telecommunications rapidly going down and the cheap availability of 'high bandwidth' internet connections for data transmission, some smart companies in the US (**GE was the first mover**) began to move some of their business services abroad – **so far mostly to India**. With the second largest pool of engineers and college graduates in the World, India soon became the preferred destination for IBM; Accenture; GE; etc. - who hired tens of thousands of these young professionals at costs a fraction of what they cost in the US. This has given India a huge competitive advantage – since the early outsource service providers were captive units of these US firms. These Indian subsidiaries applied the same management disciplines that their parent companies used in their core businesses in the US.

The biggest influencer in the early days was GE's subsidiary in India – GECIS (now renamed to Genpact) which applied 'the six sigma ' method of quality improvements to its **'service business'** as GE was applying to its **'industrial businesses'** in the US – processes were broken into modules; examined and reworked to reduce errors, improve consistency and speed things up.

Whilst manufacturing has gone a long way towards outsourcing/offshoring (China's trade surplus with the US was $ 160 billion last year – 24% of toys; 22% of shoes; etc. sold in the US were from

China), there are now growing signs that 'white collar' work will be re-organized much more quickly - with the realization that the computers used by expensive workers in the developed world can be plugged in anywhere.

The change can be harsh and deep. But a more strategic view of offshoring is beginning to emerge. The new buzzword is **'transformational offshoring'** – making better use of skilled US staff to gaining efficiency, productivity, & quality improvements resulting in Sales growth. As a CEO of a highly successful US multinational summed it up …" Don't tell me how much I can save. Show me how we can grow by 40% without increasing my capacity in the US ..." Thus, leading US companies see this as an opportunity to turn around dying businesses; speed up pace of innovation and fund development projects that otherwise would not have been 'affordable'. The more 'aware outsourcers' are re-engineering their business models to free up expensive and talented engineers, analysts and salesmen from routine tasks so that they can spend more time innovating and dealing with customers. Ask executives at a large US publishing house why it has moved software development and editorial work to India and the answer is that this has enabled them to put out a higher number of Books, Journals and Web based content more quickly. DuPont has recently signed a multi billion dollar contract with **'Convergys'** (a leading outsource service provider) to administer its human resources program for its 60,000 employees in 70 countries with data scattered among different software platforms. Whilst companies earlier struggled to gain 5% productivity gains a year, DuPont expects to lower costs by 20% in Year 1 and 30% in Year 2 – freeing up hundreds of millions of dollars in Cash Flow annually.

As has been clearly demonstrated in the Information Technology business over the last decade, sourcing from low-cost economies has spread the 'productivity enhancing effects' of this technology by making it more easily available throughout the economy. A study by the Institute for International Economics has estimated that globalized production of IT hardware has made it 10-30 % cheaper. This price reduction created a cumulative $ 230 Billion worth of additional GDP in USA between 1995 and 2002 as more widespread use of technology increased productivity growth. Sourcing IT services (which accounts for 70% of overall IT spending in the US) will have an even more dramatic impact, creating a 'second-wave' of productivity growth. **A recent study by McKinsey calculates that for every $ an American firm spends on service work from India; the US economy receives $ 1.14 in return**. The way this is calculated is as follows: 58 cents comes from savings accrued to US customers; 5 cents from increased goods purchased by Indian companies (computers; telecommunications equipment; & other hardware); another 4 cents comes back as US service providers with Indian operations (IBM; Accenture; GE; etc.) repatriate their earnings back to the US; and finally, more value is generated as US workers are retrained and redeployed. As a low value added service is sourced from overseas, the US worker previously engaged in providing this service is freed up to take other jobs. Based on redeployment rates of the past 20 years, this generates an additional 47 cents from the new jobs that are generated. ***Hence, in sharp contrast to the myth that 'offshoring' is going to be the demise of the US economy; the US economy is emerging as the biggest gainer.***

Simply put, a country should focus on what it does best. The US is best at innovating and starting new businesses – and outsourcing boosts this efficiency. The US therefore must stay focused on education & training to keep its workers competitive. Simultaneously, the US policymakers will have to determine whether 'structural' changes are required in the way employers and government share employee benefits such as healthcare & pension. But recognizing this change in 'Global Economics' should not spark a rush to reduce worker's benefits. As many German companies have demonstrated, a highly trained workforce can still command a premium in today's marketplace (BMW; etc.). And US shareholders (such as Employee Pension Funds) must continue to wield their clout by pushing their companies to use 'off shoring' not just as a cost cutting tool; but as a way to transform their business so as to ensure long-term competitiveness back home.

Few management trends have been as divisive for the American economy over the past decade as the practice of companies moving business functions (or white collar employment) overseas to countries that can do the work cheaper and better. Though India has emerged as an undisputed leader (65% market share); competition will only grow fiercer as more countries (Russia; South Africa; Philippines; etc.) recognize that unlike capital intensive manufacturing units, service outsourcing is relatively cheaper to set-up and generates as much as 100 times more jobs per dollar invested.

Like it or not, the phenomenon of 'Offshoring' is here to stay. The challenge now is how best to manage it!

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