

Offshoring: Myth and Reality

What the global trade in business
services means for the UK



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The Advanced Institute of Management Research (AIM) develops UK-based world-class management research. AIM seeks to identify ways to enhance the competitiveness of the UK economy and its infrastructure through research into management and organisational performance in both the private and public sectors.

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AIM consists of:

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- Undertaking a wide range of collaborative research projects on management...
- Disseminating ideas and shared learning through publications, reports, workshops and events...
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- To enhance UK competitiveness and productivity.

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- Expand the size and capacity of the active UK research base on management
- Engage with practitioners and other users of research within and beyond the UK as co-producers of knowledge about management

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AIM research themes

Current AIM research projects focus on:

UK productivity and performance for the 21st century.

How can UK policy makers evaluate and address concerns surrounding the UK's performance in relation to other countries?

National productivity has been the concern of economists, government policymakers, and corporate decision-makers for some time. Further research by scholars from a range of disciplines is bringing new voices to the debates about how the productivity gap can be measured, and what the UK can do to improve the effectiveness of UK industry and its supporting public services.

Sustaining innovation to achieve competitive advantage and high quality public services.

How can UK managers capture the benefits of innovation while meeting other demands of a competitive and social environment?

Innovation is a key source of competitive advantage and public value through new strategies, products, services and organisational processes. The UK has outstanding exemplars of innovative private and public sector organisations and is investing significantly in its science and skills base to underpin future innovative capacity.

Adapting promising practices to enhance performance across varied organisational contexts.

How can UK managers disseminate their experience whilst learning from others?

Improved management practices are identified as important for enhancing productivity and performance. The main focus is on how evidence behind good or promising practices can be systematically assessed, creatively adapted, successfully implemented and knowledge diffused to other organisations that will benefit.

Offshoring – the practice of sourcing business services from overseas – ignites controversy. The loss of UK jobs in business services to foreign providers makes headline news. The implication is that the UK has become less competitive in the business services market. But what is the reality? What is the economic impact of increased international trade in business services on UK firms?

This report is an overview of the findings of a team of management scholars selected by AIM to explore the recent trends in specialisation, outsourcing and offshoring of business services.

Key Findings: Setting the story straight

- The UK is a net exporter of business services;
- Business services account for over 50% of UK job growth over the last 20 years;
- Most UK business services sectors have enjoyed continued growth;
- In business services, the UK has substantially closed the productivity gap with other G5 competitors such as the US, Germany and France.

Implications for the UK

Our research indicates that the UK's business services industry makes a substantial contribution to the UK economy. But for policymakers to shape future policy in this area, and for senior executives to determine corporate strategy, further research is needed to answer key questions about the trends in the UK business services industry.

These include:

- What is the relationship between outsourcing and productivity?
- How do outsourcing and offshoring affect innovation in business services?
- What is the impact of offshoring on UK job skills?
- How do outsourcing and offshoring impact the regional distribution of jobs?

Offshoring – the practice of sourcing business services from overseas – ignites controversy.

Media reports confirm that UK firms are moving elements of their value chain abroad. What started with an exodus of manufacturing jobs has now spread to business processes. Whether it is call-centres in India, or back office administration moved to China, the impression is that the UK is a net importer of business services; that we buy more business services from other countries than we sell to them. The implication is that the UK cannot compete in the global business service market.

The reality is more complex. When we looked behind the headlines, we found little empirical evidence on the extent of outsourcing and offshoring business services, or its impact on the UK economy.

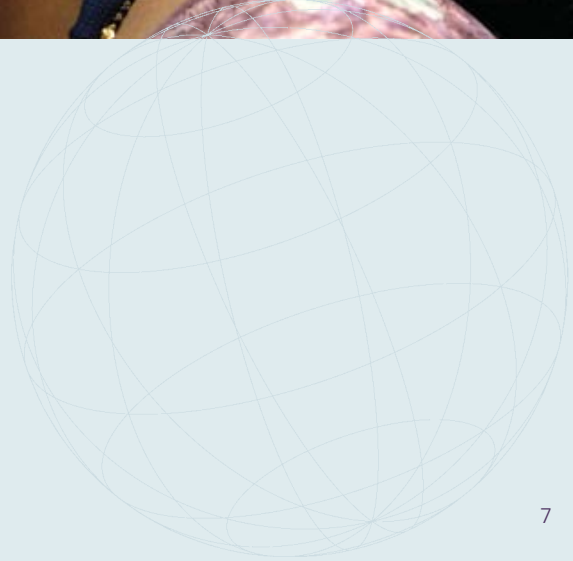
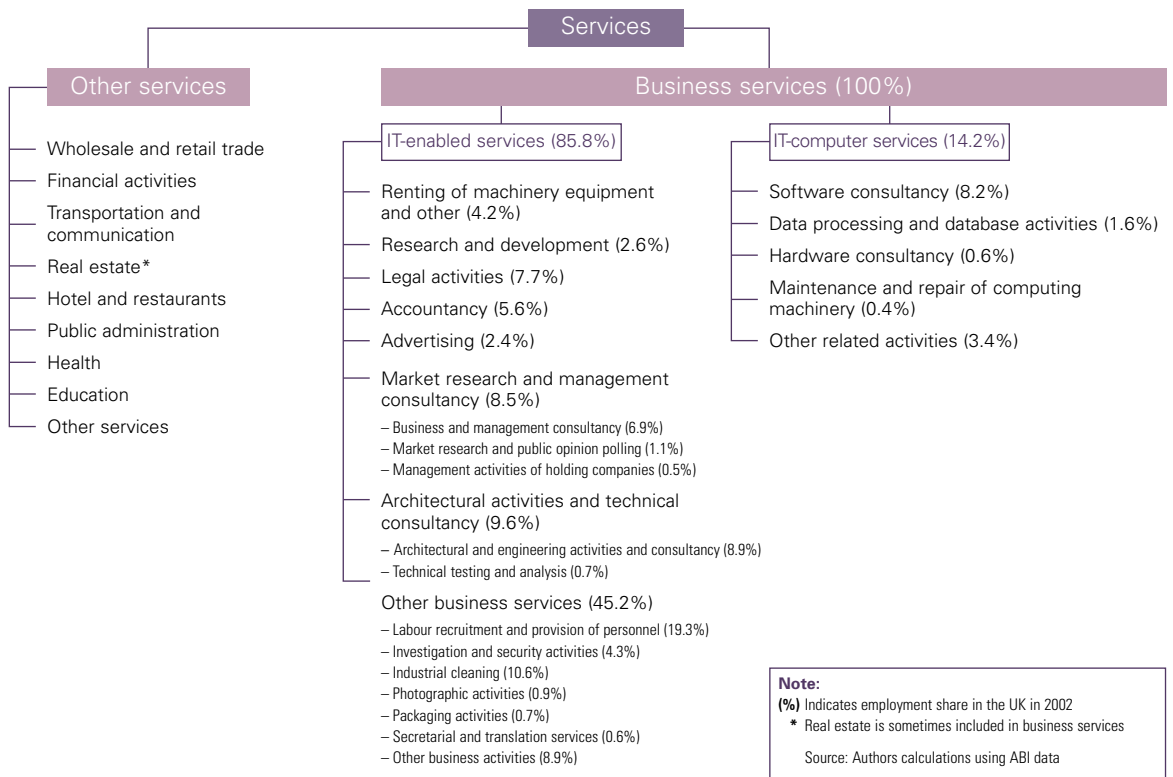
We set out to establish the true picture. In doing so our research examined a number of key issues, including: to what extent has the trade in business services in the UK increased, if at all? What trends are there in terms of specialisation, outsourcing and offshoring of business services within the UK? And what impact has this had on the UK economy? The results are surprising.

Some definitions

What do we mean by specialisation, insourcing, outsourcing, offshoring – or even business services?

- **Specialisation:** Where a firm moves an activity to a specialised production unit. This includes insourcing, outsourcing and offshoring.
- **Insourcing:** The production of the service is still owned and controlled by the firm.
- **Outsourcing:** One step further than insourcing, outsourcing occurs when the firm uses a third party provider to carry out an activity. The company buys services externally rather than providing them in-house.
- **Offshoring:** A type of specialisation where the production of the goods or service – whether it is making goods, or answering the telephone – is moved overseas. This may involve either insourcing or outsourcing.
- **Business services:** Those services used by firms as part of their business, and by the government for public administration. Business services are subdivided into IT services and IT enabled services. IT services include hardware and software consultancy; maintenance and repair of computers; and data processing and database activities. IT enabled services, a much larger and rapidly growing sector, includes professional services such as legal, accountancy, architectural, engineering, marketing and consultancy services; as well as other, more diverse, activities such as recruitment agencies, renting of machinery, R&D, and call-centres.

Figure 1: What is business services?



It is hard to obtain exact figures for the amount of business services that UK companies source offshore, or the extent to which foreign firms source their business service needs in the UK. The best way to detect meaningful trends is trade data. This shows business services sourced by UK firms from overseas as imports, and services sourced by foreign-based firms from UK firms as exports.

1 Offshoring: Trading places

(i) The impact of business service imports

When UK firms shift the provision of business services overseas it makes headline news (see box below). But this does not give the whole picture. Some people in the business service industry have lost their jobs and more undoubtedly will, but what is the real impact of importing business services?

Despite the attention focused on the offshoring of business services the reality is that the value of the UK's trade in business services is relatively small compared to other sectors. It is dwarfed by the trade in manufactured goods for example. Business services account for just £1 in £20 of imports, and just £1 in £6 of exports. Trade in manufactured goods makes up three-quarters of total imports and two-thirds of exports. As a percentage of total GDP business services imports were just 2% in 2001. The result is that the impact of importing business services on UK trade as a whole is comparatively small.

The impact on the UK business services industry also appears slight. Compare the imports of business services to the growth of the UK domestic business services industry, for example. Between 1995 and 2001 the ratio declined slightly to around 8%, compared to 50% for manufacturing in the same year. In other words, growth in the UK business services industry is outpacing growth in business services imports.

UK Firms Offshoring

British Airways was an early offshorer. The airline created call-centres in India to handle flight booking and processing in May 2002. More recently offshoring deals have featured UK-based financial firms. In October 2004, for example, insurance firm **Royal and SunAlliance** announced its decision to outsource 1,100 jobs to India, adding to the estimated 50,000 posts already offshored from the UK in the past two years. Another insurer **Aviva** transferred 2,350 jobs from Britain to India in October 2003, and doubled the jobs exported to 7,000 in October 2004. **Barclays Bank**, too, is restructuring and relocating jobs overseas. It has signed an offshoring deal with the UNIFI union, agreeing to minimise job losses and the consequent impact on people and communities. **HSBC and Prudential** also announced that they would offshore to India. Offshoring is not limited to call centres and financial service firms. **Reuters**, the business information company, recently opened a new centre in Bangalore to source financial news. It plans to eventually employ up to 15,000 people in India – 10% of its workforce.

(ii) The UK as a provider of business services to other countries

Rapid advances in information and communications technology (ICT) in recent years have made it easier for UK companies to source their business services from overseas. But it is a two-way street. Companies from overseas are also able to source their business services from the UK more readily. This shows as exports in the UK trade data.

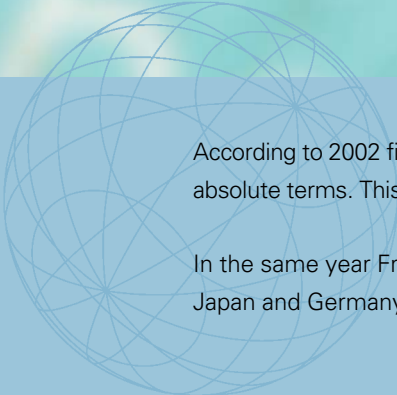
Imports of business services have grown over the past two decades, but exports have grown even more rapidly. Between 1984 and 2003, the UK has experienced a trade surplus in business services every year. The gap has widened in recent years. During the period from 1995 to 2003 export growth outpaced import growth leading to a trade surplus of £15 billion in 2001. In business services, the UK now exports more than twice as much as it imports. This means that to date the UK business services sector has benefited from offshoring.

2 Doing better than our G5 competitors

Which two countries are the world's largest exporters of business services?

Not India, nor China, nor any other of the developing countries increasingly touted as popular destinations for offshoring. The top two countries are the US and the UK¹.

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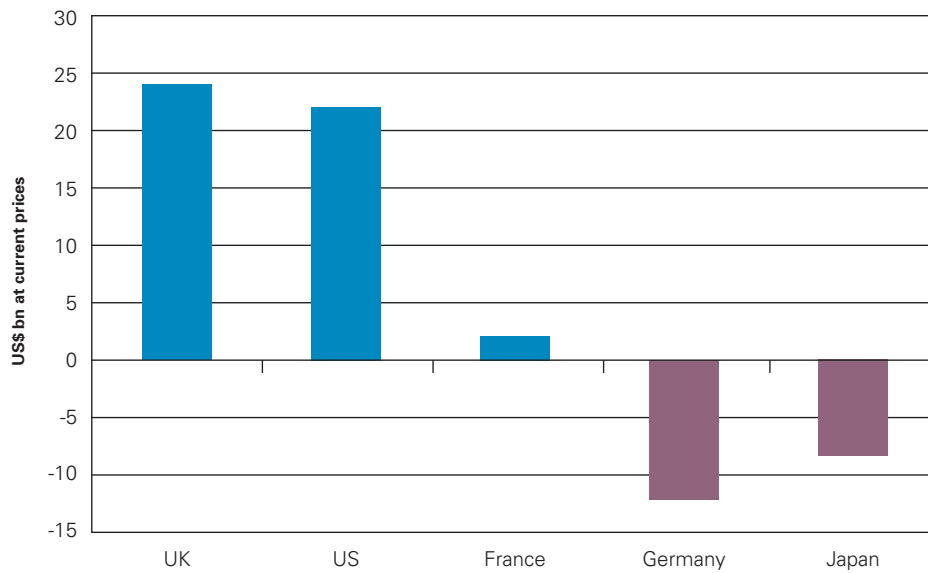


According to 2002 figures, the UK has the largest trade surplus in business services in absolute terms. This is even greater when considered relative to the size of the economy.

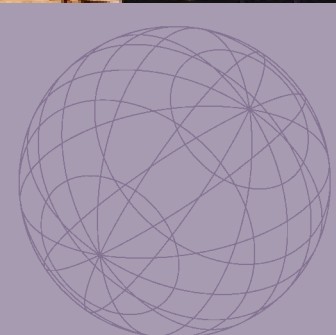
In the same year France showed a slight trade surplus in business services and Japan and Germany posted trade deficits.

offshore, onshore – myth and reality

Trade surplus in business services, 2002



Source: Authors' calculations using IMF Balance of Payments Statistics Yearbook. This includes IMF industries classifications 'business services' plus 'computer services'.



A breakdown of results for the different types of business services in 2001, shows that, with the exception of the renting of machinery, the UK had a trade surplus in every category of business services.

The top five sectors in terms of their positive trade balance were:

- 1 Other business services;
- 2 Research and development (R&D);
- 3 Architectural activities and technical consultancy;
- 4 Computer services; and
- 5 Legal servicesⁱⁱ.

These five sectors together accounted for 90% of the total trade surplus in UK business services in 2001.

3 The trend towards offshoring

Although the UK currently has a trade surplus in business services, this may not always be the case. To anticipate future events it is first necessary to consider the reasons for the move to offshoring.

Offshoring is a logical progression of a trend that started some time ago – specialisation. Specialisation began with companies identifying elements of the value chain that could be separated from where the final goods or services were produced. The main aim was to reduce costs. Banks discovered, for example, that rather than having people in every branch answering telephone calls it was cheaper to gather them together in a call-centre. Such specialisation was a response to increased competitive pressures in the new global business economy. These new ways of organising work were made possible by advances in technology. Initially, however, companies retained ownership and control of the specialised units – a practice called insourcing.

In the face of unremitting competitive pressures, the next step was increased specialisation. Companies began to focus on what the business was good at – its so-called core competences. Anything else could be hived off. The already discrete specialist units were outsourced to third party providers. The bank no longer ran its own call-centre; a call-centre specialist did. This was outsourcing.

Offshoring represents the final step in a logical progression. Technology has now made it possible to source business services from overseas. The advent of video conferencing, mobile telephony, broadband internet, and email, for example, mean that geography is no longer a limiting factor for some services. The now outsourced activity shifts to a location where costs are lower and resources more abundant. This is offshoring. Offshoring appears to be an inevitable result of globalisation.

Between 1984 and 2001 the growth in the business services sector accounted for around one-third of the total output growth in the UK economy.

4 Business services drive the growth of the UK economy

Between 1984 and 2001 the growth in the business services sector accounted for around one-third of the total output growth in the UK economy. This is a substantial proportion of total UK growth. Any setback in the business services market would have a dramatic impact on the UK economy. The global trade in business services is increasing, but does it have the potential to derail the business services industry and consequently the UK economy? The key to answering this question is to find out how much of the UK business service market is made up of imports and exports. The greater the proportion the more susceptible the UK business industry will be to changes in those imports and exports.

The good news is that between 1984 and 2001 over one half of the growth in the UK business services market was UK firms buying business services from other UK firms. Only a small proportion was due to international trade. Just 10% (3.7% of total growth) was due to foreign firms buying business services from UK firms. And an even smaller proportion 5% (1.7%) due to UK firms offshoring.

Business Services share of UK output growth, 1984-2001

	Share of total growth in UK-produced output (%)
1 Purchases of business services by UK-based firms	19.5
2 of which specialisation and outsourcing	6.5
3 Purchases of business services by foreign-based firms (exports)	3.7
4 Other purchases of business services	8.8
5 Total purchases of business services = 1+3+4	32.0
6 Purchases of foreign-provided business services by UK-based firms (imports)	1.7

Notes

- Share of the total increase in UK output that was accounted for by increased purchases of business services by other businesses in the UK, including capital goods.
- is part of **1**. It is the increase in firms' purchases of business services that is driven by an increased intensity of usage of business services produced in specialised plants or offices, in order to produce the same amount of output that they were producing in 1984.
- Share of the total increase in UK output that was accounted for by an increase in purchases of business services by foreign-based firms, that is an increase in exports of business services.
- Share of the total increase in UK output that was accounted for by changes in purchases of business services by consumers and government.
- Total is the sum of rows **1**, **3** and **4**. It is the share of the total increase in UK output accounted for by Business Services.
- Final row is growth of imports by sector as a proportion of growth in total output.

The message is that, to date, offshoring has made a relatively small impact on the UK business service industry. To date most outsourcing and specialisation of business services has taken place within the UK economy. The proportion of growth attributable to the import and export of business services is so small that it will require a substantial increase before it has the potential to seriously affect the growth of the UK economy. On this evidence, the idea that offshoring is damaging an increasingly uncompetitive UK business services industry is a myth.

5 The future of the UK business services industry

So what does the future hold? The globalisation of the business services industry and the trend towards offshoring may impact the UK economy in a number of ways.

It is likely to affect:

- The total number of jobs in the UK;
- The types of jobs available, the skills required to do these jobs and the distribution of jobs across regions and people;
- Productivity in business services and other industries;
- Overall welfare in the UK – through the impact of the cost of business services on the final cost of the associated goods.

Economic theory suggests that an increase in the trade of business services will lead to the following chain of events: workers who used to produce the services now offshored are displaced; these jobs are lost to the UK; the UK gains jobs in areas where it is competitively positioned in respect to other countries; there is a resulting shift in occupations and skills base, as well as relocation within the UK.



Competition from overseas firms may lead to UK based business services providers becoming more efficient.

In the short to medium term, then, while people are retraining and relocating, there are likely to be job losses. It should also be noted that while the benefits from increased trade will be dispersed across the nation, the job losses will affect specific geographical areas – those that specialise in the offshored business services. Areas like South East Wales for example, which has a high proportion of call centres. To achieve regionally balanced growth, efficient mechanisms to address this geographical inequality are required.

In the long term, however, economic theory suggests that despite the inevitable job losses, an increase in the trade in business services will have beneficial consequences for the UK economy. In particular, there will be the following positive outcomes:

Increased productivity. Increases in productivity can result in a number of ways. By offshoring activities that create less value, workers are freed up to pursue activities that create more value for the firm. If the HR director doesn't have to worry about payroll processing then she can concentrate on strategic HR issues. A move to more efficient activities should lead to an increase in GDP per capita. The UK becomes more productive.

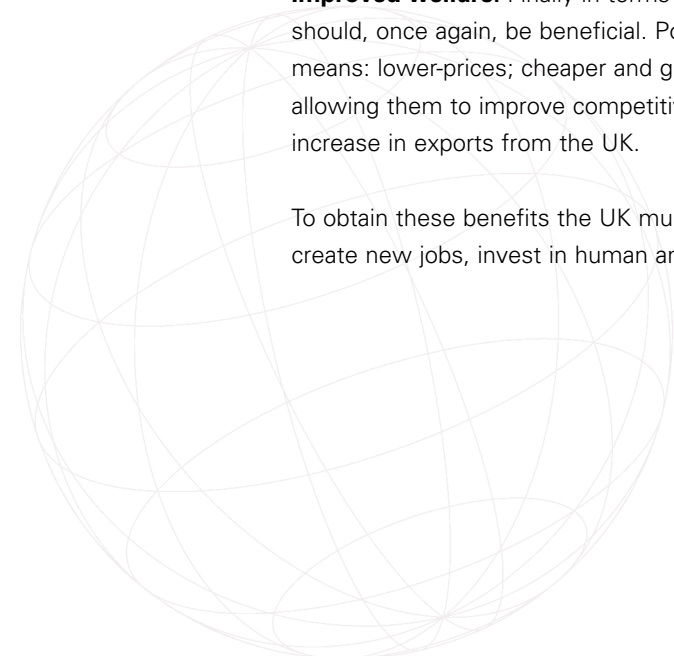
Competition from overseas firms may lead to UK based business services providers becoming more efficient. It may also drive out inefficient firms, creating a more efficient, competitive and thus productive industry. Increased specialisation can also lead to increased productivity through economies of scale.

Lower prices. Companies may choose to pass on cost savings to the customer in the form of cheaper final goods. Alternatively, they could pass increased profits on to other stakeholders, such as shareholders or employees.

Greater demand. Increases in income for all those engaged in the trading of business services would drive demand for other goods and services, including those produced by the UK.

Improved welfare. Finally in terms of overall welfare the effect on the UK economy should, once again, be beneficial. Potentially increased trade in business services means: lower-prices; cheaper and greater variety of outsourced services for UK firms allowing them to improve competitiveness and focus on core competences; and an increase in exports from the UK.

To obtain these benefits the UK must introduce new products and processes to create new jobs, invest in human and physical capital, and promote innovation.



6 The impact so far

Economic theory is one thing, but our research has examined what actually happened in business services on the UK economy in three key areas: employment; wages; and productivity.

Employment. Precise figures on the number of business service jobs relocated abroad are difficult to obtain. Evidence from job growth in the UK, trends in the UK call-centre industry, and the number of jobs in India serving foreign clients all point to job losses being small compared to total job creation in business services.

In a recent survey of UK call-centre operators, for example, nearly 60% said there was an increase in staff in the previous yearⁱⁱⁱ. The majority of the largest organisations also expected an increase next year.

In India, the beneficiary of many of the offshored jobs in business services, of a total of 505,000 people working in the computer industry in March 2004, just 26,745 were serving economies other than the US. Contrast this with the 550,000 working in the industry in the UK.




Wages. The average weekly wage in business services, around £450 in 2002, remains significantly higher than the average UK wage of around £350.

Productivity. Much is made of the productivity gap between the UK and its international competitors. In business services at least, the evidence suggests that the UK is closing the gap on its rivals. In some areas of the business services market, such as legal technical and advertising business services, the UK has moved ahead of Germany and completely closed the gap with the US.

conclusions

Despite the impression given by news reports about the loss of UK jobs in business services, the evidence reveals the following:

- The increase in the business services industry in the UK has been beneficial for the UK economy. Business services have accounted for over 50% of job growth in the UK over the last 20 years;
- The external trade in business services that exists is small in comparison with the overall size of the business services market;
- Even in the contentious area of offshoring the UK operates a trade surplus in business services;
- The overall effect of the business market is to improve the productivity of the UK. In business services the UK has substantially closed the productivity gap and even overtaken other G5 competitors such as the US, Germany and France.



The trend towards the specialisation of business services through insourcing, outsourcing and offshoring is well established.

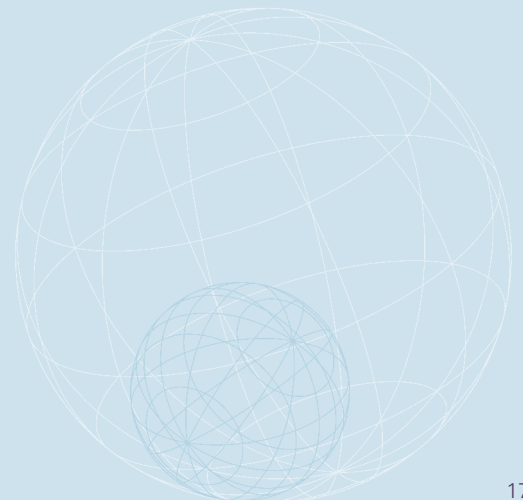
Implications for practitioners:

The trend towards the specialisation of business services through insourcing, outsourcing and offshoring is well established. It has a number of implications for UK businesses – not only for firms that could benefit from outsourcing certain business services, but also those that are in the business services industry.

Those companies that do not outsource their business services already will inevitably be forced to consider doing so in the near future. UK companies involved in the provision of business services are in a position to benefit from this.

Our research reveals that there are a number of issues firms need to consider regarding the insourcing, outsourcing and offshoring of business services.

- For UK companies involved in the business service industry the increase in the global business services market offers considerable opportunities. UK firms excel in the provision of business services. They have a well-established track record providing business services both to domestic and foreign firms. To take advantage of these opportunities, however, they will need to remain competitive on both cost and quality of services.
- Businesses considering separating out business service functions should consider their options on a case-by-case basis. A one-size fits all approach is not advisable. Offshoring will not always be the best option, or even the most cost effective. The alternatives of insourcing within the UK or outsourcing to UK based companies should be thoroughly evaluated. A combination of approaches may even be preferable.
- To remain competitive, all companies must clearly define their core competences – those activities which add the most value. Insourcing, outsourcing and offshoring of non-core business services allows firms to concentrate on higher value activities and become more productive and more competitive.
- For those companies that decide to go down the insourcing, outsourcing or offshoring route there are some challenging decisions to be made. For example, companies can choose to become more competitive by passing on cost savings to the consumer via the pricing of final goods and services. Alternatively they may decide to pass on the benefits to other stakeholders such as shareholders or by providing additional training or financial incentives to employees. Getting the balance right will be important for the future of the business.



What of the future?

Economic theory predicts what could happen in the event of an increase in the international trade of business services: Job losses, followed by reskilling and creation of new jobs, cheaper final goods and increased productivity in the UK economy.

Evidence tells us what has happened so far: Little difference in overall job totals, continuing above average wage levels and increased productivity.

However predicting whether this favourable outlook is likely to continue requires further research.

Implications for policy and research

Several countries have moved towards protectionist policies because of a fear that increased global trade will adversely affect their national economy. Traditionally the UK is one of the most open trading nations in the world. Our research reveals that the UK has benefited from increased trade in business services. However, for policymakers to shape future policy with regard to the trade in business services, and for senior executives to determine corporate strategy, it is essential that we are able to answer some key questions with a degree of confidence.

- Outsourcing and productivity. To what extent is the rapid productivity growth in UK business services due to greater specialisation through outsourcing? Is the UK business services sector using more ICT and better-educated labour force?
- The impact of offshoring on UK jobs skills. Are job losses due to offshoring just in the less skilled segments of business?
- How outsourcing and offshoring impact the distribution of jobs. How regionally concentrated are business service job gains and losses? How does this picture compare with manufacturing jobs?
- How firms decide what business services to outsource/offshore. Apart from labour cost savings, how do companies take account of upfront investment in new processes, coordination costs and risk assessment? What role does geographical distance play in developing modular or integral supply chains?
- Outsourcing and offshoring – the effect on innovation in services. Do outsourcing and offshoring contribute towards more rapid innovation through standard setting and modularisation? Or do they undermine innovative activities through the erosion of core competences and the knowledge base of integrated companies?

It is only by answering such questions that we can hope to maintain the UK's position at the forefront of the global business services market.

¹ India was the sixth largest exporter of business services in 2002.

² See Figure 1 for a detailed breakdown of what 'Other business services' is comprised of.

³ Source: IDS Pay and Condition Report on Call Centres (2004).



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The Advanced Institute of Management Research (AIM) was founded in October 2002. It is a multi council initiative of the UK's Economic and Social Research Council (ESRC) and Engineering and Physical Sciences Research Council (EPSRC) – with activities at over 30 institutions in the UK and overseas, and offices at London Business School.