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Who wins in offshoring

By moving service industry work to countries with lower labor costs, US companies can focus on creating higher-value jobs.

VIVEK AGRAWAL AND DIANA FARRELL

The McKinsey Quarterly, 2003 Number 4 Global directions

Widely cited figures predict that by 2015, roughly 3.3 million US business-processing jobs will have moved abroad.¹ As of July 2003, around 400,000 jobs already had. Other research suggests that the number of US service jobs lost to offshoring will accelerate at a rate of 30 to 40 percent annually during the next five years.² Vast wage differentials are prompting companies to move their labor-intensive service jobs to countries with low labor costs: for instance, software developers, who cost \$60 an hour in the United States, the world's biggest offshorer, cost only \$6 an hour in India, the biggest market for offshored services (see Vivek Agrawal, Diana Farrell, and Jaana K. Remes, "[Offshoring and beyond](#)," *The McKinsey Quarterly*, 2003 Number 4 Global directions, pp. 24–35).

Such projections have caused alarm in the United States. In February 2003, the cover of *BusinessWeek* asked, "Is your job next?" In June, the US House of Representatives' Committee on Small Business held a hearing on "The globalization of white-collar jobs: Can America lose these jobs and still prosper?" Several US states are considering legislation to prohibit or severely restrict their state governments from contracting with companies that move jobs to low-wage developing countries,³ and labor unions, notably the Communications Workers of America, are lobbying Congress to prevent offshoring.

Yet pandering to protectionism would be wrong. Many people believe that money spent to buy services abroad is lost to the US economy, but such views are easily disproved. Companies move their business services offshore because they can make more money—which means that wealth is created for the United States as well as for the country receiving the jobs. A McKinsey Global Institute (MGI) study reveals the extent of the mutual benefits.⁴

As the study shows, for every dollar that was previously spent on business processes in the United States and now goes to India, India earns a net benefit of at least 33 cents, in the form of government taxes,⁵ wages paid by US companies, and revenues earned by Indian vendors of business-process services and their suppliers (Exhibit 1). What of the impact on the US economy? First, it is important to put the figures in context, since fear of job losses makes many people overstate the effects of offshoring. Some 70 percent of jobs in the United States are in service industries such as retailing, catering, and personal care. This work, by its very nature, cannot be moved abroad.

Offshoring's value to India

Benefit per \$1 of US offshore spending,¹ 2002, \$

Offshoring sector	Labor	0.10
	Profits retained in India	0.10
Suppliers²		0.09
Taxes	Central government ³	0.03
	State government ⁴	0.01
Net benefit to India		0.33

¹Estimated; India offshore services industry example.

²Includes revenue accruing to supplier industries less sales taxes, income taxes for employees, and corporate taxes.

³Includes income tax from labor employed in both offshore services sector and supplier industries as well as corporate tax on second- and third-tier suppliers.

⁴Includes sales tax on second- and third-tier suppliers and revenue from sale of power to offshore service providers (providers' earnings are tax-exempt).

In addition, any job losses must be seen as part of an ongoing process of economic restructuring, with which the US economy is well acquainted. Technological change, economic recessions, shifts in consumer demand, business restructuring, and public policy (including trade liberalization and environmental regulation) can and frequently do result in job losses. Even when the economy is growing, mass layoffs—usually from restructuring—are much higher than the job losses predicted from offshoring.⁶ In 1999, for instance, 1.15 million workers lost jobs through mass layoffs, out of a total of 2.5 million lost. Liberalized, competitive economies with flexible labor markets can usually cope with such restructuring; the US economy, the world's most dynamic, certainly should be able to do so. Indeed, history suggests that, over the medium to long term, a flexible job market and the mobility of US workers will make it possible for the United States to create new jobs faster than offshoring eliminates them.

The United States today has more than 130 million employed workers. According to the Organization for Economic Co-operation and Development, it has the highest rate of reemployment of any OECD country by a factor of almost two. Over the past ten years, 3.5 million private-sector jobs a year have been created, on average, for a total of 35 million new jobs, so most workers who lose their positions find another within six months. Jobs lost to low-cost foreign competitors are not so easy to replace. Nonetheless, from 1979 to 1999, 69 percent of the people who lost jobs as a result of cheap imports in sectors other than manufacturing were reemployed.⁷ The mean wage of those reemployed was 96.2 percent of their previous wage.

Finally, remember that the population of the United States is aging. At current productivity levels, the country will need 5 percent, or 15.6 million, more workers by 2015 to maintain both its current ratio of workers to the total population and its living standards. By 2015, despite current fears about job losses as a result of offshoring, the US economy will need more, not fewer, workers. Offshoring is one way to meet that need.

But focusing the offshoring debate on job losses misses the most important point: offshoring creates value for the US economy by creating value for US companies and freeing US resources for activities with more value added. It creates value in four ways:

- *Cost savings.* For every dollar of spending on business services that moves offshore, US companies save 58 cents, mainly in wages. Offshore services are identical to those they replace—and at times better, since offshore workers, enjoying higher-than-usual wages, tend to be motivated. Reduced costs are by far the greatest source of value creation for the US economy.
- *New revenues.* Indian companies that provide offshore services need goods and services themselves, ranging from computers and telecommunications equipment to legal, financial, and marketing expertise. Often, they buy these from US companies. We estimate that for every dollar of corporate spending that moves offshore, suppliers of offshore services buy an additional five cents worth of goods and services in the United States. Exports from the United States to India

stood at \$4.1 billion in 2002, compared with less than \$2.5 billion in 1990.

- *Repatriated earnings.* Many Indian offshore service providers are in fact US companies that repatriate earnings. Such companies generate 30 percent of the revenues of the Indian offshore industry. Thus an additional four cents of every dollar spent on offshoring creates value for the United States.
- *Redeployed labor.* Beyond the direct benefits to the United States in the form of savings, new exports, and repatriated profits, offshoring can indirectly benefit the economy: capital savings can be invested to create new jobs, for which labor will be available. Indeed, this is exactly what has happened over the past two decades as manufacturing jobs moved offshore. The Bureau of Labor Statistics reports that overall manufacturing employment shrank by two million jobs in the past 20 years. But workers have found it easy to locate jobs in other areas, such as educational and health services. These service jobs, on average, pay more than the manufacturing ones they replaced, helping to increase the population's standard of living.

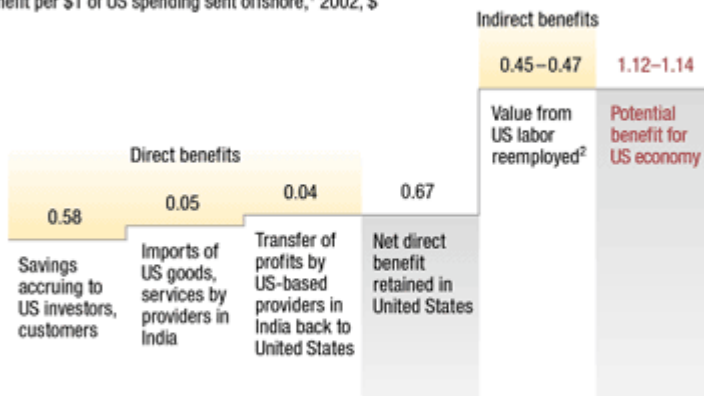
The same thing could well happen again. As jobs in call centers, back-office operations, and repetitive IT functions go offshore, opportunities to train labor and invest capital to generate opportunities in higher-value-added occupations such as research and design will appear. The Bureau of Labor Statistics estimates that from 2000 to 2010, there will be a net creation of about 22 million new jobs in the economy, mostly in business services, health care, social services, transportation, and communications.

How much value will be created in this way depends on the country's future economic performance. Historical trends can serve as a guide. If we use the statistics on reemployment and wage levels already noted—69 percent of non-manufacturing workers are reemployed at 96.2 percent of their previous wages—and bear in mind that 72 cents of every dollar offshored had previously been spent on US wages,⁸ the indirect benefit to the US economy would come to an additional 45 to 47 cents for every dollar spent on offshoring. That is a conservative estimate, since workers in IT and business services tend to find jobs more quickly than do workers in the service sector, as a whole, and the demographic shift will increase the demand for workers. In this way, offshoring, far from being bad for the United States, creates net value for the economy. It directly recaptures 67 cents of every dollar of spending that goes abroad and indirectly might capture an additional 45 to 47 cents—producing a net gain of 12 to 14 cents for every dollar of costs moved offshore (Exhibit 2).

EXHIBIT 2

Offshoring's value to the United States

Benefit per \$1 of US spending sent offshore,¹ 2002, \$



¹Estimated; India offshore services industry example.

²Conservative estimate based on historical reemployment and wage levels; value created from improved global competitiveness of US companies and multiplier effect of increased savings would likely increase amount of value created.

The total possible wealth creation does not, of course, ease the plight of people who lose their jobs or find lower-wage ones. The statistics showing that 69 percent of those who lost

jobs in the non-manufacturing sector were reemployed also show that 31 percent were *not* fully reemployed. And while, on average, those who found new jobs secured similar wages (96.2 percent of their previous wage), 55 percent took lower-paid jobs. As many as 25 percent took pay cuts of 30 percent or more.

These issues must be addressed. Training programs and generous severance packages, perhaps accompanied by innovative insurance programs (see sidebar, "[Easing the pain for workers](#)"), are among the measures that could mitigate the effects of the transition without great cost to the economy. And while many people will undoubtedly suffer short-term disruption, it should be set against the consequences of resisting change: if US companies can't move work abroad they will become less competitive—weakening the economy and endangering more jobs—and miss the chance to raise their productivity by focusing on the creation of jobs with higher value added.

The openness of the US economy and its inherent flexibility—particularly that of its labor market—are two of its great recognized strengths. The current danger is that public policy will make its economy less flexible. To do so would endanger the economic well being of the United States.

EASING THE PAIN FOR WORKERS

As part of severance packages, and for a small percentage of the savings from offshoring, companies could purchase insurance covering the wage losses of displaced workers. Building upon an insurance proposal that Lori Kletzer (of the University of California, Santa Cruz) and Robert Litan (of the Brookings Institution) developed for workers displaced by trade in manufacturing,¹ the McKinsey Global Institute estimates that for as little as 4 to 5 percent of the savings companies realized from offshoring, they could insure all full-time workers who lost jobs as a result. The program would compensate those workers for 70 percent of the wages they missed from the time they were laid off to the time they were reemployed, as well as offer health care subsidies for up to two years.

Notes:

¹Lori Kletzer and Robert Litan, "A prescription to relieve worker anxiety," Policy Brief 01-2, Institute for International Economics, February 2001.

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Notes:

Vivek Agrawal is a consultant in McKinsey's Minneapolis office; Diana Farrell, the director of the McKinsey Global Institute, is a principal in the San Francisco office.

¹An estimate by the IT research firm Forrester.

²A consensus estimate of market research firms the Aberdeen Group, Gartner, and IDC.

³"States fight exodus of jobs," *Wall Street Journal*, June 3, 2003.

⁴The study estimated the distribution of revenues from the \$8 billion in services offshored to India. Estimates were compiled from industry interviews and published reports on both the demand and the supply sides.

⁵Taxes are collected from second- and third-tier suppliers to the service providers as well as on wages earned by labor. The providers themselves enjoy tax-free status in India.

⁶The Bureau of Labor Statistics defines a mass layoff as 50 or more worker claims against an establishment's unemployment-insurance account during a five-week period.

⁷See Lori Kletzer, *Job Loss from Imports: Measuring the Costs*, Washington, DC: Institute for International Economics, 2001. Kletzer matched Bureau of Labor Statistics figures on non-manufacturing jobs with trade data to assess job displacement in sectors prone to foreign competition.

⁸Of every dollar spent, 72 cents goes to wages and the rest to equipment, furnishings, rent, utilities, financing, and other services.