The Win-Win-Win Challenge of Offshoring

Karl P. Sauvant, Columbia University
The New Global Supply Chain
How Your Company Can Make It Work In Theory and Practice
The Win-Win-Win Challenge Of Offshoring

Offshoring has raised a number of concerns in developed countries. A new study by the United Nations Conference on Trade and Development (World Investment Report 2004—see www.unctad.org/wir) shows that there are three basic considerations that are often overlooked in the debate. They suggest that the ultimate outcome of the new trend in services offshoring will be a win-win-win situation for all.

The tradability revolution
Traditionally, most services had to be produced when and where they were consumed—and hence were not tradable. The application of information and communication technologies is changing that. Information-intensive services (or parts thereof) have become tradable: they can now be produced in one location and consumed (later) in another. The immediate consequence is that an international division of labor in the production of services can establish itself.

The triggering factor is often cost, as in the case of call centers. But as in commodities, the benefits of such a division of labor are broader. They can involve higher quality (e.g., when the back office work of a firm in a sending country becomes the front office work of a firm in the recipient country), and they can derive benefits associated with specialization and economies of scale. Hence, while firms may begin to offshore services for reasons of costs, they stay and expand to realize the benefits of the international division of labor.

Once a number of firms have started (led by U.S. and UK firms), their competitors have to follow suit lest they risk compromising their competitiveness. In fact, we may well be approaching the tipping point from which cascades of new offshoring will spring. The offshoring of call centers is a manifestation of the broader tradability revolution.

Not a North-South phenomenon
Systematic data on the extent of services offshoring do not exist. One estimate for 2001 puts the size of the market at $32 billion, with Ireland, India, Canada and Israel, in that order, being the leading recipient countries. More recent data based on the location of export-oriented foreign direct investment projects of call centers (for 2002-2003) shows that 54 percent were placed into developed countries, 40 percent into developing countries and 6 percent into Eastern Europe. To be sure, developing countries (and those of Eastern Europe) are an important part of the game, but the more sophisticated the tasks become, the more likely that offshoring ends up in a developed country (in the same way as we have seen this process unfold in the manufacturing sector).

An example of costs as only one factor can be seen with the recent decision by one of India's leading IT companies to expand its call center in Belfast, resulting in the creation of 250 jobs. Indeed, a finding by the UK Department of Trade and Industry shows that the number of call centers in the country is likely to increase from 5,500 to 6,000 over the next three years, despite the fact that many UK firms are offshoring such centers.

Offshoring is a win-win-win proposition—
with appropriate policies
Companies benefit from offshoring by becoming more competitive, often saving 20-40 percent in the activities offshored. Recipient countries benefit because they can increase their exports, create jobs, acquire skills and build backward linkages. Sending countries benefit from lower prices for consumers, exports of related goods and services to recipient countries and, most importantly, by freeing resources to move into higher value-added activities.

But, these benefits are not automatic. Like any structural changes, they require appropriate policies. Recipient countries need to make sure that their telecommunication infrastructure is competitive; that the required skills are available; that the regulatory framework (including concerning privacy protection) is in place; that investment opportunities are marketed in a targeted way; and that the new facilities are properly integrated into the country's development strategy.

Countries exporting services need to focus on managing the adjustment process with a judicious use of policy instruments.

On the other hand, sending countries need to focus on managing the adjustment process—and (as many developing countries can testify) structural adjustment requires a judicious use of policy instruments. Particular attention needs to be given to concerns about jobs. Inspiration can be sought in instruments that already exist for adjustment in the manufacturing sector. Education, retraining and the encouragement of R&D play an important role in the case of service workers displayed by offshoring.

The offshoring of services is still in its infancy. It is the cutting edge of the international division of labor. The challenge is to manage the adjustment process properly and to maintain an international environment that allows all countries to benefit from the advantages offered by the services tradability revolution.

Karl P. Sauvant is Director of UNCTAD's Investment Division and lead author of its World Investment Report.