

Services and Offshoring: The Impact of Increasing International Competition in Services

Foreword

Britain is a world leader in services. Banking, insurance and financial services; the law, accountancy, consulting and business services; health, education, child and care for the elderly and personal services. All are growth areas in a service sector that now accounts for over 21 million jobs.

Call centres are one of our service sector success stories. We have more than any other European country. Estimates vary, but industry experts suggest there are around 5,500 UK call centres employing almost 400,000 workers. The skills and vital local knowledge of our workforce, the stable economic background created by this Government and the UK's strong IT and telecoms infrastructure mean we remain well placed to attract call centre jobs in a very competitive market.

But we cannot ignore the hard fact that in a competitive international market some jobs will go abroad. Job losses are always painful for workers and their families - particularly in communities that have already been devastated by the loss of manufacturing jobs. But, however painful the loss for individuals and their families, we must also be realistic about the scale of the problem. Far from having millions of people unemployed, we have more people in work in the UK than ever before - and more people working in the service sector than ever before.

Our response to international competition is three-fold. First, we have to keep raising our game, ensuring that companies and people are continually upgrading their skills and technologies so that we keep employment here. We cannot compete on low wages and nor should we try to.

Second, where jobs are lost, we must do everything we can to help people find new jobs and, if necessary, new skills as quickly as possible, deploying the rapid response teams and JobCentre Plus.

Third, we have to do even more to build strong, sustainable economies in all the regions of the UK. To raise the business birth-rate, to forge strong partnerships between regional universities and business, develop the skills that the regional economy needs, to attract more inward investors and improve the local infrastructure - in other words, to create a virtuous circle of better skills, better jobs and better, more profitable businesses.

We must focus all our effort on keeping the UK economy strong and stable, generating more jobs and better jobs by raising skill levels, supporting enterprise and raising innovation and productivity in business.

What we must not do is fall into the temptation of protectionism. Attempting to prevent offshoring by putting up trade barriers would be costly and, in the long run, ineffective. It would risk forcing companies to locate completely out of the UK or would deter future inward investment, which would not be in our long-

term interest. And it would weaken our case against governments who put up trade barriers against us - such as the US steel tariffs.

As developing countries become richer, they will also buy more from us and invest more in our economy. UK exports of goods and services to India alone are already worth around £2.5billion a year, securing thousands of UK jobs. But global trade - while making the UK as a whole richer - can have painful effects on the people and businesses who face new international competition. Our task as a government is to protect our people without lapsing into protectionism.

The government believes that the global trade in services will bring significant benefits to the UK. However, it acknowledges that there may be short-term adjustment costs and will stand ready to help those affected.

As a priority, we need to develop our understanding of the impacts of off-shoring. We will be discussing these issues with business, and with unions, to understand more about why some firms are choosing to offshore and others are choosing to stay and expand in the UK. We will be undertaking more research on the questions highlighted in this paper, identifying which areas and groups will be most affected, and how best to equip the UK economy to respond to the challenges.

Signed by *Patricia Hewitt*
Secretary of State for Trade and Industry

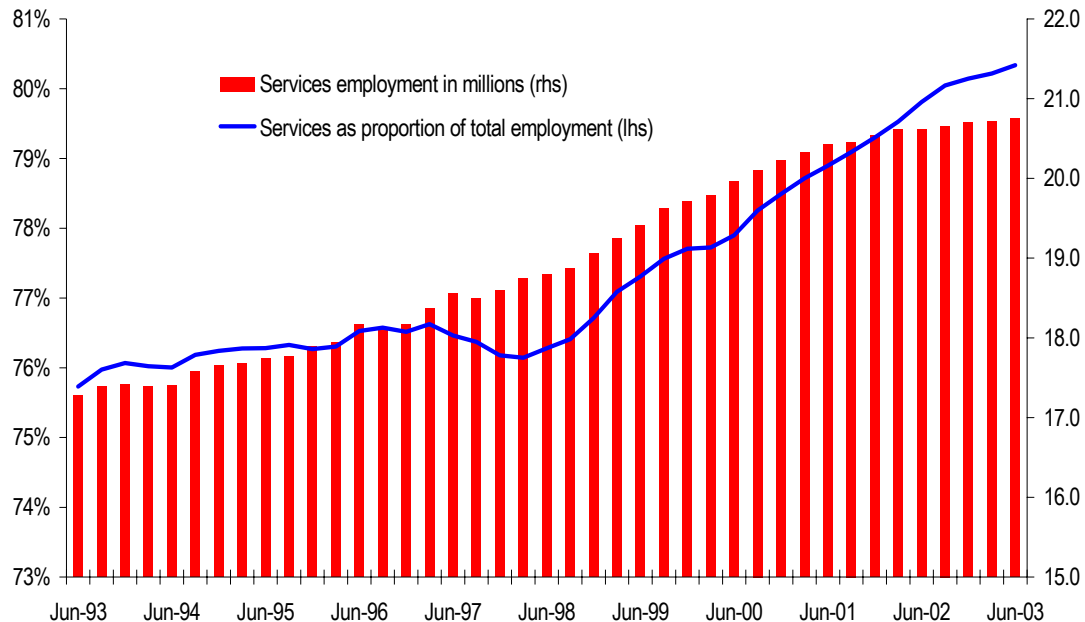
Introduction

The international outsourcing, or offshoring, of business services has been the cause of considerable and growing public attention. Much of the debate so far has tended to focus on negative aspects of the process, in particular where it results in job losses in the UK. Employment is a key issue for government, and helping workers who lose their jobs is a priority. But it is also important to look at the whole range of possible impacts and what the issue actually means for the UK in the long term as well as the short term. This document is a preliminary step in this necessary analytical process. It outlines the main issues and highlights areas for further research. It is intended to lead to an informed debate which will give all stakeholders an opportunity to contribute.

Role of services in the UK economy

The services sector in the UK, as everywhere else in the developed world, plays an increasingly important role in the economy, contributing over 70 per cent of GDP and accounting for 8 out of every 10 jobs. Employment in the services sector has increased by nearly 3.5 million in the last ten years and by over 2 million since 1997 alone and has been a key feature in the UK's highly successful recent record of job creation. The employment level is now at an all time high and the employment rate of nearly 75 per cent exceeds that achieved in other major European economies.

1. Recent employment growth* in the UK service sector, levels and rates

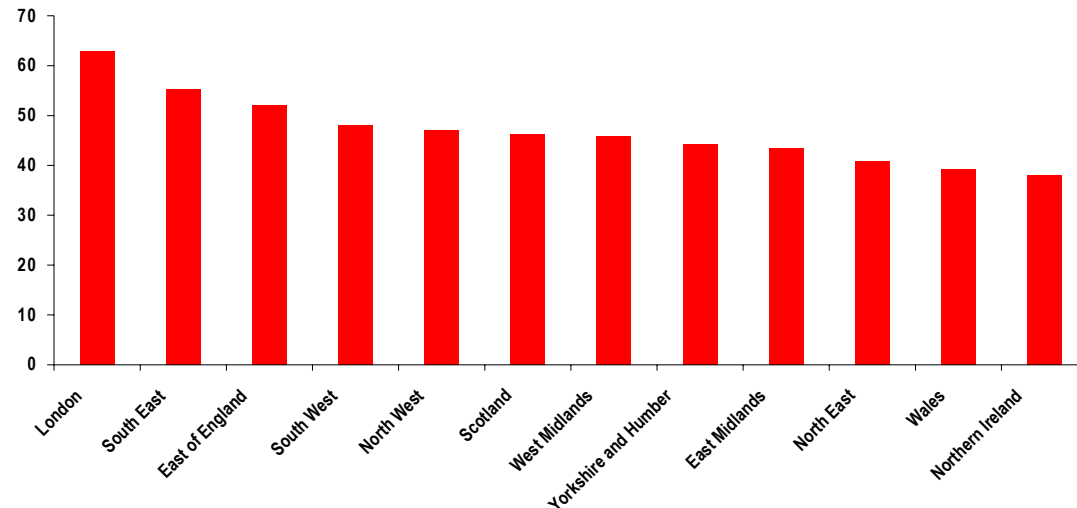


Source: National Statistics *employee jobs (ie excludes self-employed)

The growth in service sector employment has been an important factor in providing new employment opportunities for people displaced by the decline of manufacturing with call centres playing a particularly important role. The service sector is a vital component of all the regional economies of the UK. Private sector services employment has grown in all but one of the regions

since 1997 and is especially important to London and the South East (chart 2).

2. Market services employment* by region as a proportion of total employment



Source: National Statistics, March 2003 *employee jobs (ie excludes self-employed)

Economic theory and international competition

Economic theory emphasises the important role played by trade and international competition in stimulating growth worldwide and within individual countries. Living standards for all are best secured when resources are employed in those geographic regions or functions where they have a comparative advantage.

Traditionally, this has been seen in terms of whole industries locating in particular areas. But for some time international fragmentation, or desegregation, of production has been a key feature of globalisation. Firms have been able, so far largely in manufacturing sectors, to split up the various processes of production and locate them around the globe in such a way as to take full advantage of differing cost bases, skills and technical specialisations. For example, the components in a car produced as a final product in the UK may have been constructed in up to 40 different countries prior to final assembly in the UK.

Most services cannot be fragmented in this way because they are produced and consumed locally; activities such as haircuts, restaurant meals, and dentistry require that production and consumption are co-located. Whilst activities may be subject to competition from overseas firms setting up operations in the host country¹ it is unlikely that any but a small minority of service activities can be supplied from abroad.

¹ The WTO considers four “modes” by which services can be supplied to consumers: cross border trade, consumption abroad (the consumer travels to the service supplier), commercial presence (the supplier establishes a commercial presence in another country) and movement of personnel (the temporary movement of workers to supply consumers in another country).

The kinds of service sector activities that might face international competition depends partly on the technical feasibility of offshoring. Developments in information technology have significantly increased the speed and reduced the cost of communication and thereby, in some instances, reduced the need for co-location, or face to face contact, between consumers and producers of services. This means that some areas of the service sector which had previously been considered non-tradable are now starting to face international competition. Activities such as data processing and analysis, IT services such as software development, research and development and various 'back office' functions can now, in many cases, be performed on the other side of the world and then exported, often simultaneously, to the UK.

Of course, a company's decision to locate some of its operations in another country does not just reflect technical feasibility. There are a whole range of complex factors determining location decisions – including cost differentials, the strategic importance of an activity or job, relative service quality levels and legal and cultural issues.

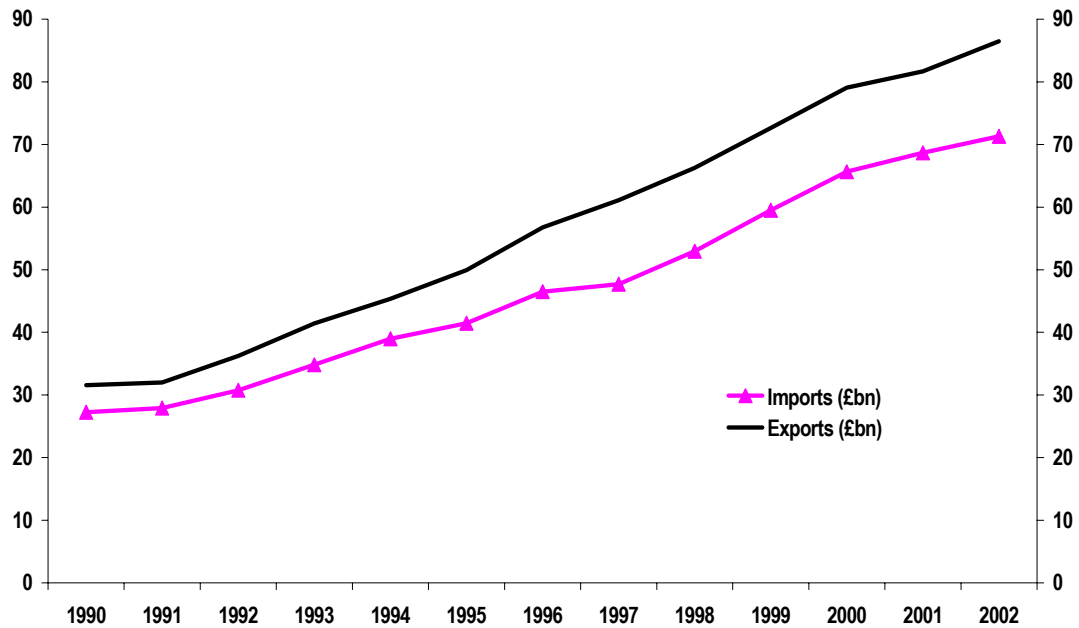
International competition for services and offshoring

While technological advances and innovations in business processes look set to intensify international competition in some service areas, quantifying the economic impact on the UK or trying to forecast numbers of jobs which might be 'lost' or 'gained' is extremely difficult.

Current evidence suggests that the movement to services offshoring is, by and large, coming from the English speaking countries, in particular the US and UK, but also Australia. The presence of large English-speaking populations has also, not surprisingly, defined the destination countries of which India is by far the most important, but countries such as Sri Lanka, South Africa, Malaysia and the Philippines are also gaining some of the business. Indeed, the UK continues to be a beneficiary of offshoring business coming from the US.

While there are no official figures on international job movements which would enable us to give a definitive figure as to the number of service related jobs moving in and out of the UK, we do have data on international trade in services. This information illustrates that the value of international trade in services is increasing, but more importantly, that the UK is a net beneficiary of this process– our service exports are £15 billion greater than our service imports (chart 3), and we are the world's second largest exporter of services. International competition is creating employment opportunities in the UK.

3. Service Sector Exports and Imports for the UK 1990 -2002



Source: National Statistics

Although service imports have grown in nominal terms, they have remained relatively stable as a share of total imports both in the UK and worldwide (chart 4). Services are still only 23% of total imports, and this share has changed very little since 1999. Moreover, around two thirds of service imports are still accounted for by flows of funds spent abroad on travel and transport, rather than buying in service delivery. Service exports have fared slightly better, now accounting for 32% of total exports. Notable areas of export growth have been financial services and “other business” service activities, including legal services, engineering and R&D.

4. Value of service imports and exports as a proportion of total imports and exports by value



Source: National Statistics

According to independent researchers (for example Deloitte Research, McKinsey Global Institute), labour costs are the main driver behind firms' decisions to offshore, with IT workers in India earning only a fraction of what their counterparts in the developed world can earn. When the additional costs of the offshoring process are factored in, cost savings (according to a recent report by McKinseys) can still be in excess of 50 per cent. Some of the other factors in the business decision over whether or not to offshore are considered in the table below.

1. Pros and cons of off-shoring from the firm's point of view

Pros	Cons
Labour cost savings	Risk of interruption of supply
Access to large, well motivated workforce	Managerial control more difficult
Access to new markets abroad	Negative affect on morale of remaining onshore staff
Economies of scale for international companies bringing together activities in one location.	Possible impact on customer loyalty
	Political risks in country of destination

Impacts

For the UK economy as a whole offshoring brings both benefits and challenges.

The opportunities

Offshoring is an innovative business process that can drive down costs, and drive up productivity. Some or all of the costs savings will be passed on to consumers as lower prices. In an international context, a lower cost base will enable UK firms to become more competitive in world markets.

Offshoring and the internationalisation of services is not a “zero sum” game. The UK stands to gain from growing world prosperity and from the continued development of a bigger global market for British goods and services. Over the long term, overseas outsourcing, whether of manufacturing production or of service sector activities, allows UK companies to remain competitive, ensuring that the UK economy continues to generate new and sustainable jobs and new business opportunities².

In addition, it would be wrong to assume that offshoring is all one way traffic. The UK can and does benefit from inward offshoring and from the expansion of firms already operating here. The UK is the second largest global recipient of Foreign Direct Investment behind the US. In the year 2002 to 2003 alone, inward investment created over 34,000 new jobs in the UK. And we also earn income from our investments abroad to the tune of around £50 billion a year.

The UK also gains from its involvement in global partnerships, for example joint ventures between Indian and UK companies to produce software for global markets or whereby Indian companies invest in the UK in order to expand within the EU.

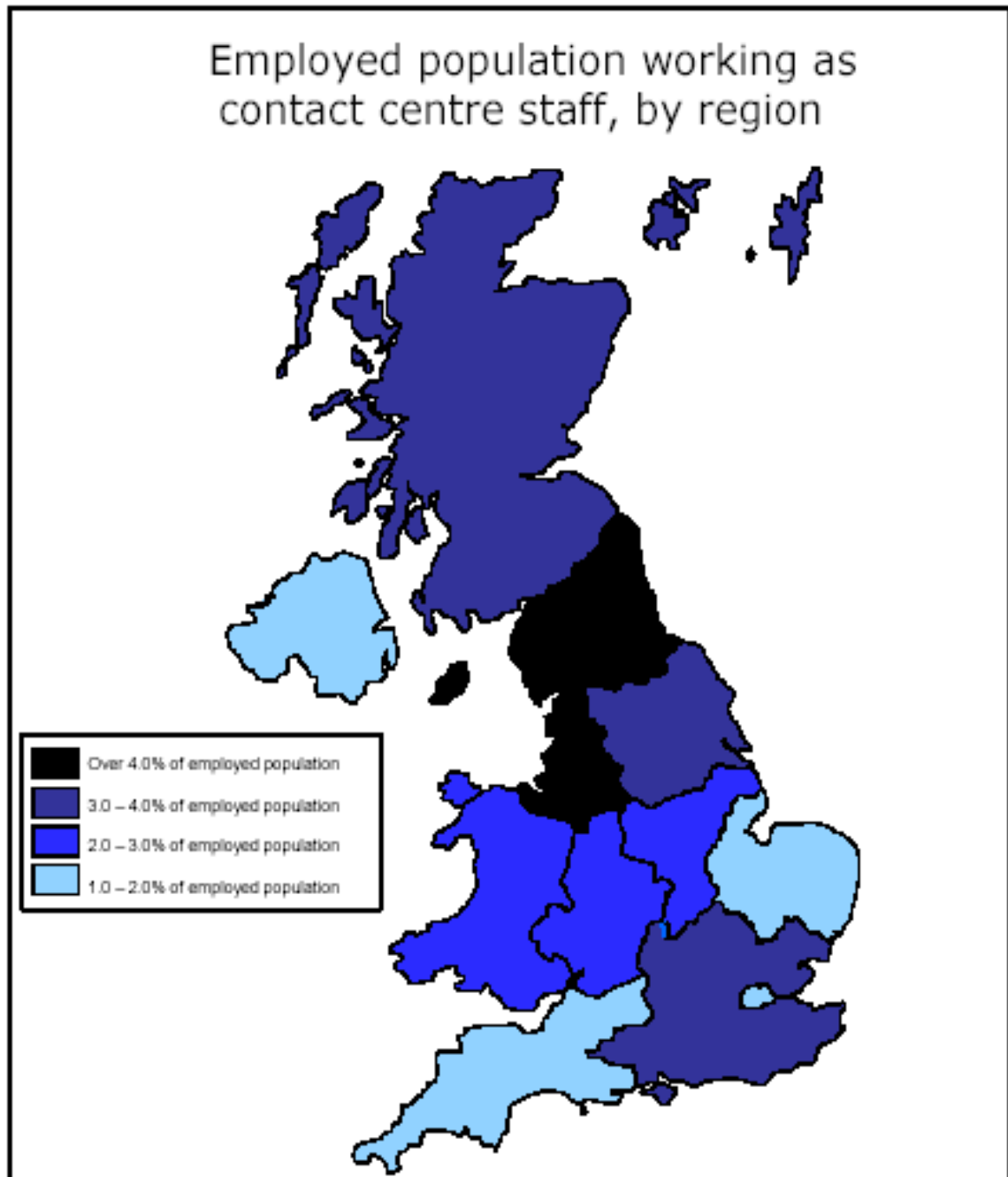
The challenges

On the downside, offshoring will result in short term, transitional job losses, although doomsday projections of possible numbers at risk are likely to prove highly unrealistic. Nevertheless, it is important that there is a better understanding of the regional impacts of any such job losses and how in particular they may affect more vulnerable workers (call centre workers for example, chart 6) or how they might disproportionately affect certain groups, for example women. The 2.2 million growth in service sector jobs since 1997 has been an important factor in providing new regional employment opportunities for people displaced by the decline of manufacturing.

Disproportionate negative employment consequences can obviously have negative knock-on effects on other government priorities, for example in terms of enhancing regional employment prospects and increasing the labour market participation of women. There may also be negative consequences in terms of uncertainty and insecurity, whether real or perceived.

² McKinseys has estimated that, for the US, when taking into account the value of re-employed labour and additional imports to the country supplying the offshored labour, for every \$1.00 of offshored labour costs the US gets back \$1.14.

6. Call centre employment by region



Source: Contact Babel: UK Contact Centres in 2003

Issues for further research

As noted earlier, this document represents a preliminary step in the analysis of the impact of offshoring on the UK. We recognise the clear need for considerable further research to inform our understanding of the issue and to ensure that UK businesses are best equipped to respond to the challenges thrown up. Initial areas identified for further research are listed below:

- What are the likely regional impacts? We need to work with RDAs/DAs on understanding the potential effects at a local level
- We need to refine our understanding of the likely economic costs and benefits and to be able to estimate how these are distributed over time and across different groups
- We need to conduct further exploration with companies as to why some are choosing to offshore and some are choosing to stay and expand in the UK.
- DTI is about to commission a “Sector Competitiveness Study” to examine the competitiveness of the UK call centre industry, what drives productivity in this sector, and the potential for competition from abroad, including where the UK has a comparative advantage.

Consultation

We invite all those with an interest in this debate – including businesses, employees and their unions, and consumer groups – to share their views with us.

Comments and contributions can be sent to the following address until 30 January 2004.

offshoringenquiries@dti.gov.uk