
FACT OR FICTION: HAS THE CURRENT ECONOMIC RECESSION DERAILED OFFSHORING OR HAS IT SIGNIFICANTLY INCREASED THE DEMAND FOR SUCH COST-CUTTING TECHNIQUES?

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Executive Summary

- What is the difference between global outsourcing and offshoring?
- What are the effects of international trade on global outsourcing in American companies?
- Are the trends of global outsourcing changing the relationships with companies and competition?
- The new 'twist' to outsourcing: What services are actually being 'outsourced' to the United States by offshore companies?

Definitions:

Offshoring is when a company moves a domestic internal business process within the same parent company or subsidiary to a foreign country; retaining ownership of those business processes.

When a parent company makes a physical investment, i.e. builds a factory with a foreign subsidiary resulting in the creation of a multinational corporation this relationship is known as foreign direct investment (FDI). The foreign subsidiary then produces the various parts of goods that are then used or assembled into the final product. Companies use this method of offshoring to reduce costs and create more profitability.

Example of offshoring:

Intel® produces microchips in China and Costa Rica using subsidiaries that it owns. Intel® has engaged in foreign direct investment (FDI) to establish those offshore subsidiaries resulting in ownership.

Outsourcing is when a company contracts a domestic internal business process through an external company in another location. The second company then provides a service or production of various parts of a good that are then used or assembled into the final product. The company subcontracting the process does not retain ownership.

Companies use of outsourcing also to reduce costs and create more profitability. A few common processes that companies are outsourcing are customer support (i.e. call center operations), telemarketing, design, and production processes (i.e. manufacturing, assembly).

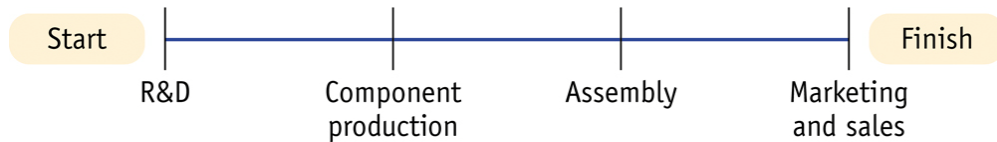
Studies have found that the practice of outsourcing intermediate inputs (goods traded between suppliers) is associated with an increase in international trade.

Example of outsourcing:

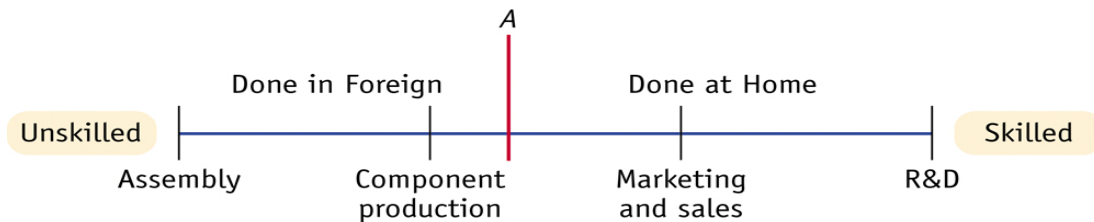
Mattel® arranges for the production of its Barbie doll in several foreign countries. Mattel® is engaged in outsourcing; resulting in subcontracting.

Models for Outsourcing

(a) Activities Ranked by Order in Production

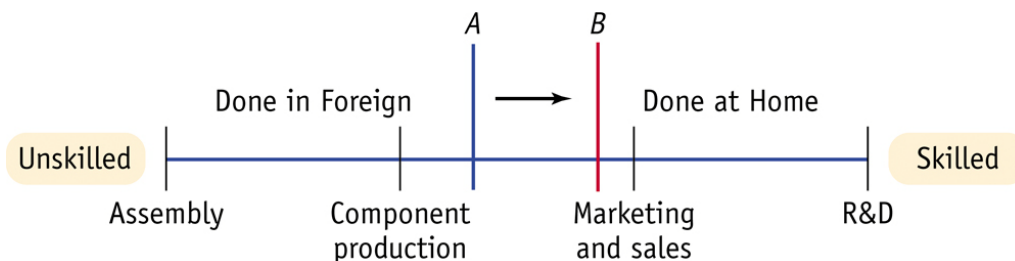


(b) Activities Ranked by Skilled/Unskilled Labor



Graph A represents the production process. **Graph B** represents the structure of the value chain of a company between unskilled (lower) labor and skilled (higher) labor. **Line A** in **Graph B** represents where the processes can be split between outsourcing to a foreign country and where to keep processes domestic. Labor costs are significantly lower in foreign countries. A company deciding to outsource must weigh the balance of savings from lower labor costs in foreign countries and the extra costs associated with capital and trade; i.e. communication, production and transportation costs. The company also needs to determine where **Line A** should fall on the value chain to maximize performance and profit for the company.

(c) Activities Ranked by a Decline in Capital and Trade Costs



Graph C represents a decline in capital and trade costs where **Line A** becomes **Line B** and shifts to the right on the value chain due to changes in government policies and technological advances. This results in an increase of processes that can be outsourced therefore most companies choose to outsource their assembly and component production processes. Typically U.S. companies keep the marketing, sales, and R&D processes domestic as U.S. companies' tend to be more innovative than foreign companies.

Graph Source:

Feenstra and Taylor, International Economics, Worth Publishers, 2008

Outsourcing in Services vs. Manufacturing

Outsourcing that occurred from U.S. companies in the 1980s and 1990s often were manufacturing operations or unskilled (lower) services. Today, U.S. companies are outsourcing service operations skilled (higher) services, i.e. customer service and telemarketing call centers. Most of these service operations are outsourced to India. The cause of the shift is that manufacturing operations require transporting component parts and in which some foreign countries like India have poor transportation infrastructures. Outsourcing skilled service operations does not require transportation of parts.

Outsourcing and Job Growth

Companies that outsource may become more efficient, expand production and create employment in other lines of work where they will gain comparative advantage. These productivity benefits can translate into lower prices; which can generate further demand and hence create more jobs. The job creation effect can offset the direct job loss due to outsourcing. Outsourcing production and services can explain the 20% increase in labor productivity amongst U.S. companies from 1979 to 1990. (Feenstra and Hanson, Quarterly Journal of Economics, 1999)

Example:

“The case of IBM® reinforces this lesson: although critics highlight the offshore outsourcing of 3,000 IT jobs, they fail to mention the company’s plans to add 4,500 positions to its U.S. payroll. Large software companies such as Microsoft® and Oracle® have simultaneously increased outsourcing and domestic payrolls.”
(Congressional Research Service report, 2008)

Personal (Direct) vs. Impersonal (Indirect) Services

Outsourcing of higher skilled services jobs such as radiology in the health sector and security analysis in the finance sector imply that there is another dimension which explains the suitability of certain activities for outsourcing.

Some low skill and high skill services clearly require face-to-face interaction. These services are called personal or direct; i.e. hotel cleaning services. Some low skill and high skill services can be provided remotely without face-to-face interaction and without lowering the quality. These services are called impersonal or indirect; i.e. computer support. The traditional view that the more education and “up-skilling” a particular service job requires would result in a reduction of outsourcing, is not the case anymore.

In-sourcing, where foreign companies outsource to U.S. companies is the new ‘twist’ to outsourcing. A major source of job in-sourcing is inward foreign direct investment (FDI). From 1988 to 2003 foreign companies increased their direct investment in American subsidiaries by 326 percent thus creating 2.3 million U.S. jobs. (James K. Jackson “Outsourcing and In-sourcing Jobs in the U.S. Economy: Evidence Based on Foreign Investments Data”, Congressional Research Service Report, 2008).

U.S. exports of services are a major source of in-sourcing and U.S. jobs. The industry grew from \$27 billion in 1998 to \$120 billion in 2003 resulting in an estimated 1.4 million jobs. Services exports include travel, passenger fares and other transportation, educational services, information and data processing, finance and insurance services, and scientific and technical services. According to the Bureau of Labor Statistics, the number of outsourced jobs increased from 6.5 million in 1983 to 10 million in 2000. The number of in-sourced jobs increased even more in the same period - from 2.5 million to 6.5 million.

Many governments spend considerable resources attracting FDI's under the belief that such investments have a number of positive impacts related to employment and technology. A 2003 study shows that technology spillovers from FDI's to U.S. owned manufacturing companies accounted to 11% of the growth in productivity in the U.S. companies between 1987 and 1996. (Keller and Yeaple, Quarterly Journal of Economics, 2003)

Conclusion:

Outsourcing in services is a consequence of the information revolution, and the current economic crisis will not alter the long-term trends in outsourcing. We will see the U.S. and other industrialized countries continue to have a comparative advantage in exporting business services. One likely prediction is that the activities in the U.S. cannot be codified in written rules and procedures, and that the benefits from face-to-face contact as well as proximity to other highly-skilled individuals in related industries will continue to have comparative advantages. Technology and markets will continue to drive the patterns in outsourcing, and companies and the economy will need to adapt in order to maximize their gains. As all important transitions require a holistic response, we need to think about appropriate responses in terms of education, trade policy and politics.

Feedback from the Roundtable Discussions

The audience at the May 14 CFO Alliance Roundtable were presented with the following questions in the context of personal (direct) vs. impersonal (indirect):

*Which two processes in your specific industry are the most likely to be outsourced in the future?
Which two processes in your specific industry are the least susceptible to outsourcing in the future?*

Table One

Processes that do not require creativity/innovation and face-to-face support

Table Two

Most likely- engineering, education, basic accounting

Least likely- IT project management, software management, sales management

Table Three

Most likely- some IT, accounting IRFS

Least likely- human resources, marketing

Table Four

Most likely- clinical trials in the second and third stage, R&D, supply and demand

Least likely- top leadership, compliance and legal activity, military

Table Five

Most likely- manufacturing, global marketing, stock listing, tax

Least likely- transitional support, value creativity, local knowledge, sales, customer management

Table Six

Most likely- low application, sales and marketing

Least likely- customized IT solutions, new product development

Table Seven

Most likely- 24 hour activity such as radiology imaging

Least likely- licensing such as architecture plans

Table Eight

Most likely- Images such as radiology

Least likely- face-to-face support, cultural knowledge

Table Nine

Most likely-call centers, procurement, payroll, IT support

Least likely- product development, regulated industry

Table Ten

Most likely- administrative, transaction processes, data reporting, printing and video

Least likely- sales management, fundraising



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