

Outsourcing Globally

Trends and Implications of Offshoring for Australia



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Introduction

Australians have become accustomed to having access to a wide variety of imported goods and services, ranging from tinned tomatoes, to televisions, computers, clothing, cars and the like. Australians are also proud of our overseas successes – such as wine sales in Europe and the US, cars exported to into the US markets, multi-billion dollar gas contracts with China, wheat and wool.

The issue of globalisation continues to attract significant attention in the media and elsewhere. Globalisation generates a sense of apprehension within the community and even outright hostility in smaller segments. Apprehension and uncertainty are understandable reactions given that globalisation is all about change, and increasingly, it is about change happening at a rapid pace – with the help of advances in telecommunications and information technology.

It is not surprising that offshoring, which is the latest phase of globalisation, is generating widespread and sometimes heated debate. Offshoring and its implications should be considered within the context of longer term globalisation trends, which have brought tremendous gain to Australia.

Globalisation has given Australian consumers access to a far wider range of goods and services, often at lower prices, than would be available from domestic producers alone. For Australian companies, access to overseas markets has enabled them to increase sales and to develop new products and services through specialisation and improved competitiveness. Australian companies have also been able to source investment and returns from overseas, allowing them to expand in ways they could not if relying on domestic markets alone.

The result of globalisation for Australia has been strong economic and employment growth, sustained low inflation and strong company performance and profitability. This in turn has produced sustained benefits for Australian shareholders and superannuation funds.

The Global Context

Over the past 150 years there have been a number of phases of rapid and deep integration between markets:

- 1870 to 1914
- the end of the World War II to around 1980
- the 1980s onwards

Australia has participated in and benefited from each of these waves. Australia became one of the richest countries in the world exporting abundant agricultural products and commodities to world markets.

While each phase of globalisation has been unique, all phases of globalisation have been underpinned by common drivers, including technological advance, and have been characterised by a rising share of trade in total output, and strong growth in the movement of capital and people across borders.

The current wave of globalisation has brought greater challenges for developed countries like Australia. This is because developed countries and their economies are facing far greater competition from developing countries adopting export-led growth strategies based initially around abundant labour and low labour costs.

The challenge for Australia is to continue to develop new sources of competitive advantage in the goods and services we produce. These changes are not easy and they are not without cost, which is understandably at the heart of community concern and anxiety. When tariffs were wound back in the early 1980s, as industries and business adjusted and jobs were lost, there were concerns about the capacity for Australia to compete in global markets and to sustain strong economic and employment growth.

Two decades later:

- Australia has sustained strong economic growth for more than a decade
- unemployment remains below six per cent
- one in five jobs are now dependent on exports

Exhibit 1 The Drivers of Outsourcing

Source: Booz Allen Hamilton

Driver	Explanation of Critical Advantage from Outsourcing
Cost Competitiveness	Savings may result from lower inherent, structural, systemic or realised costs. A detailed analysis of each of these cost categories can identify the potential sources of advantage. For example, larger suppliers may capture greater scale benefits than the internal organisation. The risk is that efficiency gains lead to lower quality or reliability.
Specialisation/Focus	Focus frees up resources internally to concentrate on where organisation has distinctive capability and scale, experience or differentiation to yield economic benefits. In this way, the organisation is focusing on <i>relative</i> advantage to maximise total value and allowing others to produce supportive goods and services.
Market Discipline	Separation of purchasers and providers can assist with transparency and accountability to identify true costs and benefits of certain activities. This can enable transactions under market-based contracts where the focus is on output not input and competition among suppliers allows choices by purchasers and innovative work practices.
Flexibility	Using an outside supplier can sometimes add flexibility to an organisation such that they can adjust the scale and scope of production rapidly at low cost. It is often suggested that networks of organisations can adjust to demand more easily than integrated organisations.
Technology	Some suppliers may have proprietary access to technology or other intellectual property advantages that the organisation alone cannot access. This technology may improve operational reliability, productivity, efficiency and long-term total costs and production.

The Australian economy has benefited significantly from deregulation domestically and internationally through greater access to global markets. Our businesses have demonstrated flexibility in seeking out new markets and opportunities. These opportunities underpin the sustained levels of jobs and economic growth we have seen in recent years.

Outsourcing Globally

Outsourcing is now common in most industries around the world. Companies are outsourcing more and more of their business activities to external suppliers. Outsourcing offers companies compelling strategic and financial advantages including lower costs, greater flexibility, enhanced expertise, greater discipline and the freedom to focus on core business activities (see Exhibit 1).

Offshoring – the hiring of workers in another country – takes the outsourcing concept to a new level, driving greater opportunities across a broader proportion of an organisation's operations. While the focus of public debate usually centres around lower labour costs, offshoring is driven by a range of factors all of which relate to enhancing competitiveness of business operations including:

- **Cost Competitiveness** – Offshoring typically offers significant infrastructure and labour

cost advantages over traditional outsourcing. In addition, many of the offshoring providers have established very large-scale operations not economically possible for domestic providers

- **Specialisation/Focus** – Offshoring takes this concept to the next level with many providers offering a single function while investing in highly professional management and systems
- **Market Discipline** – In a similar fashion to traditional outsourcing, most offshoring transactions are managed on an arms-length, market driven basis
- **Flexibility** – As with outsourcing, offshoring allows a company to adjust the scale and scope of production rapidly
- **Technology** – The significant scale of the offshoring providers allows them to invest in technology that may be cost prohibitive for domestic providers

In a global, competitive, market that rewards focus, offshoring allows companies opportunities to leverage further cost efficiencies through labour and productivity savings and process improvements (see Exhibit 2).

Still, offshoring is not for every firm and certainly not for every business process. As senior managers in Australian companies look at which functions could be offshored, they need to determine whether it makes economical sense to offshore taking into account a wide range of considerations including cost, quality and reliability.

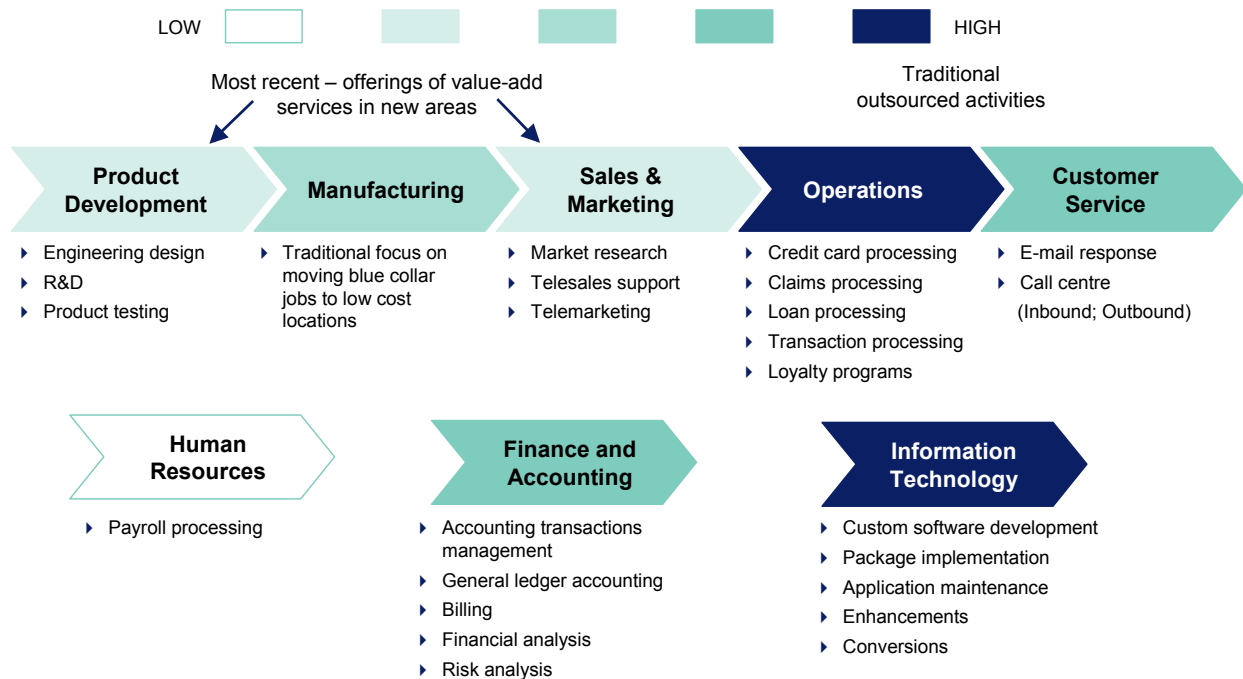
Why Are Companies Offshoring?

Outsourcing is largely about scale and the ability to provide services at a more competitive cost. At this stage offshoring is primarily driven by the dramatic wage-cost differentials that exist between labour markets. However, cost is not, and cannot be the only consideration. Other factors that influence decisions about offshoring include the quality and reliability of labour,

continuous process improvements, environment and infrastructure. Political stability and broad economic and legal frameworks are also taken into account (see Exhibit 3). In reality, even very significant labour cost differentials between countries cannot be the sole driver of offshoring decisions. Companies need to know that there is a certain level of quality and reliability in the services they are outsourcing. This is the same whether services are outsourced domestically or offshore.

While decisions about offshoring are complex, it is the case that significant labour cost differentials between Western 'onshore' economies and the economies of the sub-continent, Southeast Asia, Latin America and Eastern Europe are a very big factor (see Exhibit 4).

Exhibit 2
Level of Offshore Service Maturity



Source: Booz Allen Hamilton

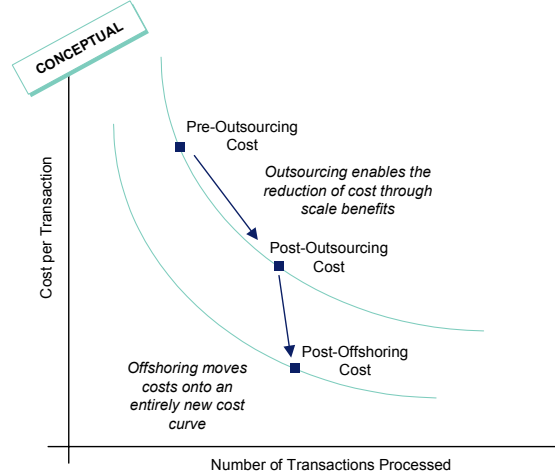
Forrester Research surveyed 57 large companies within Australia and New Zealand and found half had offshored functions already or intended to do so by the end of 2004. A popular offshoring location for Australian companies is India. IBM Australia (Telstra's contractor) could shift up to 500 software jobs to India. ANZ already has a computer applications centre in Bangalore, and other banks have also begun touring facilities in India in search of cost reduction opportunities. Booz Allen Hamilton analysis showed net cost savings of around 40 per cent were possible by shifting some functions to India. Note however, that these net cost savings are significantly less than the gap in wage costs depicted in Exhibit 3. Exhibit 4 details these opportunities and highlights that labour savings come at a price.

The additional technology, telecommunications, and management overhead required to relocate and supervise operations overseas typically reduces savings captured by 10-15 per cent. Drivers of the savings (apart from reduced direct labour costs) include lower real estate costs, and lower IT support. Inhibitors of the savings include increased IT infrastructure costs, higher management costs and increased distance driving higher product costs. Companies must also keep in mind that offshoring is a three to five-year proposition. While short-term currency movements may exaggerate the benefits and accelerate offshoring, they are not going to be a key factor as short-term fluctuations become less relevant in the longer-term decision-making process.

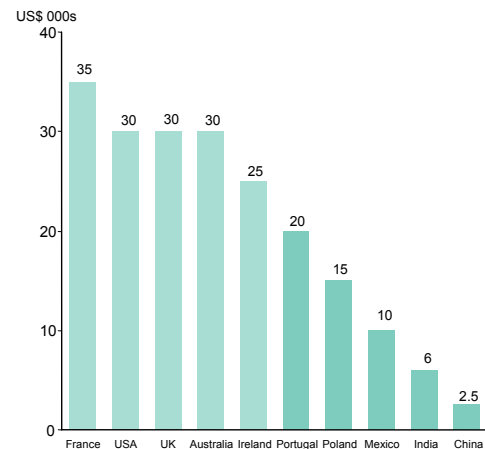
Implications for Australia

Globalisation, in providing access to wider and larger markets, allows for greater specialisation in those areas where there is competitive advantage. This advantage can be based on a range of things – natural resource endowments, relatively abundant labour, skills, the successful clustering of productive activities and knowledge to name a few.

Exhibit 3
Back-Office Costs Scale Curve

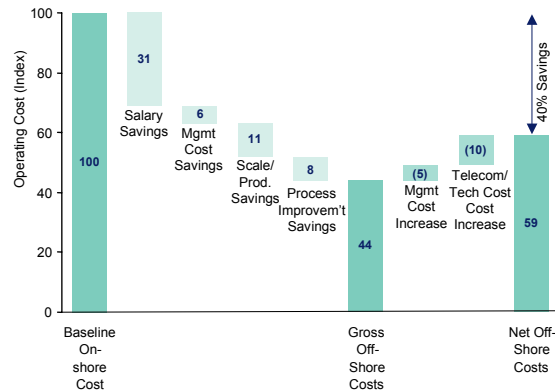


Low Workforce Costs Drive Offshore Cost Savings – Annual Wage Costs



Source: Healey & Baker, 2002; ABS 2004; China Labour Statistical Yearbook 2002

Exhibit 4
Breaking Down Offshoring Savings Opportunities from India



Source: Booz Allen Research Study of Indian Offshoring Firms, 2003

Exhibit 5
Advantages and Disadvantages for Each Offshoring Decision Factor

Decision Factor	Advantages	Disadvantages
Quality and reliability of labour	<ul style="list-style-type: none"> Offshoring workers are generally college educated, and many more have an advanced degree Treated as white collar, salaried employees, these individuals are proud to work for an international company and motivated by targets and incentives 	<ul style="list-style-type: none"> The required level of English fluency and literacy may not meet the required standard
Continuous business improvements	<ul style="list-style-type: none"> There is more likely to be a stronger focus on continuous improvements and customer service by third party providers to ensure clients are maintained and the business grows 	<ul style="list-style-type: none"> Company loses total control over the functional group as it is no longer a cost centre
Political stability	<ul style="list-style-type: none"> Choosing a politically stable country will minimise the risk of disruptions to work required 	<ul style="list-style-type: none"> If there is a risk a country could face economic, civil or political unrest, there may be disruptions to work performed offshore
Technology	<ul style="list-style-type: none"> Technical expertise and the cost of infrastructure are relatively low cost investments in offshore economies 	<ul style="list-style-type: none"> When a business relies heavily on IT for day-to-day operations, the resilience of a country's infrastructure must be evaluated

Specialisation, based on the finer divisions of production, labour, investment and ideas, in turn contribute to higher productivity and promotes innovation. In other words, specialising in those areas where there is a competitive advantage enables a country to use its resources as effectively and productively as possible. The benefits of globalisation to producers also flow from access to a wider range of inputs, be they intermediate goods, investment or labour. Once again, this enables producers to choose the best inputs from the perspective of producing the best output they can at the best price.

The same incentives and fundamental drivers apply to investment and labour. Investors look to invest in those areas where they will maximise their return on a risk-weighted basis.

The wider the range of investment opportunities and markets the more likely it is that investors are able to maximise their returns. Equally, individuals look to enhance their own opportunities, financially and otherwise through both short and long-term migration.

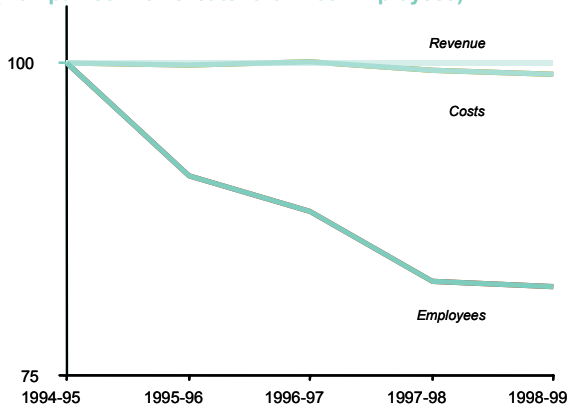
Australia is facing a significant challenge to continue to grow at the rates seen over the last ten years. Productivity improvements have driven our current economic performance and

are required to continue to maintain economic growth. However, there are limitations to productivity, which must be overcome. These include high transport costs to large markets and the small scale of domestic production.

The short-term implication of offshoring is job loss in specific industries such as information technology, financial services and communications. The impact on Australia's economy is expected to resemble the types of adjustments we have seen since the early 1980s with the share of employment in manufacturing falling, and with the share of employment in larger firms also declining. For example, during the 5 years from 1994-1999 employment in organisations of greater than 200 employees dropped by almost 25 per cent (Exhibit 6).

However, the aggregate implications for Australia were not as negative as the above figures might suggest. The Australian economy has been able to withstand short-term job losses associated with structural adjustments and the push for higher productivity. Following the sharp rise in unemployment in the early 1990s – associated with ongoing structural adjustment and a sharp cyclical downturn – growth has rebounded and remained strong and unemployment has fallen steadily.

Exhibit 6
Australian Relative Cost and Employee Trends
(Companies with Greater than 200 Employees)



The share of services jobs has grown significantly and employment in small and medium sized business has also been strong (see Exhibit 7).

The immediate challenge for Australia is to accept that offshoring will have a relatively low impact on total employment, but to manage those impacts and adjustments as well as possible. The public outcry about offshoring would have us believe that Australia will lose a vast number of jobs. But in reality this is unlikely to be the case.

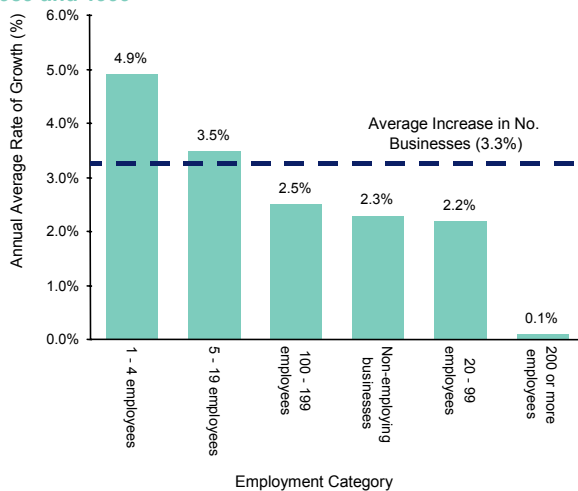
In part, it seems likely that anxiety in Australia is reflecting that which is evident in the US, and which to some extent is being exacerbated by politics around the upcoming Presidential election. In fact, five US States have proposed legislation to prohibit or severely restrict the state governments from working with firms that contract out services to low-wage developing countries. Yet offshoring estimates from the Forrester Group indicate that in the US, approximately 200,000 jobs per year will be lost to offshoring until 2015. This represents around 0.5 per cent of the current US working population. In the same time period, the US is expected to generate 3.5M new jobs per year.

Exhibit 7
Real GDP Growth and Unemployment Rates



Before Australia follows the same protectionist path as the US, we must be cognisant of the impact any political or policy decisions to inhibit offshoring may have on our position as an offshoring site and our ability to generate new jobs including through export markets, as well as returns to investors and shareholders. This is particularly important given our reliance on exports directly and indirectly for economic and employment growth. It is important to realise we are a much more open economy than the US.

Growth in the Number of Businesses Between 1989 and 1999



Currently, no data exists to show how many jobs have been offshored from Australia. However, comparable data on retrenchments is available. From 1998-2001, there was an average of 200,000 jobs lost per year through retrenchment. Of these retrenchments, 67 per cent of people were re-employed, (ABS 6266.0). Since 2001, our economy has strengthened and unemployment rates have decreased to below 6 per cent.

Source: ABS 1301.0

However, we cannot stand still. Australia needs to stay competitive on a global basis. Failure to do this could mean that Australia exits entire industries, which could threaten a significantly greater proportion of the population. Already there has been a 13 per cent fall in the number of students commencing Information, Communication and Technology (ICT) degrees around Australia this year (The Australian 16/9/03). To prevent large parts of ICT industry moving offshore, Australia needs to position itself as providing high level design skills such as software architects and project managers, to complement the lower-level work that takes place elsewhere.

Australia as an Offshoring Destination

The factors that make offshoring such an inviting proposition for Australian companies also make Australia a popular offshoring site. English speaking countries such as Australia provide obvious cultural and language similarities to the US. Other benefits include lower economic and political risk as well as better infrastructure compared with some countries with relatively lower labour costs. It has been estimated that Australia potentially benefits from offshoring to the tune of \$US400M (\$519M) per year (The Australian 19/1/04).

Australia has become a destination of choice for financial services firms, such as JP Morgan, UBS, ABN Amro and Goldman Sachs. Axiss Australia reports that it is the skill and availability of a country's labour force that determines where a firm bases its operations.

Australia is currently in an enviable position to capitalise on the offshoring trend. Australia has a large labour market with a talent pool in financial services, which outstrips that of regional rivals. Australia is also better positioned in terms of its regulatory environment and supporting infrastructure (Axiss Australia).

Nevertheless, India and China have their sights set on becoming financial services hubs and have already attracted work in call centres and shared services from financial services companies based in North America and Europe.

India is positioned to topple Australia's regional dominance in call centres within a year. ACA Research is forecasting that the number of Australian call centre seats will climb just 8 per cent to 146,000 in 2004 compared with 65 per cent growth in India, which would translate to 158,000 seats.

Australia has still proven to be the destination of choice for companies such as UBS. The bank recently established its global technical support centre in Sydney. The centre will provide computer help desk support 24 hours a day, seven days a week for 16,000 UBS staff spread across 30 countries. The NSW Department of State and Regional Development helped fund the facility, which creates 170 jobs (AFR 2/9/03). UBS is also in the process of establishing help desk operations in other regions, including the US and Europe. Many companies will spread their operations across a range of geographies in order to achieve an optimal balance between savings and risk. This will spawn significant opportunities for Australian IT workers who position themselves appropriately.

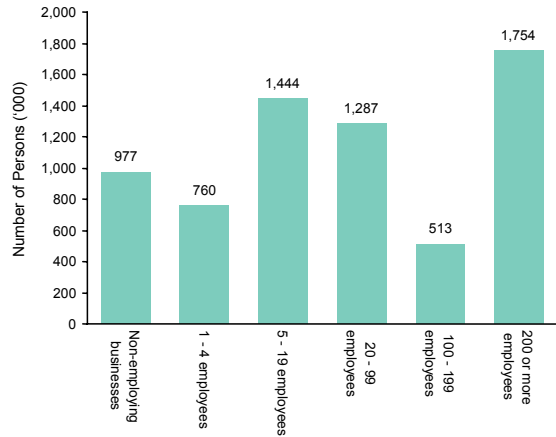
Why Australia Does Not Need to be Concerned

Our estimates indicate that between 2-4 per cent of current jobs could potentially be offshored. This number is not as large as the media attention surrounding the issue for several reasons. 73 per cent of Australia's labour force serves domestic service industries, which cannot be offshored (eg, retail trade, accommodation, cafes and restaurants, health and community services and cultural and recreational services; see Exhibit 8).

Furthermore, minimal job loss is expected from sectors such as mining and resources, as they have already undergone substantial consolidation during the 1990s.

Australia has also seen the largest growth in the number of persons employed and number of businesses in the small to medium sized enterprise segment. This segment has fewer offshore opportunities because these businesses are unable to achieve the scale benefits that larger businesses can.

Exhibit 8
Number of Persons Employed by Business Category ⁽¹⁾



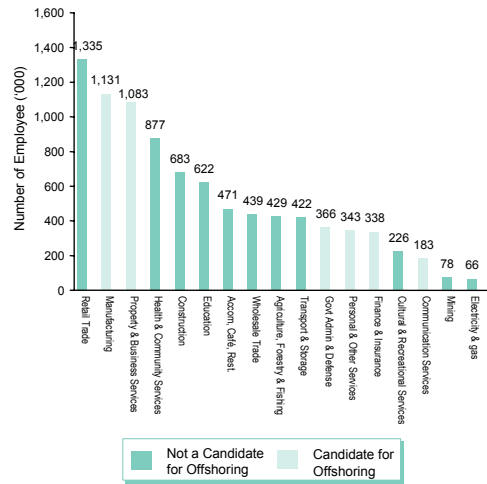
(1) Excludes public trading and general government entities and business in agriculture, fishing and forestry industries

Source: ABS 1301.0

When looking at business growth, it becomes apparent that 66 per cent of employed persons are in businesses with less than 99 employees (Exhibit 8).

Jobs that are offshored are expected to come from larger companies (eg, employing more than 100 employees). The types of jobs currently offshored include human resources (HR), finance and accounting, financial analysis, customer support/call centres, health care support services,

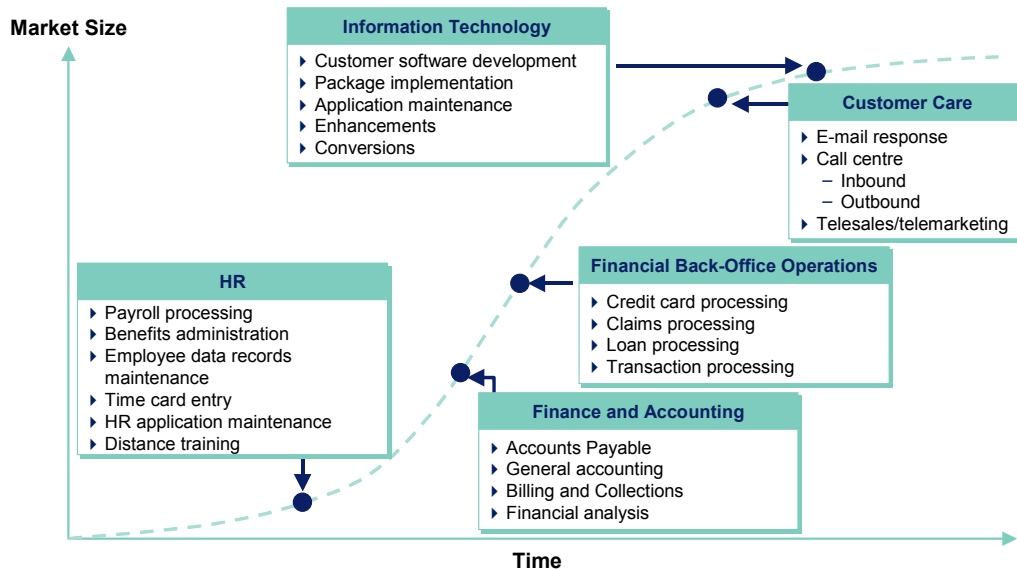
Number of Persons Employed per Industry



legal support services, transaction processing and computer professionals (see Exhibit 9).

It is obvious that the job types not only include manual labour or call centre work, but are also targeting middle class university educated professionals. This becomes a reality in the light of the potential job losses at Telstra. Up to 1500 IT jobs potentially being relocated overseas. This represents around 4 per cent of their employee base.

Exhibit 9
Level of Offshore Processing



The challenge for Australia in the longer run is to provide an education system that will enable workers to continue to upgrade their skills and move into more sophisticated fields. This, in part, will be driven by people directly affected, as many parts of the service sector, including IT, have a globally competitive culture. In the near term, even though it is estimated that a relatively small number of workers will be impacted directly by offshoring, Australia will need to manage well these adjustments and the costs.

While Australia is facing tougher competition across many fronts, this is effectively the quid-pro-quo of globalisation. In other words, it is the trade off for Australia being able to make the most of its own comparative advantages in global markets in developing and sustaining export markets for those goods and services that we produce well, such as wheat, wool, coal, education, tourism and wine.

Regulating or limiting offshoring ultimately represents a form of protectionism. If Australia denies other countries opportunities to create jobs and incomes through specialisation in goods and services, we may well find our access to markets and opportunities limited as a result. We can expect countries to retaliate against our protectionist policies, in the same way they would retaliate if we no longer allowed them to export goods to our market that compete with Australian products. In the end this will erode Australia's economic success and prosperity.

Australian companies' ability to become more globally competitive will be derived from their ability to reduce costs, raise efficiency and to provide goods or services at least on a par with their competitors. For some achieving this will involve offshoring. Ultimately, the higher profitability derived from enhanced competitiveness will flow to consumers, shareholders and other investors.

About Booz Allen Hamilton

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for 90 years. Booz Allen combines strategy with technology, and insight with action, working with clients to deliver results today that endure tomorrow.

With over 14,000 employees on six continents the firm generates annual sales of US\$2.5 billion. Booz Allen provides services in strategy based transformation, organisation, operations, systems, and technology to the world's leading corporations, government and other public agencies, emerging growth companies and institutions.

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