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HEADLINE: The logic is inescapable

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OUTSOURCING

'The logic is inescapable': why India believes commercial imperatives will help it beat the offshore backlash.

Public Opinion in Western economies might not be in favour, but cost differentials and labour flexibility mean there is plenty of scope for further migration of jobs, write Edward Luce and Khozem Merchant. When chief executives from India's booming software and services industry gather for an international conference next week they will celebrate another year in which thousands of jobs have flooded into the country, part of a tide of outsourcing of employment to India by western companies. But chatter at the event organised by Nasscom, the trade body of India's software and services companies, may be about threats as much as about celebration. After so much success in persuading western companies to transfer jobs offshore, India is alive to the danger of a backlash.

Last week the US Senate passed an amendment that would prevent private companies from using offshore workers in order to compete successfully against government workers on some contracts opened up to competition. The amendment was in fact more modest than it initially appeared, since it applied only to the US Treasury and the Department of Transportation. Yet the bill has triggered a furore in India, which sees the measure as a harbinger of other such measures and evidence that it is the principal target of a protest against outsourcing. Indian politicians have proclaimed the legislation as an example of US double standards on free trade and Arun Shourie, India's minister for information technology, even suggested that the move would endanger the revival of the Doha round of world trade talks that broke down in Cancun last year but has recently been resuscitated.

India's acute sensitivity to rising protectionist sentiment in the west cannot be written off as paranoia. Hardly a day goes by without one of the Democratic US presidential candidates pledging to "keep American jobs in America" (see below). In the UK, where there is a greater focus on the "offshoring" of call centre and back office work than on software contracts, trade unions that oppose offshoring are garnering strong sympathy in some quarters and have called for boycotts of companies that move jobs out of Britain. Could India's booming service sector be falling prey to rising western fears that jobs will disappear? The risk cannot be dismissed. But much of it is overstated. There are three reasons to believe that US and UK private companies, which generate almost all of India's outsourcing business,

will locate an increasing share of their operations in India and other developing countries in the coming years. First is the size of the cost savings that offshoring has generated for the companies that have already moved a significant chunk of their operations to India. This applies both to India's mainstream software development sector, which is principally located in Bangalore, Hyderabad, Mumbai and New Delhi, and to its call centre industry. A recent report by the McKinsey Global Institute estimates that of every Dollars 1 that is "offshored" the company gains 58 cents in net cost reduction "even as they gain a better (or identical) level of service". In other words, companies that have so far failed to shift operations to India - whether it is software development, IT systems integration, customer support, back office work, or personnel management - will be at a large and growing competitive disadvantage. "Assuming you have done your management research properly, the logic of offshoring to India is inescapable," says the New Delhi head of a large US company, which has 23,000 employees in India. "There is almost literally no limit to the supply of qualified graduates in the labour market." India has the youngest demographic profile of any big country in the world, including China. More than half its 1.05bn population is under the age of 25 and its labour force is projected to continue expanding until at least 2020. This, combined with the country's growing investment in higher education, particularly engineering and communications, means that the supply of qualified English-speaking labour will continue to outstrip demand and help keep a lid on wage inflation. "We were able to employ 800 fully qualified people in six months at cost savings of 40 to 50 per cent," says R.K. Rangan, the Mumbai manager of Prudential, the UK insurer, which runs a call centre. "It would have been hard - if not impossible - to ramp up at that rate in the UK."

Second, the process is still in its infancy. Although India's business process outsourcing sector has grown by almost 60 per cent a year since 2000, it still employs only 245,000 people. India's more established software development sector still employs fewer than 1m people, although it too is growing at about 30 per cent a year. Recent surveys of US corporate investment plans indicate that further potential is likely to be realised quite rapidly. Marc Hebert, head of **Sierra Atlantic**, a US software consultancy firm with almost 500 employees in Hyderabad, says it is now routine for start-up software companies in the US to outsource up to 80 per cent of their development work to India and China. More significantly, **Sierra Atlantic** found that a majority of venture capitalists in Silicon Valley now make it a requirement that start-up companies subcontract some software development to India or China. The implications for larger and more established US software companies - many of which currently subcontract little or no work to India - are profound. Most could be forced for competitive reasons to emulate the practices of start-ups in Silicon Valley. "We expect to see a rapid catch-up, with India's compound growth at about 50 per cent a year over the next five years," says Mr. Hebert. Furthermore, barely any of India's future growth is expected to come from western government outsourcing, which is where any backlash against the offshore shift seems most likely to manifest itself. Just 2 per cent of India's estimated Dollars 15bn (Pounds 8.2bn, Euros 12bn) of outsourcing earnings in 2003 were generated by the US public sector. Trade unions in the US and the UK are talking about boycotting private companies such as American Express and Lloyds TSB that offshore jobs to India. But Indian executives believe this threat is overplayed. "The threat is mostly symbolic at the moment," says Kiran Karnik, head of Nasscom, the Indian trade body. "We would say we are concerned rather than alarmed." Third, in contrast to conventional wisdom in the US and the UK, India's service sector productivity is improving rapidly and in some cases matches or outstrips western levels. Western executives say India has attained a

level of experience that enables them to "re-engineer" work processes much more rapidly than they would in their domestic operations.

The combination of low wages and the relative flexibility of an almost wholly non-unionised and youthful labour force enables investors to undertake tasks that were previously ignored. For example, wage costs amount to about 30 per cent of a typical call centre in India, compared with 70 per cent in the US or the UK. This gives an Indian call centre the latitude to add extra functions and continue operations round the clock. "Companies are now using offshoring to drive revenue growth (in addition to cost savings)," says Diana Farrell, director of McKinsey Global Institute in San Francisco. "One airline was able to chase delinquent bills that it could not afford to chase before, because it lacked staff or took too much time." The head of the India offshore units of one US investment bank, which has relocated equity research work from the US to Mumbai, says the logic of shifting highly skilled jobs to India is also compelling. "In reality the wage differential (after factoring in other costs) of a guy who works at a commoditised call centre in India and an equivalent centre in the US is slim," he says. "But the economies of scale for higher value-added work like equity research are much smaller for you to break even - say, 25 employees in equity research as against 500 seats in a call centre." That logic could equally apply to professions such as chartered accountancy, legal services, medical consultations and publishing. Indeed, it is the potential of outsourcing to create large-scale migration of jobs, rather than its relatively modest results to date, that has so unnerved public opinion in the west. "Look at your average call centre worker in Liverpool," says Omkar Goswami, chief economist of the Confederation of Indian Industry. "He watched his father lose his old economy shipbuilding job in the 1980s but he found employment in the newly emerging service sector. Now even that job is under threat and he is wondering what on earth will replace it." In fact, as western businesses are increasingly pointing out, the gains to the US and UK consumer - and therefore to the domestic job markets - can be considerable, whether it is in the cost savings that are used to upgrade the skills of the labour force or in the greater exports that will go to a wealthier Indian market. But it is hard to illustrate the argument to those facing imminent redundancy. "It is easy to identify a particular job that has been lost, far more difficult to point to the new jobs that have been indirectly created," says one US executive. Mr Karnik says: "Instead of pointing out the logic of Ricardian economics (the original theory of comparative advantage) we express great sympathy with individuals whose jobs are going. But the ultimate point is that the western consumer is benefiting from lower costs and your company can now afford to retrain you for higher-skilled work." evertheless, India's outsourcing industry does face a number of potential constraints to growth. One is the fact that some proactive western outsourcers are starting to bump up against their country risk limits. India and Pakistan's recent rapprochement may be encouraging. But many investors recall that less than two years ago the nuclear-armed neighbours almost went to war.

Some Indian "third-party" outsourcers, which provide an alternative for western companies that do not want to set up their own site in India, are establishing subsidiaries in the Philippines and elsewhere in order to reassure investors. Another concern, especially in the US, is data privacy and the physical security of work sites, although so far no investor has complained of leakage of customer information by Indian employees, and most software and call centre work is carried out through dedicated telecommunications facilities rather than over the internet. Nasscom says it is working with the IT Association of America, its counterpart, to develop acceptable common standards both for consumers' digital privacy - a particular

concern among insurers - and to build firewalls against other security breaches, including terrorism. Ultimately, though, these are secondary areas of friction that few believe have the potential to check India's galloping growth of offshore contracts. The most dramatic scenario so far projects that the US will lose 3.3m jobs by 2015, up from 473,000 so far, according to a widely cited study by Forrester. But this is small fry by the standards of the 1980s, when the US lost millions of manufacturing jobs to east Asia and Mexico. Against this are the gains in productivity and competitiveness to the US private sector and the jobs that will be directly and indirectly created as a result. "There is far too much emotion in this debate," says Ms Farrell. "There is a view - an incorrect view - that every job gained in India is a job lost in the United States. If enough people start thinking this way, we could be in for a whole lot of bad regulations in the US."

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Charles Schumer, the Democratic senator from New York, admits his record on free trade has been "mixed". But his anger over the disappearance of US high-technology jobs to India and China, he says, has caused him to reconsider some "fundamental assumptions" about whether open trade can ever make sense in a world of free capital flows, high-speed communications and an educated global population. "It doesn't fit the free trade model when these high-end jobs migrate overseas," he said at a Brookings Institution forum this month. "We've bet the ranch for a long time (that) the highest value-added jobs will stay here because we're the best educated." Since the rise of east Asian economies in the 1980s, the US has largely reconciled itself to the loss of low-skilled manufacturing jobs. More than 2.5m have disappeared during the tenure of President George W. Bush with few signs of a protectionist backlash. But the gradual move overseas of higher-end technology and white-collar jobs has touched a raw nerve. Paul Craig Roberts, an economist who has warned that outsourcing poses a serious threat to the US economy, says that when he talks to high school and college students "they spend a great deal of time searching for an occupation that can't be wiped out underneath them". Political debate over the issue has escalated sharply. John Kerry, one of the Democratic presidential frontrunners, has called for curbs on outsourcing of government contracts and a "right to know" law that would force all call centres to disclose their location. John Edwards, another leading candidate, says the outsourcing of jobs is part of "an extraordinary sea change" in the economy that is devastating middle-class America. Government proposals to counter outsourcing have taken several forms, according to a study by the National Foundation for American Policy, which opposes outsourcing. At the state level, several states have barred offshore companies from doing government contract work. New Jersey, for example, reworked a call centre contract - at a cost of about Dollars 900,000 (Pounds 490,000, Euros 710,000) - to require that a dozen of the jobs remain in the state rather than going to India. And in Indiana last year the governor cancelled a Dollars 15m contract with Tata, an Indian company, even though its bid was Dollars 8m less than that of the nearest US competitor. Several other states are considering legislation that would restrict foreign-based call centres or ban the outsourcing of government jobs. The federal government has so far done little. Several bills have been introduced in Congress that would restrict companies from bringing cheaper foreign workers to the US to do jobs previously done by Americans. And the omnibus 2004 spending bill soon to be signed by Mr. Bush contains an amendment that would prevent private companies that take over some government contracts in the federal transport and Treasury departments from moving that work offshore. Tita Freeman, a representative of the Business Roundtable of US chief executives, says that, while its impact would be limited, the

amendment is "isolationist in nature" and would discourage job creation. US high-technology companies, which believe that outsourcing will be crucial to their future competitiveness, have been acutely attuned to the legislative threats, however, and are ready to fight back. The chief executives of Hewlett-Packard, Dell, International Business Machines and other companies warned this month that restrictions on outsourcing would imperil one of the most productive sectors of the US economy. "There is no job that is America's God-given right any more," said Carly Fiorina, HP's chief executive. "We have to compete for jobs." Edward Alden