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Economic reasons behind outsourcing

Everybody who takes part in the process gains, and it's high time Asian companies caught up with the trend too

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CONTEMPORARY international trade flows are increasingly characterised by 'production sharing', defined as the decoupling of previously integrated goods into their constituent parts, components and accessories (PCAs) which in turn are distributed across countries on the basis of comparative advantage.

This sort of cross-border multi-staged production and trade in PCAs has in turn been facilitated immensely by major improvements in transportation and information communication technologies. By reducing the costs of production of a good, production sharing makes the entire set of countries that participates in the integrated production system more attractive as an export market and investment destination.

This in turn is a win-win arrangement for all participants. Lower income developing economies are not only able to gain a comparative advantage in lower-end light industries, but also in the lower-end production stage of heavy industries. Middle and higher income developing countries are able to graduate to higher segments of the value-added chain.

Countries could also move along the production chain horizontally, ie improve product quality and serve higher value-added market segments where profit margins are wider. This essentially involves moving from selling under a foreign label to developing and selling under their own label, hence allowing them to capture brand name rents.

Production sharing involving developing economies is highly concentrated in Mexico (because of Nafta) and Asia, primarily Greater China and Asean, but increasingly India as well, which is gradually becoming a sourcing hub for auto components, textiles and pharmaceuticals. This is largely explained by the fact that production sharing has been facilitated by the expansion of the global operations of multinational corporations (MNCs) and consequent foreign direct investment (FDI) which in turn has been clustered in these countries.

This is not to suggest that such cross-border trade always requires MNCs. In cases where there are no obvious benefits from 'internationalisation', outsourcing could also be conducted at 'arm's length' between independent actors, ie separation of ownership. Thus, MNCs have played a major role in production sharing involving computers, semiconductors, office machinery and automobiles, while arm's length transactions have tended to be more common in the case of commodity trade such as consumer goods like garments, footwear, toys and handicrafts.

Production sharing is not limited to trade in goods as MNCs have fragmented and dispersed various services functions worldwide to take advantage of marginal

differences in costs, resources, logistics and markets.

This has led to a rapid increase in the offshore outsourcing of and trade in many services activities that may have been considered non-tradable in the recent past. The often repeated mantra nowadays is 'anything that one can send over the wire is up for grabs'.

Service activities outsourced to developing countries include call centre support and back-end business process operations (BPOs) like data entry and handling, payroll management, accounting and book-keeping, processing of tax returns and insurance claims, ticketing, coding and organising of documents for major litigation cases, transcription (medical and legal), as well as IT-related services such as web hosting, network and server management, PC and application maintenance and support and development.

Many US, British and other multinationals as well as smaller enterprises routinely outsource a number of their services activities. They have come to appreciate that if they do not outsource to reduce costs, while their competitors continue to do so aggressively, they stand to lose global and local market share to their foreign rivals. The resultant stagnant corporate profit growth will limit the creation of new capital and re-investment in domestic technology.

India has become the leading destination for outsourcing of BPO and IT services for a number of reasons, including the widespread use of English, relatively low wages, large pool of science and engineering graduates, and the presence of strong indigenous service sector enterprises. However, other countries like China, Hungary, Israel, South Africa, Philippines, Poland, and Russia are also emerging as important players.

Outsourcing to India in particular has not only involved low-to-mid skill areas like call centres and routine data-crunching tasks, but also more sophisticated and skills-based services including software development, research and development (R&D), financial portfolio analysis, patent writing and product design and development, these being niche areas for Singapore as well.

From an economy-wide perspective, offshore outsourcing of service activities from developed to developing countries will inevitably lead to some white collar job losses in the former, just as production sharing has been leading to the displacement of certain blue collar workers. Such domestic adjustments are an inescapable outcome of resource reallocation to their more productive uses following international trade (which is the reason motivating such trade in the first instance).

However, this in no way justifies embracing archaic protectionist attitudes or policies that prevent the optimal allocation of resources globally. Rather, the focus of well-meaning labour unions and policy makers should be to empower people to take advantage of - rather than hinder and lament - the process of economic globalisation and inter-related forces. This is because international trade lowers the costs of final goods and services available to the consumers. This so-called consumer 'surplus' will far outweigh the job losses faced by a select group of workers in developed countries.

Indeed, outsourcing is responsible for only a small portion of recent job losses in the US, with the general business cycle and rapid automation being the main reasons behind sluggish job creation and concomitant job insecurities that have gripped the country. Thus, even in a simple static sense, outsourcing and production sharing will be beneficial on a net basis to society as a whole, though there will inevitably be some transitional costs.

An August 2003 report by McKinsey Global Institute estimates that for every US\$1 offshored by the US to India, the former gains US\$1.12 to US\$1.14, while the latter gains 33 US cents. While such estimates should be taken with a pinch of salt, they are indicative of the static gains to be reaped from offshoring.

In a more dynamic sense, the trade-induced growth in income levels in developing countries will have further positive feedback effects for the rest of the world in terms of rising exports and increased tourism inflows. This is the age-old global wealth-creation story which is a win-win game. There are already signs of this happening with rapid growth in China and India leading to a sharp increase in imports by these countries as well as increases in outbound tourism from them.

Outsourcing wisely to take advantage of the new international division of labour in both trade in goods as well as services should be an integral part of every company's corporate and economic restructuring.

Many Asian companies have been rather slow off the mark in embracing the benefits of offshore outsourcing compared to their American and European counterparts. It is high time that they started tapping countries in their neighbourhood like India and China, not solely for their large domestic markets (ie as new revenue sources), but also because of their potential to enhance the global cost competitiveness of Asian companies.

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