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## Relocating the Back Office

*The Economist*  
11 December, 2003

### **The shift of service jobs to low-cost countries has only just begun. It promises huge benefits to consumers everywhere**

The debate over "offshoring", a phenomenon unheard of a few years ago by many of those now loudly proclaiming its economic effects, is in "the percolating phase," says Brink Lindsey of the Cato Institute, a Washington, DC, think-tank. It could, he adds, be "a potentially potent contributor" to the increasingly protectionist mood in the American capital.

The debate has been brewing since a study by Forrester, a research group, in 2002 claimed that 3.3m white-collar American jobs (500,000 of them in IT) would shift offshore to countries such as India by 2015. There has been standing room only at recent presentations of a report by the McKinsey Global Institute suggesting that this process of "offshoring" benefits both the countries involved in it. It is, says the consultants' research arm, a "win-win" formula.

Others are not so sure. Stephen Roach, the chief economist at Morgan Stanley, talks about a "new and powerful global labour arbitrage" that has led to an accelerating transfer of high-wage jobs to India and elsewhere. He reckons this is adding to the bias towards jobless recoveries in western economies. An anonymous e-mailer claiming to represent a group of Boeing engineers is putting it about that Boeing's offshoring of some design engineering work to a new centre in Moscow is causing lay-offs that are cutting "deeply into Boeing's talent pool". The e-mail also alleges that this is putting "the safety and quality of Boeing airplanes at jeopardy".

Although there have been no federal legislative proposals in America against offshoring per se, there has been a tightening up on the granting of visas that allow foreign workers to enter America for training and temporary employment. The annual quota for so-called H-1B visas used by itinerant Indian software programmers fell in October to 65,000 from 195,000 a year ago. The idea is to prevent foreigners from taking Americans' jobs. In fact, the effect may be the reverse. Craig Barrett, the chief executive of Intel, a chipmaker and a big employer of Indian engineers, says that America's main problem is a lack of suitably educated engineering graduates. The impact of fewer visas may thus be to encourage American firms to shift more work to India, where well-qualified computer engineers are plentiful.

### **English spoken here**

But the vast majority of the service jobs that are now going offshore do not require highly qualified engineers. Multinationals may in future do original R&D in low-cost places, but for the moment most of the jobs on the move are the paper-based back-office ones that can be digitalised and telecommunicated anywhere around the world, plus more routine telephone inquiries that are increasingly being bundled together into call centres.

Several American states have moved faster than the federal authorities in trying to halt this "labour arbitrage". Lawmakers in New Jersey have proposed a bill to stop firms using foreign workers to fulfil state contracts. Public pressure forced the state to bring back a helpline for welfare recipients that had been outsourced to India. For similar reasons, in late November Indiana withdrew from a \$15m contract with the American subsidiary of a leading Indian IT outsourcing firm. Governor Joe Kernan said that the contract did not fit with Indiana's "vision" of providing better opportunities to local companies and workers.

On one estimate, America accounts for over 70% of all offshoring business. The second biggest market is in Britain. Big companies there regularly announce that they are moving service jobs abroad, many of them involving the wholesale transfer of call centres. In late October, the HSBC banking group announced that it is taking 4,000 jobs from Britain to India, and earlier this month Aviva (the Norwich Union insurance group) said it is transferring 2,350 jobs, also to India.

As yet, such moves have been less politically contentious than in America. Patricia Hewitt, Britain's minister of trade and industry, responded to those concerned about the job losses by saying it was a "myth" that offshoring would create widespread unemployment. Nevertheless, her department has commissioned an independent study into the competitiveness of Britain's call centres. Representatives of Amicus, a big British finance-sector union, were this week seeking to persuade the European Parliament to set up a more general inquiry into the likely impact of offshoring on Europe's economy.

The offshoring business remains predominantly English-speaking. It is dominated by American and British companies outsourcing their internal operations to third parties in places such as Ireland, Canada and South Africa, but most of all in India. The fact that America and Britain have relatively liberal employment laws has also been influential in the shift of business overseas. If offshoring is, as McKinsey claims, a "win-win" formula for both sides, the process is set to give English-speaking countries a significant competitive advantage.

There are examples to be found elsewhere. A few Japanese companies have shifted operations to north-east China, where Japanese is spoken, and Bain & Co, a consultancy, forecasts that the offshoring market in Russia will grow by 45% by 2006, compared with 57% for India. Eastern Europe too has been making a play for offshoring business based on its relatively low wages and physical proximity to western Europe. In September, DHL, a logistics firm, announced that it will shift its data centre in Britain and parts of its IT operations in Switzerland to a state-of-the-art services centre in Prague that will oversee all the company's European IT operations.

But the current political and market uncertainty in Russia could well constrain growth there for some time to come. And all of eastern Europe suffers from an excess of red tape. Earlier this year Lufthansa opened an accounting centre in Krakow in Poland. The German airline says that it is pleased with the quality of its staff. "Our employees are first-rate, but the paperwork is excessive," says Hedwig Hardtke, the head of the centre. A further threat to eastern Europe's offshoring business lies in the forthcoming entry into the EU of countries like the Czech Republic and Poland. That is sure to narrow wage differentials with the rest of Europe and eradicate much of the rationale for offshoring there.

India looks likely to remain the most attractive offshoring destination for some time. It sees its main competitors as China and Malaysia. But Sanjukta Pal, a consultant with PricewaterhouseCoopers, says that the cost of operations in India is currently 37% lower than in China and 17% lower than in Malaysia. The Philippines is another country that is well equipped to provide competition in the future. It produces almost 300,000 college graduates a year, all of them English-speakers. But they are competing against India's annual crop of around 2m college graduates, 80% of whom speak English.

#### **Much more than low cost**

The main advantage of shifting business operations to India and similar low-cost countries comes from a combination of lower wages and the improvement in the quality and price of international telecommunications. A report by HSBC says that the cost of a one-minute telephone call from India to America and Britain has fallen by more than 80% since January 2001. With high-grade jobs, the saving on wages is not as high as with lower-grade ones. NASSCOM, India's National Association of Software and Service Companies, reckons that an IT professional with three to five years' programming experience earns \$96,000 in Britain, \$75,000 in America and \$26,000 in India. At the other end of the scale, low-grade call-centre jobs that in Britain earn a salary of \$20,000 earn less than one-tenth of that in India.

But the benefits of offshoring are not confined to lower costs. An article in the latest issue of the McKinsey Quarterly says that many companies that move their back-office functions offshore miss huge opportunities to reap efficiencies beyond those that come from using cheaper labour. "Companies are merely replicating what they do at home, where labour is expensive and capital is relatively cheap, in countries in which the reverse is true." For one thing, offshoring allows companies to work round-the-clock shifts, ferrying data back and forth from one place to another as the sun sets. For another, it allows them to rethink the way they solve IT problems. American Express, for example, paid local programmers in India \$5,000 to write some software that it needed. To have bought a software package that could do the same job would, the company estimates, have cost it several million dollars.

For the future, offshoring promises to diminish the effects of the demographic crunch in countries where the ratio of the working population to the total is set to fall. HSBC reckons that America would require an extra 8.6m workers to maintain the ratio at its 2000 level for 20

years. Countries that are reluctant to allow in immigrant workers to do their unfilled jobs now have the option of sending some of those jobs out to the workers, before they even think of emigrating.

Despite all the advantages of offshoring, there are also disadvantages. With voice services—such as directory enquiries, for example—local knowledge is often important. So too are accents and culture. In late November, Dell got itself into a tangle when a spokesman in Texas said that the computer-maker was bringing some of its Indian-based customer-inquiry services back to America because “customers weren’t satisfied with the level of support they were receiving”. The next day, however, a spokesman for Dell in India denied that the work was returning.

Whatever the truth of the matter, there is no doubt that customers with complex queries requiring local understanding do not respond well to far-off operators repeating parrot-fashion a series of learned responses. Convergys, one of the world’s biggest providers of “contact-centre services”, advises companies to shift simple queries offshore while retaining the more complex ones on the same shore as the caller. It calls this process “rightshoring”, and estimates that about 80% of the companies that it is working with in Britain are planning to split their call-centre operations in this way.

### **Boomerang jobs?**

Many companies have not yet taken anything like full advantage of offshoring. Harris Miller, president of the Information Technology Association of America (ITAA), a lobby group, says that offshore locations have so far captured just 3-4% of all American companies’ outsourcing. The bulk remains onshore in the hands of big firms such as Accenture, CSC, EDS and IBM. A report by Forrester released at the beginning of this week says that 60% of Fortune 1,000 companies are doing nothing, or are only just beginning to investigate the potential of offshoring. Mr Harris says some big companies have told him that up to 40% of their outsourcing business could end up offshore. That suggests the industry still has a long way to grow.

Technology may accelerate that growth. One thing currently limiting the ability of companies to outsource tasks, says Bain’s Simon Heap, is the inflexible architecture of modern business-information systems. It forces firms to perform tasks as a series of discrete steps. So a business wanting to outsource some of those steps (billing, for instance, or customer service), but not others, gets involved in designing horribly complicated flows of information that are all too prone to error. Newer software and hardware promise a future in which, says Mr Heap, firms will be able to outsource smaller and smaller slivers of their business. They will not, as now, have to commit themselves to outsourcing the whole of, say, their customer-service department or nothing.

There are limits though to how far the phenomenon can go. First of all, there are natural limits to the shifting of service jobs overseas. Many of them are in industries like hotels and restaurants, or in public services like education and health, most of which can never be moved abroad. In Britain, some 60% of all service-sector employment falls into this category. Then there are alternative pools of labour to be tapped at home. Citigroup, for instance, has hired about 100 college students in America to do programming for it, and it pays them \$17 an hour. The bank reckons that is about half what it would have to pay comparable programmers in India.

Technology too may place some constraints on offshoring. Irving Wladawsky-Berger of IBM argues that some of the tasks currently going to low-cost centres may eventually return because their underlying technologies will evolve in a way that makes economic sense of putting them back in rich countries. At the moment, for instance, customer-service call centres are very labour-intensive. McKinsey says that wages account for 70% of the costs of a call centre in America. That is why they are rapidly shifting to Bangalore, Hyderabad and other Indian cities.

But firms such as AT&T are working on speech-recognition software that might, says Hossein Eslambolchi, AT&T’s chief technology officer, soon be good enough to replace a lot of the routine inquiries currently handled in call centres. Indian call-centre employees, in other words, might soon find themselves competing with “offshore” computers in New Jersey, and Indian doctors currently providing remote diagnosis of patients in other countries might find themselves undercut by a supercomputer’s analysis of, say, digital mammograms and dental records.

### **Indian territory**

The business of shifting back-office functions offshore began in earnest in the early 1990s when companies such as American Express, British Airways, General Electric and Swissair set up their own "captive" outsourcing operations in India. However, many of these captives are now finding that their costs are up to 50% higher than those of independent third parties. British Airways' captive business was recently spun off as an independent Indian firm called WNS, handling high-volume, low-value back-office business processes for a dozen western airlines and a raft of other big companies. In what might become a model for other such offshore captives, WNS was bought in 2002 by a private-equity firm, Warburg Pincus, and a group of its own managers.

A bunch of home-grown Indian IT groups have become powerful players in the market for offshore IT services: companies such as Wipro, Tata Consultancy Services and Infosys. They got their big breaks as subcontractors to overloaded western firms during the Y2K software crisis at the turn of the millennium. Now they are beginning to expand beyond core IT maintenance and support work into helping multinationals, for instance, to roll out new software applications.

Younger Indian IT firms are competing in an increasingly crowded market by offering different services. For example, vMoksha builds, operates and then transfers offshore centres to multinational clients, flouting the usual Indian reluctance to hand over ownership. In another sign of the growing sophistication and maturity of the industry, big western outsourcing firms such as Accenture, EDS and IBM are developing their own facilities abroad in order to shift more of their outsourcing business, currently performed in the West, to offshore destinations. But the cost advantages for the latecomers are being continually eroded. Salaries in Bangalore have been rising with the demand for skilled workers, and firms like Wipro and Infosys invest heavily in training and facilities. The Infosys campus in Bangalore's Electronics City, for instance, is the equal of anything in Silicon Valley.

#### **A better deal**

The protectionist response to offshoring may force some government work that would otherwise have gone abroad to remain at home, the extra cost to be picked up, of course, by the taxpayer. But government work is only a small part of the market. David Tibble, the boss of WNS, says that it accounts for some 30%; the rest is in the hands of a private sector that is just awakening to the extent to which offshoring can boost its productivity.

Offshoring is not new. Pankaj Ghemawat, a Harvard Business School professor, suggests that the whaling fleets and floating factory ships of the late 18th century "can be said to have originated offshore manufacturing", a development that accelerated sharply in the 1980s and 1990s. But the beginning of what seems likely to be a mass migration of traditional in-house corporate services to third parties abroad presents companies with new structural challenges.

Many fear the loss of control implicit in the process. But Jane Linder of Accenture's Institute for Strategic Change says that the majority of those who pass on traditional back-office functions to others find, in the end, that substituting a single supplier for many employees allows them greater control and discipline over their operations. At the same time, it frees them to think more clearly about strategy. And the boost to efficiency means lower prices and better services for customers everywhere. That, surely, is not something to fear.