

# Economic Update

## The emergence of offshore outsourcing

The increasing trend towards the outsourcing of business and technology processes overseas has sparked considerable debate. Media commentary has largely focussed on the jobs that will be lost in Australia, however as this paper explains, the benefits of offshore outsourcing seem to outweigh the costs.

### What is outsourcing?

Outsourcing is the contracting out of a company's non-core, non-revenue producing activities to specialists. Two common types of outsourcing are Information Technology (IT) outsourcing and Business Process Outsourcing (BPO). IT outsourcing relates to the outsourcing of computer applications and network backbone services, whereas BPO includes outsourcing related to accounting, human resources, call centres, payroll and finance activities.

### Advantages of outsourcing

There is more to outsourcing than cost reduction. Generally companies outsource to:

- focus on core competencies;
- gain on-going access to experts;
- provide high performance levels;
- reduce costs;
- redirect capital investment;
- gain access to the latest technology; and
- eliminate the need to recruit, train and retain staff in non-core functions.

### Background

#### Information Technology outsourcing

The concept of outsourcing in Australia took a big step forward in the late 1990's, when the Federal government announced it would outsource many of the functions of its IT departments. Between 1998 and 2000, five contracts worth \$1.2bn from 23 agencies were outsourced (representing 0.8% of total government spending in the 2000-01 financial year). However in November 2000, the Federal Government's outsourcing program became the subject of a Senate Committee investigation. In early 2000, the Australian National Audit Office reported that the IT outsourcing program after two years had cost nearly three times what was budgeted and was behind schedule to achieve the cost savings which were expected. As a result, the cluster approach to outsourcing contracts was halted and departments were given more autonomy to manage their own IT systems and contracts.

A survey by analyst group IDC revealed that only half the companies that have outsourced their IT functions are satisfied with the service enough to continue the current contract. However, only 13% have indicated they will terminate the contract, and less than 5% indicated they would be bringing the IT back in house, with the remainder indicating a renegotiation of a contract is likely.

Many existing corporate and government-outsourced contracts are now coming up for renewal and are to undergo a review process. Some of these contracts are likely to be in-sourced, while others may be broken down into smaller components and tendered individually.

The recent trend in outsourcing – particularly in the public sector – is to seek relationships with small, niche service providers, rather than enter contracts with large generalist providers.

#### Business Process Outsourcing

BPO is a fairly immature market in Australia with only a small number of BPO service providers, however the market is experiencing growth as companies are increasingly focussed on cost cutting and improving business methods.

BPO is becoming more common in the private sector. According to technology analyst, Gartner consulting, just over half of Australian companies outsource at least one critical business process. While in the public sector, BPO is much less common, partly due to the fact that the pressure to be competitive is not as fierce.

Traditional IT service companies are now also moving into the growing market of BPO, following a period of reduced expenditure on IT.

Gartner Consulting estimates the worldwide market for BPO grew from US\$115 bn in 2000 to US\$124 bn in 2001, and will expand to US\$178.5 bn in 2005. Gartner believe the drivers to this growth will be the desire for companies to focus on their core competencies and reduce transaction costs.

The target industries for BPO are banking, insurance, communications, healthcare, high-tech, professional services, retail and transport.

## Trends in outsourcing

In the past, IT and other business processes have generally been outsourced to other Australian based companies, however a growing trend that has received considerable attention of late is the outsourcing of contracts overseas to countries like India, which offers a highly skilled but lower cost labour force. This has been driven by the perceived cost reductions that can be achieved. It has been suggested that the relocation of services from Europe and the United States to India can cut costs by up to 40%.

These cost savings have enticed many companies to outsource services to lower cost countries. Both Telstra and IBM have made headlines recently over plans to outsource IT jobs to India, sparking debate that many Australian jobs will be lost in the process.

A Forrester survey of 57 chief information officers of Australian and New Zealand companies revealed that while only 28% were presently using offshore resources, 47% either intended to use or would consider using offshore resources over the next year.

Gartner Consulting has estimated that currently just 1-2% of the money spent on business process outsourcing and IT related outsourcing by Australian companies went offshore. However offshore outsourcing is growing at 20-25% per annum, with little evidence of slowing.

The trend towards offshore outsourcing will have a significant impact on the service sector. Australian suppliers will need to adapt to change. They will need to become even more specialised and will have to seek new ways of improving their efficiency and productivity.

### What are the benefits of offshore outsourcing?

Offshore outsourcing will yield efficiency benefits for the service sector. Consumers will be able to purchase services at lower prices, and given that many businesses also purchase services, their lower costs will result in savings that can also be passed on to consumers. Empirical studies by Catherine Mann estimate that offshore outsourcing has reduced prices of IT hardware in the US by 10-30%.

Additionally, Australian exporters of goods and services can benefit from the extra income generated overseas. The money spent by Australian companies to purchase services from abroad, may flow back to Australia in the form of demand for Australian goods (Australian exports to India etc.) or foreign investment in Australia. These effects are job creating and help to offset losses from outsourcing. Indeed, India's Minister for

Communications and Information Technology, Arun Shourie, said in an interview that Indian companies could invest in research and development in Australia. "In countries like Australia we see great possibilities for investments. In the UK, for instance, 400 Indian companies have invested and created 10,000 jobs. Part of this is because they are close to customers. I see Australia as one of those areas where Indian companies are beginning to invest and will be increasing it."

Figures from global consultancy McKinsey show that for every dollar in costs cut by offshore outsourcing, another \$1.42 is generated in benefits. Of that, about \$1.12 goes to the country that outsources its services, while the remainder goes to the country offering the services.

### Should the Australian Government impose restrictions on offshore outsourcing?

In a word, no! However not everyone shares this view. Recently Telstra has come under fire from Canberra for a deal that will result in 1,500 jobs moving offshore and the ALP has also passed a resolution opposing IT offshore outsourcing. The Community and Public Sector Union, which represents telecommunications, call-centre and IT workers, estimates that approximately 4% of jobs in the Australian IT industry have gone overseas. India also faces a bill in the US Congress to prevent the movement of white-collar jobs overseas.

With rapid advancements in technology, Australia is increasingly operating in a global marketplace, where people are being seen more and more as a mobile resource. If restrictions were imposed to prevent Australian companies from outsourcing to offshore service providers, this would place Australian companies at a competitive disadvantage to foreign rivals that are able to reap efficiency gains from offshore outsourcing.

Further, if the Australian Government limits the outsourcing of Australian jobs by creating international trade restrictions, then it is likely that other countries would follow suit and pass similar restrictions on the outsourcing of their jobs to Australia. This could also jeopardise potential foreign investment, possibly resulting in many more Australian jobs migrating to other countries in the region.

US Federal Reserve Chairman Alan Greenspan recently warned against setting off "a new round of protectionist steps", suggesting that "besides enhancing education, we need to further open markets here and abroad to allow our workers to compete effectively in the global marketplace." The same applies to Australia.

It should also be noted that, just as Australian companies outsource services overseas, companies in foreign countries also utilise services from Australia. Official data from 2001-02 shows that Australia was actually a net exporter of computer services and business, professional and technical services, which are the kind of services typically outsourced offshore. The main reason why Australia is a net exporter of these services is because Australia provides many high-value services to users overseas, including legal, accounting and research and development services, while many of the services imported by Australian companies are less sophisticated and hence of lower cost.

### **What needs to be done?**

Without government intervention, offshore outsourcing is here to stay. Australian companies that choose to outsource services will have to make the decision as to whether they go with either an Australian based service supplier or an overseas company. With cost minimisation being a high priority of Australian companies, offshore service providers are expected to win many of the service contracts put up for tender as Australian based suppliers find it difficult to compete against low cost countries. This will put pressure on Australian based suppliers, and could subsequently result in the loss of jobs in some sectors.

To remain competitive, Australian-based service suppliers will need to adopt new strategies. The Australian Information industry Association has stated that Australian software and service suppliers need to improve their competitiveness and look for opportunities to turn offshore outsourcing into an advantage.

This could include:

- promoting Australia as an attractive destination for offshore outsourcing;
- using global sourcing and other strategies to improve the competitive position of Australian based IT service suppliers;
- adopting quality software development methodologies; and
- partnering with offshore IT service providers to provide solutions to global customers.

Australian companies will never be able to compete with the cost structures available to Indian companies, however Australia does possess a highly skilled workforce capable of designing and developing leading edge technologies. Combined with the stability of Australia's political and economic environment, Australia is capable of becoming a low risk offshore alternative, particularly to the likes of Europe and the United States.

### **Summary**

The outsourcing of IT functions and business processes is growing rapidly and will continue to do so as companies are increasingly focussed on cutting costs and becoming more efficient. Advancements in technology have also enabled the outsourcing of services to shift offshore, taking advantage of lower labour costs in Asian countries.

The resultant threat to Australian jobs has raised concerns amongst the community and sparked considerable debate about whether the government should introduce restrictions to prevent offshore outsourcing.

While it is tough for those that have lost jobs, the lower prices of goods and services and the expected increase in exports resulting from offshore outsourcing, will help to create new jobs in other sectors.

The introduction of trade restrictions would only make things worse. Rather, Australian companies need to focus on improving their competitiveness and look for opportunities to turn offshore outsourcing into an advantage.

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