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Outsourcing: The New Big Thing or the Slippery Slope?

Software and "outsourced" services account for 3 percent of India's economy but are growing at 30 percent a year and are a major export earner. The controversy over U.S. policy toward outsourcing—one of India's economic success stories—centers on the states more than on the federal government. Restrictive legislation is unlikely to cause significant change in this lucrative practice. The trend points toward a more intimately integrated world, in which high-technology industries continue to globalize despite periodic political backlash.

The many faces of Indian information technology: Information technology (IT) is one of India's major success stories. NASSCOM, India's National Association of Software and Service Companies, estimates total revenue from the industry at $15.9 billion in 2003. Its share of GDP doubled from 1.4 percent in 1998-1999 to 3 percent in 2003-2004; its export revenues came to $12.5 billion. That is equivalent to 20 percent of all India's exports of goods.

The Indian industry divides into two parts. Development of software, either independently or in concert with businesses outside India, produces India's most technologically advanced work and the greater part of value added. The second category is outsourcing, sometimes referred to as business process outsourcing (BPO) or as IT-enabled services (ITES). This accounts for most IT-related employment, estimated by NASSCOM at 245,000 and growing at close to 30 percent per year. The BPO industry grew 30.5 percent in the past year, and is expected to grow another 30 to 32 percent in the coming year. Export revenues in this segment of the industry have risen about 46 percent per year, to $3.6 billion in 2003-2004. The top five firms account for some 32 percent of total software exports.

The biggest customers for software and BPO exports are in the banking and financial services sectors, followed by the manufacturing and telecommunications industries. North America accounts for some 70 percent of these exports, with most of the rest going to Europe. The services involved include payroll processing, information help lines, financial and accounting work, procurement processing, medical data transcription, research, and some aspects of human resource management.

According to a report in the *McKinsey Quarterly*, business process outsourcing attracted 15 percent of total foreign direct investment in India in 2002. Foreign investment in this sector is projected to reach about 30 percent in 2008 and to generate $60 billion a year in exports and close to a million new jobs. This report also states that Indian outsourcing firms now control over half of the intensely competitive global IT and back-office outsourcing market.[1]

Why India? Since early in the computer age, India has been one of the most active participants in the "silicon economy," with close ties of business, family, and inclination to the centers of the U.S. industry. World-class schools like the Indian Institutes of Technology turn out highly qualified computer engineers. According to the NASSCOM report, 81 percent of India's software professionals have a graduate degree. English is widely spoken among the middle class, providing a natural bridge to the kinds of services most amenable to outsourcing. India's rapid growth in the past decade and a half has expanded the size of the middle class. That growth has been tilted toward services. In contrast with other countries in its income group, the share of services in India's GDP has risen from 39 to 51 percent since 1985, while industry has remained essentially fixed at 26 percent. Geography is another asset, with India located nine time zones away from the U.S. east coast and easily able to work through the night in the United States. And the structure of India's economy is tilted toward services.

Impact on employees: Buyers of outsourced services are also attracted by India's relatively low wages. A 2003 report by Ashok Deo Bardhan and Cynthia A. Kroll of the Fisher Center for Real Estate and Urban Economics found that employees in the United States earn 1.5 to 12 times as much as their "outsourced" counterparts in India. The differentials are largest at the low end of the skill scale, with telephone operators earning $1 or less per hour in India and $12.57 in the United States. Among the more skilled occupations, financial researchers and analysts were reported as earning $6 to 15 per hour in India and $33 to 35 in the United States.[2]

The industry is generally popular in India, though labor unions have objected to the expansion of nonunion workplaces, especially those run by multinational corporations. The net

[1] http://www.mckinseyquarterly.com/article_page.aspx?ar=1440&L2=7&L3=10&srid=6&gp=1.

[2] http://www.haas.berkeley.edu/news/20031029_outsourcing.html.

impact on employment in the United States is hotly disputed. A University of Illinois study reports 400,000 positions lost between March 2001 and April 2004. Forrester Research estimates that 3.3 million service positions will be outsourced over the next 15 years, or 220,000 per year, but argues that 22 million new jobs will be added between now and 2010. So the net impact depends not only on the accuracy of these broad-brush assessments but also on the ability of workers in the IT sector to find other jobs in the industry. The sluggish job creation record of the past four years has added powerfully to the political impact of the job loss issue.

Two examples—General Electric and Motif: General Electric (GE), a company best known for the size and vigor of its manufacturing operations, has become a major player in the Indian IT industry. Processing and IT centers owned by multinationals, like GE's Indian operations, account for some 26 percent of the industry. "GE pioneered the concept of software sourcing from India through Offshore Development Centers across the country, which now account for approximately 5 percent of India's software exports." This statement from the company's Web site shows how influential GE has been in India, where it employs 22,000 people. Bangalore is home to the John F. Welch Technology Centre, GE's first and largest research and development center outside the United States.

Motif International sells services to outside clients. NASSCOM describes its work with a financial institution from the United States that was looking for an offshore location that could maintain the security of information and accuracy of transactions processed. Motif hired English-speaking college graduates trained in computers and accounting; they used a U.S. trainer who understood not only the U.S. financial market, but the culture, history, and geography as well; they set up quality control and computer security arrangements to meet the customer's needs.

The policy response—India: The IT industry developed largely below the radar screen of the Indian government's regulatory network. Once IT was recognized as a major contributor to the country's balance of payments and economic modernization, India moved to strengthen the country's telecommunications, now considered the strongest success story in India's deregulation effort—although India still lags behind China in telecommunications intensity. The private sector has become a major provider of wireless and value-added services, and owners of wireless telephones now outnumber possessors of wire-line telephones.

India uses tax holidays and other incentives to attract investment. The most important ones for the IT and outsourcing industries are those that facilitate investment in telecommunications, venture capital, and research and development. These are not necessarily the most generous incentives in India's tax code, however. What the industry seems to value most is the Indian government's willingness to leave it alone.

The response in the United States: Within the last few years, the impact of India's success in outsourcing began to provoke a political backlash in the United States. In the 2004 U.S. presidential election, Democratic candidate John Kerry promised to enact legislation that would eliminate the tax incentive for corporations to establish facilities overseas instead of in the United States. He conceded that this measure would not stop outsourcing but undertook to "level the playing field." The Bush campaign did not make outsourcing a prominent issue, focusing instead on a proposed $23 billion program to train workers in more competitive skills and on business tax cuts.

The most concrete political reaction has taken place at the state level. Close to 150 bills are in various stages of legislative consideration in about 40 states. Most of these restrict state government procurement, such as the bill that recently passed the New Jersey legislature that "would ban any government jobs in the state from being shipped overseas."[3] The target of the New Jersey bill was the fact that call-center work from a company hired by the state to take care of contacts from New Jersey welfare recipients was being sent to India. Other bills would require companies to provide advance notice if an employee is to be displaced by someone abroad. Others simply require call centers to identify their location within 30 seconds of the call. Sending work overseas may raise other legal issues as well. Some of the bills now pending at the state level impose privacy restrictions on sending personal information abroad, for example.

On the other hand, many states are currently in great fiscal difficulty and are eager to lower costs. NASSCOM estimates that California, home to the Silicon Valley, could save $180 million by outsourcing IT services, which could reduce the state's $30-billion debt. Kevin Terpstra, California's IT spokesman, says that it is harder for the government to outsource than for a private corporation. But one law in Colorado specifically allows state contract work to be done outside the United States.

This pattern is similar to what happened after the United States signed the GATT/WTO Code on Government Procurement, which resulted in a promise to abolish "buy local" requirements for most of the federal government and for the states. In practice, both the federal structure and the way U.S. courts treat international agreements make it difficult for the U.S. government to enforce international commercial agreements on the states, despite the clear statement in the U.S. Constitution that international commerce is the responsibility of the U.S. Congress.

Good or bad—and for whom? Outsourcing has provided additional jobs for India and lower costs for U.S. businesses, creating winners and losers in both countries. The most interesting questions concern its impact on international production processes. Outsourcing-related sectors are among the most open in the Indian economy. Will their success encourage greater openness? The United States, with its generally open market and its array of multinational corporations, has for the past three decades been steadily integrating with the rest of the world. The same is true within individual major corporations. Regardless of possible changes to tax codes or requirements for government procurement in the United States, and barring a major depression or

[3] http://www.nasscom.org/artdisplay.asp?Art_id=1803.

interruption in telecommunications services, this trend is now likely to encompass services that do not need to be rendered in person.

But there are counterweights to this momentum as well. Wage differentials are lower as one moves up the skill chain. Highly trained young Indian professionals are beginning to expect wages that are much closer to their Western counterparts. As India continues to grow, the structure of this industry will continue to change. It is already, for good reason, the best example of a field where comparative advantage changes with little warning.

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