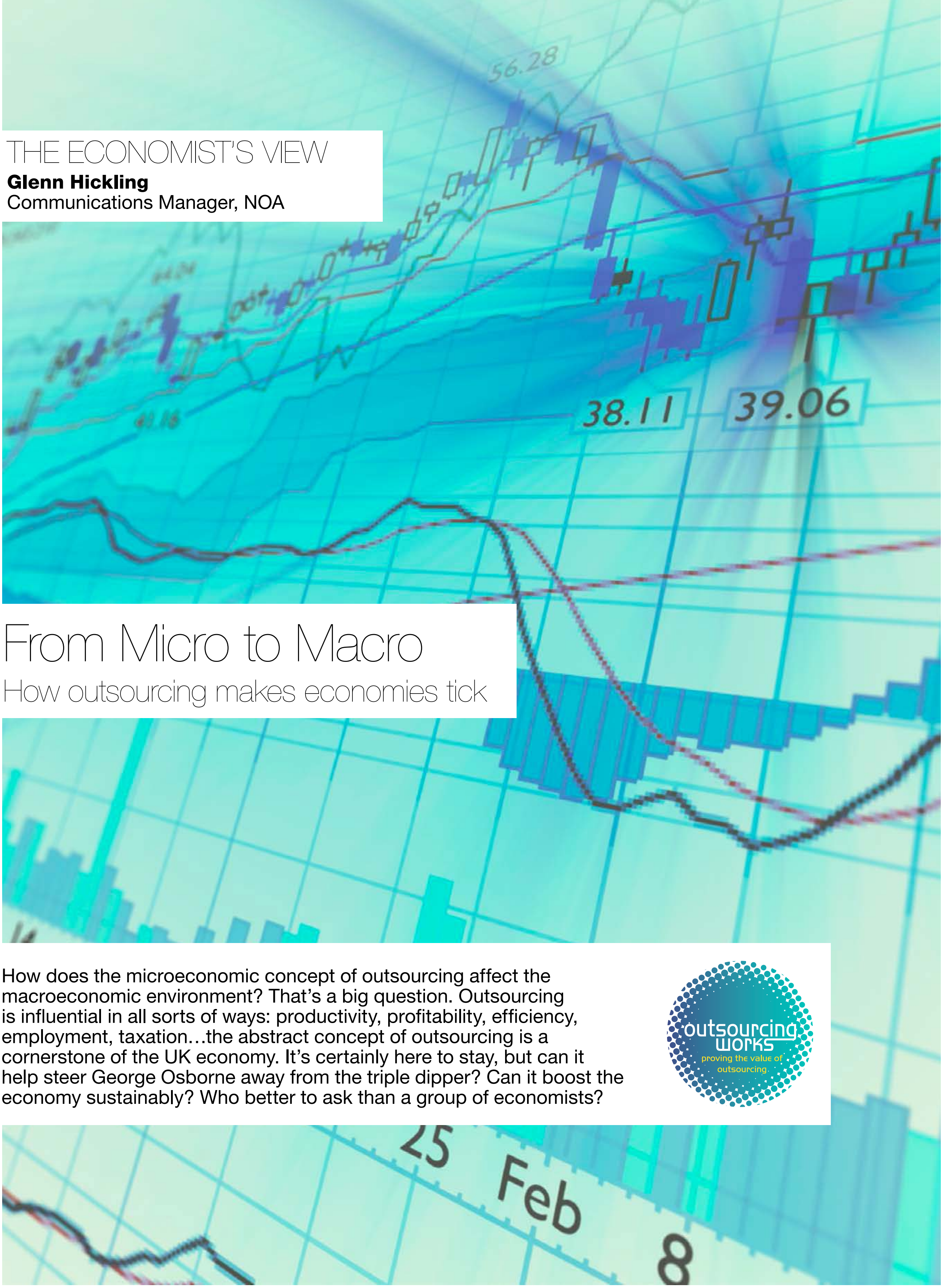


THE ECONOMIST'S VIEW

Glenn Hickling
Communications Manager, NOA

From Micro to Macro

How outsourcing makes economies tick

How does the microeconomic concept of outsourcing affect the macroeconomic environment? That's a big question. Outsourcing is influential in all sorts of ways: productivity, profitability, efficiency, employment, taxation…the abstract concept of outsourcing is a cornerstone of the UK economy. It's certainly here to stay, but can it help steer George Osborne away from the triple dipper? Can it boost the economy sustainably? Who better to ask than a group of economists?

outsourcing works
proving the value of outsourcing

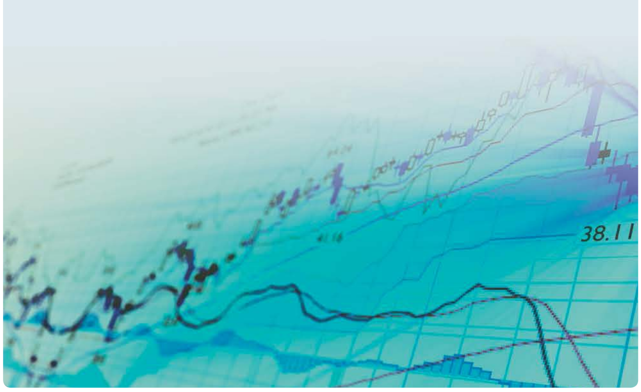
Executive Summary

In the eyes of the Great British public, outsourcing has a poor reputation. The National Outsourcing Association's 2012 research project the *Public Perception of Outsourcing* revealed that a staggering **80percent of the general public do not think the sourcing industry is helping UK PLC**. The general public just does not currently believe that outsourcing helps the British economy, with **only 19percent believing that outsourcing can help get the UK out of recession**.

The man in the street might not recognise it, but economists do. Learned men, who study economic affairs professionally, know that a few high profile failures do not mean that outsourcing per se is ripe for demonisation. **The Outsourcing Yearbook 2013 spoke to economists from Henley, Ashridge, Loughborough and Kingston Business Schools, as well as getting a German perspective from an economist at Deutsche Bank**.

- All agreed that outsourcing contributes strongly to GDP, and is a valued contributor to tax – without outsourcing's contribution, it was predicted that the UK would be in serious recession, much worse than this period of negative growth we are currently enduring.
- There was a unanimous opinion that the most common motivator for outsourcing is cutting costs, and everyone agreed that it is a sagacious business decision to concentrate on your core activities and particular competitive advantages
- Everyone agreed that outsourcing generates certain transaction costs and these need to be minimised in order to maximise the efficiencies of outsourcing
- All agreed that outsourcing and associated division of labour is a positive thing in the manufacturing industry – and that the production of added value products and growing exports is the way to grow the economy

The unanimity ended there. It's true what they say about economists not agreeing much, which leads to all sorts of interesting caveats and angles on "The Outsourcing Effect."



The Outsourcing Effect: The Economists' View

Giampiero Favaro, Professor of Corporate Finance at Kingston University, immediately referenced recent research conducted by Oxford Economics, which states that the UK outsourcing market is worth £207bn per year – roughly 8percent GDP – and employs roughly 10percent of the nation's workforce.

Professor Favaro said: "If you look at employment as human capital, the major factor of production, then look at the gross value added by the industry; the outsourcing industry is employing 10percent of the entire working capital, and is creating 8percent of the gross value added. So if you look from an economic perspective, outsourcing appears to be destroying value."

Favaro continued: "In contrast, the manufacturing sector employs only 8percent of the human capital, and is able to create 11percent of gross value. It is creating value. But we should ask ourselves if without outsourcing the gross value of manufacturing would be greatly reduced. "

Roger Martin Fagg, a visiting fellow at Henley and Ashridge Business Schools, and former advisor to the Bank of England said: "Outsourcing has a positive effect on the macroeconomic environment if the outsourcing taking place increases both the efficiency and the effectiveness of the business. You have to have the two for it to be a worthwhile activity. If you've only got one, then you haven't got a sustained position.

"Efficiency is reduction in cost, usually achieved by lowering the wages paid in the organisation – this allows for a profit margin for the outsourcer but it doesn't change the net position of the economy, it just moves things around. However, if the outsourcing boosts effectiveness – being where the activity increases the added value per person per hour – then the outsourcing effect is positive.

"If you look at the data for British manufacturing, up until two years ago, it had managed to increase its productivity by about 4percent a year for 10 consecutive years. Which is a massive turnaround that outsourcing must have played a role in, as this is the period it became most fashionable."

COST EFFICIENCY

Outsourcing, done well, will save you money. But you must retain control – through strong governance – to maximise efficiency.

Divide and Conquer = Productivity Booster

Which raises the question; would companies in the service sector benefit from increased use of outsourcing? After all, economists do tend to favour division of labour as a route to improved productivity. As Thomas Meyer, an economist at Deutsche Bank said: "Upstream and downstream companies are becoming more important in the production chain. Division of labour and specialisation are rightly regarded in economic research as the cornerstones of productivity and prosperity."

Meyer went on to compare outsourcing and vertical integration (where all the companies in the supply chain have a common ownership) declaring that outsourcing seems to create competitive advantage. He said, in his whitepaper 'Division of Labour Gives Competitive Edge': "In keeping with this idea, European firms reduced their degree of vertical integration by about 1.5 percentage points between 2003 and 2007. A vertical integration that was 1 percentage point lower in 2003 is statistically associated with 5-10 percentage points higher earnings growth (cumulative) in the following four years.

"Disintegrated production thus delivers a competitive edge. With outsourcing, it is also a matter of the right degree, striking the right balance between specialisation benefits on the one hand and transaction costs on the other."

EFFECTIVENESS

Make your freed up resources count – reallocate wisely. Launch projects that will create revenue. Hire good people, who will make money.

There's No Such Thing as a Free Cost Reduction

Anthony Mitchell, a Professor in Operations Management at Ashridge Business School said: "The motivations could be multifarious but the usual starting point if we're honest is to reduce costs: often labour and then associated overhead charges. So, particularly when moving activities, what they're doing is restructuring or reorganising their value chain. This raises issues of responsibility and the extent to which the company doing the outsourcing retains some kind of control."

Transaction costs – such as those arising from supplier selection, putting the contract together and policing / enforcement – need to be minimised in order to contribute to efficiency. But commit too little, and it might cost you your desired results. It's a balancing act.

Giampiero Favaro said: "An outsourcing decision generates a level of cost for a company: the cost of negotiating, the cost of monitoring and the cost of supervising external contractors. If these costs are lower than the costs saved by the outsourcing of certain activities the decision should be "go for it." You should free up resources that can be focused on your competitive advantage, which can have two kinds of perspective: if a company is engaging in a very highly competitive market it can reduce prices, to be more competitive that way. In less competitive markets, it can also concentrate its resources on its key competitive advantage, whatever that may be. Both those outcomes should end up with companies being more competitive and more productive."

Your Competitive Advantage is Exactly That: Yours

Which, on the face of it, seems like everyone's a winner. But Favaro offered a caveat: "Do not outsource something that is a competitive advantage, and do not outsource competencies that are not core but very important. It is very difficult to make the decision about that, usually it's trial and error because companies often do not really understand what the customer really values. Sometimes banks believe that a customer stays with a bank because they get something at the end of the year e.g. a free calendar or 0.1 percent more interest. But it could very well be the case the customer stays with the bank because the people on the other end of the phone understand them. This level of competency should not be outsourced. The contact between the bank and the customer, the clarity, the efficiency, the promptness of the customer service, is not a core asset in that it doesn't generate additional income. But the core competency in any business plan will always be to retain the customer. It's about recognising what is core."

Further to his comments about effectiveness, Roger Martin Fagg said: "Companies must be absolutely clear on what I call their value chain, and the value chain is – particularly in a service company – where the moments of truth happen. Take an insurance company, you only know it's a good company when you have to make a claim, and if the procedure that the individual has to go through to make that claim is long and torturous because it's been outsourced to a number of subcontractors, generally speaking that company has lost a customer for life. I've experienced that. There are plenty of examples out there where outsourcing has not increased effectiveness, it's reduced it."

Given that efficiency alone does not aid the economy, it needs its opposite number, effectiveness, to drive genuine value. So what can outsourcing companies do to ensure that efficiency boosts effectiveness: so that by doing things right, you can do the right things (to paraphrase Peter F Drucker)....

TRANSACTION COSTS

Transaction costs are unavoidable but controllable. Do a full audit of these before entering into a deal, to avoid any nasty surprises later on.

Do The Right Thing

Ilan Oshri, Professor of Globalisation and Technology at Loughborough School of Business and Economics, said: "When it comes to the contribution to the UK economy from an efficiency point of view, then the common conception is that outsourcing contributes to efficiency by allowing the corporate to focus on core capabilities or processes, and outsourcing those that are considered to be non-core. By and large this is true, but what we are seeing now is the relationships between core and non-core capabilities is becoming more and more complex, as we see value chain integration increasing. Firms are now highly integrated, particularly when it comes to the effect of one function on another. There is a belief that the UK economy is still fixated on looking for cost efficiency rather than leveraging on the relationship that they can build with their outsourcers. I think this is a myth in itself because many of the vendors that we have studied were able to actively deliver far more than just cost reduction to their customers."

He went on to detail an example of this – where an outsourcing supplier was keen to help an organisation to add effectiveness in areas of their business other than their contracted service line. "IBM has an approach to teach innovation, it's part of the service contract. And the way that they do that is not necessarily related to the service but it is about innovating for their clients the business side. A good example is a solution that IBM developed for Novartis, a pharma company involved in the area of supply chain management of anti-malaria medicine. The contract with IBM related to IT service infrastructure. But they routinely made enquiries as to whether there were challenges that IBM could engage. It put together a group of graduates to look into proposing solutions, and came up with a novel solution involving mobile devices to communicate inventory levels of malaria medicine in extremely remote locations such as the Sahara desert. That's just one example."

KNOW YOUR CORE

Work to truly understand your core – assess where your competitive advantages are, outsource the rest. Division of labour is a cornerstone of productivity and therefore, prosperity.

Shooting For The Moon: Aim For Higher Value

Letting your outsourcers innovate on your behalf seems contrary to the comments of CK Prahalad – the distinguished Professor of Corporate Strategy at the University of Michigan – who contended that outsourcing did not contribute to innovation, and did not look to create the next generation of products: the inventiveness of its products being a key differentiator for any firm. This seems to fit with Giampero Favero's opinion that you should not outsource your competitive advantage, and you cannot simply buy in success.

Or can you? Maybe you can outsource some aspects of invention. As Anthony Mitchell says: "What we're seeing with outsourcing, is a move into higher added value research and development, higher added value production, higher added value software development and so on and so forth."

Which, for many companies of course, is core activity, but enhancing capability in these areas is essential if the UK economy is to grow.

Roger Martin Fagg said: "If we take outsourcing as a whole, if it allows British business to increase its efficiency and effectiveness, in essence through time it should grow our share of world exports.

"But it takes time: I would say that the benefits of efficiency and effectiveness, if they're in a growing business, will certainly take five to ten years to be established in a global market. If you compare Britain and Germany, Germany has products with low price elasticity but Britain has services with low price elasticity. We have competitive advantage i.e. price inelastic positions in aerospace, pharmaceuticals, automotive design and in quite a lot of high intellectual content technologies like digital media and computer games. And also, what we can call high end financial services: London law firms who do international trade, legal stuff, plus the City of London that has 40percent of Europe's foreign exchange trading."

Creating products and services with low price elasticity of demand, that is, products which are still in great demand even when prices go up: competing on quality, rather than price should be a priority for the UK. That way we increase the profitability of our exports, which in turn creates tax revenues and, crucially jobs, which naturally stimulates demand for goods and services produced and consumed in the UK.

MORE THAN CASH SAVINGS

The expertise that saves money – can make you money. Or impress your customers, and improve customer retention. Invite your outsourcing partners to suggest innovations.

Job's a Good Un

Another key parameter by which to judge the outsourcing industry is its effect on the jobs market.

Giampiero Favaro said: "In the labour market, we have to view that as a net balance because there are two kinds of outsourcing. In terms of labour it depends if you are an outsourcing company, you contribute to the labour pool by increasing it. If you are a company which outsources offshore you decrease it. But this can generate job losses that can actually improve the value of the corporation. By reducing costs to become more competitive, therefore your productivity will increase, therefore you should sell more and your profitability should go up. Then maybe you might reinvest, hire more people onshore."

Whenever a conversation turns to outsourcing's effect on the jobs market, the conversation inevitably turns to offshoring. But it's worth remembering that outsourcing is the second biggest aggregate employer in the UK, providing work for around 10percent of the UK labour force: every morning over 3 million people get out of bed, brush their teeth and go off delivering services for other brands. Which is a very positive contribution to the economy, not just in terms of increasing the pool of taxpayers, but other factors such as benefit payments not required, reduced strain on NHS budgets as health levels improve, more money to spend on the High Street etc.

But it's not all rosy: Roger Martin Fagg claims that average wages are actually lower due to the concept of outsourcing. "Outsourcing historically has been beneficial to the economy, for example, in the case of the UK manufacturing industy, where the outsourcing is of low added value activity. But the effect of that outsourcing has been to depress wage rates for un- and semi-skilled employees, and that therefore it makes the organisation more financially efficient, but from the economy's point of view the benefit is not that great, if any, of an improvement in cost efficiency alone."

PRODUCTS MAKE GROWTH

And growth makes jobs. And jobs make wealth. Investing wealth makes growth. Invent something.

Necessity is always the mother of invention: now invention is a necessity in itself, as invention is the founding father of growth.

Skills, Glorious Skills: The Enemy of Unemployment

Fagg continued: "If the outsourcing is to a business outside the UK and if labour cannot be transferred to a higher added value activity then outsourcing reduces overall what's called nominal GDP growth. However, if the labour can be released to a higher added value activity, it increases it. Now, the next thing we need to look at is outsourcing within the UK. If the outsourcing takes place within the UK and it does allow a greater specialisation for division of labour it will increase added value per person per hour, so it is hugely beneficial if it does that."

But this assumes that people can be moved into higher value positions. And the reality is, more often than not, they can't. Although work is on-going to up-skill the labour force, bringing back technical colleges and apprenticeships.

This skills gap, according to Roger Martin Fagg, is leading to offshoring. "employer surveys are showing that yes there's a lot of people available for work but most of them don't have the right attitude or skillset or both, which of course raises the point that there will be some British businesses that outsource to an overseas country out of desperation."

Offshoring and unemployment go hand in hand. But, as Fagg says, "There is a need to distinguish cyclical unemployment which is due to a lack of demand, and structural unemployment which is due to the wrong mix of skills. At the moment, particularly amongst young people, the unemployment level is, in my opinion, probably 80percent cyclical, 20percent structural and so when credit begins to flow again that cyclical unemployment falls away quickly. A lot of young people are unemployed at the moment, not because of a lack of skills or indeed because of the wrong attitude, they're unemployed because finance directors are sitting on £ 600 billion cash reserves."

Ashridge's Anthony Mitchell says: "I think we've got to improve skills levels, we've got to change our education system. Spain is encouraging vast numbers of young people to go to university and do non-academic subjects – I believe this is foolish. I think it would be better having more technical and craft and other forms of skilled training. We've got to find ways of making it easier for small/medium size enterprises to borrow money and to grow. I think there needs to be lower restrictions. But if you look at the costs of employing people in Britain it's quite high – national insurance costs and so forth. It needs to be easier to have more flexible workforces and in some cases, we've got to start paying more reasonable sums in wages. To attract the right sort of people, at the higher end of IT, engineering, building, construction, design to stop people going abroad. You know, I think it used to be that if you graduated in a technical subject or engineering subject back in the seventies or eighties you saw, kind of, Europe or the US as your future career path. People now increasingly see South-East Asia and so on as perhaps future growth areas. If we want to retain talent back in the UK, wages in those areas need to rise."

Roger Martin Fagg had his own take on addressing the skills deficit: going back to the old fashioned way, hiring somebody because you like the cut of their jib. "It's happening because the companies in question are doing more and more of the skilling in-house. So, what they're saying is we'll employ someone for the right attitude and then we will create the skillsets."

BOARDROOM COURAGE

Banks must lend, FDs must spend. Investing in aggressive growth strategies – particularly in SMEs, the backbone of our economy – is the route to growth. Resumption of normal lending is the ONLY way forward.

Banks. Are. Ruining. Things. For. Everyone

Fagg also commented around the problem of lending, as raised by Anthony Mitchell: "What's holding us up are banks, and the fact that they're destroying money by not lending it out. That is the fundamental problem. It's not normal. Once banks get back to normal which is about five years away at least then we'll begin to motor a bit harder. In the meantime the only way Britain can grow is by selling more to the third world, in the previously discussed areas of competitive advantage."

But German Thomas Meyer was largely impressed with the UK's efforts: "One of the remarkable things in the UK, I find, is the resilience in the labour market. Despite all that's going on unemployment is reasonably okay so far. It's not much higher than in Germany. It's a lot lower than in many other European countries. You have your own independent monetary policy that helps a lot. What you clearly would need to do is to go for higher productivity and that can be done by promoting industry, it can be done by all sorts of traditional things; education, research and development etc. but of course that's not a short term fix, it's a long term strategy. But I do think the UK is doing quite well, in all these things. You could try and increase the share of industry, because industry tends to have so much higher productivity than lots of the services – but again, that's not something that could be achieved in 5 years' time."

A five year time frame for economic improvements is being suggested all too often. Is anything happening now, to create jobs and growth in the UK. Or is everybody merely waiting, contemplating and pontificating as to when things might get better?

SKILL SHIFT

Effective economies have the right mix of skilled people. The skills are within the companies. Find some people with can-do attitudes and mould them into your corporate image.

Repatriation Strategies: a Coming Trend

The potential for repatriation of BPO and manufacturing work will continue to be a hot topic throughout 2013.

Anthony Mitchell said: "Offshoring has now taken on a political dimension – there is a growing belief that priorities should be given to creating jobs and preserving jobs at home. I think it started in the US. It's been a major thing in the recent presidential elections with Obama criticising the Republicans for a lot of their initiatives in the past. So, governments have actually been giving money to businesses to encourage them to bring work back and set up new plants in America. Now we're seeing 'insourcing' in Britain to some degree. There's been examples in France, like Meccano coming back from China. It's still a trickle really; it's not a definite trend. But there are examples of business being brought back into the UK from Asia, across a whole range of domestic appliances, office equipment, vacuum cleaners, industrial machinery, Yorkshire for electronics and cables, miniature railways, computers to Nottingham, jewellery manufacturing to Birmingham and so on."

Roger Martin Fagg agreed, but went further, advocating insourcing as a definite trend. "You'll know quite a lot of companies are insourcing, they're bringing the activity back into the country. I'm certainly seeing it in manufacturing in a big way, as a number of things are happening, particularly if you look at Asia: on a price quality basis certainly China is losing its competitive position and on a total cost/effectiveness basis companies are saying, "I'm gonna have it made in Birmingham or Leeds or Manchester".

Ilan Oshri confirmed the trend, but warned that companies could be 'back sourcing' for the wrong reasons: "a study that we did we Professor Julia Kotlarsky showed 40percent of the companies surveyed are doing back sourcing and the vast majority of them are doing it because the offshoring hadn't realised the value it was supposed to deliver. Unrealised value is not necessarily the right reason to backsource. First, you have to build the capabilities in house to ensure that you are capable of back sourcing and you are still running a professional service organisation internally."

The moral of the story appears to be: backshoring can win you friends, but don't rush. Ensure that the plan that replaces the offshore activity is going to compete, in terms of efficiency and effectiveness, and that you are ready to deliver stronger results on home shores.

How Outsourcing Affects Share Prices

Anthony Mitchell said: "They're have been a number of studies over the years which suggest that in the very short term if companies announce an outsourcing or offshoring decision their share price will go up. A study commissioned by Logica, now prt of CGI – The Outsourcing Effect on Stock Price – suggested that when companies announce an outsourcing or offshoring decision, their share price will go up. Benchmarked against other companies in their sector, the short term benefit is touted to be performing 1.7percent better after an outsourcing announcement.

"Five out of seven sectors studied found that outsourcing benefits their stock price. The large assumption behind this is that there will be a reduction in costs and an improvement in productivity because the business is focusing more on its kind of core activities.

Giampiero Favaro said: "There has been a lot of effort trying to measure the impact of outsourcing in terms of accounting performance, but it's impossible to isolate the value of outsourcing. Looking at the reaction of the market when a company is announcing an outsourcing decision, it is clear that the outsourcing of non-core assets generates increases in the valuation of the company. There is no doubt about that, it has been proven by a number of studies."

Despite Loughborough Business School's work that suggests that 40percent of offshoring deals are not delivering the expected value, the market still appears to favour it. Favaro said: "There are some differences according to what kind of outsourcing is announced. If the company announces that it is outsourcing offshore the market reaction is generally positive. If they're announcing that the company is outsourcing in the same country, the market is neutral and doesn't seem to care.

"Another specificity is related to the duration of the contract. Apparently if a company announces a long term outsourcing the reaction of the market is wary, because they want to wait and see. If the company announces a kind of short term, flexible outsourcing contract, the reaction of the market is positive and this basically tells us that the way that the financial market is looking at outsourcing, it is more looking at flexibility and the ability to change, as required. So the market likes flexibility, and is a little bit sceptical when long contracts are announced.

"So, for example, if I am a company making cars and I announce that from now on my steering wheel is going to be done in China the reaction is positive. If I announce a long term outsourcing contract for engines, for example, the market reacts in a different way because everyone wonders how much of your technology are you giving away?"

Roger Martin Fagg said: I think you have to look at the difference between FTSE 100 companies and the rest of the market. If we take FTSE 100 companies, if outsourcing increases efficiency in the short run that will boost earnings per share which will boost the share price, but that effect may only last for two or three years because after that period a lack of effectiveness will show up in top line revenues – then you get a reversal in the share price. Now, if the outsourcing increases efficiency and effectiveness it will continuously boost the share price. But in so many cases it just increases the efficiency which gives a short run boost but then the company runs out of steam."

SHARE PRICE

Short flexible deals boost share prices. Keep your outsourcing agile to impress the market. Keep your governance strong to ensure they stay impressed.

Does Outsourcing Work for UK PLC?

Anthony Mitchell says: "I think in recent years it's helped us. We've managed to shed activity where we've been fairly inefficient and not productive. We've been able to focus our value chain more clearly around higher value activity. We've seen this huge shift in the UK towards business services; so lots of new work and areas have been created around engineering and outsourcing facilities management, IT sourcing… "

Ilan Oshri added: "Outsourcing Works when it comes to a sophisticated customer that develops a contract that is not necessarily perceived to be transactional, but is seen as relational but with transactional elements. When both sides benefit from outsourcing then clearly I can see that UK PLC benefits from outsourcing."

The Oxford Economics Research states outsourcing employs 10percent of the working population, and generates roughly 8percent of GDP. Which, as previously mentioned, is a value gap. But it's not all bad; as Giampiero Favaro says: "The way I look at that is first of all there is a gross value produced which is very important and outsourcing is performing much better than retail, for example, which employs 15 percent of the human capital of the UK, and creates only 11 percent of value added."

Yet, the manufacturing sector is known to outperform its human capital: employing 8percent of the people to create 11percent of the value. This is because the best way to add value to an economy is to make things, and sell them abroad. Products and intellectual property that can be sold again and again. Your time can only be sold to one user at a time.

Over exposure to the European market has resulted in reduced exports. The answer is to find higher value, price inelastic products to export to growing markets: BRIC countries are the ones with money to spend. The UK needs to get out there, touting its wares. Where we have competitive advantage, we should make the most of it. Industries where we are at the cutting edge include computer games, aerospace, pharma and many more. Increasing the division of labour in these areas could lead to greater efficiency, and more resource for new product development, which is the answer to sustainable growth, as it creates demand from outside our own economy.

Another area where we are in demand is outsourcing knowledge. UK outsourcing consultants are internationally renowned for their knowledge, experience and wisdom. The government needs to take steps to spread this message abroad, and create more demand from abroad.

We know outsourcers can bring savings. These companies need to impart the skills and knowledge they use to create these savings to help companies be creative with their freed up resources.

Ilan Oshri says: "As well as cost savings, there will be learning and there will be relationships that will allow UK firms to tap into knowledge bases to learn about advanced methodology and to see how the relationship develops as the company progressing in terms of entering new markets, thinking about new products and the like.

GLOBAL STRATEGIC HUB FOR OUTSOURCING

Due to its breadth and depth of experience, the UK has an enviable skills base in outsourcing consultancy. Positioning the UK as the global strategic hub for outsourcing advice should be a key growth strategy for the government.

Making Things Better

Outsourcing companies should take a stand – the only way they can assist the country out of recession is to use the expertise they have to educate customers on the best ways to reallocate resources and develop new products. That way, we, as an economy can have effectiveness born out of efficiency.

Roger Martin Fagg suggested that outsourcing has depressed UK wage levels. But low wages go hand in hand with low inflation, which we will certainly need if we are to create a period of economic stability where insituitions can invest confidently.

The biggest single factor at play is fear. Finance Directors at big companies need to show courage, by get off their £600bn cash pile – create some products, create some jobs and create some demand, at home and abroad. That's effectiveness in action, working for the economy. To create the best possible opportunity to be effective, you need to be efficient. And to maximise your efficiency, you need a strong ethos of division of labour – the most direct route to that, you guessed it: outsourcing.