

# BUSINESS OFFSHORING IMPLICATIONS ON THE LABOUR MARKET

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## Abstract

*In terms of economic policy, three new aspects are important in the current context of globalization which brings forward new strategies regarding the outsourcing and offshoring of activities and functions of the value chain. These aspects refer to the instant appearance of an offshore transferable function, to the unpredictability of winning and losing functions and to the lowering of competition from the levels of sector, company or professional qualification category to an individual level. Of the three features, the most problematic for policy makers is the unpredictability of the impact of globalization. For example, in Europe we can not reasonably believe that workers in the most competitive sectors will be in a position of winners, nor that these winners will be the most prepared or trained in analytical functions. Many European workers currently work at prices fixed by the local market and not covered by productivity. But when the competition on functions will expand through globalization outside the country or area, their choices will be either a job loss or a reduction in salary. The question that will be raised ever insistently will be the following: what jobs are more exposed to this new competition? On the one hand, offshoring is on balance positive for Western economies, because it makes domestic companies more competitive. At the same time the material outsourcing is, for most developed economies, much more important than the outsourcing of services and the implications for labor market must be objectively differentiated in the two sectors. On the other hand, if we take into account the amplification of the effects that offshoring already has on the structure and distribution of labor, the socio-economic European policy of labor orientation to the coordinates of a "knowledge based" economy and to the jobs of the "information society" could be wrong.*

**Keywords:** *outsourcing, offshoring, labor market, competition, education*

## Introduction

In recent years, a host of famous economists in the study of international economics and social issues, argued, in one way or another, the idea that globalization has entered a new phase. As Professor Gene Grossman from the Princeton University said, this phase is so different from previous ones, that its understanding claims even a new paradigm.

In an article published in 2006, Professor Richard Baldwin from the Institute of International Studies in Geneva<sup>1</sup> is trying to clarify the paradigms of the old and the new globalization, analyzing the phenomenon as a long process, characterized by two major "unbundlings".

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<sup>1</sup> "Globalisation: The Great Unbundling(s)" – article published in the report "Globalisation Challenges for Europe" of the Secretariat of the Economic Council of the Government of Finland, march 2006.

The first unbundling, driven by rapid drop in transportation costs, has put an end to the need of manufacturing the products near the areas of consumption, allowing the spatial separation of factories and consumers. The basic levels at which globalization spread its effects were firms and economic sectors.

The second unbundling was driven by significant reduction, in the last decade, in the costs of communication and coordination of activities in the international space, which ended the need to perform most phases of production in close proximity. Also, more recently, period, a further decoupling of activities or functions of the company (besides the production) has taken place, by offshoring the service sector activities. Thus, the second unbundling has dissociated in space factories and offices and drew the global competition to the level of functions that these structures previously retained. This unbundling can be found under names such as fragmentation, offshoring, vertical specialization and segmentation of the value chain.

Marketing of products is replaced by marketing of functions, including those individually performed, which lowers the overall competition at the level of individual workers in manufacturing or services, which perform similar tasks in different countries.

### **The second unbundling triggered by globalization**

By the mid '80s globalization was developed exclusively at the level of companies and industries. Though savings could be achieved by transferring labor intensive activities to the South, production bases were maintained in individual locations in the North, to facilitate coordination of activities of managers and workers. Both financial considerations and those of coordination made sense to coupling labor, capital and European technology right in Europe, despite salary differentials.

The geographical separation of the different bases of production has become more attractive with the growing wage gap, adjusted for productivity and for the cheaper cost of fragmentation through the reduction of telecommunications and air transport costs. The importance of distance, especially on travel costs of managers and skilled workers results also from the fact that the first major unbundlings in industry started in the mid 80s, on short geographical distances: Japan to Southeast Asia and the U.S. to Mexico.

This trend was pejoratively called "the voiding" of the Japanese economy. The differentiation of countries in headquarters- countries and production host- countries has increased further by practicing the same " voiding " by countries like Taiwan, Korea, Singapore and Hong Kong. China's readiness to integrate into the global economy in the '80s spurred offshoring's strong appeal.

More recently, the second unbundling was reflected also in the field of "offices", by outsourcing functions that were previously regarded as nonmarketable. The classic example are the American call- centers in India.

Meanwhile, the latest unbundling process is found in the services area. This is in rapid expansion, although at a smaller scale.

The result of these processes of unbundling functions and tasks is the transfer of competition to the level of production phases, tasks of departments and duties of individual employees. Also, competition may affect functions which are common to a large number of sectors, regardless of their characteristics, namely labor intensive or capital-intensive. In conclusion, the North losers of globalization are not anymore just industries or activities that are labor intensive. Because transportation costs do not vary significantly, depending on the nature of goods, we can say that the reduction of these costs affects likewise all sectors.

For functions, the situation is different. Some of these, such as truck driving, are completely uninfluenced by lower international costs of coordination, while others are strongly affected, such as call-center services.

In terms of economic policy, three new aspects become important:

- the unpredictability of the winning and the losing functions. At present, even economists have difficulty in understanding the glue that unites the various functions in "packages" (of factories and offices), and thus how they will be removed in future.

- the instantaneous appearance of an offshore transferable function, due to the differential impact of the reduction in telecommunications costs on various functions and development of new management technologies.

- the lowering of competition from the levels of sector, company or professional qualification category to an individual level.

## Implications of offshoring on the labor market

Of the three features mentioned above, the most problematic for policy makers is the unpredictability of the impact of globalization. For example, in Europe we can not reasonably believe that workers in the most competitive sectors will be in a position of winners, nor that these winners will be the most prepared or trained in analytical functions. Many European workers currently work at prices fixed by the local market and not covered by productivity. But when the competition on functions will expand through globalization outside the country or area, their choices will be either a job loss or a reduction in salary. The question that will be raised ever insistently will be the following: what jobs are more exposed to this new competition?

Already in 1996 P. Krugman<sup>2</sup> warned that the differentiation will operate not due to the education level of workers, but due to the entering of the various services in the category of marketable services. This point of view was recently taken over by other authors, such as A.S Blinder (2006)<sup>3</sup> or G. Grossman and E. Rossi-Hansberg (2006)<sup>4</sup>. The latter's analyzed the implications of offshoring in general, and especially on wages, in terms of three effects: the effect of business conditions, the effect of employment and , the effect of productivity.

The first effect of production offshoring to countries with lower wages is to reduce product prices on international markets. This price will trigger the reduction of wages in the country of origin, remaining in the same sector. Their salary will be reduced also by the decreased demand for jobs in the sector. In reality, workers in the country of origin will focus on functions involving higher productivity, in order to increase the salary in accordance with this productivity. Of course the productivity effect may be exceeded by the cumulative effect of business and employment conditions, but Grossmann and Rossi-Hansberg paradigm allows the following important conclusion: if commodity prices fall and offshoring is not allowed, the workers in the country of origin will face even higher wage cuts.

Offshoring refers, in this case, to the routine (both normal routine, and cognitive routine) functions (tasks). In contrast, non-routine functions involving face-to-face interaction and continuous optimization and revaluation are not unbounding. An American study from 2003 shows that the share of jobs with routine functions declined since 1970 and this trend accelerated after 1990.

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<sup>2</sup> Krugman P.(1996): "White Collars Turn Blue" Article for centennial issue of the NYT magazine.

<sup>3</sup> Blinder A.S. (2006): "Offshoring: The Next Industrial Revolution?"

<sup>4</sup> Grossman G. & Rossi-Hansberg E. (2006): "The Rise of Offshoring:It's Not Wine for Cloth Anymore".

Simultaneously, the share of non-routine job rised. This study urged Grossman and Rossi-Hansberg to say that the offshoring of routine functions is already underway.

Two examples of North-South tradable and non-tradable functions are provided by A.S.Blinder (2006)<sup>5</sup>. The first category includes, for example, taxi drivers in Sweden and India. Prices of these functions are set locally and no matter how small would be the difference in productivity between two taxi drivers in these countries, it can not influence their relative wages, because it does not create competition between the functions performed by these drivers on the two markets.

An example of until recently non-marketable functions, are the computer security or informatic systems analysts. Many routine activities in this area can be provided remotely now. Remotely means another floor the same building or another office in Germany, either, due to the lower costs of communication and management technologies, a company in India. This option puts the Germans and Indian computer workers in direct competition with the very important consequence that the German-Indian wage differential has to be justified now also by a compensating differential in productivity.

However the difference should be made between the services sector and the trade in goods sector, thus involving industrial area, where it is considered (R. Baldwin 2006<sup>6</sup>) that the North-South wage differential has been brought more or less in line with the productivity differential.

A massive offshoring of jobs in production with intensive use of labor had taken place between Japan and China, and this has led to a significant increase of the international competitiveness of Japanese industry, even without any noticeable impact on unemployment. Japanese workers have rapidly specialized in new functions that maintained the productivity gap against Chinese workers, abundantly justify the wage gap towards them.

Regarding the U.S. market, A. Bardhan and C. Kroll (2003)<sup>7</sup> estimated that about 10% of the U.S. workforce was employed in occupations that can be transferred offshore, such as financial analysts, medical technicians, computer and math specialists

D. Van Welsum and X. Reif (2005)<sup>8</sup> and D. Van Welsum and G. Vickery (2006)<sup>9</sup> define tradable and offshorable jobs as those characterized by the following four characteristics:

- To be IT intensive
- Results to be IT-transmittable,
- Functions to be encodable,
- To require little face-to-face interaction.

Based on this definition, they found that about 20% of the American workforce could be offshored.

Studying the occupational statistics C. Mann (2005)<sup>10</sup> shows that most affected were the low-wage American workers in IT institutions, about one third of the jobs disappearing in the 1999-2004 period, despite the very low wages (\$ 25,000 on average per year). This includes occupations such as telemarketing, telephone operators, computer operators, etc..

In antithesis stood the occupations implying high skills, reasoning and solving problems, in which wages are three times higher, and which have offered 17% more jobs in the same period.

<sup>5</sup> Blinder A.S. (2006): "Offshoring: The Next Industrial Revolution?"

<sup>6</sup> R. Baldwin (2006): "Managing the Noodle Bowl: : The Fragility of East Asian Regionalism".

<sup>7</sup> Bardhan A & Kroll C. (2003):"The New Wave of Outsourcing: Fisher Center for Real Estate and Urban Economics, University of California".

<sup>8</sup> Van Welsum D. & Reif X. (2005): "Potential Offshoring: Evidence from Selected OECD Countries".

<sup>9</sup> Van Welsum D. & Vickery G. (2006): "The Share of Employment Potentially Affected by Offshoring – an Empirical Investigation".

<sup>10</sup> Mann C. (2005):"Accelerating the Globalisation of America. Institute for International Economics."

Regarding the situation in Europe, the study prepared by M.Falk and Y. Wolfmayer (2005)<sup>11</sup> estimated that due to offshoring about 0.3% of jobs in the industry were lost annually during 1995-2000, with sensitive differences between sectors, but, in some of the most dynamic of them, no losses of jobs due to offshoring have been recorded.

K.Ekholm and Hakka K. (2006)<sup>12</sup> conducted an analysis of the effects of offshoring of intermediate productive inputs on the labor force in Sweden and found that:

- Offshoring to low-income countries has reduced demand for workers with average level of education;

- Offshoring to high-income countries (mainly in the case of Sweden) did not produce statistically significant effects on the workforce.

Also, other studies for Germany, such as, for example, those of M Falk and Koebel (2003), show that offshoring reduces the demand for medium skilled workers.

Another type of analysis attempts to show what type of outsourcing has greater effects on developed countries. In this respect M. Amiti and S.J.Wei (2005)<sup>13</sup> analyzed the statistics on trade in services of the U.S. and other industrialized countries, in the period 1983-2003, concluding that:

- Outsourcing of services has increased significantly in recent years but it is not still an important phenomenon (eg for U.S. imports of IT and business services in 2003 represented only 0.4% of GDP).

- U.S. and other developed countries are net exporters of IT and business services, the surplus increasing even for some of these countries (ie USA).

- the material outsourcing is far more important than the outsourcing of services.

A recent study prepared by H.Goerg, D.Greenaway and R. Kneller (2008)<sup>14</sup> points out some implications of offshoring on the U.K economy. Research has covered a total of 66,000 companies and, after they found that offshoring is practiced mostly by large companies with branches abroad, focused on the 2850 British multinationals with foreign subsidiaries.

Thus, during 1995-2004, the offshoring of these companies increased by 35% in production and 48% in services. But even after this increase, it was still below 5% of GDP in 2004. Despite the somewhat automatic association of offshoring with the call centers in India, only 4.5% of multinationals in services and 8% in the industrial sector had branches in India and China. Most of the international outsourcing is done in other developed countries, and primarily in the EU.

An essential problem is related to the offshoring's impact on unemployment, but unlike media exaggerations, the study in question found that in 2005, only 3.5% of the jobs lost in England can be attributed to offshoring . Simultaneously, however, companies could produce more because offshoring made them more competitive and thus, overall, have created more jobs than were lost. In the analyzed period there were added due to offshoring about 100,000 new jobs.

A negative impact of offshoring and more generally of globalization is considered to be the alleged phenomenon of wage cuts in developed countries. The study to which we refer does not discover such an effect in the industrial sector, but in the services sector it is however found some average decrease. The explanation seems to lie in the fact that companies in the services sector outsource more qualified and better paid work. But the reduction was small and by extrapolation it was estimated that if the offshoring will continue to grow at the same rate in a decade, the average salary in services will directly shrink with only 2%.

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<sup>11</sup> Falk M. & Wolfmayer Y. (2005): "The Impact of International Outsourcing on Employment: Empirical Evidence from EU Countries. Austrian Institute of Economic Research Paper".

<sup>12</sup> Ekholm K. & Hakala K. (2006): "The Effect of Offshoring on Labour Demand: Evidence from Sweden".

<sup>13</sup> Amiti M & S.J. Wei (2005): "Fear of Service Outsourcing: Is It Justified? Economic Policy".

<sup>14</sup> Goerg H., Greenaway D. & Kneller R. (2008): "The Economic Impact of Offshoring. Nottingham University's Globalisation and Economic Policy Centre".

The conclusion of the study is optimistic through the fact that offshoring is on overall positive for the economy because it makes companies more competitive and generate jobs in the country and abroad.

## Conclusions

In terms of socio-economic impact of policies promoted at EU level, we have to emphasize the idea brought into question since 1996 by Paul Krugman<sup>15</sup> and reiterated by Alan Blinder (2006) and R. Baldwin (2006), that the European economic policy of orientating the workforce in accordance with the coordinates of a “ knowledge based economy ” and with "information society" jobs could be wrong.

If the offshoring trend in the services sectors is maintained, many analytical jobs, which today seem to have a high value added could be outsourced to other countries. Overall, such offshoring will be an opportunity for Europe to improve productivity, but the investments in qualification of workers would be unnecessary. Emphasis on analytical skills should be at least doubled by a similar emphasis placed on the ability to be flexible and to learn new skills. The most important conclusion for educational policies becomes that that is more important for future generations to learn how to learn than to teach skills in a particular field. The educational system must prepare them for lifetime employability, and not for lifetime employment.

Also, the employees protection policies become more feasible than workplaces protection policies. Offshoring will become more attractive to companies located in countries with more powerful social policies of jobs protection because, ultimately, offshoring gives companies the flexibility they need to go out of the rigidity of legal schemes in the country of origin .

As for Romania, starting from the analysis of the factors that favor offshoring decisions internationally, but also from the strategies of TNCs present in the country, that would not be late to predict the evolution of Romania in terms of offshoring host of activities and functions and also as source of offshoring. The logical purpose of such a study would be the development of appropriate strategies and policies in the labor market area, and the rethinking of the foundations of the Romanian educational system of tomorrow.

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