Offshoring: Taking the long view

In time, the gains derived from moving a company's operations to a more competitive location can actually enhance productivity in the country of origin.

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When a company decides to relocate its production operations to another country, it hopes to achieve increased efficiency and productivity.

What it leaves in its wake, however, is scores, perhaps even hundreds or thousands, of unemployed men and women, and a severely weakened local economy.

In the short term, there can be no denying that offshoring negatively impacts a country's domestic manufacturing base, resulting in widespread job destruction.

But economics isn't always a zero-sum game in which any gains are cancelled out by equivalent losses.

In the medium and long term, the increased productivity resulting from offshoring can and should be used to create and develop new capabilities and higher-skilled jobs in the country of origin.

As such, from a long-term perspective, offshoring can significantly boost a country's productivity, claim Joan E. Ricart and Pablo Agnese in an article published by the Spanish banking foundation Funcas.

They recommend that countries capitalize on what they call "dynamic competitive advantages" — offshoring certain activities initially and later focusing on nurturing the development and growth of more complex, higher value-added activities.

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The offshoring boom

In the absence of any official index, the authors made a rough estimation of the scale of offshoring in recent times, based on the input/output tables compiled by the OECD.

What they found is that between 1995 and 2005, offshoring increased in most countries around the world, as well as in the two major global economic sectors of manufacturing and services.

Although manufacturing operations were the first to be intensively relocated, service offshoring has also taken off in recent years.

The authors also note a negative correlation between the size of the economies, in terms of GDP, and their propensity to relocate.

Smaller countries, such as Belgium, Hungary, Ireland and Luxembourg, are among the most actively engaged in offshoring, whereas larger economies, such as Brazil, China, India, Japan and the United States, tend to have lower rates.

That said, Brazil and China are among the countries to have experienced the fastest growth in offshoring between 2000 and 2005.

Long-run benefits

The authors identify a positive correlation between the intensity of offshoring processes and increased productivity in the host economies, albeit without proving a causal relationship, which would require an econometric model.

What's more, they examine the evolution of offshoring and productivity in a number of developed economies: Canada, France, Germany, Italy, Spain, the United Kingdom and the United States.

They make a striking observation: the relationship between the increase in offshoring and productivity is positive for the second period (2000-2005), while it is null or even negative for the first period (1995-2000).

This suggests that developing long-term offshoring strategies may ultimately be the best approach, since productivity gains may take several years to materialize.

The article also points out a common pattern in offshoring processes.

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Almost all strategies start by taking the simplest functions with low added value, such as production or administration, and relocating them to other countries.

Only later do they target operations with a higher degree of complexity and risk, such as IT and call centers or, in the more advanced stages, R&D and product development.

The Spanish paradox

Offshoring rates for the Spanish economy are relatively low compared with countries with similar GDP levels, such as Brazil, Canada and Russia. As such, there should be potential for serious growth in this area.

However, the low productivity levels of the Spanish economy, coupled with equally low wage levels, make it less attractive to transfer manufacturing operations to other countries, since the cost differential and resulting savings are negligible at best.

Offshoring tends to appeal far more to countries with high wages and incomes, such as Canada and Germany, as the cost differential and resulting savings are that much greater.

In the case of Spain, relocation would make more sense for activities with higher added value. But for now, Spanish offshoring seems to be stuck at the bottom of the value scale.

In addition, companies based in Spain face a plethora of obstacles in offshoring their more complex functions. These include hostile public opinion, opposition from unions, widespread concerns about reduced-quality service and compromised data security, and a corporate culture largely unaccustomed and hence resistant to such practices.

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