McKinsey Global Institute

Can Germany Win from Offshoring?

July 2004 | Diana Farrell

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McKinsey Global Institute

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Preface

"Can Germany Win from Offshoring?" is a perspective based on the McKinsey Global Institute's ongoing research on the impact of offshoring, conducted as part of a broader effort to understand cross-border activities and how they are shaping the global economy. This research also builds on MGI's extensive work analyzing the drivers and inhibitors of productivity in Germany and other economies.

The report is part of the fulfillment of MGI's mission to help global leaders: 1) understand the forces transforming the global economy; 2) improve the performance of their corporations; and 3) work for better national and international policies.

MGI worked in close collaboration with our Germany office and our worldwide Business Processes Outsourcing and Offshoring Practice. We would particularly like to thank Jürgen Laartz, Frank Mattern, Stefan Spang, Martin Riedel, Dirk-Michael Reich, and Saule Serikova. Susan Lund from the McKinsey Quarterly also made significant editorial contributions to this work.

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Can Germany Win From Offshoring?

European companies are joining the growing trend of outsourcing service jobs to low-wage countries. But Western Europe's rigid labor and product markets, coupled with persistent unemployment and anemic job growth, could deprive its economies of much of the upside.

A recent survey[1] shows that 40 percent of Western Europe's 500 largest companies have already begun moving service operations abroad. This trend, enabled by the digital revolution and the dramatic fall in international telecommunications costs, is creating waves of anxiety among white-collar workers once protected from global competition while fueling protectionist sentiment.

Although outsourcing can create wealth both for countries that send jobs offshore and for those that receive them[2], this might not happen in Europe. New research from the McKinsey Global Institute (MGI) reveals that every euro of corporate spending that German companies offshore returns just €0.80 of value for its economy. In contrast, the United States economy gains more than $1 of new wealth for every dollar of corporate spending that US companies outsource abroad. Far from being a zero-sum game, offshoring can be a story of mutual gain. But to capture this mutual gain, German policy makers must raise the reemployment rate of workers who lose their jobs, and this will require adopting more flexible labor policies.

Protectionism is not the answer. Outsourcing is a powerful way for companies to reduce costs, improve quality, and extend the scope of customer services. For European companies, it can also create a new source of flexibility to help them meet fluctuations in demand-a flexibility now hindered by the thicket of labor laws at home. And Europe's rapidly aging populations mean that offshore labor will be increasingly needed in coming years to make up for a dwindling workforce. Far from viewing offshoring as a threat, Germany's leaders should make it the catalyst for the structural reforms their economy has long needed.

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1 *Straight Times*, June 21, 2004.

2 Vivek Agrawal and Diana Farrell, "Who wins in offshoring", *The McKinsey Quarterly*, 2003 Special edition: Global directions (www.mckinseyquarterly.com); Catherine Mann; Globalization of IT services and white-collar jobs: The next wave of productivity growth, *Institute for International Economics Policy Brief*, December 2003 (iie.com).

THE DIRECT ECONOMIC IMPACT

In August 2003, the McKinsey Global Institute published an analysis of the economic benefits, both direct and indirect, of offshoring back-office service and IT functions from the United States to India.[3] Of the direct benefits, MGI found that every dollar of spending that US companies transfer to India creates as much as $1.46 in new wealth. India receives 33 cents, through wages paid to local workers, profits earned by Indian outsourcing providers and their suppliers, and additional taxes collected by the government. The US economy captures the remaining $1.13, through cost savings to businesses, increased exports to India, repatriated earnings from offshore providers in which US companies have invested, and from the additional economic output created when US workers are reemployed in other jobs.

But a similar analysis shows that Germany benefits less in every category, and as a result, captures just €0.80 for every euro of corporate spending on service functions moved offshore (Exhibit 1). To understand this discrepancy, consider how offshoring creates wealth for an economy.

Cost savings

In the United States, companies save 58 cents for every dollar of spending on back-office service functions and IT jobs they move to India. These savings can then be reinvested in new business opportunities with higher value added, passed on to consumers in the form of lower prices (which then sparks growth in demand), or distributed to shareholders.

German companies save only €0.52 for every euro of corporate spending on jobs they offshore to India because differences in language and culture raise the cost of coordinating offshoring projects. But German companies send the majority of their offshore work to Eastern Europe, where they save still less.[4] Wages and infrastructure costs in Eastern Europe are higher than in India, a disadvantage only partially offset by lower telecommunication expenses, lower margins for Eastern European outsourcing providers, and lower tax rates.[5]

[3] Vivek Agrawal and Diana Farrell, “Offshoring: Is it a Win-Win Game?”, McKinsey Global Institute Perspective, August 2004. Available online at www.mckinsey.com/mgi.

[4] A recent survey of German business executives found that 59 percent of planned offshoring investments were headed for Eastern Europe. FTE, August 26, 2003.

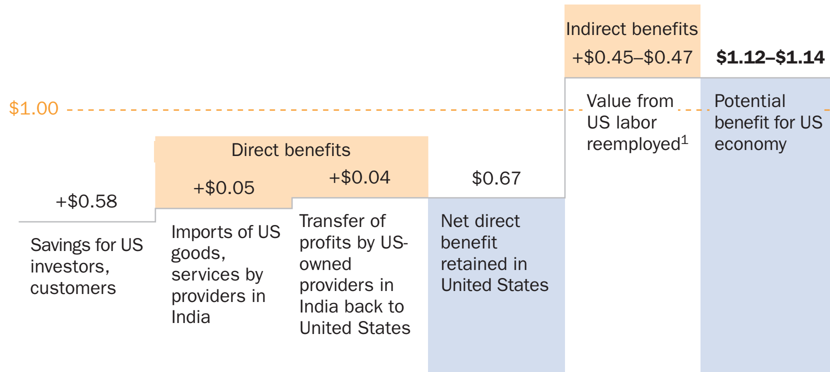
[5] Because Eastern European countries import more from Germany than India does, the overall value to the German economy is slightly higher.

Exhibit 1

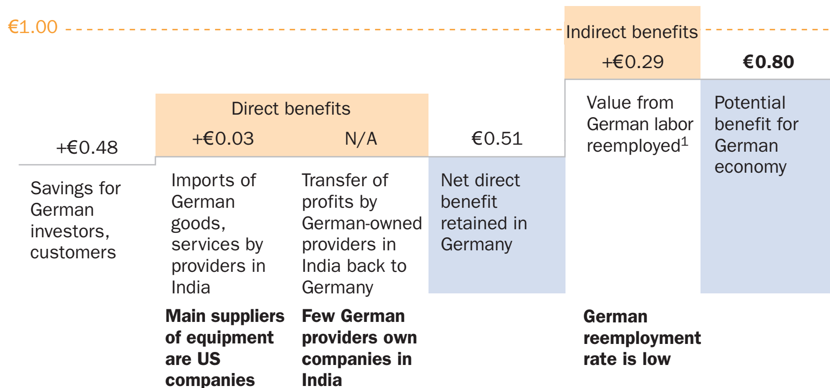
LESS FOR GERMANY

Benefits of US and German spending sent offshore, 2002

For every $1.00 of corporate spending moved to India . . . **. . . United States gains $1.12–$1.14**



For every €1.00 of corporate spending moved to India, Eastern Europe[2] . . . **. . . Germany loses €0.20**



[1] For United States, estimate based on historical reemployment and wage levels; for Germany, estimate based on turnover in unemployment claims.

[2] Of German corporate spending moved offshore, ~ 60% goes to eastern Europe, ~40% to India.

Source: Bureau of Labor Statistics (US Department of Labor); McKinsey analysis

Because Eastern European countries import more from Germany than India does, the overall value to the German economy is slightly higher. Averaging the savings across both India and Eastern Europe, German companies save €0.48 for every euro of spending they offshore.

Added flexibility

In a single respect, offshoring helps German companies more than their US counterparts: added flexibility in deploying labor. Strict German laws about

laying off workers and creating new job categories mean that German companies have more trouble adjusting their use of labor than US ones do. As a result, the Germans are more likely to face poor utilization rates and imbalances in supply and demand. Taking advantage of foreign labor gives these companies more flexibility for experimenting with new ideas and responding to market changes. Although we can't quantify the magnitude of this benefit, interviews with German and other European CEOs suggest that it can be substantial for many companies.

New revenues

Offshoring boosts exports. Outsourcing providers—whether in India or in Poland, whether subsidiaries of multinational companies or independently owned firms—buy many goods and services abroad. A call center in Bangalore, for instance, might purchase Dell computers, HP printers, Microsoft software, and Siemens telephones. We estimate that for every dollar of US corporate spending that moves to India, US exports there increase by five cents. This partly explains why exports from the United States to India grew from $3.7 billion in 2000 to $5 billion in 2003.

For Europe, the boost in high-tech exports is somewhat smaller, mainly because American firms dominate the industry. For every euro of spending on work outsourced to India or Eastern Europe, MGI estimates that Germany gains €0.03 from new exports.

Repatriated earnings

Indian firms wholly or partly owned by US companies generate 30 percent of the revenues of the Indian IT-and business-process-outsourcing industries. An additional four cents of every dollar spent on offshoring services to India thus returns to the United States in the form of repatriated profits.German companies, however, hold only negligible positions in Eastern European and Indian outsourcing providers and thus miss out on this benefit.

THE BENEFIT OF REDEPLOYING WORKERS

As the above analysis shows, Germany derives fewer direct benefits from offshoring than the United States does. Germany also gets less indirect economic value from redeploying workers whose jobs are outsourced, and this

discrepancy produces the crucial difference between the economic impact of offshoring in Germany and the United States.

In the United States, many people whose work is outsourced move on to other, higher value-added activities. From 1979 to 1999, 69 percent of US workers who lost their jobs due to trade in sectors other than manufacturing found new work within half a year.[6] On average, they received similar wages in their new jobs, though roughly half took pay cuts while the remainder found higher-paid work.

History shows that as economies grow, some job categories shrink or vanish and new ones appear: auto assemblers replaced carriage makers, and factory workers replaced farmers. The same thing is now happening as jobs in call centers, back-office operations, and some IT functions go offshore. Opportunities for redeploying labor and investing capital to generate opportunities in higher value-added occupations will continue to emerge, even if it isn't always possible to say exactly where. Twenty years ago, for instance, no one could have predicted that the global mobile-phone industry would now employ hundreds of thousands of people.

Even if the reemployment of workers remains at its current rate, the US economy gains an additional 45 to 47 cents of economic output over time for every dollar of corporate spending offshored. We believe this is a conservative estimate of the value created, since white-collar service workers are more likely to find new jobs, at higher wages, than are manufacturing workers.

But in Germany, 4.3 million people are unemployed, partly as a result of the integration of East Germany into the German Federal Republic, and job growth is very low. Workers who lose their jobs to offshoring may thus have a harder time finding new ones. Data on this point are scarce, but we estimate that the reemployment rate for IT and service workers could be as low as 40 percent. If so, Germany would lose up to €0.20 for every euro offshored. If Germany could increase its reemployment rate to match that of the United States, offshoring would create €1.05 of value for the German economy for every euro offshored. The drain of wealth would end.

[6] Lori G. Kletzer, "Job loss from imports: Measuring the costs" Institute for International Economics, Washington DC, 2001.

Offshoring in perspective

Embracing protectionism to stop offshoring would be a mistake. Companies move business service functions offshore because they can become more profitable and competitive by doing so. This protects many existing jobs and allows companies to invest additional money in the next-generation technologies and business ideas that will create the jobs of the future. Protecting a few jobs from offshoring now could mean losing many more jobs later if companies lose their competitive edge.

Offshoring must be seen as part of an ongoing process of economic restructuring. Technological change, shifts in consumer demand, and economic recessions can and frequently do result in job loss, but flexible, dynamic economies can cope. Every month, more than one million people in the United States change their employment-a figure that dwarfs the several hundred thousand service jobs that by current estimates went offshore during the past several years. In fact, the US Bureau of Labor Statistics recently reported that the offshoring of service work accounted for only 1 percent of US job losses in the first quarter of 2004 (Exhibit 2), and the picture probably wouldn't change very much if longer periods were taken into account. Even if manufacturing jobs that move overseas are included, offshoring accounted for only 4 percent of all layoffs.

Europe, for its part, faces a workforce that is shrinking because of an aging population-a trend that will hit Germany particularly hard. MGI research on demographic trends around the world indicates that over the next 15 years, Germany's workforce will decline by two million, while the elderly population that must be supported by the remaining employed workers will grow by five million. To prepare for this demographic shift, the country will have no choice but to raise the productivity of those left in the workforce dramatically. Outsourcing business processes to workers abroad can help.

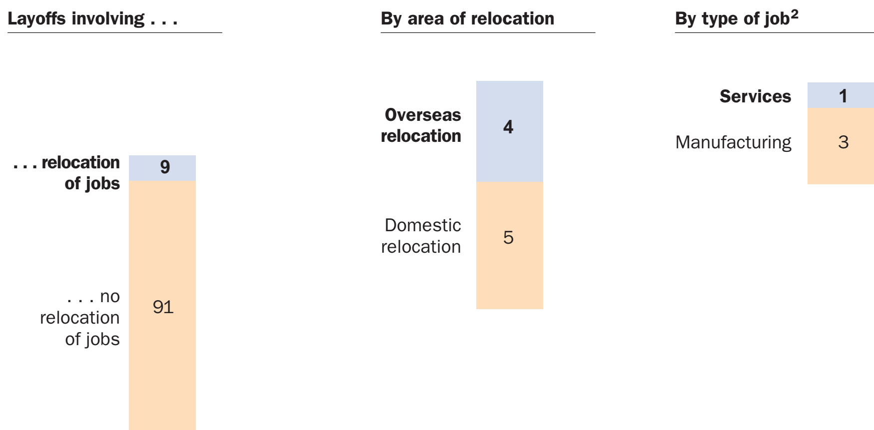
Of course, public policies can and should be adopted to ease the transition for German workers whose jobs move abroad. This includes job-retraining programs, incentives to increase labor mobility, and company-sponsored insurance programs, transferable from one employer to another, that offset wage losses.[7]

[7] Lori G. Kletzer and Robert E. Litan, “A prescription to relieve worker anxiety”, Policy Brief 01-2, Institute for International Economics, Washington DC, February 2001 (www.iie.com).

Exhibit 2

PUTTING IT IN PERSPECTIVE

% of layoffs in United States,[1] Q1 2004, %
100% = 183,000 layoffs



1 For nonagricultural private-sector companies (with >50 workers) where 50 or more workers filed initial unemployment claims during 5-week period and where employers indicate that 50 or more workers had no jobs for at least 31 days; excludes seasonal, vacation effects.

2 Estimated.

Source: "Extended Mass Layoffs Associated with Domestic and Overseas Relocation," Extended Mass Layoffs, Q1 2004, Bureau of Labor Statistics (US Department of Labor); McKinsey analysis

Such re-employment aids will not only make the economy more flexible and resilient, but will reassure frightened workers and reduce political strains.

The route to reform

To remain competitive in the global economy and to turn offshoring to its advantage, German policy makers must create new momentum in the economy. Since 1993, economic growth has averaged just 1.4 percent a year, little more than half the average for the rest of the European Union and far below the US growth rate of 3.3 percent. Employment in Germany has increased by only 0.2 percent a year, compared with 1.2 percent in the rest of the EU.

To spur growth, Germany's policy makers must make labor markets more flexible and rethink regulations that stifle competition and innovation. Although Agenda 2010 is a good start, it doesn't address all of the country's

problems. First, hiring and firing workers remains difficult because of the need to get approval from worker representatives. Moreover, companies must often wait six months or longer to hire new workers, and using temporary ones involves filing extensive paperwork. For a certain multinational German company, a recent round of layoffs took two weeks to accomplish in the United States, four weeks in the United Kingdom, and three months in Germany.[8] Faced with these difficulties, companies rightly remain cautious about adding new workers in Germany.

Second, high wages have contributed to the lackluster growth in jobs. Although Germany doesn't have a minimum wage, the combined effect of wage floors set through collective bargaining and social benefits for the long-term jobless create an effective minimum employment cost. This reduces total employment by making many lower-paid jobs economically unfeasible. US retailing, for instance, employs roughly 30 percent more people per capita than German retailing does, and they work more hours on average. The creation of "minijobs" that pay €400 to €800 a month for part-time work was meant to fill this gap, but a researcher found that they have mainly cannibalized full-time jobs rather than created new ones.[9]

German businesses are now taking the lead in driving labor market reforms. Siemens's recent deal with IG Metall, Germany's largest union, put a dent in the once-sacrosanct 35-hour work week and the 13th month of pay, at least for two plants that manufacture cordless and mobile telephones. Other businesses have no doubt taken note. The country's new president, Horst Kohler, says that the Agenda 2010 reforms don't go far enough and that the welfare state has "overstretched itself".[10]

To get the full value of offshoring, however, Germany needs to create jobs in high-value-added occupations, not just those at the lower end of the wage scale. To do so, it must address the inappropriate product market regulations that stifle competition and innovation. Without pressure from competitors, managers have little incentive to innovate and boost productivity on an ongoing basis. Although some people might think that higher productivity

[8] *The Economist*, "How to pep up Germany's economy", May 8, 2004.
[9] Viktor Steiner and Katharina Wrohlich, *Work Incentives and Labor Supply Effects of the "Minijobs Reform" in Germany*, The German Institute for Economic Research, (DIW Berlin), February 27, 2004.
[10] "Lose no time in reforming, says new German President," *Financial Times*, July 2, 2004.

means fewer jobs, the empirical evidence shows that it is the source of economic growth in mature, advanced economies such as Germany and the United States.[11] Higher productivity lets the companies that achieve it offer consumers lower prices and better value, thus stimulating demand and allowing more productive competitors to take market share from less productive ones.

In Germany, a variety of market restrictions-price regulations, zoning laws, subsidies-distort and dampen competition and innovation. So does weak corporate governance. Restrictions on the operating hours of stores, for instance, prevent retailers from realizing the better service and higher employment that would come from remaining open longer. In automotive, retail trade, road freight, and utilities, regulatory barriers directly or indirectly limit market access, and competition and innovation are therefore much less common than they are in comparable countries that don't have such barriers. In retail banking, small state-owned and cooperative banks with subscale operations and little shareholder pressure prevent consolidation and dampen competition.

Germany's labor laws and product market regulations were designed to achieve important social objectives, such as protecting workers' incomes and preserving employment. But over the past two decades, one lesson has become clear: mixing social and economic policy reduces employment and slows growth. By decoupling these policies, Germany could boost economic growth and employ more people and thus be better able to finance its social agenda.

Sweden holds a cautionary tale for German policy makers who waver in their commitment to reform. In 1990, that country boasted the 7th-highest standard of living in Europe; in 2002, it ranked 14th.[12] An inflexible labor market reinforced by restrictive regulations constrained growth in the service sector at a time when manufacturing jobs were going abroad.[13] Job growth may

[11] In developing countries, economic growth is sometimes fueled by increasing the amount of capital used. But once optimal levels of capital intensity are achieved, as they have been in advanced economies, this avenue for growth is closed.

[12] Based on the purchasing-power-parity measure of GDP per capita published by the Organisation for Economic Cooperation and Development.

[13] Improving European competitiveness, MGI Perspective, July 2003, available online at www.mckinsey.com/mgi.

have been strong more recently, but Sweden has experienced a net loss of jobs over the decade, and its standard of living has fallen precipitously relative to that of its European neighbors. Swedish policy makers are now discussing the structural reforms needed to reverse course, but the country has lost out on years of growth.

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Germany's political leaders should view offshoring not as an economic threat but as an important opportunity for the nation's businesses, consumers, and shareholders. That may be cold comfort for workers whose jobs are threatened, but the truth is that globalization is gathering speed and can't be stopped. Offshoring could create new wealth for Germany, but only if it makes the structural reforms needed to put displaced employees back to work. China, India, and other emerging markets have staked their claims in the globalizing workforce. Now it is time for Germany to respond.