McKinsey Global Institute

# The Emerging Global Labor Market:

# Part I—The Demand for Offshore Talent in Services

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# The Emerging Global Labor Market:

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## Guiding Principles

We consider any job that is not confined to a particular location as having the potential to be performed anywhere in the world (i.e., globally resourced). If the activities comprising a job do not require physical proximity, local knowledge, or complex interactions, then it is not confined to a particular location. In Part I of this report, the section Global Resourcing Potential—Theoretical Maximum addresses this potential to remotely locate jobs.

Jobs that are not confined to a particular location may be performed wherever a company deems most attractive. A company may choose to have a particular "location insensitive" job performed in the demand market (that is, in the market in which the resulting output is sold), in a border zone (nearshore), or remotely (offshore). Therefore, not all location insensitive jobs will move offshore.

Although manufacturing jobs may be insensitive to their location, this study focuses on service jobs only. Besides service jobs in service sectors, the study also includes service jobs (e.g., accounting) in manufacturing sectors.

We primarily evaluate the demand for low-wage employment from high-wage countries (i.e., offshoring). To estimate labor demand by global industry sectors, we treat countries as neither inherently on the supply side nor inherently on the demand side in the global labor market. However, as cost is a major determinant of companies' location decisions, developed countries are clearly likely to provide the bulk of demand for offshore labor, and developing countries the bulk of supply. When we discuss how fast offshoring will grow, we examine only the demand for low-wage labor from high-wage countries. The evaluation of "degree of adoption" refers only to the demand for low-wage labor.

We assume that the demand for labor per activity is equal in all countries. Capital/labor tradeoffs and increased service levels may cause high-wage countries to seek more labor in low-wage countries than they would for performing the same activity in the demand market. Productivity differences between the original location and the new location may also influence demand for labor. As these effects can be both positive and negative, our default assumption is that the number of FTEs needed for an activity is the same whether located onshore or offshore.

# Executive Summary

*"Outsourcing is a problem for the US and First World in general, because all tradable goods production and service jobs can be outsourced."*[1]

*"It's hardly the size of the [offshoring] phenomenon that accounts for the uproar. More important, I think, is concern about how big this trend could become and the fact that it's affecting a segment of the workforce that hitherto was never subject to this kind of competition, namely service workers."*[2]

Only facts about the dynamics of demand for offshore talent can prove or refute claims like these. So far, however, the debate about offshoring has been fueled by anecdote rather than fact and, as one observer of the debate commented recently, "the plural of anecdote is not data."[3]

The McKinsey Global Institute has therefore conducted a large-scale research study with the aim of providing hard data about the emerging global labor market. This report, the first in a series of three, quantifies potential, actual, and projected demand for offshore labor in services. Its key findings, outlined below, have implications for players on the demand side of the emerging global labor market and for policy makers in countries that would like to participate to a greater extent on the supply side.

1 Paul Craig Roberts, interviewed by Timothy Aeppel, "Leadership (a special report)—offshore face-off: moving jobs overseas can cut a company's costs; but is it bad for the U.S economy? Two economists debate the issue," *Wall Street Journal*, May 10, 2004.

2 Raghuram Rajan as quoted in "The outsourcing threat is: a) big b) small c) both," *Washington Post*, June 13, 2004.

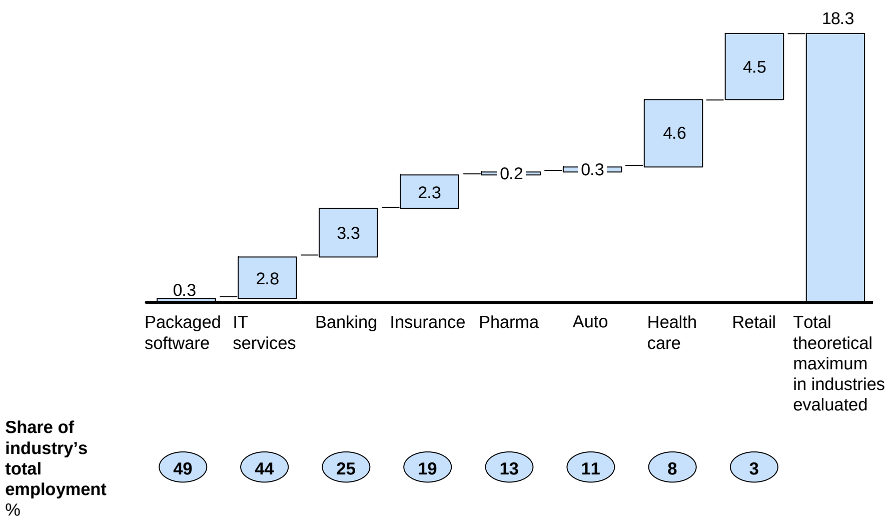
3 William A. Wulf, "Outsourcing/Offshoring of engineering jobs", Keynote address, annual meeting of the United States National Academy of Engineering, New York, NY May 2005.

**Eleven percent of worldwide service employment could in theory be performed remotely**

By breaking down eight representative sectors[4] of the global economy into the functions they comprise and the occupations undertaken by people in those functions, we have calculated that 18.3 million jobs in these sectors could be done by people located anywhere in the world in 2003 (Exhibit 1). Extrapolating from these eight sectors to the global economy in 2008, we estimate that 160 million jobs, or about 11 percent of the projected 1.46 billion service jobs worldwide, could in theory be carried out remotely, barring any constraints on supply.

**Exhibit 1**

**THEORETICAL MAXIMUM GLOBAL RESOURCING IN SECTORS EVALUATED IS APPROXIMATELY 18.3 MILLION FTEs**
million FTEs, 2003




Source: McKinsey Global Institute analysis

4 The eight sectors are: auto, health care, insurance, IT services, retail, retail banking, packaged software, and pharmaceuticals.

This 11 percent theoretical maximum is an average across all industries in the global economy. In fact, individual sectors vary quite widely in the amount of labor they could employ remotely, with some more amenable to the practice than others. A sector's capacity to locate jobs remotely and its size together determine the potential scale of its employment of remote labor.

As a rule, the more customer facing functions a sector has, the lower its potential to resource those functions remotely. Consequently the retail sector, with the vast majority of employment tied to stores, has the lowest such potential: 3 percent of all retail jobs could be performed remotely. However, because of the large scale of the retail sector as an employer, that percentage represents a potential 4.9 million of the world's retail jobs in 2008. In contrast, almost half of all employment in the packaged software industry could be resourced remotely. Yet this fraction represents a potential 340,000 jobs by 2008, because that sector employs far fewer people than retail worldwide.

Like industries and functions, some occupations are more amenable to remote employment than others. Engineering and finance and accounting occupations are the most amenable (52 percent and 31 percent, respectively), while generalist and support staff occupations are much lower (9 percent and 3 percent, respectively; Exhibit 2). However, because of the high share of total employment in every sector represented by the latter two categories, they in fact contain the highest number of jobs that could theoretically be filled by remote talent—a combined total of 26 million.

**Actual offshore employment will reach 4.1 million jobs worldwide in 2008**

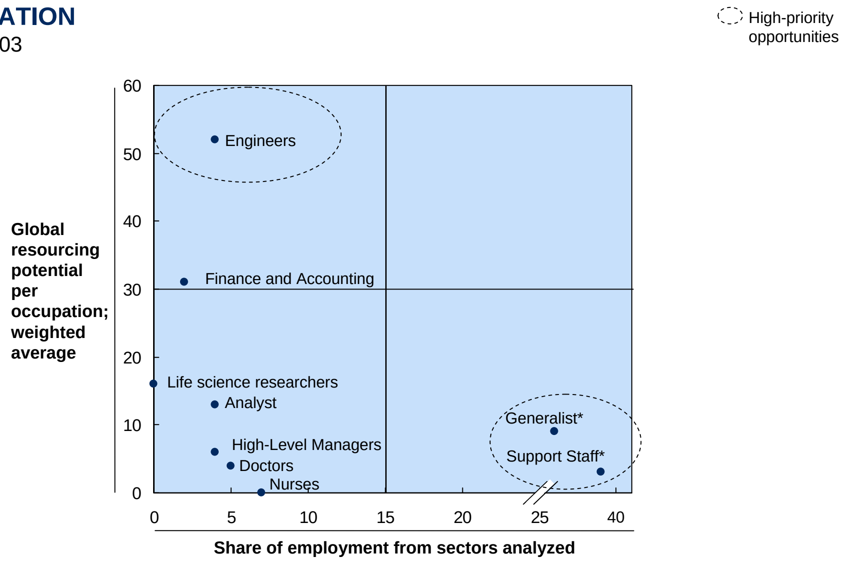
The number of service jobs performed remotely will remain modest compared to total employment in service activities in developed economies over the medium term. Although the trend toward offshoring is growing among companies in developed countries, a gap exists between the number of service jobs that they could locate remotely and the actual number of jobs that they have located offshore, or plan to offshore, by 2008.

To date, 565,000 service jobs in the eight sectors we evaluated are performed in low-wage countries for companies and customers in developed countries. By 2008, we expect that number will grow to 1.2 million for the same eight sectors (Exhibit 3). Extrapolating to the global economy, we estimate that total offshore

## Exhibit 2

**ENGINEERING OCCUPATIONS ARE THE MOST AMENABLE TO REMOTE LOCATION**

%, 2003




* Generalist accounts for 36% and support staff accounts for 39% of employment in sectors analyzed.
Source: McKinsey Global Institute analysis

employment amounted to approximately 1.5 million jobs in 2003. In 2008, total offshore employment will reach an estimated 1.2 percent of total demand for labor in services from developed countries, equivalent to 4.1 million employees. To put this number in perspective, consider an average of 4.6 million Americans starting to work with a new employer every month in the 12 months to March 2005.[5]

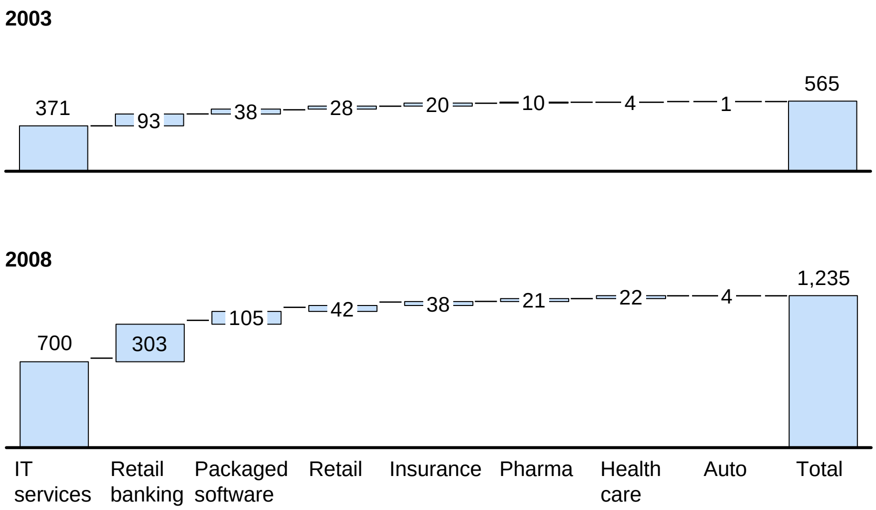
Of the eight sectors we analyzed, retail and health care employ offshore labor the least. We estimate that of the high-wage employment demand in each sector, less than 0.1 percent of retail and 0.07 percent of health care employment will actually be located in low-wage countries by 2008. At the other end of the spectrum are packaged software and IT services, which we estimate will offshore 18 percent and 13 percent of their high-wage employment demand, respectively, by 2008.

5 Source: US Bureau of Labor Statistics

**Exhibit 3**

**OFFSHORE EMPLOYMENT IN THE EIGHT SECTORS ANALYZED IS PROJECTED TO DOUBLE BY 2008**

thousand FTEs in low-wage countries




Source: McKinsey Global Institute analysis

**Company-specific barriers more than regulatory barriers deter companies from offshoring**

Cost pressures make offshoring potentially attractive for numerous companies in developed economies. Nevertheless, they could locate many more jobs remotely than they actually do. Regulatory barriers beyond companies' control have so far been held largely responsible for their slow uptake of offshoring. However, our research indicates that company-specific barriers are generally more powerful than regulatory barriers in deterring many companies. Such barriers include having processes unsuited to offshoring, managers' attitude toward offshoring, or insufficient scale (Exhibit 4).

Most of the sectors we evaluated reported cost pressure at home combined with much lower labor costs abroad as their main incentives to resource labor globally. Companies that already conduct some operations in low-wage countries find the switch to resourcing service labor from them easier than do less internationally experienced firms. Those companies that find the prospect of offshoring difficult generally face company-specific barriers of three types: operational issues, management attitudes to offshoring, and structural issues.

**Exhibit 4**

## DEGREE OF ADOPTION IS DRIVEN BY COST PRESSURE BUT LIMITED BY OPERATIONAL FACTORS

\+ Strong driver
– Strong inhibitor

| | Drivers/inhibitors | Packaged software | IT Services | Banking | Insurance | Pharma | Auto | Health care | Retail |
|---|---|---|---|---|---|---|---|---|---|
| **Sector characteristics and dynamics** | **• Cost pressure** | | + | | | | + | + | + |
| | **• Cost differential (perceived or real)** | + | | + | + | + | | | |
| | • Availability (perceived or real) of quality vendors | | | | | | | | |
| | • Availability (perceived or real) of suitable labor | | | | | | | | |
| **Organizational, operational, and technical factors** | **• Global presence and experience in managing global footprint** | + | | + | | | | | – |
| | **• Scale of business processes to be globally resourced** | | – | | | | | – | – |
| | **• Suitability of process to support global resourcing** | – | – | – | | | – | | |
| | • Intensity of paper-based processes in sector | | | | | | | – | |
| | • Suitability of IT to support global resourcing | | – | | – | | | | |
| | • Alignment of management incentives with profit maximization | | | | – | | | | |
| | **• Comparison of global resourcing Return On Investment (ROI) (perceived or real) with alternative profit-maximization strategies** | | | – | – | | – | | – |
| **Legal, regulatory, political, and social factors** | • Access to attractive markets | | | | | | | | |
| | • Social/political position towards global resourcing | | | | | | | | |
| | • Labor market regulation in the home country | | | | | | | | |
| | • Product market regulations in the home country | | | | | – | | | |
| | • Intellectual Property (IP) regulation in the producing country | – | | | | – | | | |

Source: Interviews; McKinsey Global Institute analysis

Unsuitable business processes are the most important operational issue inhibiting companies from offshoring. Several companies, especially those that have been through a series of mergers and acquisitions, have business processes that are too convoluted to allow easy separation into discrete groups of activities, some of which could then be offshored. This issue can affect companies even in sectors with a high potential to resource labor remotely. Several packaged software companies, for example, find their software development processes unsuited to parallel execution at multiple R&D locations around the world. Similarly, a great many players, especially in health care, still rely on paper-based processes that cannot be moved too far away from core operations. Legacy IT systems may also be too idiosyncratic for companies to disaggregate and manage remotely. This issue is particularly restricting for insurance companies, some of which still run IT systems more than half a century old.

Management attitude and strategies are another important determinant of whether a company goes ahead with global resourcing, when it would be both convenient and reasonable. In several sectors, we found managers unwilling to become more involved overseas. Some were unprepared to deal with the new challenges it presented or were uninformed about the opportunities. Mindsets like these are particularly prevalent among local and even national companies whose managers have little or no experience leading operations abroad. As a consequence, they are unlikely to prioritize global resourcing ahead of alternative measures for reducing costs.

Finally, other company-specific barriers we identified were structural. For example, many companies find their offshorable activities are too small in scale to warrant the risks of locating them remotely—smaller retailers in particular face this barrier. Until good intermediaries can achieve scale benefits by serving multiple smaller companies, enterprises like these will not pursue offshoring opportunities.

Regulatory barriers to offshoring play a smaller role than company-specific barriers in explaining the pace at which companies are resourcing labor remotely. Regulatory barriers include labor market regulations in the home country, such as high statutory severance awards; product market regulations in the home country restricting, for instance, where a service can be provided; and insufficient legal protection for intellectual property in offshore locations. With the exception of regulations governing drug development in the pharmaceutical sector, these barriers are less inhibiting overall than company-specific barriers. However, their force varies considerably by country and by sector. As an example, formerly state-owned German companies find it difficult to lay off redundant employees because of German labor laws.

**Offshore employment will grow gradually, making no sudden impact on labor markets overall in developed countries**

Observations that we made in the course of our research combined with these key findings have a number of implications for companies and countries on the demand side of the emerging global labor market and also for policy makers in countries on the supply side.

From a company perspective, as we saw above, several in the sectors we studied would need to make changes to their organizational structure and operations before they could save costs by resourcing labor globally. But tapping low-cost labor pools could provide them with opportunities beyond cost savings. Some will also be able to enhance revenues, accelerate product development, and provide customized services profitably in ways that would not have been feasible with onshore cost structures. For example, using offshore labor to develop simplified versions of its software is enabling one packaged software company to enter emerging markets with lower-priced versions of existing products.

At a country level, our observation is that labor markets in developed economies are experiencing and will continue to experience the trend toward offshoring as a slow, evolutionary change. It will have less impact on patterns of employment than the decline in manufacturing employment developed economies have experienced recently. In the United States, for example, the share of manufacturing jobs in overall employment fell by 11 percentage points to 21 percent in the 30 years to 2002. By contrast, the total number of service jobs in the United States that could in theory be filled remotely represents 9 percent of total current employment.

The moderate impact and generally slow pace of offshoring will not soften the blow for those individuals in developed countries who do lose their jobs as a result. However, most are college graduates, and therefore likely to be more amenable to retraining than manufacturing workers. And in the United States, growth rates in both wages and jobs in the computer and data processing services sector, where offshoring is prevalent, are higher than in the economy as a whole.[6]

From the standpoint of countries on the supply side, the gap between companies' potential to employ labor remotely and their actual rate of offshoring represents an opportunity to increase that rate. Understanding what makes individual companies reluctant to offshore and what they require from an offshore location will allow policy makers on the supply side to target companies in particular sectors and tailor their offerings. We examine this opportunity in more detail in "How Demand and Supply for Offshore Talent Meet," the third report in our series on the emerging global labor market.

6 Source: US Bureau of Labor Statistics, (SIC 7370; Current employment statistics)

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