

# The Challenges to Indian IT Off-shoring Industry at the time of Global Economic Recession: An Insider's View

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## ABSTRACT

*The global economy is nose diving to the bottom leading to be the worst financial crisis during the postwar period. (IMF) International Monetary Fund stated that growth was projected to slow appreciably. The world growth was projected to slow down from 5 percent in 2007 to 3.75 percent in 2008 and to just over 2 percent in 2009, with the downturn led by advanced economies. The activity in the advanced economies was expected to contract by 25 percent on an annual basis in 2009. The projections forecast have come true and the U.S. economy is suffering severely; the growth in Europe is hard hit and the growth out of exports in Japan has declined. These have collectively led to global economic crisis. The IT sector is the most affected industry. Currently 50% offshore business in India comes from US. Consequently, this is widely and deeply affecting the Indian Off-shoring industry.*

*This paper presents comprehensively the challenges confronted by the Indian Off-shoring industry and the measures to be taken by the industry, associated institutions and the government.*

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## Introduction

The Off-shoring is the movement of a business process of a company in one country to the same or another company in a different country. The ability to offshore depends on the availability of well educated talent pool, robust distributed communications technology, liberal trade rules, growing confidence among companies in the stability of emerging markets and a sizable gap between their pay expectations and those of their peers in the employer's home market.

The Off-shoring has been a controversial issue spurring heated debates among economists. It is seen as benefiting both the origin and destination country through free trade, providing jobs to the destination country and lower cost of goods and services to the origin country. This makes both sides see increased GDP. And the total number of jobs increase in both countries since those workers in the origin country that lost their job can move to higher-value jobs in which their country has a comparative advantage.

The Off-shoring has important implications for companies and countries on both the 'demand' and the supply sides of the market. At the highest level, it represents an opportunity for multinational companies to create more value at lower cost, enhancing the productivity of global economy. In other words, it benefits the whole

world. But gains from off-shoring do not automatically flow to all the people it affects, notably those workers in developed economies who are displaced as a result. Although off-shoring will result in a net increase in employment worldwide, in practice, it means that individual service jobs – in emerging as well as developed markets – feel less secured. The off-shoring trend evokes enormous political controversies in both developed economies, where it may displace workers, and in emerging markets, where policy makers worry about foreign companies crowding out incumbents and exploiting workers. Policy makers in both countries have thus called for measures to stop off-shoring or to limit its reach.

The off-shoring can have both positive and negative effects. But if decision makers understand the phenomenon and manage it well, the impact of off-shoring may be broadly positive for all societies that engage it. At the same time the decision makers may think about the alternative, to go for Near-shoring when it provides the same quantity with quality, of course, with same cost cut, without compromising data security, communication issues, virtual operations, different and difficult time zones, etc.

### **Some facts from McKinsey Global Institute's "Study on Off-shoring Trends in 2008":**

- Off-shoring will probably continue to create a relatively small global market-one

that threatens no sudden discontinuities in overall levels of employment and wages in developed countries.

- Demand for offshore labor by companies in the developed world will increasingly push up wage rates for some occupations in low-wage countries, but not as high as current wage levels for those occupations in developed countries.
- Potential global supply and likely demand for offshore talent are matched inefficiently, with demand outstripping supply in some locations and supply outstripping demand in others.
- The university graduates from Central European countries are well suited to work for multinationals. By contrast, job candidates from Russia are well educated but often, the universities fail to give them practical skills, while in India the quality of the education system – top universities apart – handicaps graduates.
- The salaries for engineers in the lowest-cost countries would double.
- MGI suggests that India's policy makers must make a priority of helping companies to avail themselves of the country's untapped pockets of supply before too many more of them

discover the charms of other off-shoring locations. The government may, for instance, have to build airports in less well-known cities and help them with their marketing. Companies exploring these second-tier cities could consider telecommuting as a way of gaining access to additional employees or offer housing deals to get more graduates to move.

- US has 7.7 million young university graduates available for the future workforce in 2008.

### **Off-shoring in India - Current status**

India, being the world's preeminent off-shoring destination, has attractive qualities beyond low-wage professionals for companies that want to offshore their operations. With 15 years of off-shoring experience, the country has developed a stable group of world-class IT services vendors that can save foreign companies from the trouble of setting up their own offshore centers. And it has a large supply of qualified talent in areas outside IT, such as R & D, finance and accounting, call centers, and back-office administration.

India's pool of young university graduates is estimated at 14 million – the largest of all 28 low-wage countries. It is 1.5 times the size of China and almost twice that of the United States. This huge number of university graduates is topped up

by 2.5 million new ones every year. As in other low-wage countries, however, only a fraction of these people are suited for work in multinational companies. The downfall of IT and ITES sectors has considerably impacted India's overall economy.

### Issues related to Off-shoring in India

- **Employability:** High rates of emigration among graduates of the top schools decrease local supplies of suitable talent. Despite the large number of students graduating, it is not uncommon to hear companies complain about not finding suitable candidates. Every year India produces over 500,000 engineering graduates and over 3 million non-engineering graduates. But the question arises: Does India produce quality workforce that is employable. The NASSCOM says that only 15 – 25 % of the fresh graduates are **employable**. Current projections indicate that by 2010, the IT industry alone may face a shortfall of 500,000 professionals, unless proactive steps are taken. The remaining 75 % are unsuitable because of lack of soft skills, particularly communication skills, which are essential for IT and ITES sector.
- **Deterioration of Education Quality:** The quality of Indian universities varies a great deal. The graduates of the top schools such as the seven IITs (Indian Institutes of Technology) and six IIMs (Indian Institute of

Management) are world-class, but elsewhere the level of quality declines deeply. The problem is poor communication skill. The graduates from certain region appear to be handicapped by strong local accents. The curriculum in most universities is obsolete and the quality of faculty and of infrastructure is poor; and the pedagogic methods and materials are completely inadequate, to meet the current demands of IT industry.

- **Employee Retention:** The IT industry has, during the last decade, been probably the most attractive sector to work in. It has, therefore, been able to get the best talent. The challenge now is to safeguard and build on this prime position. Attractive compensation, challenging assignments, good working conditions and growth opportunities are amongst the main determinants of where talent gravitates.

Talent Retention is a major concern for companies in India today. The Hewitt – Nasscom study says that the attrition rate in 2006 was 14.9 % in IT sector. Compensation is probably one of the significant parameters for attrition. The challenge here is to provide an attractive package in the context of rising expectations, and yet minimize overall cost escalation. In this situation, "poaching" people from other companies by offering

higher pay packages is self-defeating for the industry as a whole. Still, it continues to be a common practice that affects the off-shoring.

- **Lack of Talent Pool:** MGI's study shows that the demand for India's young professional engineers is likely to exceed supply by 2008 if current rates of growth in demand (especially from US and UK) persist. As early as 2006, the demand for suitable engineers will surpass the local supply; by 2008, demand will hit 138 percent of supply.
- **Lack of Middle Managers:** Although India has more of middle managers than other destinations do, the country also has higher demand for middle managers because the off-shoring sector has grown so fast; over the past decade, the number of middle managers it employees has expanded by more than 20 % a year, and even more in some cities. New entrants often lure qualified managers from existing business instead of training their own. Sometimes they poach across borders as well. Rapidly rising remuneration is evidence of their scarcity.
- **Infrastructure:** India's most serious flaw is its Infrastructure. On a scale of 1 to 5 (from good to bad) in infrastructure, India rates 3.3. The poor roads and rudimentary traffic management make local commuting a big problem. The poor infrastructure includes roads, airports, enhancing communication networks, etc.
- **Threat to Security (Physical and Data) due to terror attacks:**
- **Rising Labor Cost:** Wages for India's graduate software engineers have already risen steeply in the most popular offshore destinations such as Mumbai, Bangalore, Chennai, Hyderabad, Noida, Gurgaon and Pune. Annual wages for project managers in India has increased by 23 % annually over the past 4 years, while salaries of programmers have risen 13 %. Because of wage inflation, some offshore companies worry that the Indian rates will soon reach US levels.
- **Change in Life Style – luxurious / western life culture:** The young generation software engineers in India are attracted by western culture and they are more of "spend centric". The salary expectation is driven by the installments that are to be paid every month. The IT industries have led to increasing levels of disposable income in the hands of the young workforce. Their consumerist culture drives the young workforce towards higher salary expectations.
- **Hike in Real Estate Price:** The real estate in Tier I cities and Tier II cities has seen a 300 %

hike in the last 2 years and it leads to imbalance of buying power and income. This increases the overall running cost for the offshore companies. Also this has a side effect of stimulating the software engineers look for higher salary.

- **Effect of Exchange Rates:** The fluctuation of exchange rate between US Dollar (\$) and Indian Rupee (INR) leads to budgeting issues. The reality is far from forecasting. Hence, it is difficult to negotiate the service fee with the clients

### **Why Near-shoring is competitive with Off-shoring?**

McKinsey Global Institute says that: The companies tend to choose cities where other companies have gone already for Off-shoring. As a result, for example, some offshore locations like Mumbai and Bangalore (in India) are already suffering a labor squeeze and rapidly rising wages, even though supplies of skilled labor in emerging markets as a whole are plentiful. The wage inflation will probably continue in most of the off-shoring locations as long as the multinationals concentrate their demand in a few cities or countries. Because of the sunk costs of setting up an offshore facility, if demand in that location begins to outstrip local supply, the wages paid by individual companies may rise above the levels prevailing in neighboring cities.

Dispersing demand will slow down overheating in the hot spots. The offshore companies in low-wage countries have started moving to optimal places, Tier II Cities. The same reason tempts companies in US to opt for **Near-shoring** that has to go to Tier II cities and small towns in US.

It seems as if every corner of the world is pitching itself as an outsourcing alternative to India, from Eastern Europe to Latin America to China. But a number of alternatives are emerging in the U.S. "Rural America" is becoming an option, particularly for U.S. companies that want to keep work on their own shores and for European companies that desire outsourcing locales with a closer proximity, both geographic and cultural. The neolT research report said that India would face stiff competition from Near-shoring, where US and European companies would ship back-office work to destinations near their countries or places within their countries. This move will have: No Data Security issues, No Communication issues, No difficult time zones; Decent cost cut with same quality; physical verification of projects by clients-just a flight away; no virtual offices, etc.

### **Some factors to be considered**

These are some factors that should be seriously considered - *Employability, Attrition, Inadequate Infrastructure, Education Quality, Short of Middle Managers, Risen Wages, Hike in Real Estate, etc.*

The “**employability**” is another factor to be considered seriously. The high rates of emigration among graduates of the top schools decrease local supplies of suitable talent. Despite the large number of students graduating, it is not uncommon to hear companies complain about not finding suitable candidates. Every year India produces over 500,000 engineering graduates and over 3 million non-engineering graduates. But the question arises: Does India produce quality workforce that is employable. The NASSCOM said that only 15 – 25 % of the fresh graduates are employable. The current projections indicate that by 2010, the IT industry alone may face a shortfall of 500,000 professionals, unless proactive steps are taken. The remaining 75 % are unsuitable because of lack of soft skills, particularly communication skills, which are essential for IT and ITES sector.

The “**turnover**” or “**attrition**” is another hurdle. The IT industry has been probably the most attractive sector to work in, during the last decade. It has, therefore, been able to get the best talent. The challenge now is to safeguard and build on this prime position. Attractive compensation, challenging assignments, good working conditions and growth opportunities are amongst the main determinants of where talent gravitates. Retaining talent is a major concern for companies in India today. The Hewitt – NASSCOM study reported that the attrition rate in 2006 was 14.9 % in IT sector. The figure was 35 – 40 % in 2007. The compensation

is probably one of the significant parameters for attrition. The challenge here is to provide an attractive package in the context of rising expectations, and yet minimize overall cost escalation. In this situation, poaching talents from other companies by offering higher pay packages is self-defeating for the industry as a whole. Still, it continues to be a common practice that affects the off-shoring.

The “**real estate**” in Tier I cities and Tier II cities saw 400 % hike in prices, in the last 4 years and it led to imbalance of buying power and income. This increased the overall running cost for the offshore companies. Also this had a side effect of stimulating the information technology workforce demanding for higher compensation. This also created an imbalanced economy in the society.

### **What Corporate World may expect?**

The Corporate World is moving from cost arbitrage to skill arbitrage with quick innovation; needs outsourcing partners with higher quality and lower price, due to huge budget cut. The outsourcing initiatives may mostly depend on the criticality of business.

In the case of US market’s contribution to Indian IT industry, the newly elected US government’s support to the concept of “protectionism”, proposals for changes in education system, business taxes, and policy changes in employment,

immigration, off-shoring may have some impact on off-shoring business in India in the long run.

Mercer HR 2008 survey reports that US firms (both IT and non-IT) respond to off-shoring outsourcing as follow: 21% - Very important; 37% - Somewhat Important; 43% - Not Important.; speedy ROI, with a horizon of 2 -3 years period;

Buy or Build Talent Strategy in US: Mercer 2008 survey reports that IT firms opt: 32 % for Buy, 38 % for Buy and Build, 27 % for Build and 3 % - Not Sure.

If the "Build" strategy continues to gain significance, recruiting of nonimmigrant workers and off-shoring opportunities may decline gradually.

### **What should India Inc do to meet the challenges and retain its dominance?**

The mid-size companies should: focus on one technology; focus on one domain; needs quick innovation and creativity, of course with lower price.

The IT workforce should realize the situation and make up the mindset to have job satisfaction with reasonable compensation. This is very much needed especially in the current economic situation. The education system should be revived, with more industry-institute collaborations.

The companies should give higher priority to training and career development. Generally, the employees worldwide give more importance to compensation and benefits rather than career development and training opportunities. In fact, the employees should realize that career development and training opportunities on new and related technologies would help them climb up the career ladder quicker and hence it's more important than mere compensation and benefits.

The companies should follow "Build" strategy - building more talent rather than "Buy" strategy - trying to buy more talents. It may happen when industries in a large scale tie-up with educational institutions to impart curriculum that is 100 % designed for today's need.

The education systems including UGC and AICTE should make sure that all educational institutions in India have a mandatory curriculum on Soft Skills, covering a wide array of skills (presentation skills, oral / written communication standards, spoken English, German, Spanish, Japanese, etc.). The government is on the right move to introduce "English" as a compulsory subject at the primary school level and uniform curriculum at par with central board education systems like ICSE, CBSE, etc. This will ensure that the future generation will have language skills that are essential to work in the multinational companies (MNCs).

The companies should provide value proposition through transparency and control to customers



through automated tools to ensure visibility of workers and status of the projects; a business or project plan and pricing model associated with risk factors; leveraging customer's resources to the possible extent.

The rise in terror attacks in India poses a new and severe threat to off-shore business. It makes the foreign investors think twice to do business in India. There are more possibilities for threat to data and physical security. The clients from developed countries will hesitate even to visit India to inspect the status of the ongoing projects. This may heavily affect the future off-shore business. The government should make major strategic changes in homeland security and cyber crimes to make clients from developed countries feel comfortable and safe.

The government should give still more importance to physical infrastructure, like roads, airports, etc. Of course all the metro cities in the country have been linked through four-lane roads and the airports in the Tier II cities are upgraded to international standards (for example, Trichy, Madurai, etc.). The government should also make sure that the workers get housing facilities at reasonable costs, by controlling the real estate

market. Otherwise Tier-II cities like Madurai and Trichy will become Mumabais and Bangalores sooner. Thanks to central and state governments as they are taking right steps to move the industry to tier-II cities, to utilize the untapped talent pool.

The state and central governments are moving in the right direction by providing subsidized energy; establishing Special Economic Zones and IT Parks; concession in tax for software exporters, etc. The government should also force the software companies that enjoy income tax benefits, to help state and central governments to automate government systems and applications at a discounted cost.

### **References & Sources of facts**

- Survey conducted by Franklin Joseph in 7 offshore companies in India. The companies are located in Mumbai, Bangalore, Kolkota and Chennai.
- McKinsey Quarterly
- NASSCOM reports
- Hewitt – NASSCOM reports