ISSUE 11

Is the Corporate Strategy of Outsourcing Unpatriotic?

YES: Sarah Anderson and John Cavanagh, from "Outsourcing: A Policy Agenda," Foreign Policy in Focus (April 2004)


ISSUE SUMMARY

YES: Sarah Anderson and John Cavanagh argue that outsourcing is a real threat to the economic health of the United States and provide several suggestions as to the types of governmental actions necessary to keep American jobs from moving overseas. Included in their discussion is an analysis of the views of the two 2004 presidential candidates, John Kerry and George W. Bush.

NO: Dr. Daniel Drezner argues that the controversy surrounding outsourcing is not new and that its current form is more hype than substance. He shows how outsourcing is actually economically beneficial to America, despite the warnings of critics. Dr. Drezner also asserts that the concept of outsourcing is consistent with a solid understanding of free-market capitalism and an appreciation of traditional American principles and values.

As his Democratic party foes constantly pointed out during the 2004 election year, President George W. Bush's early years in the White House were characterized by, among other things, a steady increase in the number of jobs lost as a result of the recession, which started almost immediately upon his taking office in 2001. An interesting residual effect of this situation was the increased attention both economists and politicians gave to outsourcing. Indeed, if one were to believe the media, offshore outsourcing—the transferring of work previously done by Americans to foreign countries as a strategic response to pressures to keep costs low—occurred at epic rates and was partly responsible for the economic downturn of the early part of the decade. Democratic presidential nominee John Kerry campaigned on a platform built, in part, on the promise that he would keep American jobs in America. The implication, of course, is that outsourcing is unpatriotic. On the surface, such corporate behavior would indeed appear to be unpatriotic—after all, what could be more anti-American than moving American jobs to foreign countries? But is this indeed the case?

Those who argue that outsourcing is bad business and anti-American maintain this is so simply because it moves jobs out of America. Sarah Anderson and John Cavanagh note that this is no small trend: Millions of jobs have left American shores in recent years, and many millions more are vulnerable. Critics also point to the alarming growth of outsourcing in the service sector. The historical justification for outsourcing was built on the belief that jobs lost in manufacturing would be replaced by jobs in the service sector as the United States shifted from an industrial to a service-based economy. Since the current outsourcing wave is primarily service-based, the concern is that outsourcing will accelerate further as we move toward a service-oriented society. Finally, many charge that outsourcing is nothing more than American firms exploiting cheaper labor in other countries in order to increase profits (see Issue 17 regarding sweatshops for further insight into this contentious topic). Do you agree with this point and, if so, how patriotic is this type of corporate behavior?

Proponents of outsourcing have strong points on their side of the issue as well. The call to end outsourcing is, in their view, merely protectionism in disguise, a concept entirely at odds with traditional American political and economic principles. American capitalism and prosperity were built on free trade; forcing American firms to forego cheap overseas labor in the name of patriotism will ultimately cause U.S. firms, and society, to suffer. In terms of the exploitation of foreign labor argument, supporters respond that it is not exploitation at all. Consider these comments by Edwin Locke, Dean's Professor of Leadership and Motivation at the University of Maryland, and Ayn Rand, Institute contributing author:

"... the claim that multinational companies [e.g., American firms] exploit workers in poor countries by paying lower wages than they would pay in their home countries. Well, what is the alternative? It is: no wages! The comparative advantage of poorer countries is precisely that their wages are low, thus reducing the costs of production. If multinational corporations had to pay the same wages as in their home countries, they would not bother to invest in poorer countries at all and millions of people would lose their livelihoods."

In the following selections, you will be exposed to both sides of this controversial topic. Sarah Anderson and John Cavanagh defend an anti-outsourcing perspective. During the course of their discussion, the authors present an analysis of the viewpoints on outsourcing held by Democratic nominee John Kerry and Republican President George W. Bush just prior to the 2004 presidential election. Daniel Drezner, professor of political science at the University of Chicago, provides a pro-outsourcing perspective in his article. Among other things, Professor Drezner invites his readers to consider the following question: In today's increasingly competitive global marketplace, wouldn't domestic political actions designed to curb outsourcing ultimately make American firms less competitive?
Outsourcing: A Policy Agenda

Don’t worry; they’ll get better jobs in the service sector.” During the last three decades of the 20th century, this was the mantra of most government and business leaders when corporations transferred auto or apparel jobs to Mexico or China. That line doesn’t work anymore, since U.S. companies have started shifting a wide range of service jobs as well—from high-skill computer programming to entry-level call center jobs—to India and other lower-wage nations. This breach of the final frontier of American jobs has caused understandable anxiety and has become a hot-button issue in the presidential election campaign.

The trend toward foreign “outsourcing” of service jobs is an extension of a longstanding practice of cutting costs by subcontracting parts of business operations to nonunion shops within the United States. The practice has gone global, in part because of technological changes. Massive amounts of information can now be transmitted across the world at low cost, making geographic distances less important. International financial institutions and trade agreements have also facilitated the trend by promoting investment liberalization and privatization of public services, creating new opportunities for U.S. corporations in overseas markets.

Forrester Research estimates that about 40 percent of Fortune 1,000 firms have already outsourced some work and that at least another 3 million service jobs will leave the United States by 2015, led by information technology work. A study by the University of California, Berkeley estimates that 14 million U.S. jobs (11 percent of the total work force) are vulnerable to being outsourced.

Although the number of jobs lost so far is small relative to the total work force, these layoffs have a huge impact on the affected communities, and the potential for white-collar jobs to be offshored is deeply unsettling for many American workers. In addition to job cuts, service workers must now also contend with the enhanced power of highly mobile, increasingly unregulated global corporations to bargain down U.S. wages and working conditions by threatening to move jobs elsewhere.

According to McKinsey and Company, a consulting firm that helps businesses develop offshore operations, U.S. companies make up about 70 percent of the global outsourcing market. Their top destination in the developing world is currently India, where domestic subcontractors perform a range of services for

the U.S. market. At the low-skill end, Indian workers earn $1 or less per hour to handle customer service calls for firms like Earthlink and Travelocity. Among the higher-skill workers are Indian computer programmers, who earn about one-tenth the pay of their U.S. counterparts to write code for multinational corporations like Citigroup. Given a lack of other economic opportunities, Indian workers are often eager to secure new jobs catering to the U.S. market. However, there is also a nagging fear that these jobs may evaporate as soon as companies can find lower costs elsewhere.

China, of course, looms on the horizon. It is already the second-biggest developing-country draw for service work, offering rock-bottom wages and an official ban on basic union rights. Though it lacks India’s English-speaking advantage, this may not be the case forever, as Beijing is heavily promoting English-language education. Mexico’s experience in competing with China over manufacturing jobs could foreshadow events to come. Although employment in Mexico’s border export zone more than doubled after the implementation of the North American Free Trade Agreement (NAFTA) in 1994, the country has in recent years lost several hundred thousand of these jobs, partly in economic flight to lower-wage China. India has even lost some foreign manufacturing jobs to China.

Public pressure has galvanized U.S. state and federal legislators to introduce a flurry of bills to curb outsourcing, primarily by requiring that government contract work not be performed overseas. However, there is still resistance from the corporate lobby, such as the new Coalition for Economic Growth and American Jobs, which represents some 200 trade groups, including the U.S. Chamber of Commerce and the Information Technology Association of America. These and other pro-outsourcing groups argue that the practice is good for U.S. workers, because it lowers the cost of services for U.S. consumers and enhances the overall competitiveness of U.S. companies. Another common claim is that recent job losses are due to productivity gains, not outsourcing. However, because workers are facing a “jobless” recovery and see few personal benefits from enhanced productivity, these arguments convince very few.

One reflection of public opinion is that concerns about U.S. trade policy have spread up the income ladder. Lower- and middle-class workers have been consistently skeptical of U.S. trade policies, but a February 2004 University of Maryland poll showed that even among Americans earning over $100,000 a year, support for actively promoting more “free trade” has dropped from 57 percent in 1999 to 28 percent in 2004.

Problems with Current U.S. Policy

As they vie for votes in layoff-ridden swing states, both presidential candidates are offering solutions to the prevailing American angst about trade and outsourcing. Railing against “Benedict Arnold” companies, Sen. John Kerry has vowed to eliminate government incentives for outsourcing. For example, he would place conditions on most government contracts to require that the work be performed in the United States. He would also eliminate a tax break that currently allows U.S. businesses to defer tax payments on income earned

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abroad, and he proposes to use the resulting revenue to lower the overall corporate tax rate from 35 to 33.25 percent. Similarly, Kerry would offer incentives to encourage transnational corporations to repatriate earnings and would then channel these revenues into an employer tax credit for new hires. Regarding trade, Kerry has vowed to include stronger labor and environmental protections in future trade pacts and to review all existing agreements.

The Bush administration has delivered mixed messages regarding outsourcing. Two prominent officials have publicly endorsed the practice—Treasury Secretary John Snow and Gregory Mankiw, chairman of the Council of Economic Advisers. Both have argued that foreign outsourcing of service jobs is good for the American economy, because it helps companies become more efficient. Meanwhile, President Bush has sought to distance himself from such statements and instead to focus public attention on his administration’s new “21st Century” jobs plan. Bush argues that the real driving forces behind outsourcing are “foul” lawsuits, excessive regulation, and high taxes. He also claims that NAFTA and other trade agreements have been good for U.S. workers, and he promises that by breaking down even more trade barriers his policies will boost export-related jobs. “The best product on any shelf anywhere in the world says, ‘Made in the USA,’” Bush told an audience of women entrepreneurs in Cleveland.

But the Bush administration’s jobs plan ignores the historical record and thus misdiagnoses the problem. Government figures show that U.S. employment for American multinational corporations grew only 25 percent between 1982 and 2001, while employment at their overseas affiliates increased 47 percent. (These figures likely underestimate foreign expansion, because they do not include information on employment through subcontractors, data the U.S. government does not require businesses to report.) This period of rapid overseas expansion has coincided with increased trade and investment liberalization and a declining corporate tax burden. U.S. employers are leaders in outsourcing, even though their share of the national tax bill is considerably lower than the average for employers in other industrial nations.

Bush’s claim that companies are fleeing “Big Government” is also dubious. McKinsey and Company claims that U.S. corporations have led the outsourcing trend not to escape burdensome regulations, but because the relatively unregulated U.S. labor market facilitates sending jobs abroad. McKinsey, a pro-outsourcing consulting firm, points out that compared to most European counterparts, the United States has “liberal employment and labor laws that allow companies greater flexibility in reassigning tasks and eliminating jobs.”

Kerry’s early jobs plan is encouraging, but it addresses only one side of the issue. His proposal to end taxpayer subsidies for outsourcing, whether through government contracting or tax breaks, is long overdue. Citizens should not have to pay higher taxes to subsidize the evaporation of their jobs. To ensure effectiveness, any reforms must be carefully crafted to prevent potential loopholes. More effort will also be needed to address the threat posed by existing international agreements to domestic legislation that requires public contract work to be performed in the United States. For example, under World Trade Organization rules, the Government Procurement Agreement bans governments from favoring domestic firms in procurement contracts. Although only 25 countries have signed the agreement thus far, plans are under way to expand its scope and incorporate similar rules in other trade pacts.

Kerry’s primary focus on domestic measures will have only a modest impact on the jobs issue, because these policies cannot make up for the extreme gap in labor costs, which is the primary driving force behind outsourcing. McKinsey estimates that global pay gaps result in a net cost savings for outsourcers of at least 45-55 percent (after accounting for higher infrastructure and other costs). If this is true, figures in a 2003 University of California, Berkeley study suggest that companies could save around $300 billion a year if they outsourced all of the estimated 14 million U.S. service jobs considered feasible to transfer overseas.

Kerry’s promises to change U.S. trade policy are also a step in the right direction. If there were effective international mechanisms to strengthen labor rights enforcement, developing-country workers would have a better chance of obtaining fair wages. Research commissioned by the AFL-CIO indicates that labor rights violations in China artificially depress wages by 47-86 percent and that if the country were to respect basic internationally recognized labor rights, wages would likely increase 90 to 95 percent. However, the goal of strengthening labor rights protections should be pursued as part of a broader strategy to uplift conditions generally in poorer countries. Without overall economic improvements, developing-country governments will continue to face strong pressure to attract foreign investment by offering lax labor rights enforcement, thereby undermining efforts to maintain high standards in the richer countries.

### Toward a New Foreign Policy

The overall goal of U.S. policy on outsourcing should be to attack the factors that make workers—in the U.S. as well as around the world—vulnerable to exploitation by increasingly mobile and unregulated global corporations. The approach needs to recognize that raising standards overseas is vital to retaining stable and substantial jobs at home. This requires a multifaceted response encompassing changes in domestic tax, procurement and labor laws as well as in multilateral trade, finance and aid policies.

On the domestic side, a first step should be to reform tax and procurement policies at all levels of government to ensure that they support good jobs in the United States. Additional subsidies that enhance the incentives for corporations to shift jobs overseas should also be eliminated. These include risk insurance and loan guarantees provided by the Overseas Private Investment Corporation as well as technical assistance and other supports offered by the U.S. Trade and Development Agency. Moreover, the U.S. government should ensure that U.S. authorities, as well as their counterparts around the world, have the right to use tax and procurement policies as instruments to support social goals without being undermined by international trade agreements.

The domestic policy response should also involve labor law reforms that reduce current obstacles to union organizing and that beef up rules related to laying off workers. Most European countries require that corporations guarantee higher severance pay based on years of service, which substantially raises the cost...
of moving jobs. Many European countries also oblige companies that are planning to close an operation to consult with unions and sometimes to negotiate over the decision. By contrast, under U.S. law, unions may only bargain over the effects of a closure. Thus, although European countries also experience outsourcing-related job loss, the practice is not as advanced as in the United States.

However, domestic measures, while significant, do not address the biggest incentive for outsourcing—extreme wage gaps. Tackling this problem will require a long-term commitment to supporting sustainable economic activity in poor countries and should focus on the factors that make workers around the world vulnerable to exploitation by global companies.

One of these factors is lax enforcement of internationally recognized labor rights, which artificially depresses wages. U.S. policymakers must learn from the failure of NAFTA’s weak labor rights mechanism and should develop a better model. The Hemispheric Social Alliance has proposed involving the International Labor Organization in monitoring compliance and investigating complaints related to rights violations. If necessary, assistance would be provided to help countries achieve compliance. Only if this approach was unsuccessful would sanctions be applied, and if the perpetrator was a specific company, the punishments would be targeted at the company rather than at the host government.

Any labor rights initiative, however, should be integrated within a broader strategy toward poorer nations. Other factors that make workers vulnerable are high unemployment and poverty. Although national governments are not without responsibility for these problems, international financial institutions and trade agreements have played an exacerbating role. For example, the World Bank, the International Monetary Fund and the World Trade Organization all threaten the livelihoods of tens of millions of farmers by pressuring poor-country governments to eliminate tariffs and agricultural subsidies. Likewise, privatization supported by these international financial institutions has often resulted in mass layoffs and weakened social services. These multilateral agencies should instead join governments in promoting “global green deal” policies that stimulate stable and substantial employment while protecting the environment.

Regarding trade, Washington should withdraw its support for rules—such as in Chapter 11 of NAFTA—that grant excessive protection to U.S. investors against public interest laws and other host government actions that diminish profits. Such trade rules undermine democracy and encourage U.S. firms to shift jobs overseas.

To enhance this new and broader strategy toward poorer nations, the U.S. government should advocate for stronger international mechanisms to transfer resources from richer to poorer countries. Where appropriate, this would include debt reduction or cancellation. Washington could also promote the adoption of international taxes on both foreign exchange transactions and arms sales to generate revenues for development purposes. The U.S. must also revamp its development aid policies to emphasize anti-poverty measures, healthy communities and a clean environment rather than handouts to U.S. corporations like Halliburton and Bechtel.

In short, a comprehensive response to corporate outsourcing requires a sea change in the outlook of both the U.S. public and its politicians toward

America’s role in the world. Just as Americans are less secure when much of the world is plagued by extreme poverty, inequality and instability, worker exploitation overseas translates into exploited workers and less secure jobs at home. The electoral debate over outsourcing offers an opportunity to create a new policy approach that combines solidarity with self-interest in a whole-scale effort to benefit the entire world.

Sources for More Information

Organizations

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Email: contact@washtech.org
Web site: http://www.washtech.org/

Publications


Web sites

Communications Workers of America
http://www.cwa-union.org/outsourceing/

India Resource Center
http://www.corpwatchindia.org/
The Outsourcing Bogeyman

The Truth Is Offshore

When a presidential election year coincides with an uncertain economy, campaigning politicians invariably invoke an international economic issue as a dire threat to the well-being of Americans. Speechwriters denounce the chosen scapegoat, the media provides blanket coverage of the alleged threat, and legislators scurry to introduce supposed remedies.

The cause of this year's commotion is offshore outsourcing—the alleged migration of American jobs overseas. The depth of alarm was strikingly illustrated by the firestorm of reaction to recent testimony by N. Gregory Mankiw, the head of President George W. Bush's Council of Economic Advisers. No economist really disputed Mankiw's observation that "outsourcing is just a new way of doing international trade," which makes it "a good thing." But in the political arena, Mankiw's comments sparked a furor on both sides of the aisle. Democratic presidential candidate John Kerry accused the Bush administration of wanting "to export more of our jobs overseas," and Senate Minority Leader Tom Daschle quipped, "If this is the administration's position, I think they owe an apology to every worker in America." Speaker of the House Dennis Hastert, meanwhile, warned that "outsourcing can be a problem for American workers and the American economy."

Critics charge that the information revolution (especially the Internet) has accelerated the decimation of U.S. manufacturing and facilitated the outsourcing of service-sector jobs once considered safe, from backroom call centers to high-level software programming. (This concern feeds into the suspicion that U.S. corporations are exploiting globalization to fatten profits at the expense of workers.) They are right that offshore outsourcing deserves attention and that some measures to assist affected workers are called for. But if their exaggerated alarmism succeeds in provoking protectionist responses from lawmakers, it will do far more harm than good, to the U.S. economy and to American workers.

Should Americans be concerned about the economic effects of outsourcing? Not particularly. Most of the numbers thrown around are vague, overhyped estimates. What hard data exist suggest that gross job losses due to offshore outsourcing have been minimal when compared to the size of the entire U.S. economy.

The outsourcing phenomenon has shown that globalization can affect white-collar professions, heretofore immune to foreign competition, in the same way that it has affected manufacturing jobs for years. But Mankiw's statements on outsourcing are absolutely correct; the law of comparative advantage does not stop working just because 401(k) plans are involved. The creation of new jobs overseas will eventually lead to more jobs and higher incomes in the United States. Because the economy—and especially job growth—is sluggish at the moment, commentators are attempting to draw a connection between offshore outsourcing and high unemployment. But believing that offshore outsourcing causes unemployment is the economic equivalent of believing that the sun revolves around the earth: intuitively compelling but clearly wrong.

Should Americans be concerned about the political backlash to outsourcing? Absolutely. Anecdotes of workers affected by outsourcing are politically powerful, and demands for government protection always increase during economic slowdowns. The short-term political appeal of protectionism is undeniable. Scapegoating foreigners for domestic business cycles is smart politics, and protecting domestic markets gives leaders the appearance of taking direct, decisive action on the economy.

Protectionism would not solve the U.S. economy's employment problems, although it would succeed in providing massive subsidies to well-organized interest groups. In open markets, greater competition spurs the reallocation of labor and capital to more profitable sectors of the economy. The benefits of such free trade—to both consumers and producers—are significant. Cushioning this process for displaced workers makes sense. Resorting to protectionism to halt the process, however, is a recipe for decline. An open economy leads to concentrated costs (and diffuse benefits) in the short term and significant benefits in the long term. Protectionism generates pain in both the short term and the long term.

The Sky Is Falling

Outsourcing occurs when a firm subcontracts a business function to an outside supplier. This practice has been common within the U.S. economy for some time. (Witness the rise of large call centers in the rural Midwest.) The reduction of communication costs and the standardization of software packages have now made it possible to outsource business functions such as customer service, telemarketing, and document management. Other affected professions include medical transcription, tax preparation, and financial services.

The numbers that are bandied about on offshore outsourcing sound ominous. The McKinsey Global Institute estimates that the volume of offshore outsourcing will increase by 30 to 40 percent a year for the next five years. Forrester Research estimates that 3.3 million white-collar jobs will move overseas by 2015. According to projections, the hardest hit sectors will be financial services and information technology (IT). In one May 2003 survey of chief information officers, 68 percent of IT executives said that their offshore contracts would grow in the subsequent year. The Gartner research firm has estimated that by the end of this year, 1 out of every 10 IT jobs will be outsourced overseas. Deloitte Research predicts the outsourcing of 2 million financial-sector jobs by 2009.

At first glance, current macroeconomic indicators seem to support the suspicion that outsourcing is destroying jobs in the United States. The past two years have witnessed moderate growth and astonishing productivity gains, but overall job growth has been anemic. The total number of manufacturing jobs has declined for 43 consecutive months. Surely, many observers insist, this must be because the jobs created by the U.S. recovery are going to other countries. Morgan Stanley analyst Stephen Roach, for example, has pointed out that “this is the first business cycle since the advent of the Internet—the enabler of a new real-time connectivity to low-cost offshore labor pools.” He adds, “I don’t think it’s a coincidence that this jobsless recovery has occurred in such an environment.” Those who agree draw on anecdotal evidence to support this assertion. CNN’s Lou Dobbs routinely harangues U.S. companies engaged in offshore outsourcing in his “Exporting America” series.

Many IT executives have themselves contributed to this perception. When IBM announced plans to outsource 30,000 jobs overseas this year, one of its executives said, “[Globalization] means shifting a lot of jobs, opening a lot of locations in places we had never dreamed of before, going where there’s low-cost labor, low-cost competition, shifting jobs offshore.” Nandan Nilekani, the chief executive of the India-based Infosys Technologies, said at this year’s World Economic Forum, “Everything you can send down a wire is up for grabs.” In January testimony before Congress, Hewlett-Packard chief Carly Fiorina warned that “there is no job that is America’s God-given right anymore.”

That last statement chills the blood of most Americans. Few support the cause of free trade for its own sake, out of pure principle. The logic underlying an open economy is that if the economy sheds jobs in uncompetitive sectors, employment in competitive sectors will grow. If hi-tech industries are no longer competitive, where will new jobs be created?

**Inside the Numbers**

Before answering that question, Americans need to separate fact from fiction. The predictions of job losses in the millions are driving the current outsourcing hysteria. But it is crucial to note that these predictions are of gross, not net, losses. During the 1990s, offshore outsourcing was not uncommon. (American Express, for one, set up back-office operations in India more than a decade ago.) But no one much cared because the number of jobs leaving U.S. shores was far lower than the number of jobs created in the U.S. economy.

Similarly, most current predictions are not as ominous as they first sound once the numbers are unpacked. Most jobs will remain unaffected altogether: close to 90 percent of jobs in the United States require geographic proximity. Such jobs include everything from retail and restaurants to marketing and personal care—services that have to be produced and consumed locally, so outsourcing them overseas is not an option. There is also no evidence that jobs in the high-value-added sector are migrating overseas. One thing that has made offshore outsourcing possible is the standardization of such business tasks as data entry, accounting, and IT support. The parts of production that are more complex, interactive, or innovative—including, but not limited to, marketing, research, and development—are much more difficult to shift abroad. As an International Data Corporation analysis on trends in IT services concluded, “the activities that will migrate offshore are predominantly those that can be viewed as requiring low skill since process and repeatability are key underpinnings of the work. Innovation and deep business expertise will continue to be delivered predominantly onshore.” Not coincidentally, these are also the tasks that generate high wages and large profits and drive the U.S. economy.

As for the jobs that can be sent offshore, even if the most dire-sounding forecasts come true, the impact on the economy will be negligible. The Forrester prediction of 3.3 million lost jobs, for example, is spread across 15 years. That would mean 220,000 jobs displaced per year by offshore outsourcing—a number that sounds impressive until one considers that total employment in the United States is roughly 130 million, and that about 22 million new jobs are expected to be added between now and 2010. Annually, outsourcing would affect less than .2 percent of employed Americans.

There is also reason to believe that the unemployment caused by outsourcing will be lower than expected. Gartner assumed that more than 60 percent of financial-sector employees directly affected by outsourcing would be let go by their employers. But Boston University Professor Nitin Joglekar has examined the effect of outsourcing on large financial firms and found that less than 20 percent of workers affected by outsourcing lose their jobs; the rest are repositioned within the firm. Even if the most negative projections prove to be correct, then, gross job loss would be relatively small.

Moreover, it is debatable whether actual levels of outsourcing will ever match current predictions. Despite claims that the pace of onshore and offshore outsourcing would quicken over time, there was no increase in 2003. In fact, Transpoint Inc., an outsourcing advisory firm, even reports that the total value of business process outsourcing deals in the United States fell by 32 percent in 2003.

There is no denying that the number of manufacturing jobs has fallen dramatically in recent years, but this has very little do with outsourcing and almost everything to do with technological innovation. As with agriculture a century ago, productivity gains have outstripped demand, so fewer and fewer workers are needed for manufacturing. If outsourcing were in fact the chief cause of manufacturing losses, one would expect corresponding increases in manufacturing employment in developing countries. An Alliance Capital Management study of global manufacturing trends from 1995 to 2002, however, shows that this was not the case: the United States saw an 11 percent decrease in manufacturing employment over the course of those seven years; meanwhile, China saw a 15 percent decrease and Brazil a 20 percent decrease. Globally, the figure for manufacturing jobs lost is identical to the U.S. figure—11 percent. The fact that global manufacturing output increased by 30 percent in that same period confirms that technology, not trade, is the primary cause for the decrease in factory jobs. A recent analysis of employment data from U.S. multinational corporations by the U.S. Department of Commerce reached the same conclusion.

What about the service sector? Again, the data contradict the popular belief that U.S. jobs are being lost to foreign countries without anything to replace them. In the case of many low-level technology jobs, the phenomenon has been
somewhat exaggerated. For example, a Datamonitor study found that global call-center operations are being outsourced at a slower rate than previously thought—only five percent are expected to be located offshore by 2007. Dell and Lehman Brothers recently moved some of their call centers back to the United States from India because of customer complaints. And done properly, the offshore outsourcing of call centers creates new jobs at home. Delta Airlines outsourced 1,000 call-center jobs to India in 2003, but the $25 million in savings allowed the firm to add 1,200 reservation and sales positions in the United States.

Offshore outsourcing is similarly counterbalanced by job creation in the high-end service sector. An Institute for International Economics analysis of Bureau of Labor Statistics employment data revealed that the number of jobs in service sectors where outsourcing is likely actually increased, even though total employment decreased by 1.7 percent. According to the Bureau of Labor Statistics "Occupation Outlook Handbook," the number of IT-related jobs is expected to grow 43 percent by 2010. The case of IBM reinforces this lesson: although critics highlight the offshore outsourcing of 3,000 IT jobs, they fail to mention the company’s plans to add 4,500 positions to its U.S. payroll. Large software companies such as Microsoft and Oracle have simultaneously increased outsourcing and domestic payrolls.

How can these figures fit with the widespread perception that IT jobs have left the United States? Too often, comparisons are made to 2000, an unusual year for the technology sector because Y2K fears and the height of the dot-com bubble had pushed employment figures to an artificially high level. When 1999 is used as the starting point, it becomes clear that offshore outsourcing has not caused a collapse in IT hiring. Between 1999 and 2003, the number of jobs in business and financial industries increased by 14 percent. Employment in computer and mathematical positions increased by 6 percent.

It is also worth remembering that many predictions come from management consultants who are eager to push the latest business fad. Many of these consulting firms are themselves reaping commissions from outsourcing contracts. Much of the perceived boom in outsourcing stems from companies’ eagerness to latch onto the latest management trends; like Dell and Lehman, many will partially reverse course once the hidden costs of offshore outsourcing become apparent.

If offshore outsourcing is not the cause of sluggish job growth, what is? A study by the Federal Reserve Bank of New York suggests that the economy is undergoing a structural transformation: jobs are disappearing from old sectors (such as manufacturing) and being created in new ones (such as mortgage brokering). In all such transformations, the creation of new jobs lags behind the destruction of old ones. In other words, the recent recession and current recovery are a more extreme version of the downturn and "jobless recovery" of the early 1990s—which eventually produced the longest economic expansion of the post-World War II era. Once the structural adjustments of the current period are complete, job growth is expected to be robust. (And indeed, current indicators are encouraging: there has been a net increase in payroll jobs and in small business employment since 2003 and a spike in IT entrepreneurial activity.

Offshore outsourcing is undoubtedly taking place, and it will likely increase over the next decade. However, it is not the tsunami that many claim.

Its effect on the U.S. economy has been exaggerated, and its effect on the U.S. employment situation has been grossly exaggerated.

The Upside of Outsourcing

To date, the media's coverage of outsourcing has focused on its perceived costs. This leaves out more than half of the story. The benefits of offshore outsourcing should not be dismissed.

The standard case for free trade holds that countries are best off when they focus on sectors in which they have a comparative advantage—that is, sectors that have the lowest opportunity costs of production. Allowing countries to specialize accordingly increases productivity across all countries. This specialization translates into cheaper goods, and a greater variety of them, for all consumers.

The current trend of outsourcing business processes overseas is comparative advantage at work. The main driver of productivity gains over the past decade has been the spread of information technology across the economy. The customization of simple business services allows those benefits to spread further, making growth even greater.

The data affirm this benefit. Catherine Mann of the Institute for International Economics conservatively estimates that the globalization of IT production has boosted U.S. GDP by $230 billion over the past seven years; the globalization of IT services should lead to a similar increase. As the price of IT services declines, sectors that have yet to exploit them to their fullest—such as construction and health care—will begin to do so, thus lowering their cost of production and improving the quality of their output. (For example, cheaper IT could one day save lives by reducing the number of "adverse drug events." Mann estimates that adding bar codes to prescription drugs and instituting an electronic medical record system could reduce the annual number of such events by more than 80,000 in the United States alone.)

McKinsey Global Institute has estimated that for every dollar spent on outsourcing to India, the United States reaps between $1.12 and $1.14 in benefits. Thanks to outsourcing, U.S. firms save money and become more profitable, benefiting shareholders and increasing returns on investment. Foreign facilities boost demand for U.S. products, such as computers and telecommunications equipment, necessary for their outsourced function. And U.S. labor can be reallocated to more competitive, better-paying jobs; for example, although 70,000 computer programmers lost their jobs between 1999 and 2003, more than 115,000 computer software engineers found higher-paying jobs during the same period. Outsourcing thus enhances the competitiveness of the U.S. service sector (which accounts for 30 percent of the total value of U.S. exports). Contrary to the belief that the United States is importing massive amounts of services from low-wage countries, in 2002 it ran a $64.8 billion surplus in services.

Outsourcing also has considerable noneconomic benefits. It is clearly in the interest of the United States to reward other countries for reducing their barriers to trade and investment. Some of the countries where U.S. firms have set up outsourcing operations—including India, Poland, and the Philippines—are vital allies in the war on terrorism. Just as the North American Free Trade Agreement
(NAFTA) helped Mexico deepen its democratic transition and strengthen its rule of law, the United States gains considerably from the political realignment spurred by economic growth and interdependence.

Finally, the benefits of "insourcing" should not be overlooked. Just as U.S. firms outsource positions to developing countries, firms in other countries outsource positions to the United States. According to the Bureau of Labor Statistics, the number of outsourced jobs increased from 6.5 million in 1983 to 10 million in 2000. The number of insourced jobs increased even more in the same period, from 2.5 million to 6.5 million.

**Political Economy**

When it comes to trade policy, there are two iron laws of politics. The first is that the benefits of trade diffuse across the economy, but the costs of trade are concentrated. Thus, those made worse off by open borders will form the more motivated interest group. The second is that public hostility toward trade increases during economic downturns. When forced to choose between statistical evidence showing that trade is good for the economy and anecdotal evidence of job losses due to import competition, Americans go with the anecdotes.

Offshore outsourcing adds two additional political pressures. The first stems from the fact that technological innovation has converted what were thought to be nontraded sectors into tradeable ones. Manufacturing workers have long been subject to the rigors of global competition. White-collar service-sector workers are being introduced to these pressures for the first time—and they are not happy about it. As Raghuram Rajan and Luigi Zingales point out in "Saving Capitalism From the Capitalists," globalization and technological innovation affect professions such as law and medicine that have not changed all that much for centuries. Their political reaction to the threat of foreign competition will be fierce.

The second pressure is that the Internet has greatly facilitated political organization, making it much easier for those who blame outsourcing for their troubles to rally together. In recent years, countless organizations—with names such as Rescue American Jobs, Save U.S. Jobs, and the Coalition for National Sovereignty and Economic Patriotism—have sprouted up. Such groups have disproportionately focused on white-collar tech workers, even though the manufacturing sector has been much harder hit by the recent economic slowdown.

It should come as no surprise, then, that politicians are scrambling to get ahead of the curve. During the Democratic primary in South Carolina—a state hit hard by the loss of textile jobs—billboards asked voters, "Lost your job to free trade or offshore outsourcing yet?" Last Labor Day, President Bush pledged to appoint a manufacturing czar to get to the bottom of the outflow of manufacturing positions. In his stump speech, John Kerry bashes "Benedict Arnold CEOs who send American jobs overseas."

Where presidential candidates lead, legislators are sure to follow. Senator Charles Schumer (D-N.Y.) claimed in a January "New York Times" op-ed authored with Paul Craig Roberts that because of increased capital mobility, the law of comparative advantage is now null and void. Senator Tom Daschle (D-S.D.) has observed, "George Bush says the economy is creating jobs. But let me tell you, China is one long commute. And let me tell you, I'm tired of watching jobs shift overseas." Senator Christopher Dodd (D-Conn.) and Representative Nancy Johnson (R-Conn.) are sponsoring the USA Jobs Protection Act to prevent U.S. companies from hiring foreign workers for positions when American workers are available. In February, Senate Democrats announced their intentions to introduce the Jobs for America Act, requiring companies to give public notice three months in advance of any plan to outsource 15 or more jobs. In March, the Senate overwhelmingly approved a measure banning firms from federal contracts if they outsource any of the work overseas. In the past two years, more than 20 state legislatures have introduced bills designed to make various forms of offshore outsourcing illegal.

**Splendid Isolation?**

There are real examples of jobs being sent across U.S. borders because of U.S. trade policy—but not for the reasons that critics of outsourcing believe. Consider the example of candy-cane manufacturers: despite the fact that 90 percent of the world's candy canes are consumed in the United States, manufacturers have sent much of their production south of the border in the past five years. The attraction of moving abroad, however, has little to do with low wages and much to do with protectionism. U.S. quotas on sugar imports have, in recent years, caused the domestic price of sugar to become 350 percent higher than world market prices. As candy makers have relocated production to countries where sugar is cheaper, between 7,500 and 10,000 workers in the Midwest have lost their jobs—victims not of outsourcing but of the kind of protectionism called for by outsourcing's critics.

A similar story can be told of the steel tariffs that the Bush administration foolishly imposed from March 2002 until December 2003 (when a ruling by the World Trade Organization prompted their cancellation). The tariffs were allegedly meant to protect steelworkers. But in the United States, steel users employ roughly 40 times more people than do steel producers. Thus, according to estimates by the Institute for International Economics, between 45,000 and 75,000 jobs were lost because higher steel prices made U.S. steel-using industries less competitive.

These examples illustrate the problem with relying on anecdotes when debating the effects of offshore outsourcing. Anecdotes are incomplete narratives that fail to capture opportunity costs. In the cases of steel and sugar, the opportunity cost of using protectionism to save jobs was the much larger number of jobs lost in sectors rendered less productive by higher input prices. Trade protectionism amounts to an inefficient subsidy for uncompetitive sectors of the economy, which leads to higher prices for consumers and a lower rate of return for investors. It preserves jobs in less competitive sectors while destroying current and future jobs in sectors that have a comparative advantage. Thus, if barriers are erected to prevent offshore outsourcing, the overall effect will not be to create jobs but to destroy them.

So if protectionism is not the answer, what is the correct response? The best piece of advice is also the most difficult for elected officials to follow: do no harm.
Politicians never get credit for inaction, even when inaction is the best policy. President George H.W. Bush, for example, was pilloried for refusing to follow Japan’s lead by protecting domestic markets—even though his refusal helped pave the way for the 1990s boom by letting market forces allocate resources to industries at the technological frontiers. Restraint is anathema to the political class, but it is still the most important response to the furor over offshore outsourcing. As Robert McTeer, president of the Federal Reserve Bank of Dallas, said when asked about policy responses to outsourcing, "If we are lucky, we can get through the year without doing something really, really stupid."

The problem of offshore outsourcing is less one of economics than of psychology—people feel that their jobs are threatened. The best way to help those actually affected, and to calm the nerves of those who fear that they will be, is to expand the criteria under which the Trade Adjustment Assistance (TAA) program applies to displaced workers. Currently, workers cannot apply for TAA unless overall sales or production in their sector declines. In the case of offshore outsourcing, however, productivity increases allow for increased production and sales—making TAA out of reach for those affected by it. It makes sense to rework TAA rules to take into account workers displaced by offshore outsourcing even when their former industries or firms maintain robust levels of production.

Another option would be to help firms purchase targeted insurance policies to offset the transition costs to workers directly affected by offshore outsourcing. Because the perception of possible unemployment is considerably greater than the actual likelihood of losing a job, insurance programs would impose a very small cost on firms while relieving a great deal of employee anxiety. McKinsey Global Institute estimates that such a scheme could be created for as little as four or five cents per dollar saved from offshore outsourcing. IBM recently announced the creation of a two-year, $25 million retraining fund for its employees who fear job losses from outsourcing. Having the private sector handle the problem without extensive government intervention would be an added bonus.

The Best Defense

Until robust job growth returns, the debate over outsourcing will not go away—the political temptation to scapegoat foreigners is simply too great.

The refrain of "this time, it’s different" is not new in the debate over free trade. In the 1980s, the Japanese variety of capitalism—with its omniscient industrial policy and high non-tariff barriers—was supposed to supplant the U.S. system. Fifteen years later, that prediction sounds absurd. During the 1990s, the passage of NAFTA and the Uruguay Round of trade talks were supposed to create a "giant sucking sound" as jobs left the United States. Contrary to such fears, tens of millions of new jobs were created. Once the economy improves, the political hysteria over outsourcing will also disappear.

It is easy to praise economic globalization during boom times; the challenge, however, is to defend it during the lean years of a business cycle. Offshore outsourcing is not the boogeyman that critics say it is. Their arguments, however, must be persistently refuted. Otherwise, the results will be disastrous: less growth, lower incomes—and fewer jobs for American workers.
