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Beyond the Outsourcing Angst:
Making America More Productive

by Thomas F. Siems

The best companies keep costs low and boost productivity by doing what they do best and outsourcing the rest.

Outsourcing is not new. For years, American companies have focused on core competencies and contracted out activities that could be accomplished better, faster and cheaper by outside, specialized providers. These vendors may be across town, elsewhere in the country or on the far side of the world.

The motive has always been to remain competitive. In today's business environment, profit and even survival depend on making constant improvements throughout supply chains by lowering costs and improving quality, designs, cycle times and processes. Through specialization and trade, businesses develop important competitive advantages that help them become more flexible and innovative in rapidly changing markets.

Indeed, the best companies keep costs low and boost productivity by doing what they do best and outsourcing the rest.[1]

Even when it involves foreign workers, outsourcing benefits individual companies. Many Americans, however, express a deep unease over reports of firms' "exporting jobs" and displacing domestic workers by moving jobs to India, China or other up-and-coming nations.

One reason today's overseas outsourcing generates heat is the wider swath of occupations being performed offshore.

The concern is understandable. Job losses are painful, especially when they are related to global economic forces beyond individual workers' control. As reports of outsourcing grow, many Americans are advocating policies designed to preserve existing jobs and industries. But many economists—including such notables as Milton Friedman and Jagdish Bhagwati—discourage these efforts as harmful to the overall economy.[2] They argue that outsourcing increases efficiency and productivity and leads to competitiveness, innovation and ever-larger market opportunities.

Knowledge Workers at Risk

One reason today's overseas outsourcing generates heat is the wider swath of occupations being performed offshore. Computers, software, the Internet and fiber-optic cables form an infrastructure that allows businesses to break apart activities and redistribute them elsewhere—increasingly to knowledge workers all over the world. Digital technologies and inexpensive telecommunications have created an efficient and effective information superhighway: Strings of zeroes and ones can be moved to Bangalore, Beijing or just about anyplace in seconds.

White-collar activities such as processing accounting data, performing standard financial analyses, writing routine software and maintaining call centers are no longer exempt from international competition. With an Internet connection and specialized skills, individuals and companies in the remotest ends of the earth are able to compete and collaborate in today's global economy.

How many knowledge jobs are affected by offshore outsourcing? Data on outsourcing's effect on employment are limited, but one estimate puts the total number of U.S. white-collar jobs moving overseas at 832,000 through

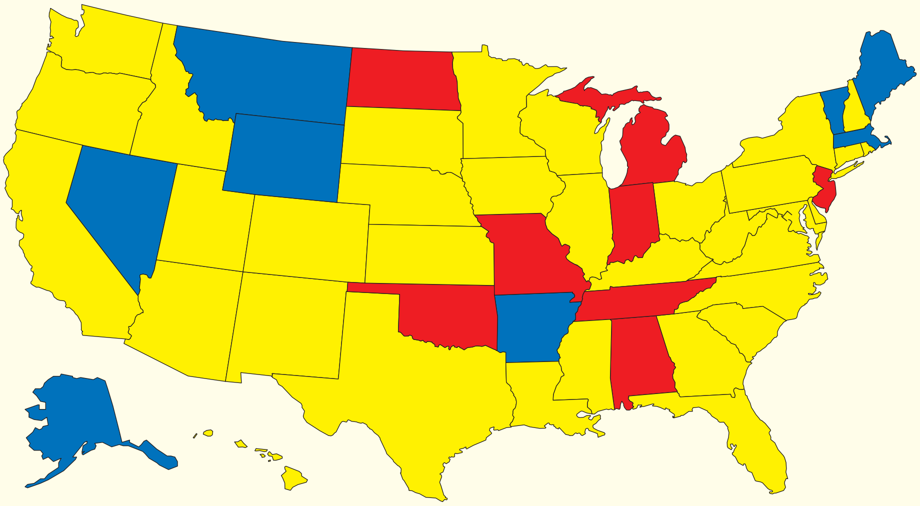
Table 1
Offshoring of U.S. Jobs to Low-Wage Countries

	Estimated	Projected		
Profession	2003	By 2005	By 2010	By 2015
Art, design	2,500	8,000	15,000	30,000
Architecture	14,000	46,000	93,000	191,000
Business	30,000	91,000	176,000	356,000
Computer	102,000	181,000	322,000	542,000
Legal	6,000	20,000	39,000	79,000
Life sciences	300	4,000	16,000	39,000
Management	3,500	34,000	106,000	259,000
Office	146,000	410,000	815,000	1,600,000
Sales	11,000	38,000	97,000	218,000
Total	315,300	832,000	1,679,000	3,314,000

NOTE: Numbers are cumulative and have been rounded.

SOURCE: "Near-Term Growth of Offshoring Accelerating," by John C. McCarthy, Forrester Research Inc., May 14, 2004.

Chart 1
Anti-Outsourcing Legislation, 2005



SOURCE: National Foundation for American Policy.

2005, nearly triple the figure through 2003 *(Table 1)*. In another five years, the total could rise to 1.7 million; in a decade, to 3.3 million. We should keep in mind, however, that the U.S. has added 18 million jobs in the past 10 years. Total employment rose to nearly 135 million workers in early 2006, so the offshore outsourcing estimates represent a relatively small part of a growing economy.

The recent increase in offshore relocation of knowledge work has been followed by a surge in anti-outsourcing legislation by U.S. state governments *(Chart 1)*. According to the National Foundation for American Policy, more than 300 bills have been introduced over the past two years to protect American workers against outsourcing to other countries.[3] The Constitution's commerce clause constrains the states' power to interfere with business, so many of these proposals are limited, often covering only companies doing government work.

Outsourcing is fundamentally a trade phenomenon, and empirical evidence suggests protectionist policies entail significant economic costs. They result in higher prices for consumers and declining domestic and global competitiveness. The economy also loses the productivity gains that would have come from shifting resources to their best uses. Trade barriers do long-term harm by short-circuiting healthy economic evolution.[4]

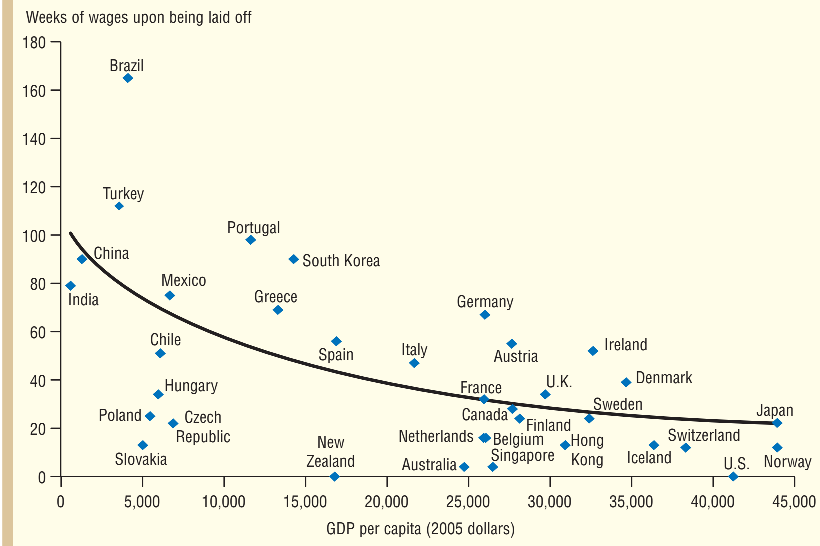
Protectionist measures rarely save jobs. A generation ago, American angst focused on foreign competition's impact on manufacturing employment, particularly in automobiles, steel and textiles. We passed laws to restrict imports. Despite trade restraints and domestic-content laws, manufacturing jobs continued to decline even as overall employment rose. Most significant, some of the biggest job losses have come in autos, steel and textiles.

Saving existing jobs exacts a price. Countries that impose laws aimed at

Protectionist policies entail significant economic costs. Trade barriers do long-term harm by short-circuiting healthy economic evolution.

Chart 2

Job Security and Income per Capita



NOTE: A similar relationship is obtained using purchasing power parity adjustments for GDP per capita. James J. Heckman and Carmen Pagés, in "The Cost of Job Security Regulation: Evidence from Latin American Labor Markets," NBER Working Paper 7773, June 2000, obtain parallel findings using 1995 GDP data for Latin America.

SOURCES: World Bank, World Development Indicators Database; World Bank Group, Doing Business 2006.

Outsourcing often creates employment uncertainties because it's not always immediately apparent where the new jobs will materialize. History tells us, however, that job creation outpaces job destruction in the long run.

easing the burdens of job loss tend to have lower per capita incomes *(Chart 2)*. World Bank data indicate that many countries impose huge burdens on employers who lay off workers—the equivalent of 165 weeks of pay in Brazil, 112 in Turkey, 90 in China, 79 in India. All are poor countries. High firing costs rob economies of their vitality by discouraging companies from hiring new employees in the first place. While generous severance is helpful to the displaced workers, it makes societies poorer by slowing job creation and dragging down labor productivity.

By contrast, countries with lower burdens on firing are usually richer. The United States, for example, mandates no severance at all, allowing companies to determine their own policies. Giving companies a freer hand in staffing decisions allows firms to pare payrolls quickly in response to changing market conditions, and it reduces the risk of hiring and forming new businesses. This labor market flexibility encourages efficiency, productivity and economic growth—all of which contribute to higher incomes.

Outsourcing often creates employment uncertainties because it's not always immediately apparent where the new jobs will materialize. History tells us, however, that job creation outpaces job destruction in the long run. If the U.S. had tried to hang onto the jobs of its past, we would be far poorer today. Living standards would have stagnated, and American consumers would be paying higher prices.[5]

Economists Milton and Rose Friedman put it this way, "If all we want are jobs, we can create any number—for example, have people dig holes and then fill them up again or perform other useless tasks." The Friedmans conclude that the real objective is not just jobs, but productive jobs—those that will result in more goods and services for consumers around the globe.[6]

Toward Greater Productivity

The most successful economies tend to resist calls for protectionism and keep their markets open. This sometimes means short-term economic dislocations, but in the long run competition spurs economic progress. The challenge for U.S. companies and workers involves reinventing themselves and creating the next generation of jobs, products and services.

Recent history proves that lost jobs, while they often mean hardship for the affected workers and their families, aren't an impediment to growth in one of the world's most resilient, dynamic and flexible economies. From 1980 to 2005, U.S. workers filed 118 million claims for unemployment insurance *(Table 2)*. Many others lost their jobs, of course, but either didn't qualify for benefits, weren't unemployed long enough to file claims, or quickly transitioned to new jobs. It's hard to find the total number of displaced workers, but it surely would be more than 150 million.

Despite all the job losses, the economy performed quite well. Total employment over the same 26-year period rose by 44 million. At annual rates, unemployment fell from 7.2 percent to less than 5 percent today. Productivity increased by 72 percent. Per capita real gross domestic product shot from $25,309 to $41,257. The average workweek fell by nearly two hours to 33.7, and average household real net worth more than doubled to $431,000. All this was accomplished, by the way, with relatively little economic downtime. Since the beginning of 1983, the United States has had just 16 months of recession, fewer than any other major country *(Table 3)*.

Increasing productivity—getting more for less—is key to business success and the ultimate source of higher living standards. Sometimes greater

Table 2
The Churn: Recycling America's Labor

Year	Initial claims*	Dec.-to-Dec. net job gains*	End-of-year employment*	End-of-year unemployment rate (percent)	Productivity (index, 1980=100)
1980	5,850	267	90,936	7.2	100
1981	5,419	(52)	90,884	8.5	102
1982	7,033	(2,128)	88,756	10.8	101
1983	5,294	3,454	92,210	8.3	105
1984	4,484	3,877	96,087	7.3	108
1985	4,702	2,500	98,587	7.0	110
1986	4,529	1,897	100,484	6.6	113
1987	3,897	3,150	103,634	5.7	114
1988	3,704	3,237	106,871	5.3	116
1989	3,950	1,938	108,809	5.4	117
1990	4,616	309	109,118	6.3	119
1991	5,363	(857)	108,261	7.3	121
1992	4,905	1,157	109,418	7.4	126
1993	4,117	2,785	112,203	6.5	127
1994	4,076	3,853	116,056	5.5	128
1995	4,298	2,154	118,210	5.6	128
1996	4,223	2,793	121,003	5.4	132
1997	3,858	3,358	124,361	4.7	135
1998	3,810	3,003	127,364	4.4	139
1999	3,563	3,172	130,536	4.0	143
2000	3,590	1,948	132,484	3.9	147
2001	4,869	(1,763)	130,721	5.7	150
2002	4,852	(535)	130,186	6.0	156
2003	4,823	112	130,298	5.7	163
2004	4,114	2,097	132,395	5.4	168
2005	3,985	1,976	134,371	4.9	172
Total	117,924	43,702			
Avg./month	378	140			

*Establishment survey, data in thousands. Claims are for unemployment insurance.

SOURCES: Bureau of Labor Statistics; Federal Reserve Board.

Recent history proves that lost jobs, while they often mean hardship for the affected workers and their families, aren't an impediment to growth in one of the world's most resilient, dynamic and flexible economies.

Table 3
Economic Downtime, 1983–2005

	Recession	
	Months	Percent of time
U.S.	16	5.8
U.K.	22	8.0
Australia	23	8.3
Canada	24	8.7
Italy	25	9.1
Austria	36	13.0
Spain	42	15.2
France	42	15.2
Sweden	43	15.6
Germany	70	25.4
Japan	82	29.7
New Zealand	85	30.8
Switzerland	87	31.5

SOURCES: National Bureau of Economic Research; Economic Cycle Research Institute.

Globalization doesn't just mean increased competition; it opens opportunities for cooperation.

productivity means automating processes and replacing workers with improved technologies. Sometimes it entails adding resources to work on high value-added activities. Sometimes it involves moving noncritical work to lower-cost providers.

Today, global firms increasingly use outsourcing to redeploy and redirect staff to higher value-added activities. Farming out some tasks frees up talent to work on new products and new ideas. It creates greater worker flexibility and allows firms to put the right resources in the right places at the right times.

Competition gives companies the incentive to move production to lower-cost locations. Large segments of the textile industry left New England for the Southeast; more recently, textile plants in the Carolinas have closed as companies shift production to other parts of the world. Automobile manufacturers sent a lot of their parts and assembly work to Mexico in an effort to compete with Asian rivals. The electronics industry has developed a global supply chain, and it takes components from a hodgepodge of nations to build computers and other gadgets.

Laptops, for example, are assembled in Mexico with memory chips and display screens from South Korea; cases, keyboards and hard drives from Thailand; graphics chips from Taiwan; and batteries from any number of Asian countries. The microprocessor, the machine's highest valued and most complex part, is still made in the United States. This is the future of business—a global integration of production, where countries do what they do best, dictated by David Ricardo's principle of comparative advantage.

As a technological powerhouse, with skilled workers and adept managers, the U.S. should strive for the most complex and rewarding tasks, while other countries will specialize in the routine, labor-intensive tasks. Globalization doesn't just mean increased competition; it opens opportunities for cooperation.

Outsourcing creates partners, not rivals. For example, India has historically been viewed as an attractive place to do knowledge work because of its low production and labor costs, talented and skilled workforce, and English-language proficiency. A.T. Kearney Inc. ranks India as the most attractive offshore location for doing business *(Chart 3)*, particularly for call centers and data-processing operations. Among the U.S. companies expanding their presence in India are Dell, Sun Microsystems, Ford, General Electric and Oracle.

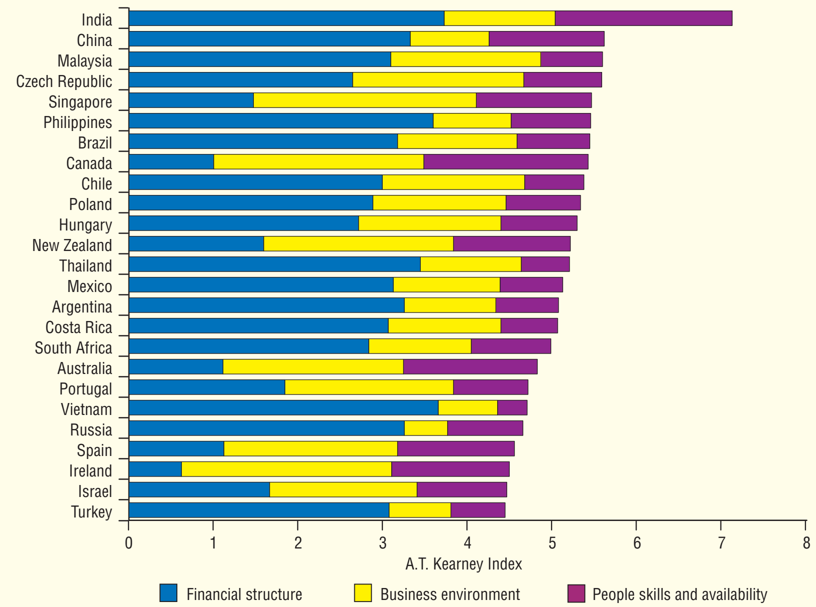
The key differences between India two decades ago and now are twofold: (1) the role that technology has played in quickly and inexpensively subdividing and moving work, and (2) the nation's willingness to remove regulatory burdens and attract foreign firms to establish operations there. The availability, affordability and speed of today's technologies allow Indian workers to instantaneously provide highly competitive services to organizations around the globe. And since the new era of fewer regulatory burdens began in 1991, foreign direct investment into India has increased dramatically *(Chart 4)*.

History has proven the power of letting global competition run its course: Many better, higher-paying jobs have been created as new ideas and technologies replace older ones. The key to the U.S. economy's future lies in maintaining a flexible labor market, where resources can flow from declining sectors to emerging ones. Innovation and entrepreneurship depend on it. Job losses and other unsettling aspects of the process can't be ignored, and society can consider policies to make economic change less burdensome. Preparing workers for new opportunities through retraining and education is often mentioned as an alternative to protecting existing jobs.

Outsourcing's Future

Offshore outsourcing presents complex and often divisive issues, but

Chart 3
Offshore Location Attractiveness



NOTE: Financial structure is rated on a scale of 1 to 4; business environment and people skills and availability are on a scale of 1 to 3.

SOURCE: A.T. Kearney Inc.

The key to the U.S. economy's future lies in maintaining a flexible labor market, where resources can flow from declining sectors to emerging ones.

it is unlikely to wither away. The market pressures that create incentives for outsourcing will not abate. Our economy, however, is resilient and flexible. The long-run evidence on employment-turnover patterns demonstrates that offshore outsourcing results in overall economic gains, such as lower consumer prices, better products and higher productivity growth.

Like other trade, offshore outsourcing can have negative impacts on some jobs and wages while affecting others in a positive way. These structural changes influence where jobs are located and what tasks workers perform. While policy can address ways to help displaced workers gain the necessary skills to compete in the global economy, it also can encourage Americans to embrace change and adapt to globalization's effects on the changing nature of work.

We have a choice. Saving specific jobs and industries inhibits innovation and short-circuits the next round of new jobs and services, raising prices for everyone.

Accepting the challenge of competition, however, takes a longer-run view. It leads to innovation and ever-larger market opportunities and, in the end, true productive job creation and a lower cost of living. Indeed, the secret to faster growth and greater prosperity lies in allowing individuals and businesses to do what they do best—and outsource the rest.

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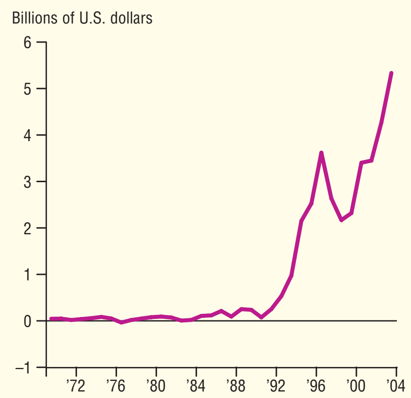
Chart 4
Foreign Direct Investment into India



SOURCE: United Nations, World Investment Report.

Beyond the Outsourcing Angst

(continued from page 7)

Notes

The author thanks Julia Carter and Timothy J. Schaaf for assistance in research.

[1] A prelude to this article is "Do What You Do Best, Outsource the Rest?" by Thomas F. Siems and Adam S. Ratner, Federal Reserve Bank of Dallas *Southwest Economy*, November/December 2003, pp. 13–14.

[2] The debate over outsourcing is clearly framed in "The Muddles over Outsourcing," by Jagdish Bhagwati, Arvind Panagariya and T.N. Srinivasan, *Journal of Economic Perspectives*, vol. 18, no. 4, Fall 2004, pp. 93–114.

[3] "Outsourcing Saves Money," by Stuart Anderson, *State Legislatures Magazine*, June 2005, and "Outsourcing Attacks Not Over," by Stuart Anderson, *National Review*, February 11, 2005.

[4] Interested readers are directed to *In Defense of Globalization*, by Jagdish Bhagwati, New York: Oxford University Press, 2004.

[5] Job anxieties brought on by offshore outsourcing highlight the tension between efficiency and distributional concerns. See "A Specific-Factors View on Outsourcing," by Wilhelm Kohler, *North American Journal of Economics and Finance*, vol.12, issue 1, 2001, pp. 31–53, and "What Does Evidence Tell Us About Fragmentation and Outsourcing?" by Ronald Jones, Henryk Kierzkowski and Chen Lurong, *International Review of Economics and Finance*, vol. 14, 2005, pp. 305–16.

[6] "The Case for Free Trade," by Milton Friedman and Rose Friedman, *Hoover Digest*, no. 4, 1997.

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