What Has Outsourcing Done to the Economy?

by Professor Sarah Rummery

"*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. 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*." [1]

Outsourcing is a very controversial political issue in 2004, however it is not controversial when viewed from the economist's perspective. In fact, there is a strong economic justification for outsourcing, however politically unpalatable that may be. We are currently witnessing the discomfort that arises when the political realities of a slow economic recovery in an election year coincide with the outcomes predicted by free market economics.

The economic theory referred to in the preceding paragraph is that of David Ricardo (1772-1823). Ricardo developed an economic theory to explain trade flows between countries. His model was based on the notion that relative cost advantages should determine what a country produces and therefore what it exports and imports. If relative cost advantages do in fact form the basis of production decisions, then all nations would be better off as more total output could be produced and living standards would increase. This became known as the theory of comparative advantage, and is a core component of every principles of economics class. "*Ricardo emphasized the supply side of the market. The immediate basis for trade stemmed from cost differences between nations, which were underlaid by their natural and acquired advantages.*" [2]

How then does comparative advantage explain outsourcing of jobs? Firstly, businesses, the employers of labor, are assumed to be profit maximizers and secondly, many of these same businesses operate in a competitive market. Many businesses use standardized services for which there is no requirement of geographic proximity by the supplier. This then creates a chain of events culminating in what we now know as outsourcing. Business owners must be concerned with cost containment and labor is an expensive resource. If a lower cost form of labor can provide the same service, theory would predict that a profit maximizing business owner should employ the lower cost resource, assuming quality is comparable, and assuming such a choice is not prohibited by law. To frame this in financial terms, the Bureau of Labor Statistics (hereafter BLS) reported in December 2003 that the average hourly compensation for a U.S. worker in the service sector of the economy was $13.92. Of this, $10.08 was the hourly wage and $3.83 was benefits[3]. In comparison, the average hourly wage for a call center employee in India is $2.00[4]. The cost savings are large and difficult to ignore.

The obvious and immediate consequence resulting from the decision to outsource jobs, is that workers in the U.S. location can and do become unemployed. As economists will point out, there are winners and losers associated with all economically motivated actions. However, if the benefits to society outweigh the costs, the action would be considered worthwhile. Also to be considered is the time frame in which the costs and benefits occur. The costs of outsourcing, borne primarily by the displaced workers and their

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[1] *The Outsourcing Bogeyman*, by Daniel W. Drezner, Foreign Affairs, May/June 2004.

[2] Carbaugh, Robert J. *International Economics.* 9th Edition. South-Western Publishing 2004.

[3] NEWS, United States Department of Labor, Employer Costs for Employee Compensation, Table 9: Employer Costs per hour worked for employee compensation, Private Industry, by major occupational and industry group, December 2003.

[4] "*Global Linkages in the IT workforce: The Case of India*" by Rafiq Dosanni, Stanford University. Presentation to IBM Almaden Research Center, March 2004.

communities, are hopefully short run. Under the assumptions that labor is both mobile and able to be retrained, the displaced labor will ultimately be reemployed in another industry. The business (that has outsourced) will be more profitable, and therefore be more likely to create new jobs in greater numbers in the future, both in the U.S and overseas locations, and pass the cost savings on to consumers in the form of lower prices. Finally, scarce resources are not used to produce something in which the country no longer has the comparative advantage. Benefits such as these will be experienced in both the short and long run. An important caveat to this discussion, and one that is recognized by the current administration is that the benefits of outsourcing will not be as large if displaced workers are not reemployed.

With this in mind, the Bush administration has announced a new job training initiative (April 2004). One element of this initiative is to introduce "innovation training accounts", that will provide a stipend to workers in order for them to upgrade their skills or seek training. Existing legislation already provides financial help to eligible workers who were laid off as a result of foreign competition. The Trade Adjustment Assistance Reform Act, signed into law in August 2002, provides displaced workers with financial benefits and tax credits for health insurance and training. The purpose is to ease the burden of job loss. This legislation extends benefits to eligible workers until 2007.

Despite the costs in terms of lost jobs and displaced workers, many economists argue that the benefits derived from outsourcing are substantial. One estimate of these benefits has been provided by McKinsey Global Institute[5] and predicts that for every $1 spent on outsourcing in India (by a U.S. company), a multiplier effect creates a total return of between $1.45 and $1.47. Of this total return, the U.S. reaps between $1.12 and $1.14 in benefits, while India gains approximately $0.33. U.S. firms lower their costs, increase profits and provide a greater rate of return to investors. In fact, not only is the consensus amongst economists that outsourcing makes good financial sense, some have predicted that outsourcing will become a necessity due to the changing demography and age distribution in the U.S. "*The United States will be losing people rather than jobs as the population ages. The result, assuming growing GDP, will be a demand-supply gap of 5.6 million jobs by 2010. Industries facing a shortfall will include IT and healthcare.*"[6]

Despite the negative connotation currently attached to the term outsourcing, the data tend to suggest that outsourcing is small relative to the size of the labor market. Relative to total employment, the number of jobs that could be outsourced is limited because "*90% of jobs in the U.S. require geographic proximity*" (Drezner 2004), so the idea that outsourcing is a major threat to employment is clearly not true.

A November 2002 prediction by Forrester Research (an independent technology research company) is that by 2015, 3.3 million service industry jobs will have been outsourced to foreign countries. This number of jobs, while large, is inconsequential when compared to the millions of jobs destroyed and created every year in the U.S. economy, a process known as job churning. During 1994-1995 alone, 3.5 million private sector jobs were added to the economy. "*..but that was after new firms created 5.7 million jobs, failing firms eliminated 4.5 million jobs, expanding firms added 10.5 million jobs, and contracting firms eliminated 8.2 million others*."[7] Additionally, the BLS reports that trade related layoffs (even at their peak in 2001) represented only 0.6% of total U.S. unemployment.

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[5] "*Who Wins in Offshoring*", McKinsey Quarterly, 2003, Number 4.

[6] *Offshore outsourcing may not cause flood of lost jobs*, Information Week, November 2003.

[7] *The Metropolitan New Economy Index, Benchmarking Economic Transformation in the Nations Metropolitan Areas*, by Robert D. Atkinson and Paul D. Gottlieb, April 2001.

Evidence from the U.S. Department of Commerce also suggests that outsourcing is not a huge issue for the economy. In fact, the U.S. has a substantial trade surplus of $4.2 billion in the IT services most affected by outsourcing. [8]

It is impossible to divorce the current political reaction to outsourcing from election year realities. This was epitomized by the negative reaction by Republicans and Democrats alike to comments by N. Gregory Mankiw (the chairman of the Council of Economic Advisors to the President). On February 9th 2004, the Annual Economic Report of the President was released. As Chairman of the Council, Mankiw met with the press and created a political firestorm, when amongst other things he was quoted as saying: "*outsourcing is just a new way of doing international trade, more things are now tradable than were tradable in the past. And that's a good thing…outsourcing is sort of the latest manifestation of the gains from trade that economists have talked about at least since Adam Smith*." [9] The anger at his comments derived from the perception that he was insensitive to the loss of U.S. jobs.

Political posturing and election year considerations have given rise to several examples of legislation designed to reduce outsourcing. In February 2004, Senate Democrats announced their intention of introducing a "Jobs for America Act", which would require companies to give public notice three months in advance of any plan to outsource 15 or more jobs. In March of 2004, the senate approved a measure banning firms from federal contracts if they planned to outsource any of the work overseas. A newly released report by the National Foundation for American Policy (NFAP) cites 36 State legislatures that have introduced more than 100 bills to restrict overseas outsourcing. The NFAP paper suggests that such laws may in fact be unconstitutional. "*Prohibitions on state contract work being performed overseas are the most legally suspect category of proposed outsourcing legislation, since courts would likely find that such measures improperly intrude on the federal foreign affairs power and violate the U.S. Constitutions Foreign Commerce Clause*." [10]

While politically popular, the consensus amongst economists is that such legal restrictions on free trade are at best misguided. In the September 2003 issue of CIO (Chief Information Officer) magazine, Christopher Koch argues, that rather than putting up barriers to outsourcing, the Government should be thinking of ways to encourage and create a more flexible workforce, better able to respond to the outsourcing threat. For example, making retirement plans and health insurance more flexible and portable across jobs. Providing tax credits to older workers who want to relocate for a new job, or return to college to become retrained. Rigidity and lack of flexibility in the labor market and specifically in work related health and retirement plans, is considered more problematic in the long run, than outsourcing.

A 2003 Morgan Stanley Survey of 225 Fortune 1000 CIO's found that at least 25% of the respondents said they would plan to spend on offshore IT services in 2004. The general perception of many of these same CIO's is that outsourcing as a business practice is only in its infancy.

In conclusion it would appear that whilst there are certainly costs associated with outsourcing, specifically in the form of lost jobs, there are also substantial benefits. The difficult political reality is that the costs are concentrated and tangible (and widely reported on programs such as CNN's Dobbs Report), while the benefits (from the perspective of the average consumer) are more difficult to quantify (such as lower prices, and higher returns to shareholders). In other words, the costs and benefits are not equally borne and distributed across society. However, the consensus amongst economists is that in aggregate, the benefits outweigh the costs. Minimizing the costs involves instituting arrangements that increase worker

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[8] U.S. Department of Commerce, Digital Economy 2003, p. 42.

[9] *Outsourcing of U.S. jobs comes under sharp criticism*, by Berta Gomez, Washington File.

[10] *Exporting the Law; A Legal Analysis of State and Federal Outsourcing Legislation*, by Shannon Klinger and M. Lynn Sykes, April 2004, NFAP.

flexibility and mobility, and also efforts by government and non-governmental agencies to facilitate retraining and reemployment of displaced workers.

"*Calls for new trade restrictions to preserve current jobs are misguided. There is no significant difference between jobs lost because of trade and those lost because of new technologies or work processes. All of those job losses are a painful but necessary part of the larger process of innovation and productivity increases that is the source of new wealth and rising living standards*." [11]

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Submitted May 19, 2004

[11] "*Job Losses and Trade, A reality check*" by Brink Lindsey, March 2004. Trade Briefing Paper, Center for Trade Policy Studies.