Is your job headed for Bangalore?

The Myths and Realities of Outsourcing

By Martin N. Baily and Diana Farrell

With the digital revolution

and the dramatic fall in international telecommunications costs comes the prospect that white collar jobs, long insulated from global competition, can be performed offshore in countries where labor can be had for as little as one-tenth its cost in the United States. Call-center agents, data processors, medical technicians and software programmers are all finding their jobs at risk from the nation's growing trade in services with emerging markets. In fact, offshoring is often blamed for the agonizingly slow pace of job growth in the United States during the current economic recovery.

Even free-trade advocates have wavered in their convictions that open is always better. Pessimists warn that millions of Americans will lose their jobs to an army of disciplined, educated Indian and Chinese workers. In response, Congress's 2004 omnibus spending bill included a provision that prohibits federal agencies from outsourcing some kinds of work to private companies that use workers in foreign countries. Twenty-three states are considering similar restrictions, and at least four have already passed them.

The debate over outsourcing, which cast a long shadow over this year's election campaign in the Midwest, is misplaced, however, because the issue is not globalization, but the way nations allocate the benefits of economic integration. Trade in labor services, like other international trade, benefits the United States as a whole by making the economic pie big-

ger and raising the standard of living. Outsourcing jobs abroad can help keep companies profitable, thereby preserving other jobs in the United States. The cost savings can be used to lower prices, and in some cases to offer consumers better service. And by increasing their productivity, offshoring enables companies to invest more in the new technologies that will create jobs at home. With the world's most flexible and innovative economy, the United States is uniquely positioned to benefit from the trend.

Of course, what is good for the economy as a whole is not good for every individual. History and common sense confirm that outsourcing will cost some workers their jobs. But this painful reality does not weaken the case for free trade. The United States could enjoy the benefits of free trade in services while protecting individuals with programs that help workers make the transition to new jobs. These programs might include job retraining opportunities and generous mandated severance packages, portable health and pension benefits, and wage insurance.

HOW THE UNITED STATES BENEFITS

We looked into what happens to a dollar of U.S. corporate spending when a company moves a service job to India. We found that, far from being a zero-sum game, offshoring is a story of mutual gain, benefiting both countries. The receiving economy (India) captures 33 cents, in the form of wages paid to local workers, profits earned by local outsourcing providers and their suppliers, and taxes collected from second- and third-tier suppliers to the outsourcing companies.

But the gains to the U.S. economy are much larger. The most obvious source of value is the cost savings enjoyed by U.S. companies. For every dollar of corporate spending that moves offshore, American businesses save 58 cents. Companies can reinvest the savings in new business opportunities, pay additional dividends to shareholders, or both. Moreover, because wages are lower in the relevant foreign labor markets, companies can hire more (as well as better-qualified) workers to do the same job, and spend more on supervision and training. Some companies have found that offshore workers are more highly motivated and perform better, particularly in low-skilled jobs that lack prestige and suffer from high turnover at home. One British bank's call-center agents in India process 20 percent more transactions than their counterparts in the United Kingdom and have a 3 percent higher accuracy level.

Consumers benefit, too, as companies are forced to pass on savings in the form of lower prices – much as they now benefit from trade in goods. New research by Catherine Mann of the Institute for International Economics found that the globalization of computer manufacturing has reduced the cost of hardware by as much as 30 percent, thereby boosting demand and adding roughly $230 billion to the U.S. GDP since 1995. Trade in services will do the same. A medical technician in India, for instance, can read an MRI scan at a fraction of the cost of a comparable analysis in the United States. Transferring that position to India may cause an American technician to

PREVIOUS PAGE: ©DAVID H. WELLS/CORBIS; LEFT: ©MARGOT GRANITSAS/THE IMAGE WORKS; RIGHT: ©MICHAEL WOLF/VISUM/THE IMAGE WORKS be laid off, but lower prices for these lifesaving technologies enable more sick people to receive scans.

Offshoring yields benefits for the U.S. economy in other ways as well. First, Indian companies that sell the services will also import goods and services – everything from telecommunications equipment to legal and financial expertise. A call center in Bangalore is likely to be filled with HP computers, Microsoft software and telephones from Lucent, and to be audited by PricewaterhouseCoopers. We estimate that for every dollar of corporate spending that moves abroad, offshore companies buy five cents' worth of goods and services from the United States. On top of that, young Indian workers employed by outsourcing firms buy imported goods. Thanks to these corporate and individual buyers, exports from the United States to India stood at $5 billion in 2003, up from $3.7 billion in 2000.

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In addition, the U.S. economy benefits because many Indian outsourcing firms are owned in whole or in part by U.S. companies, including General Electric and EDS, that repatriate their earnings. In this way, another four cents of every dollar spent abroad returns to the United States.

All told, the direct benefits to the United States from corporate savings, added exports and repatriated profits total 67 cents – twice the benefit to India. But the gains don't end there. Corporate savings may be invested in new businesses in the United States, and that investment will boost productivity as well as creating jobs. Based on historical experience, these new jobs will, on average, add more value than the ones lost: carriage makers were replaced by auto assemblers, and farmers by processed food factory workers.

Indeed, this has been the pattern in recent decades as manufacturing jobs moved offshore. U.S. manufacturing employment shrank by two million in the past 20 years – but net employment increased by 43 million jobs in other areas, including educational and health services, professional and business services, trade and transport, government, leisure and hospitality, and financial services. Over the same period, domestic manufacturing output increased despite the decline in the number of manufacturing workers, because factories became much more productive. Higher productivity means a higher national income and a higher standard of living.

The pattern is likely to be repeated as jobs in call centers, back-office operations, and information technology services go offshore. Opportunities will appear to redeploy labor and invest capital to generate higher-value-added occupations will appear. The Bureau of Labor Statistics estimates that between 2000 and 2010, the United States economy will create 22 million jobs (net of jobs lost), mostly in business services, health care, social services, transportation and communications.

The Bureau of Labor Statistics also predicts that computer-related occupations –

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often thought to be at high risk of offshoring – will be among the fastest-growing domestic job categories. While code writing can be done abroad, many other IT functions like systems integration cannot. In addition, there will undoubtedly be jobs created in areas we can't even imagine today. Thirty years ago, for example, no one could have guessed the coming ubiquity of the cellular phone, an industry now employing nearly 200,000 workers in the United States.

The view that new jobs will be created as old jobs disappear is based on repeated experience. For example, in the 1990s, trade expanded rapidly, with increases in offshoring of both manufacturing and service jobs. At the same time, overall employment soared, unemployment fell to 4 percent, and real wages rose.

Lori Kletzer, an economist at the University of California (Santa Cruz), found that between 1979 and 1999, 69 percent of non-manufacturing workers who lost jobs due to free trade found new ones within one year, and on average earned 96.2 percent of their old wages. These figures, combined with the fact that 72 cents of every dollar spent offshore had previously been spent on U.S. wages, implies that the additional value to the United States economy of redeploying workers would be 45 to 47 cents. This is a conservative estimate, based on historical figures of job loss due to trade. White-collar employees at risk of offshoring today are generally more highly educated and might be expected to find new jobs faster than workers in the service sector as a whole.

Thus, far from being bad for the United States, offshoring creates net value for the economy – to the tune of $1.12 to $1.14 for every dollar that goes abroad.

OFFSHORING IN CONTEXT

Offshoring's impact on employment needs to be put in perspective. Forrester Research predicts that by 2015, roughly 3.4 million business-processing jobs for U.S. firms will be performed abroad. Although this number may seem large, it is only a small piece of the jobs picture.

Employment in the United States today

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totals more than 150 million. Technological change, economic recessions, shifts in consumer demand and other shocks generate continual job turnover. Each month, roughly 2 million Americans change jobs. Even the most pessimistic predictions of job loss due to offshoring will be far lower.

The number of service jobs likely to be lost to offshoring is also small compared to the number of workers who lose jobs through mass layoffs prompted by corporate mergers and restructuring, even when the economy is growing. In 1999 alone – at the peak of the 1990s boom – 1.15 million workers lost their jobs due to corporate restructuring. Job churn is part of life, even in a growing economy.

Competitive economies with flexible labor markets can cope with the natural process of job creation and destruction, and the U.S. economy is arguably in the best position of any to do so. According to the Organization for Economic Cooperation and Development, the United States has the highest rate of re-employment of any OECD country by a factor of almost two. Most workers who lose their positions find another within six months. Over the past 10 years, 3.5 million private-sector jobs have been created each year on average – and job growth was fastest among high-wage jobs.

A flexible job market will enable the U.S. to create jobs faster than outsourcing eliminates them. Consider how the American semiconductor industry reinvented itself after losing out to Japanese competitors that entered the market during the late 1980s. The Japanese quickly dominated the memory chip segment of the industry, and spurred a public outcry over "unfair" Japanese competition and the loss of high-paying jobs at home. The big U.S. players – Intel, Texas Instruments and Motorola – all exited the memory business.

But this prompted American companies to invest more aggressively in the production of microprocessors and logic products – the next growth wave in semiconductors. Intel became the dominant global player in microprocessors; Texas Instruments became dominant in digital signal processors, the brains in mobile phones, while Motorola gained a strong position in communications devices. Throughout this shift toward higher-value-added activities, the total number of U.S. jobs in semiconductors and closely related electronics held constant at around half a million.

SEPARATING FACT FROM FICTION

A number of myths and half-truths muddle the public debate over white-collar offshoring. Virtually all economists have concluded that trade contributes to economic growth.

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But skeptics argue that trade in services is somehow different from trade in goods, and will be less beneficial to the U.S. economy.

That's implausible, however, given the strength of U.S. service industries. The United States continues to run a trade surplus in services, even with India. Indeed, it can boast of the most productive service sector of any country in the world. American banks, law firms, accounting firms, information technology integrators and management consultants (to name a few service businesses) have established themselves as global competitors. As a result, it has been Washington's policy to demand more openness on the part of other countries in these areas. What's more, the depreciating dollar will undoubtedly help boost service exports even higher.

Others argue that the number of workers in China and India is so large that integrating them into the global economy will lead to persistent unemployment in the United States and Europe. Certainly, both of these emerging economies have a large supply of productive workers. But they also have fast-growing appetites for goods and services. The great majority of their enormous workforces will be producing for their own economies. Provided China and India allow their currency exchange rates to adjust to market forces, they will not be a net drain on economic activity or jobs in the rest of the world.

The notion that China and India are taking work from the United States because of their low wages is equally untenable. The truth is that many jobs in India today are viable only in a low-wage environment and could not exist in the United States. Thus, the fact that a half-million people are now employed in India's outsourcing industry does not mean

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that there could be 500,000 more jobs in the United States. Without offshoring, companies would scale back or stop offering premium services like round-the-clock customer help. Moreover, technology is putting many U.S. jobs at risk even without offshoring. Automated voice-response systems are replacing call-center workers, online hotel and airline booking systems are replacing live operators and travel agents and imaging software is replacing data-entry workers.

A related myth is the notion that service-sector offshoring is responsible for the anemic job creation during this economic recovery. More than two million jobs in the United States have been lost since 2000. But nearly all of those jobs were in manufacturing, not services. Moreover, employment in information technology, which is allegedly one of the sectors hardest hit by offshoring, has actually grown since 1999. While it is true that 70,000 computer programmers have lost their jobs, more than 115,000 higher-paid software engineering jobs were created during the period. Jobs for computer support specialists and systems analysts and administrators grew by roughly 83,000.

THE CHALLENGE FOR POLICYMAKERS

Arguments about the greater good and the long-term health of the economy do not, of course, ease the plight of the people who do lose their jobs or find themselves in lower-wage employment. While free trade creates wealth and improves a nation's average standard of living, not everyone benefits – particularly not in the short-term. Today, globalization is creating a higher level of turnover in the work force than ever before. Rather

INDIAPICTURE/ALAMY

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than pursuing a single career with just one or two companies, as workers in previous generations could expect, most people today will have many employers, and a growing number will switch their careers as well. Job change is a much larger part of life than it used to be, and the challenge for policymakers is to lubricate the transition.

A sizable number of workers who lose their jobs because of free trade do not easily find new ones, or must accept jobs with lower wages. From 1979 to 1999, roughly 30 percent of the people who were laid off as a result of cheap imports in sectors other than manufacturing had not found jobs a year later. And for the majority who did find new jobs, the wages varied considerably. On average, wages in the new jobs were about the same as the wages in the jobs that had been lost. But hardly anybody is average: 55 percent took lower-paid jobs, and about 25 percent took pay cuts of 30 percent or more.

Public policy can help such workers make the transition. Job-retraining programs and continuing-education grants can help workers gain new skills as the economy evolves. Mandated severance packages could help, too; increased portability of health benefits and pension plans between jobs is essential. Tax credits might be offered to companies that hire workers who lost their jobs because of trade.

Wage insurance also would help. For a small percentage of the savings from offshoring, companies could purchase insurance covering the wage losses of displaced workers. Building upon an insurance proposal that Lori Kletzer and Robert Litan of the Brookings Institution developed for workers displaced by trade in manufacturing, we estimate that for as little as 4 to 5 percent of the savings companies realize from offshoring, they could insure all full-time workers who lost jobs as a result.

The program would compensate workers for 70 percent of the difference between the wage rate they received on the jobs they lost and the wage rates they received on the new jobs, as well as offer health care subsidies for up to two years.

These policies would make the U.S. labor force more flexible, allowing the economy's wealth-creation engine to flourish. Protectionism, by contrast, might save a few jobs in the short run, but would stifle innovation and job creation in the long run. And as a practical matter, protectionism makes little sense, given how enmeshed the U.S. economy already is with the rest of the world.

In early 2004, Congress debated an amendment to a trade bill that would have prohibited federal agencies from contracting with companies that outsource abroad. But it found that under the terms being discussed, procurement for the Department of Defense would grind to a halt. The amendment that finally passed was a weaker version that hardly constrains any activity. Similarly, Ohio considered a law to prohibit state contracts from going to companies with ties abroad – only to find that it would exclude virtually all of the current contractors in the state.

Facilitating change, not stopping it, must be the policymakers' goal.