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Outsourcing and American Jobs

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Overseas outsourcing of jobs has quickly become a controversial national issue. Some see outsourcing as a way of maintaining or increasing a company's competitiveness. Many others view outsourcing in a far more negative light, focusing on the people who lose their jobs.

Clearly, outsourcing is not a subject that can be dealt with on a bumper sticker or even on a 30-second sound bite. Let us start with a little background before we try to come up with any firm conclusions. Outsourcing involves far more complicated advantages and disadvantages than the debaters on either side are willing to admit.

Why Do Companies Outsource?

Many service companies started creating jobs overseas to gain access to foreign markets. They had to audit, consult, and repair where customers are located. To state the matter mildly, they did not tell their overseas customers that they had to come here. Moreover, many foreign markets have been growing quickly while some domestic areas have become relatively saturated or at least mature.

Simultaneously, some domestic businesses hired specialized workers

stationed overseas to respond to U.S. limits on immigration. When these American employers could not get those workers to come here, they had to send the work to them. While doing so, the companies learned how to use modern technology to shift the location of work economically. They thus became accustomed to taking advantage of lower costs, domestic and foreign.

Moreover, the shift of some telemarketing and customer service jobs overseas followed an earlier pattern within the United States when such work was outsourced from urban to rural areas where labor costs were lower. Telecommuting from employees' homes also helped pave the way for some enterprises to extend the process to new suppliers, at home and abroad.

Viewing these matters in a broader perspective, the age of economic isolationism has long since passed. In various industries — ranging from banking to consumer products to job placement services — leading firms report that their overseas revenues exceed their domestic sales. Despite the shift to India of some domestic call center work, approximately 60 percent of the revenue of American information technology companies originates overseas.

Most fundamentally, many companies are focusing their efforts on their core competence. It is the rare enterprise that produces an entire product by itself — or even half of the end value. Most businesses subcontract out most of their activities to other companies, mainly domestic. Viewed from that perspective, overseas sourcing is a minor part of the trend to decentralize business operations.

Nevertheless, over time many American corporations came to appreciate

how frequently the higher productivity of U.S. workers offset the wage differentials and other costs of operating overseas. Thus they quickly encountered practical limits to offshore outsourcing. To put the matter bluntly, no company can outsource the management, responsibility, or accountability of its activities.

On the other hand, outsourcing can help a company operate in an increasingly competitive global marketplace. Many U.S. companies learned the benefits of drawing on workers stationed in other countries. Outsourcing can enable a business to provide 24/7 coverage, especially for consumers who need around-the-clock support. It is frequently impractical for a firm to adopt a unilateral policy against outsourcing work — especially when its foreign and domestic competitors are doing it.

There is also a growing division of labor. For example, system designers in the United States working closely with the retailer may conceive the inventory-management software that helps use electronic product tags more effectively. But once the system has been mapped out, the actual software code can be written by programmers in India.

All sorts of adjustments are being made in this complicated world. For example, in 2003, Delta Airlines outsourced 1,000 jobs to India, but the \$25 million in savings allowed the company to add 1,200 reservation and sales positions in the United States. Large software companies Microsoft and Oracle have simultaneously increased both outsourcing and their domestic payrolls.

It is important to gain some perspective by seeing the relative importance

of domestically and internationally produced services. Much of the current controversy focuses on information technology (IT). In 2003, approximately \$120 billion was spent on IT in the United States. Approximately 1.4 percent was moved offshore. However, the 98.6 percent of the work that stayed here was not deemed newsworthy.

In total, about 400,000 U.S. positions in information technology have gone offshore. Meanwhile, total U.S. employment rose from 129 million in 1993 to 138 million in 2003, mainly in services. It turns out that, contrary to much of the heated public discussion, the international movement of services is very positive to the American economy.

That is so because American corporations are not the only companies that engage in offshoring. In 2003, for example, the United States imported (that is, offshored) \$87 billion of business services. Yes, that included a lot of relatively low-skilled call center and data entry work done in lower-cost developing countries.

But, in the same year, we exported (that is, companies in other nations offshored to us) \$134 billion of business services. That “insourcing” generated a substantial array of relatively high-skilled jobs in engineering, management consulting, banking, and legal services. On average, “insourced” jobs pay 16 percent above the national average. A net balance of \$47 billion flowed to the United States. That is more than a 60 percent increase over 1994, a decade earlier. This good news rarely surfaces in the often emotional debates on offshoring.

The Limits to and Dangers of Outsourcing

A word of warning, however, is necessary in the face of the current business enthusiasm for overseas workers. Companies who outsource just because “everybody is doing it” may be surprised by unexpected costs and complications. About one-half of the outsourcing arrangements are terminated, for a variety of reasons. Some new overseas vendors encounter financial difficulties or are acquired by other firms with different procedures and priorities.

Businesses that arbitrarily set a fixed percentage of work to be outsourced likely will regret it. Newcomers to overseas contracting may find themselves dealing with unreliable suppliers who put their work aside when they gain a more important client or their overseas vendor may suffer rapid turnover of skilled employees who find jobs with more desirable firms. Typical Indian operations in business processing — including call centers and offices handling payroll, accounting, and human resources functions — often lose 15-20 percent of their work forces each year. While software-programming skills are plentiful in some parts of Asia, good managerial experience is very limited.

Other costly complications can arise. Local highways and transportation networks may be inadequate. Some overseas companies wind up busing their employees to and from work. Also, electricity may not be available as assuredly as in the United States, where blackouts are very infrequent.

Some American companies are paying much more for real estate for their offshoring activities than they would in the United States. That negative differential occurs for two reasons. One is the cost of upgrading poor

infrastructure overseas. The second reason is the fact that inexpensive overseas labor pools are usually found in very large cities, while facilities such as call centers back home are located in lower-cost suburban and rural areas.

Some U.S. companies limit their outsourcing to routine engineering and maintenance tasks because they worry that their core technology may be swiped by vendors in Asia that do not respect intellectual property rights. U.S. firms also may encounter a variety of unanticipated difficulties, such as dealing with arcane legal systems and meeting the requirements of different tax and regulatory agencies. Moreover, they may more frequently encounter corrupt officials in the public sector.

Furthermore, overseas managers often do not understand the American business environment — our customers, lingo, traditions, and high quality control and expectations for prompt delivery of goods and performance of services. Dell moved its call center support for corporate business from India back to the United States in 2003. Its clients had complained about foreigners speaking English in hard-to-follow accents and giving vague answers to technical questions. Given the continued flow of complaints from individual customers, we may wonder what further pullbacks may occur.

What Happens to the Company's Employees?

The effect of outsourcing on U.S. employment is far more complicated than it appears at first. The visible part (the tip of the iceberg) is widely known. Some U.S. employees lose their jobs or get shifted to less desirable work. In recent years, this iceberg may have a very large tip. However, any serious

analysis must extend to the rest of the iceberg.

Looking at the total employment effects of outsourcing, the less visible part of the impact is much larger. Far more U.S. employees keep their jobs because outsourcing helps the company stay competitive. Some get new or better jobs because the firm enhances its financial strength. For example, as companies upgrade their software systems, there may be less domestic demand for basic programmers — but more need for higher paid systems integrators.

Corporate IT departments report that they are changing their mix of in-house skills. They now give more emphasis to managerial experience, business process knowledge, and understanding the domestic customer. These capabilities rarely can be provided effectively from an overseas location.

Outsourcing and the savings it generates are the beginning — not the end — of the adjustment process. Cost reductions from outsourcing can open up new market opportunities for U.S. companies and thus generate additional jobs here at home. The companies also can afford to buy new equipment and expand training programs. Hence, higher domestic labor costs can be offset by higher worker productivity.

Over time, there is a positive feedback effect from outsourcing. As poor countries overseas develop their economies, new markets are created for U.S.-made products and services. China already has become a major importer of industrial and consumer goods as well as of agricultural products and raw materials. In time, India is likely to do the same.

Moreover, economic trends rarely move in a straight line for long periods

of time. Salaries of IT personnel in India are reported to be rising at 15-20 percent a year. In addition, a lot of hidden costs arise, such as the need for U.S.-based managers to visit the overseas sites from time to time to assure that the work being performed meets the standards of the American firm.

Some historical perspective is also useful. In the early 19th century, the United States was a poor developing country. European capital helped finance our canals, railroads, steel mills, and other factories. American workers began to manufacture goods that competed with European production.

Because markets were relatively open, Europeans as well as Americans benefited in the process. Economic growth and job creation occurred on both sides of the Atlantic Ocean. Currently, service providers overseas require American-made computers, telecommunications equipment, and software. They also obtain legal, financial, and marketing services from United States sources. Their employees and their families increasingly are customers of American products.

What Is the Net Effect on the USA?

On reflection, most service jobs cannot be outsourced. Personal contact is vital in virtually all business activities. It takes domestic companies to tailor new products and services to the needs of local customers. Most of the people we work with regularly remain close by. We normally do not take long domestic trips to see our doctor or dentist or lawyer or accountant. Much less do we go to New Delhi or Manila for those purposes.

One of the great strengths of the American economy is that we have a

very open labor market. That characteristic is basic to this nation's economic vitality. Approximately one million workers are laid off or quit each week and an equal number is hired in their place. It is much harder to lay off workers in Europe or Japan than here. However, there is another side to the coin. Employers there are very reluctant to take on new workers. In striking contrast, American companies are much more likely to add personnel — and they do so.

Over the years, far more new jobs are created in the United States than are outsourced. Moreover, many foreign companies have been setting up operations in the United States and they hire American workers to staff these operations. Our more realistic labor policies do work, while their labor policy “straightjackets” do not. By its nature, a strong and flexible labor market has plenty of movement — out of some jobs and into others.

The bottom line is clear: the United States creates far more new jobs (net of layoffs) than Europe and Japan combined. We have the highest proportion (66 percent) of the population employed of all industrialized countries.

The record also shows that groundbreaking technology — rather than international competition — is the major cause of layoffs, and of new hires. Technological progress is the heart of the dynamic American job-creating economy. Our positive technology environment also encourages foreign manufacturers, such as pharmaceutical companies, to set up laboratories here.

Let me add a factual note to the emotional debate on the loss of manufacturing jobs. Despite lower wages abroad, foreign firms have chosen to produce automobiles made by high-wage American workers. Examples include

Honda in Ohio, Mercedes-Benz in Alabama, BMW in South Carolina, and Toyota in California.

Moreover, while direct manufacturing employment has been declining, total U.S. production of manufactured goods has risen about 40 percent over the past decade. This is a tribute to rapidly advancing productivity. By the way, this combination of trends is an international phenomenon. In recent years, China, Japan, and Brazil each lost more manufacturing jobs than did the United States.

A portion of the reported decline in manufacturing employment is a statistical quirk. So is a part of the rise in service employment. That offsetting change results when a manufacturing company contracts out some of its support activities. After all, converting a business function from an overhead burden center in an industrial corporation to a profit center in a service firm is a prod to achieving greater efficiency. It helps keep American businesses more competitive. As for the corporate profits that may result from outsourcing, we tend to forget that the typical shareholder is a pension fund or a mutual fund representing ordinary Americans.

What Should We Do?

Do those who advocate laws against American business outsourcing overseas really believe that foreign governments would not retaliate? My guess is that they never even thought about the fact that, in a global marketplace, companies all over the world are outsourcing. The United States is both the world's largest exporter as well as the world's largest importer. In other words, we have the greatest stake in maintaining open markets — at home and abroad.

As in many other forms of regulation, proposed government restraints on outsourcing would have all sorts of unanticipated adverse consequences. Recently, the University of Maryland requested an exemption from a proposed prohibition on outsourcing by agencies and departments of the federal government. It turns out that the university maintains a network of training centers at many U.S. overseas installations. The alternative to increasing the skills of Americans stationed overseas via “outsourcing” would be to hire foreigners with the needed skills!

Hysterics aside, the Information Technology Association reports that setting up the “do-not-call” list already has eliminated more call-center jobs than all of the outsourcing to India. Conversely, not every job created overseas means that an American job has been lost. For example, in the past, U.S. airlines traditionally did not pursue small billing discrepancies with travel agencies because it was not worth the cost. Now, using cheaper Indian workers, the airlines can afford to correct small billing errors. For the airlines, it is a welcome saving, while those are new jobs in India.

Ironically, experts on offshoring report that all of the publicity on offshoring — unfavorable as well as favorable — has been generating more awareness on the part of U.S. companies of the potential benefits of outsourcing overseas!

Nevertheless, the national debate on offshoring requires a constructive response, especially in a presidential election year. Many of the people who lose their jobs are truly hurting. If old-style protectionism is not a good answer, what should we do?

The positive approach is to enhance the productivity and competitiveness of American workers. IBM recently announced the creation of a new \$25 million retraining program for employees who worry about losing their jobs to outsourcing.

More fundamentally, the fact that we have the highest high school dropout rate of all industrialized nations is nothing that can be blamed on foreigners. Nor can we be proud of the fact that, at the other end of the skill spectrum, the United States has fallen from third to seventeenth among nations in terms of the share of 18 to 24 year olds who earn degrees in science and engineering. Also, let us not overlook all the regulatory and tax barriers to innovation and to more efficient domestic production of goods and services that have been erected by the U.S. government.

An agenda of economic reforms is long overdue in order to make the United States a more attractive place to hire — and keep — productive employees. It is fascinating to contemplate that, if we would adopt such a positive approach to the outsourcing debate, the unexpected results would be real and positive for American workers.