

IN DEFENSE OF OUTSOURCING

Timothy Taylor

You probably did not sew the clothes you are wearing as you read this, nor did you grow the food you will eat today. You also didn't build your own home, manufacture your own car, perform your own dentistry, or cut your own hair. You may not clean your own house or mow your own lawn. If you're single you may opt for a dating service to find romance, and once you've found it you may delegate part of your child rearing to a day-care service.

In other words, you outsource in your personal life. Everyone does, and with good reason. I am not grotesquely less competent at the ordinary tasks of life than my fellow citizens. But if I tried to produce personally all or most of what my family consumes, my family would face a dirt-poor standard of living. Adam Smith ([1776] 1994: 485–86), patron saint of economists, recognized this lesson two centuries ago, writing, “It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy.” Smith also noted that the logic of outsourcing applied to nations as well as householders. He continued: “What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom.”

Modern technological developments have opened the door to outsourcing of an unprecedented type and scale, and in the process, “outsourcing” became a political dirty word during the 2004 election campaign. It conjures up images of low-paid workers from India taking service jobs from U.S. workers in a wide range of decently paid occupations: telephone call centers, payroll and accounting departments, medical and legal transcription services, software writing and maintenance, preparation of standard tax forms, and reading routine medical x-rays. This article offers a primer on the economics of

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outsourcing: the evolving economic meaning of outsourcing, how outsourcing brings economic gains, why it is so deeply implausible that outsourcing is to blame for U.S. economic woes in recent years, and how the controversy over outsourcing reflects some deep structural changes in the U.S. economy.

Trade By Any Other Name

Outsourcing first became an explicit controversy in disputes between big American auto producers and the autoworkers union in the early 1980s. The union feared that the automakers were going to purchase an increasing number of components for cars like window cranks and seat fabrics from foreign and nonunion suppliers, rather than having them made by unionized workers (see, e.g., “A Deal That Could Put a Brake on Car Costs” 1982 and Flax 1983).

When outsourcing is defined in this way, it effectively includes all imports. In fact, this definition also includes purchases from non-unionized American firms. After all, almost everything that the U.S. economy imports, with the exception of some rare raw materials, could at least theoretically be produced within its borders. During the election campaign of 2004, a number of ads used this broad definition of “outsourcing” when they referred to products with labels that said “Made in China” or “Made in Mexico” and implied that these imports were the reason for America’s stagnant job growth. If outsourcing is defined to cover all imports of goods and services, then the debate over outsourcing is just another chorus in the familiar arguments over whether or how an economy benefits from international trade, and whether or how those who gain from international trade should compensate those who lose. New lyrics, perhaps, but the same old tune.

But the outsourcing debate in 2004 offered a variation on the traditional arguments about trade. This time outsourcing did not refer to all imports of goods and services, but instead focused on imports of certain business services. For example, in February 2004, the members of President Bush’s Council of Economic Advisers (2004: 25) stated in their annual *Economic Report of the President*: “Outsourcing of professional services is a prominent example of a new type of trade.” The chairman of the CEA at the time, Harvard economist N. Gregory Mankiw, followed up in an interview that caused a public relations squall (Andrews 2004):

I think outsourcing is a growing phenomenon, but it’s something that we should realize is probably a plus for the economy in the long run. We’re very used to goods being produced abroad and being

shipped here on ships or planes. What we are not used to is services being produced abroad and being sent here over the Internet or telephone wires. But does it matter from an economic standpoint whether values of items produced abroad come on planes and ships or over fiber-optic cables? Well, no, the economics is basically the same.

Even some of those who accept the argument that international trade in goods can benefit an economy overall—when all costs and benefits are taken into account—have expressed uncertainty about Mankiw's claim. After all, five-sixths of American jobs are in service-producing industries, and only one-sixth involve goods-producing industries (Council of Economic Advisers 2005: Table B-46). Isn't there some difference between importing goods like television sets or machine tools and outsourcing service jobs? As a starting place for answering that question, let's first consider why outsourcing provides economic gains at all.

Core Competencies and Make-or-Buy Decisions

Every firm faces make-or-buy decisions. Should a car company make windshields and seat covers and door panels itself, or should it buy them from outside suppliers? Should a company run its own lunchroom, clean its own building, and trim its own trees, or should it outsource these tasks to firms that specialize in catering, janitorial services, and grounds-keeping?

Ronald Coase (1937), University of Chicago economist and 1993 Nobel laureate, first tackled this question almost 70 years ago in a classic article. His broad argument was similar to Adam Smith's: If a firm can buy a certain good or service from outside the firm at a lower cost and at least the same level of quality, then it should buy; if not, then it should make. Coase also emphasized that the make-or-buy choice can evolve over time, as firms respond to price and technology changes and to variations in the degree of quality control they can exercise. He especially emphasized the role that contract enforcement plays in the make-or-buy decision, by determining how confident an outsourcing company can be in the quality of the goods it receives if it chooses to buy.

In the last few decades, many American firms have been deciding to buy rather than to make an increasing number of inputs. This trend follows developments in management theory, especially the belief that most firms have only a few "core competencies" in which the firm has distinctive skills and abilities (Prahalad and Hamel 1990). Managers and key employees of a firm, the thinking goes, should focus

their scarce time and energy on honing and taking advantage of these core competencies, and hire other firms with their own core competencies to perform other tasks. Aiding and abetting this new thinking have been new communications and information technologies that have altered the cost and quality-control issues at the heart of the make-or-buy decision.

For example, most firms used to employ a human resources department that posted job listings, collected applications, and hired workers. Firms would also maintain a payroll department to cut paychecks and keep track of benefits. Yet there is no reason to believe that all firms in the American economy, regardless of what they sell, also have core competencies in human resources, payroll, and benefits. The advances in computer technology have made it possible to outsource a considerable share of these functions to other firms. Thus a firm called ADP (Automatic Data Processing) now cuts paychecks for one in six private-sector workers in America. Manpower, Inc., connects two million workers per year to 400,000 different employers, in jobs that typically start as temporary but can become permanent. One company—First Data Corporation—manages credit cards for 1,400 issuers, handling 400 million credit card accounts (Edwards 2004). Many employers, rather than running a company pension plan, instead connect employees with a selection of financial firms and help them make contributions to their own retirement in 401(k) accounts or Individual Retirement Accounts.

The best news for the U.S. economy in recent years has been its extremely strong productivity growth. Measured by output per hour in the business sector, productivity growth was 4.4 percent in 2002, 4.3 percent in 2003, and 3.9 percent in 2004 according to the Bureau of Labor Statistics, giving this period three of the best four years for productivity growth since 1971 (the other year in the top four was 1992). Producing more per hour is how an economy raises the average standard of living over time. U.S. firms have generated this remarkable productivity growth in large part by taking advantage of the gains in information and communications technology—and outsourcing is one mechanism by which this has happened. The practice of outsourcing both to domestic and foreign firms allows businesses to harness dramatic innovations in communications and information technology more effectively than they could if they just gave each of their own payroll-department employees a fancy new computer. Instead of every firm individually needing to learn how to run an expensive computerized system for collecting job applications, mailing paychecks, and offering choices of employee benefits, these services can now be provided by firms with core competencies in these areas.

Winners and More Winners

Even the harshest critics of outsourcing agree that it can benefit the firm itself; after all, the firm wouldn't choose buying over making unless it saved money. But is it possible that, at least under certain conditions, outsourcing could benefit the narrow interests of firms but hurt the broader American economy?

In order to answer "no" to that question—to argue that outsourcing offers net social benefits—two conditions must hold. First, workers and resources that are dislocated because of outsourcing must find new opportunities elsewhere in the economy. Second, outsourcing must not be so sweeping that it will lead to direct competition for most American workers, but instead will supplement the tasks of most of them. The facts regarding both of these conditions suggest that outsourcing benefits both the firms that do it and the economy as a whole.

Take the first element in this two-pronged test. Any gain in the efficiency of production, whether through outsourcing or some new production wizardry, can lead some workers in a firm to lose their jobs. But when a firm or an industry can produce at lower cost, it can also sell more of its products and eventually end up hiring more workers, rather than fewer. For example, the incredible productivity gains in producing personal computers haven't eliminated jobs in the computer industry broadly defined—even if jobs have shifted away from manufacturing computers and toward providing computer-related services.

When outsourcing allows firms to produce more cheaply, competition between firms that are outsourcing will drive down the prices of their products. If insurance companies and health-care providers can hold down their costs by outsourcing various back-office operations, consumers will have more money to spend on other goods, which will help jobs in other industries.

Martin Baily and Diana Farrell (2004a) recently conducted a study for the McKinsey Global Institute that investigated what happens when an American firm moves work that cost one dollar to India (also see Baily and Farrell 2004b). Out of that dollar, India's economy garners 33 cents in wages paid in India and profits earned by Indian firms. But 67 cents accrues back to American firms, in three categories. Indian firms spend five cents buying equipment from American firms. Some American firms own the operations in India that perform the outsourcing, so four cents in profits comes back to the United States in that form. Finally, American firms that outsource to India save 58 cents of the original dollar. Baily and Farrell then consider

estimates of the costs to American workers who lose their jobs because of outsourcing, and also how well the American economy redeploys the workers whose jobs are lost and the money that is saved through outsourcing. After taking human and financial costs and benefits into account, they conclude that a corporate dollar spent on offshore outsourcing ends up providing \$1.12 in benefit to the American economy.

From this perspective, outsourcing is just another manifestation of a classic challenge for market economies. Many economic changes create winners and losers: outsourcing and international trade; the rise of new domestic competitors, new products, and new methods of production; shifts in consumer demand; changes in laws and regulations; superior or lousy management; and shifts in the methods and availability of finance. Faced with a world of continuous economic upheaval, a dynamic market economy must attempt a balancing act. On one side, the economy must embrace flexibility in the face of productivity-enhancing innovations, including outsourcing and international trade, since growing productivity is the pathway to a higher standard of living. On the other side, policymakers should consider what laws and institutions are needed to cushion and assist those who suffer as a result of these changes. If a society attempts instead to shut down economic changes, like those from outsourcing, international trade, and new technology, it can avoid some economic disruption in the short run, but at a cost of blocking overall economic gains.

The Foreigners Are Coming?

A shift in world trading patterns can injure some countries. For example, if the United States discovered massive new oil reserves or a cheaper substitute for oil, the discovery would presumably hurt the economies of countries in the Middle East that now export oil. In the outsourcing debate, the parallel concern is that the American economy is a producer of services linked to technology, and so if other countries start producing services linked to technology, American businesses may suffer. But this analogy is highly inexact and ultimately misleading. Outsourcing of professional services is a tiny slice of the American economy, and it seems more likely to complement the productivity of vast majority of American service workers than to threaten their jobs.

Much of the public furor over outsourcing begins with an incorrect premise: that a surge of imports in services has led to a substantial reduction in American jobs. But there's no empirical basis for thinking either that foreign goods and services are flooding the U.S.

economy or that such a flow is costing American jobs. Total imports have not surged in recent years. U.S. imports of goods and services were 15 percent of GDP in 2000, dropped below 14 percent of GDP in 2001 and 2002, and by 2004 had rebounded back to 15 percent of GDP. Meanwhile, the American job picture in 2004 was fairly bright, with an unemployment rate of 5.5 percent. While the 2004 unemployment rate was higher than the unsustainably low rates of the bubble economy in the late 1990s, it was lower than every year except one (1989) between 1974 and 1995.

However, the recent outsourcing controversy does not concern all imports, only imports of services. In 2004, preliminary estimates from the U.S. Bureau of Economic Analysis show that the American economy exported \$1,147 billion in goods and services, and imported \$1,764 billion. However, looking only at trade in *services*, Americans exported \$339 billion and imported \$291 billion. Thus the United States had an overall trade deficit of \$617 billion in combined goods and services—but a trade surplus of \$48 billion in services alone.

Trade in the broad category of services includes many items that do not much resemble the business services that have come under the glare of the outsourcing spotlight. For example, trade in services includes foreign travel and transportation, overseas education, and financial services. The services relevant to the outsourcing debate appear in the trade statistics under the subcategory of business, professional, and technical services, which is further subdivided into categories like computer and information services; management and consulting services; and research and development and testing services.

In 2003, the most recent year for which the detailed breakdown of trade data is available, the United States exported \$69.7 billion in business, professional, and technical services, and imported \$40.8 billion, for an overall surplus in this subcategory of \$28.9 billion (Borga and Mann 2004: 44–45). But most of the concern over outsourcing is over trade with low-income countries like India, while the data show that about two-thirds of American trade in services is with other developed economies, not with low-wage countries (pp. 46–47).

To sum up: America imports goods and services to the tune of 15 percent of GDP. Of that total, 2.7 percent are imports of business services. India then represents about 2 percent of American imports of business services (Amiti and Wei 2004a). The concern about whether outsourcing of business services to low-wage economies like India has dramatically unsettled the entire American economy in the last few years is, in effect, like worrying about whether the tip of the tail is wagging the entire dog.

Even if outsourcing to low-wage countries has not devastated the American economy and workforce so far, might it be poised to do so in the near future? It seems unlikely. Remember that outsourcing, like all forms of trade, is a two-way street. Any outsourcing of business services by American firms to foreign suppliers is more than counterbalanced by “insourcing” of business services by foreign firms to American suppliers, a sector in which the United States has long run trade surpluses and seems likely to continue doing so.

Moreover, two economists at the International Monetary Fund, Mary Amiti and Shang-Jin Wei (2004a, 2004b), have calculated that while the United States is the largest importer and exporter of business services in the world when measured in dollar terms, it is far from the largest when measured relative to the size of each nation’s economy. Amiti and Wei calculate that American imports of business services are less than one-half of 1 percent of GDP, which ranks the American economy 117th among the nations of the world in outsourcing. By way of comparison, India outsources 2.4 percent of its GDP. American exports of business services run almost 0.6 percent of GDP, which ranks the United States 90th among the nations of the world in insourcing. In India, insourcing is 3.8 percent of GDP.

Finally, outsourcing of business services is subject to natural limits, because some services by their nature must be provided close to the customer. Some software can be written in India, but installing a high-speed computer network for an American firm needs to happen on site. Medical x-rays can be read in India, but skilled nursing services need to be provided in person. Some services are likely to remain highly unsuitable for offshore outsourcing. If you buy a sweatshirt made in India or a television set made in China, you do not need to deal with that manufacturer ever again if the quality turns out to be poor. But when a firm outsources business services, it enters into a lasting contractual relationship. The outsourcing firm will need to manage the business relationship, share data, and work out problems as they arise. Managing relationships with distant firms works best when the tasks are well-defined, such as filling out standard tax forms, answering predictable customer-service calls, entering data, and transcribing legal or medical files. But as services become more complex, managing them long-distance becomes more complex, too. Issues arise such as maintaining privacy for customers and security for the firm, as well as whether the faraway service provider is giving its best effort. These difficulties place real and severe limits on how much work can be outsourced.

Thus, it is quite misleading to say that because of business outsourcing, service jobs are going overseas. Overall job growth in the

United States was stagnant from the 2001 recession up through spring 2004. However, the real problem was a sharp drop of almost three million manufacturing jobs during this time, while service jobs, which are presumably the main competition with the modern incarnation of outsourcing, continued to rise. Actually, a combination of outsourcing and new technology is causing service jobs to be redefined. Service jobs that are straightforward enough to be automated or outsourced will be, but this will allow other service workers to become more productive. In some situations, like providing directory information assistance over the phone, if the job wasn't outsourced to a worker in India, the job would soon be automated anyway. When a job can be easily outsourced or automated, it doesn't provide good long-term prospects for American workers.

Growing Pains

Why did outsourcing become such a salient political concern in 2004? One obvious explanation is that 2004 was an election year, and job growth was stagnant from the end of the recession in 2001 through spring 2004. Foreign trade is always a convenient economic scapegoat, and anecdotal news stories about outsourcing conveyed a dramatic theme that powerful technology could combine with low-wage labor to threaten American workers. The facts that outsourcing was only a small slice of the American economy, and that the United States insources more in business services than it outsources, and that outsourcing was helping to produce productivity gains for the economy as a whole, were no match for election year sloganeering. But the debate over outsourcing also reflects a public unease about two deeper structural changes in the U.S. economy.

The first major change is the growing importance of international trade in services. Five-sixths of American workers hold jobs in service-producing industries rather than in goods-producing industries, but roughly five-sixths of all imports in the last few decades have been goods rather than services. Thus, most Americans have been able to view international trade in terms of the benefits they receive from being able to purchase imported goods, while not worrying that imports of services might threaten their jobs. But trade in services has been creeping higher. American imports of services were 1.6 percent of GDP in 1980, but 2.5 percent of GDP in 2004. With the arrival of outsourcing of business services, American workers in service industries are getting a small taste of what foreign trade has long felt like to autoworkers and steelworkers—and they don't like it. American consumers have become oblivious to buying foreign goods, from cars

to computers to clothing, but many consumers are not yet comfortable with the idea that when you call your bank to ask about your account, or when you call an airline to ask about a flight time, that the person on the other end of the phone may be in Bangalore rather than Omaha.

The second major change is that increased outsourcing, of both goods and services, challenges the traditional notions of what a successful firm looks like. Many people have a sense that the nation's economy is built on big firms that do it all—like the famous River Rouge complex that Henry Ford built in the 1920s, an enormous production plant where supplies of iron and coal and other raw materials went in at one end and completed cars rolled out the other end. From this perspective, it may seem improbable and peculiar to think that the American economy can thrive and prosper on the basis of firms that provide more efficient payroll services or credit card accounts. But creating productivity gains behind the scenes is valuable to an economy, too. The broad trend toward outsourcing—that is, the spread of firms that buy rather than make—is shifting the role of large firms in the American economy. Lawrence White (2002) of New York University compiled evidence that the share of total American employment for the *Forbes* 500 (ranked by profits) fell from 21.2 percent of total employment in 1980 to 16.3 percent of total employment in 2000. U.S. employment is shifting toward firms of medium size, and many of these firms have carved out their niche by developing a core competence in selling business services that used to be produced within the boundaries of enormous corporations.

The Paperwork Dividend

Back in the 1990s, there was much talk of a “peace dividend”—that is, the money that no longer needed to be spent on national defense against the Soviet threat could now move to other social priorities. In this decade, the combination of new communication and information technologies and outsourcing to both domestic and foreign firms promises a “paperwork dividend”—that is, many routine business services can be handled much more cheaply. In many sectors of the economy, including health care, education, insurance, and financial services, if American businesses can spend less on the background services that go into production, the larger economy will reap substantial benefits.

Outsourcing is part of an economic evolution in which the linkages of production stretch around the world not just for high-profile products like cars, but also for services as pedestrian as telephone

directory information. Outsourcing does cause economic disruption, like all productivity improvements (and for that matter, all new laws and regulations), but it is also one way in which the economy seizes the opportunities offered by the transformative advances in computer and telecommunications technologies.

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