American Enterprise Institute for Public Policy Research

February 2004

On the Issues

"Outsourcing" Is Good for America

By Douglas A. Irwin

Some critics argue that "outsourcing" of service sector employment to foreign countries will lead to a serious decline in U.S. white-collar jobs. In reality, outsourcing will reshape but not undermine U.S. service sector employment, making companies more efficient. It will also benefit consumers and export businesses.

"The United States will be a Third World country in twenty years." So intoned Paul Craig Roberts, a former Reagan administration Treasury official and supply-side economist, at a Brookings Institution briefing on January 7. Roberts makes this prediction because of white-collar job losses from the outsourcing of service sector employment to India and China. As a result, whole classes of high-wage service sector employees—from software programmers to radiologists—now find themselves in competition with highly skilled workers abroad who earn a fraction of what their U.S. counterparts make.

Roberts also teamed up with Senator Charles Schumer, a Democrat, to suggest in the *New York Times* that "the case for free trade is undermined by changes in the global economy." The fears they expressed about the service sector were eerily reminiscent of the early '90s, when Ross Perot insisted that NAFTA would hollow out America and produce a "great sucking sound" of jobs being siphoned off to low-wage Mexico. The conservative Roberts and the liberal Senator Schumer are the most politically incongruous team of trade analysts since Patrick Buchanan and Ralph Nader opposed NAFTA a decade ago. Fortunately, just like their predecessors, their analysis is wrong.

AEI adjunct scholar Douglas Irwin is a professor of economics at Dartmouth and author of *Three Simple Principles of Trade Policy* (AEI Press, 1996). A version of this article appeared in the *Wall Street Journal* on January 28, 2004.

The unlikely bedfellows are right in that the world is changing. The service sector, which traditionally has been insulated from international competition, is now ripe for outsourcing on a global scale. According to management consultants McKinsey & Company, about 90 percent of the value of services output is now produced within the providing firm, but they expect this share to drop to 60 percent in ten years. High-tech firms such as IBM are now outsourcing software programming to India, and medical centers are relying on Indian doctors to process data—to say nothing of the loss of America's call centers.

What will the service sector look like as a result of these developments? Some clues come from manufacturing, which already has been vastly reshaped. Outsourcing has transformed manufacturing from vertically integrated production structures to highly fragmented ones. Fifty years ago, Detroit's River Rouge plant sucked in iron and coal at one end and spat out an automobile at the other. Now, auto firms source component parts from a vast array of domestic and foreign suppliers.

Has U.S. manufacturing been vaporized in the process? No—manufacturing production has risen about 40 percent over the past decade. Despite lower wages abroad, foreign firms have chosen to produce cars made by high-wage workers here, including Honda in Ohio, Mercedes-Benz in Alabama, BMW in South Carolina, and Toyota in California. Of course, the share of the

American workforce in manufacturing has fallen steadily over the postwar period because of vast increases in productivity, but this is a worldwide phenomenon. Between 1995 and 2002, China, Japan, Brazil, and other countries lost more manufacturing jobs than did the United States, according to an Alliance Capital Management study.

The service sector will be reshaped by international developments, too. But just as low-wage China has not taken all of our manufacturing capability, low-wage India is not going to take all of our service sector production. Service producers will become even more specialized and will have to seek new ways of improving their efficiency and productivity. (Productivity in the service sector has notoriously lagged behind that in manufacturing.) As long as the American workforce retains its high level of skills and remains flexible as firms position themselves to improve their productivity, the high-value portion of the service sector will not evaporate.

Besides, while Roberts and Schumer, and others focus on the issue of displaced workers, they have completely ignored the efficiency benefits of service sector outsourcing.

First, consumers will be provided with the services they demand, at lower prices. As many businesses themselves purchase services, their lower costs will result in savings that can be passed on to consumers. If a capable radiologist in India can read x-ray pictures at a quarter of the cost of doing so domestically, important health care services can be delivered at lower cost to everyone, putting a brake on exploding medical costs.

Second, U.S. exporters of goods and services will benefit from the extra income generated abroad. The outsourcing of services to India counts in the U.S. balance of payments as an import of services. If we are going to start importing large amounts of such services, these imports must be paid for by exports of something. The dollars being spent by firms to purchase these services will come back to the United States either in the form of demand for U.S. goods (our exports to India) or foreign investment in the United States. As McKinsey has noted, "[service] providers in low-wage countries require U.S. computers, telecommunications equipment, other hardware and software. In addition, they also procure legal, financial, and marketing services from the U.S."

Indeed, the United States is a major exporter of services, accounting for nearly a fifth of the world's trade in services. Services amount to nearly 30 percent of the value of all U.S. exports. Last year, when the United States had approximately a $550 billion deficit in goods trade, we racked up nearly a $60 billion surplus in trade in services.

Of course, importing services can create difficulties for some firms and their workers who are undergoing the process of adjusting to a new way of doing business. Specialization becomes much more refined across different economic activities, and can change quickly with shifts in technology. Roberts and Schumer claim that comparative advantage and the old rules of trade no longer apply in today's world of mobile factors of production. But it is technology—not the movement of labor—that is creating new opportunities for trade in services, and this does not undermine the case for free trade and open markets.

To their credit, Roberts and Schumer do not advocate what they call "old-fashioned protectionism." Indeed, it appears that policymakers have few direct options to halt this process of technological change. Unfortunately, however, several state governments are considering laws that limit contracting with businesses that outsource from developing countries. Labor unions, such as the Communications Workers of America, have been lobbying Congress to follow suit.

Yet penalizing firms that import foreign-produced services is not an attractive option. If such imports help high technology and other service firms become more efficient, then forbidding U.S. companies from doing that when their foreign rivals are free to do it will only handicap U.S. firms. As American firms themselves are facing difficult competitive challenges from foreign producers, this would be like forcing them to fight with one hand tied behind their back.

Rather than penalizing firms, outsourcing reinforces the importance of public policies that allow workers to manage their best in a period of rapid economic change. This includes such things as ensuring the portability of health and pension benefits in order to reduce the adverse impact of changing jobs, which must inevitably happen in an ever-changing economy.

When a hand-wringing friend worried that some misfortunes would ruin the country, Adam Smith famously replied, "There is a great deal of ruin in a nation." The U.S. economy will face many challenges in coming decades, but as long as we do not stifle our dynamic economy that is the envy of the world, we need not fear that—as Roberts predicts—the United States will become a Third World nation by 2024.