November 2004

The Economy Today

NEWS FLASH

A Newsletter for Teachers of Economics to accompany Bradley R. Schiller's The Economy Today, and Essentials of Economics

Outsourcing Whose Job?

Pity poor Ricardo. He was the Classical Economist (1772-1823) who had to convince a skeptical public that international outsourcing was a good idea. Rather than trying to produce all goods and services within the domestic economy, David Ricardo encouraged nations to import products that could be obtained more cheaply from foreign producers. If England would import wine from Portugal rather than produce it, English consumers would end up with higher incomes (and better wine!).

New York winemakers still decry the heresy of Ricardo's theory of comparative advantage. As *In the News* on pg. 739 of The Economy Today relates, New York winemakers think the U.S. economy teeters close to economic disaster when American consumers imbibe imported Italian wines. They want the U.S. Congress to protect their jobs and profits from "unfair" foreign competition.

The clamor for "saving" American jobs gets particularly intense during economic downturns. This was strikingly evident during the Great Depression. When the U.S. economy began spiraling downward, throwing millions of Americans out of their jobs, a desperate blame-game ensued. Foreigners were the easy targets. Stop importing goods, it was argued, and there would be more jobs for domestic workers. So Congress passed the Smoot-Hawley Act (World View, p.744), sharply reducing imports. As economists had predicted, however, that legislation ended up destroying more jobs than it saved.

Today, the U.S. economy is again struggling. Although GDP has been growing at a brisk pace, job creation has been slower than anticipated. This has led people to characterize the 2003-4 recovery as a "jobless" expansion and to seek out a culprit. Foreigners are again the easiest target. Stop "outsourcing" jobs, it is argued, and U.S. employment will increase faster. A Harris poll revealed that 68 percent of Americans agreed that "outsourcing jobs to foreign countries is bad for the U.S. economy" (only 16 percent said outsourcing is "good;" the rest were unsure).

Refining the Concept

Prior to the recent recession, "outsourcing" was not a bad word. On the contrary, outsourcing had become a basic ingredient of corporate reorganizations. Companies recognized that they could cut costs by transferring some in-house functions to outside suppliers. By focusing on core strengths and outsourcing secondary functions, productivity and profits improved.

What transformed outsourcing into a dirty word was the increased use of foreign suppliers in the production chain. Dramatic improvements in telecommunications and transportation have created virtual global markets in both products and inputs. A systems engineer in Detroit can video conference as easily with an engineer in Bangalore as with one in Los Angeles. As U.S. consumers have discovered, call centers for information, reservations, or technical support can just as easily be located in Slovakia, India, or Grenada as in the United States. As barriers to global interaction have fallen, the range of outsourcing possibilities has broadened. This has intensified the fear that "good jobs"(e.g. software development, accounting, engineering) are increasingly at risk of being outsourced.

Defenders of international outsourcing concede that the range of outsourcing possibilities has expanded. But they are quick to cite the depth of insourcing. They point to foreign investments in the United States that create jobs here. There's a BMW plant in South Carolina, a Honda factory in Ohio, a Mitsubishi plant in Illinois. Foreigners have also invested billions of dollars to acquire and streng then U.S. corporations (e.g. Mercedes-Benz and Chrysler). Shouldn't the 6.4 million U.S. jobs financed by foreign investments be counted as an offset to jobs lost to outsourcing?

Critics of (international) outsourcing reject this argument. They argue that foreign investments in the United States are motivated by the desire to bring (foreign) production closer to the (U.S.) market. By contrast, offshoring entails outsourcing production of goods and services that will return to the U.S. for final sale. There are no location and transportation advantages, just lower labor costs (e.g. Indian telephone operators are paid 80 cents an hour versus $12.50 an hour for U.S. operators; Philippine computer programmers make $6,600 a year, versus $60,000-$80,000 for a U.S. programmer).

Comparative Advantage

The argument that offshoring is motivated by different concerns than other foreign investments and procurements may be true. It isn't evident, however, how that changes the substance of the debate. The argument for specialization (comparative advantage) was always about the resulting increase in output, not about the balance of traded goods or jobs. The cost savings made possible by outsourcing (even offshoring) translate into lower prices for U.S. consumers. Those same savings also increase corporate profits. The specialization facilitated by outsourcing also enables U.S. workers to focus on higher value-added jobs, thereby increasing U.S. wages. Last but not least, the jobs created abroad raise foreign incomes and, with them, the demand for U.S. exports. As all this added income gets spent, new jobs in other industries are created. Labor gets re-allocated, not permanently displaced.

Not My Job!

Unfortunately, labor doesn't get reallocated as quickly and efficiently as economic theory presumes. The Detroit software engineer who loses his job to an outsourced substitute in India feels the pain of job loss immediately. Re-employment is neither immediate nor certain. Although the overall economy ultimately gains from outsourcing, this is of no comfort to the workers who get displaced in the process. Even if the aggregate gains exceed the aggregate losses, the job losers aren't collecting enough unemployment benefits to cover their losses. At its core, then, the argument over outsourcing isn't really about the size of aggregate gains or losses, but about the distribution of those gains and losses.

President Bush isn't wholly off base when he points to education reforms as an answer to outsourcing. The more skills an outsourced worker has, the better and faster the prospects of re-employment. Tax cuts, low interest rates, and increased government spending can also boost job creation and re-employment prospects. More generous transfer payments can also help mitigate job losses. The one thing that won't help is a ban on outsourcing. Aside from the impossibility of enforcing such a ban in an interwoven global market, such a ban would depress productivity, slow economic growth, reduce incomes and ultimately destroy more jobs than it "saved."

Small Numbers

What is most surprising about the intensity of the current debate is the small number of affected jobs. A widely-quoted Forrestor Research study projects that 3.3 million service jobs will be outsourced over the next fifteen years. That may sound like a big number.

But it barely creates a ripple in the U.S. labor market. That 3.3 million projection works out to 55,000 jobs lost per calendar quarter. That loss gets swamped in the dynamics of the U.S. labor market, where an average of 7.71 million jobs have disappeared each quarter in the last decade (and 8.11 new jobs have been created). In other words, outsourced jobs would account for only 0.7 percent of normal job turnover.

"It's The Economy, Stupid!"

The U.S. Labor Department has come to a similar conclusion. During the first quarter of this year, just 2.5 percent of mass layoffs were related to the movement of jobs to another country. That already small gross loss is offset by the "ripple effects" noted earlier. A much-quoted study by the economics consulting firm Global Insight reckons such ripple effects may actually yield a net job gain for the U.S. Whatever the final number turns out to be, it is evident that Bill Clinton had it right a decade ago—it's the (macro) economy, not foreign telephone operators that caused widespread job losses in 2001-2002. And it's the recuperating macro economy that will have to create more new net jobs to displace the current outsourcing debate.

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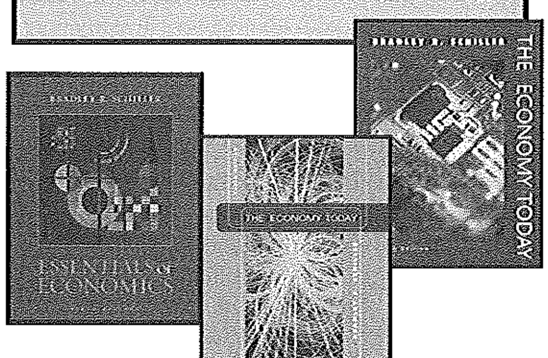

TextNote

The new Tenth Edition of The Economy Today, available Spring 2005, includes an "Economy Tomorrow" section in Chapter 6 on outsourcing.

WebNotes

- An executive summary of the Global Insight study is available from the Information Technology Assn. of America at www.itaa.org/itserv/docs/execsumm.pdf
- The Economic Policy Institute offers a critical Issue Guide to Outsourcing at www.epinet.org

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