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OUTSOURCING, OFFSHORING

SERVICES OFFSHORING: BANE OR BOON AND WHAT TO DO?

LAEL BRAINARD* AND
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Services offshoring is without a doubt the newest chapter in the American globalization debate. Americans are worried that the economy is permanently shedding jobs and compressing wages, not just in blue-collar manufacturing but also now in the white-collar services sector, once thought to be immune to foreign competition.

Public anxiety centers on low-wage countries such as India, China, and to a lesser extent Russia and Southeast Asia, where American companies are outsourcing services jobs, ranging from routine call center and clerical jobs to higher-value software programming, medical diagnosis, and even research and analytical jobs. The digitization of information and expanded bandwidth abroad are for the first time bringing international wage competition to a sector that economists used to describe as “nontradable.”

Coming on the heels of an economic recovery with record-low job creation, the offshoring debate hits at a time when anxieties about job losses and insecurity about trade are at fever pitch. Concern runs across political and demographic lines, with political leaders at all levels of government calling for measures to slow down or even halt offshoring.

The nation still has much to learn about offshoring, and existing data is not adequate to the task. Economic theory and past economic performance suggest that, on balance, although offshoring provides overall economic gains, it also is redistributive,

with affected workers facing the prospect of job loss and wage pressures. The challenge for policymakers is to make sure Americans have the skills they need to compete successfully in the global economy, America remains the most attractive location in the world for high value services and manufacturing, and the economic playing field does not artificially induce U.S. firms to go abroad, while doing a much better job of addressing the serious challenges faced by permanently displaced workers.

Services offshoring: How much, how fast?

Despite all the headlines, we know surprisingly little about how many jobs have moved offshore in the recent past, let alone how many are likely to do so in the future. One of the first priorities in the offshoring debate should be to improve the data that the government collects.

Goldman Sachs has estimated that offshoring has accounted for roughly half a million layoffs in the past three years. Looking forward, perhaps the best-known projection is by Forrester, an information technology consulting firm, which expects the number of U.S. jobs outsourced to grow from about 400,000 in 2004 today to 3.3 million by 2015. If this estimate turns out to be accurate, then offshoring could result in roughly 250,000 layoffs a year. How should we think about that number? It is small relative to total U.S. employment of 137 million, and accounts for less than 2 percent of the roughly 15 million Americans who involuntarily lose their jobs each year. But to workers who lose their jobs, and to the far larger number of workers who worry that they will lose theirs, the foreign outsourcing total, whatever it is, resonates powerfully. Indeed, a recent study by Ashok Deo Bardhan and Cynthia A. Kroll suggests that up to 14 million Americans now work in occupations that could reasonably be considered “at risk.”

Gathering more accurate official data about the extent of offshoring may be difficult. The data on services collected by the Bureau of Economic



Offshoring could result in 250,000 layoffs a year, less than 2 percent of total unemployment

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Analysis, for example, do not seem to be capturing any noticeable upticks in imports in the services where outsourcing is believed to be prevalent – a finding that raises questions about the accuracy of those numbers. Meanwhile, the Labor Department surveys employers, asking if they have had significant layoffs attributable to moving offshore. But firms are reluctant to offer such information, and without extensive (and expensive) verification of their survey responses, Washington is unlikely to get a good handle on the real numbers any time soon.

The economic theory of offshoring

What does economic theory have to say about the likely economic impact of offshoring? Economic principles point to two quite robust conclusions. Overall, offshoring will offer economic gains. But, with equal certainty, some American workers, companies, and possibly communities will lose out in the process. Let's examine each conclusion in turn.

Offshoring is closely related to technological advance: both are driven by competitive pressures to reduce costs and result in displacement of existing jobs. Both productivity gains and the displacement of existing jobs associated with technological advance have been features of the U.S. economy since its inception. Indeed, manufacturing productivity has been increasing roughly 4 percent a year for several decades now, which helps explain why the share of U.S. workers engaged in producing "things" has declined significantly, although the pace has been very uneven.

International trade works much the same way. Economists who point to the overall benefits of offshoring to the U.S. economy – such as Catherine Mann of the Institute for International Economics and, more recently, economists at the President's Council of Economic Advisers – typically argue that it helps lower costs and prices. A recent McKinsey study estimates that the net cost savings of moving some jobs offshore is about 50 percent – far lower than the sometimes 80 percent to 90 percent wage differential between U.S. and foreign workers (because of costs incurred for coordination and telecommunications), but still sizable. In turn, lower inflation and higher productivity allow the Federal Reserve to run a more accommodative monetary policy, meaning that overall and over time the economy will grow faster, creating the conditions for higher overall employment.

Catherine Mann has estimated that GDP growth would have been lower by 0.3 percent a year between 1995 and 2002 without foreign outsourcing of jobs in information technology.

Foreign outsourcing may also accelerate the formation of innovative products and services – an effect that has thus far been unmeasured but may be important. Some new and young firms, especially those reliant on information technology, are using highly trained foreign technicians (principally in India and China) to build prototypes of new products and services. In this way, U.S. based firms – that ultimately employ highly trained U.S. employees to bring new products and services to market – can develop those products and services at far lower cost, and often more quickly, than if the "proof of concept" stage activities were conducted solely in this country.

But if fewer people are needed in existing jobs and occupations, then won't total employment fall over time? Historically, the number of jobs has closely followed the growth of the labor force, despite major increases in foreign trade and the advent of a host of new job-displacing technologies, such as voicemail, word processors, and optical scanners. Indeed, despite a surge in openness, the U.S. economy since 1985 has added 30 million workers to its payrolls, even taking account of the recent recession and the jobless recovery. At the same time, median family income has jumped 20 percent. Structural changes, including trade and technology, influence where the jobs are, not their total number.

The policy challenge arises from the second sure bet from economic theory and practice. Offshoring, like trade and technology, is a process of creative destruction whereby workers in affected industries face the very real possibility of losing not only their jobs but also their health care. Even worse, some workers fall down the economic ladder when they have no choice but to take new jobs at lower pay and thus face the prospect of lower lifetime earnings.

This concern is particularly acute because it comes at a moment when anxieties about jobs and wages are at fever pitch. Against the backdrop of a breathtaking acceleration in manufacturing job losses over the past few years, the jobs picture remains bleak two years into recovery. Stephen Roach of Morgan Stanley estimates that the current "jobless" recovery is short 2.4 million jobs compared with the previous

Impact: general
gain, but individual
pain

“jobless” recovery of the early 1990s, and Laura Tyson, Dean of the London Business School, estimates that even those Americans that have jobs are short about \$350 billion in “missing income.” In such an economic climate, it is easy to understand why many Americans lack interest in parsing out how much dislocation is due to offshoring and how much to other causes and instead simply want to put on the brakes.

Just how redistributive is offshoring likely to be? Here, both the theory and the evidence only give partial answers. Let’s take an illustration from the McKinsey study, which estimates that for every dollar of U.S. services activity offshored, there is a global gain of \$1.44, suggesting a net gain of 47 cents. In their analysis, India captures 33 cents of the total, leaving the United States with the remaining \$1.12. How is this \$1.12 distributed? “Reemployed” workers get 45 cents – a substantial reduction – additional exports account for a relatively modest 5 cents, and shareholders of the firms doing the offshoring

gain the other 62 cents. U.S. shareholders, it appears, win while U.S. workers lose.

Indeed, the experience since the end of the 2001 recession is very negative, although current data is not adequate to determine how big a role offshoring has played. Figure 1 shows that the profit share has grown much more strongly in the current recovery than in the recovery of 1992–93, while worker compensation has suffered a more pronounced decline than in any previous recovery in the last four decades, a point also highlighted by Jared Bernstein of the Economic Policy Institute.

But this new allocation may be only temporary. Over the longer run, competition among firms should drive down profits, and consumers should benefit from lower prices. Historically, as shown in figure 2, there does not appear to be a long-term trend in the share of income going to profits relative to labor compensation.

Even so, these averages conceal what is happening to individual workers. Solid economic research now documents that the wages of low-skilled workers – those in the bottom of our income distribution – were pushed down in the 1980s and early 1990s by a combination of foreign trade, immigration and a drop in demand caused by changes in technology that favor greater skills. This downward pressure increased income inequality during this period, until the mid-1990s, when the rising tide of the overall economy lifted all boats.

Now that college-educated, white-collar American workers will increasingly be in competition with

Low-skilled workers, but increasingly also college-educated workers will lose

Figure 2

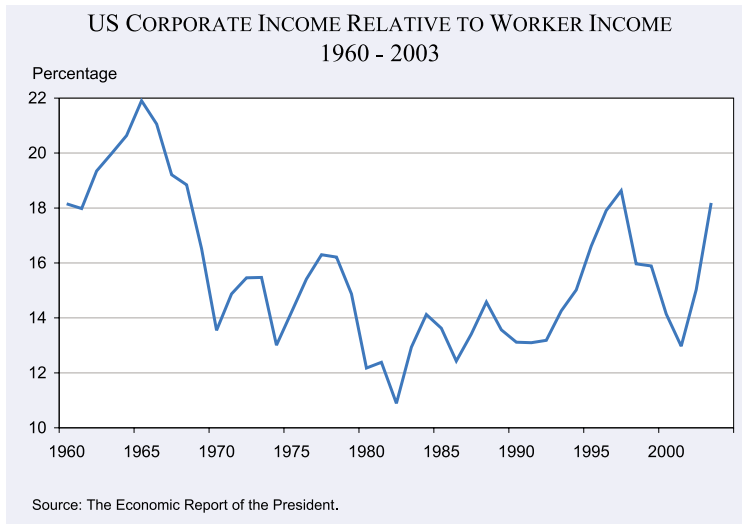
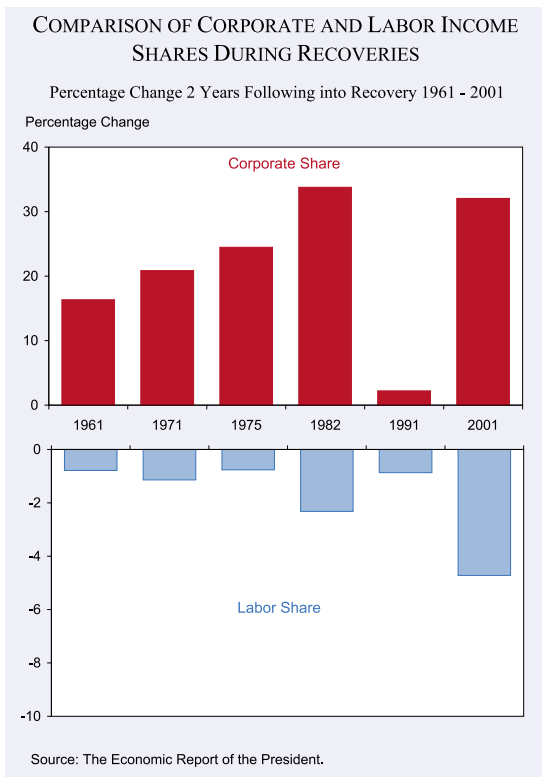


Figure 1



highly qualified workers in the developing world whose wages are a fraction of their own, won't they be subject to the same pressures? In a forthcoming book, *Business Week's* chief economist Michael Mandel worries that the answer to this question is "yes," and he may well be right. If so, then the "skills premium" that educated workers earned in the past may be pushed down in the future, thus reversing a decades long trend. At the same time, however, wages within sectors may diverge. In services, for example, some workers whose jobs are vulnerable to offshoring will suffer an erosion of their wages while others in supervisory positions see compensation gains. With all these possible changes, it is no wonder that fears about foreign outsourcing resonate across a broad spectrum of society.

Policy agenda

One thing is clear. Unless policymakers get out ahead of this debate, they will find themselves reacting to a host of band-aid proposals that do more harm than good. They should act proactively by taking five important steps.

First, they should ensure that America remains the most attractive location in the world for high-value services and manufacturing. That means taking a hard look at distortions in the tax code that may artificially encourage offshoring. It also means reducing reliance on an employer-based system of health insurance that adds to costs of U.S. firms, as well as strengthening government support for R&D in some areas.

Second, much must be done to make sure American workers have the knowledge and skills they need to compete in the global economy. That means strengthening the K through 12 curriculum, investing in science and engineering higher education, and restoring funding to community colleges and retraining programs that have suffered large cuts in recent years. Designing policies to strengthen the skills of the American workforce is particularly critical because the American economy is likely to confront a skill shortage of growing dimensions fast on the heels of the offshoring debate. In separate reports, Anthony Carnevale and Donna M. Derochers of ETS and David Ellwood of Harvard University forecast a "skilled worker gap" of 5.3 million workers by 2010 and 14 million by 2020. This is attributable both to the aging of the American workforce and to the

expectation that the increases in average educational attainment achieved over the past two decades will flatten out over the next two decades. Meanwhile, the demand for skills will continue growing at a rapid pace.

Third, policymakers must do more on trade, not less. They must make sure trade agreements are being enforced and must also regain the market-opening momentum lost in recent years. Ultimately it will not be feasible to sustain political support for the relative openness of U.S. services markets while countries such as India maintain high barriers on entry into their own services markets.

Fourth, while refraining from blunt, potentially counterproductive approaches, policymakers must pay attention to legitimate regulatory issues – notably, the need for oversight of consumer privacy, cyber security, and consumer protection when services (especially dealing with sensitive medical and financial information) are produced in jurisdictions with different regulations and professional credentials. Moreover, consumers have a right to know in services no less than in manufacturing, where country of origin labeling is mandated by law.

Finally, and most immediately, leaders must address the dislocation faced by workers in the services sector. Although Congress made far-reaching reforms to the Trade Adjustment Assistance program in 2002 – including adding a health care benefit – it ultimately rejected efforts by Senators Max Baucus, Jeff Bingaman, Tom Daschle, and others to extend its reach to services workers. Software programmers are now suing the Department of Labor to gain access to the same extended unemployment insurance and retraining benefits long guaranteed to trade-impacted manufacturing workers. Congress could make the suit moot by making clear that service workers are covered by Trade Adjustment Assistance.

"Wage insurance" should also be a central part of the safety net for displaced services workers. In 2002, Congress added to the Trade Promotional Authority Act a program providing wage insurance to workers older than 50 who can prove that trade is a "major cause" of their displacement. The goals of the wage insurance program were not only to ease the economic dislocations associated with trade-induced displacement, but also to encourage affected workers to search for and accept new jobs quickly.

Education, open markets, consumer protection and safety net for dislocated workers are urgent policy issues

Payments start when workers take new jobs and stop two years from the date they were laid off.

Workers who qualify receive, temporarily, half the earnings they lose when taking a new job, up to an annual ceiling of \$10,000. Clearly, therefore, one ready way to address worker displacement by offshoring would be to make such workers eligible for wage insurance, albeit with some qualifications: lowering or eliminating the age requirement and possibly raising the compensation limit to reflect the likely higher income of many dislocated services workers.

Of course, limiting the kinds of benefits available under Trade Adjustment Assistance to workers displaced by trade and offshoring more generally raises fundamental questions of fairness – in addition to the difficulties of identifying the cause of displacement. Why should those protections not also be available to workers who are permanently displaced for other reasons, notably improvements in technology and shifts in consumer demand? Because there is no satisfactory answer to this question – other than one of cost to the federal government – one author of this brief (Litan) proposed three years ago, with Professor Lori Kletzer of the University of California at Santa Cruz, to offer wage insurance to all permanently displaced workers regardless of age. The proposed insurance would be identical to that in the TPA program except that it would also provide a federal subsidy for up to six months of health insurance coverage. Had both programs been in place in 1997 for example, when the national unemployment rate was 4.9 percent, the annual total cost would have been \$3.6 billion. With today's 5.6 percent unemployment rate, and the likelihood that average wage losses suffered by displaced workers have increased since 1997, a reasonable estimate is that the two programs would now cost roughly \$4.5–5 billion.

When the wage insurance proposal was first made, amidst worries over what to do with a looming multi-trillion dollar budget surplus, \$4–5 billion annually seemed like a lot of money. Now, paradoxically, with a federal deficit exceeding \$500 billion for this year alone, \$4–5 billion a year seems eminently reasonable. After all, if the nation can afford \$87 billion in one year to rebuild Iraq and roughly \$400 billion over the next decade to cut taxes for Americans in the top income bracket, a program with a ten-year price tag in the neighborhood of \$50 billion to address losses from permanent job displacement,

whatever its source, seems not only affordable, but the only fair thing to do. And it could be paid for with a barely noticeable rate increase in the upper income tax bracket, which also seems fair. After all, people in this group, directly or indirectly, own most of the corporate stock in the country and thus will benefit from any short-run gains in profits from offshoring.

The nation still has much to learn about offshoring, and existing data is not adequate to the task. Economic theory and past economic performance suggest that, on balance, although outsourcing provides net benefits to the economy, it also is disruptive and worsens the anxiety that workers already feel during the current jobless recovery. The challenge for policymakers is to make sure Americans have the skills they need to compete successfully in the global economy, America remains the most attractive location in the world for high value services and manufacturing, and that the economic playing field does not artificially induce U.S. firms to go abroad, while doing a much better job of addressing the serious challenges faced by permanently displaced workers.

One proposal: wage insurance offered to all permanently displaced workers

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