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Outsource or perish

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With India becoming an increasingly important outsourcing destination, it has become politically prudent for many pressure groups within the developed world to engage in India bashing. The question is, how justified is it to oppose an increasingly important trend that many corporates are undertaking purely on the basis of economic considerations?

Outsourcing is now talked about in terms of a national disaster. In fact, there has been a push in some industrial countries, in the US and Australia, for example, to introduce legislation limiting the outsourcing activities of firms with government contracts. The point that's conveniently forgotten is the economic benefit that comes with outsourcing, such as lower prices, leading to lower inflation, resulting in an increase in real purchasing power for people with relatively stagnant wages. It also begets lower interest rates, culminating in higher investment and economic growth and lower mortgage rates.

The latest research undertaken by consulting firm McKinsey shows offshoring is as beneficial to a country like the US as it is to the destination country, probably more so. The most obvious benefits of offshoring accrue to businesses and destination countries. Lower wages in foreign countries translate into significant savings and, often, improved quality. A software developer in the US, for example, costs US$60 an hour whereas one in India costs $6 an hour. This, and other benefits, could translate to a net impact of a 50% increase in profits for American businesses.

Back in August 2003, McKinsey Global Institute (MGI) published an analysis of the economic benefits, both direct and indirect, of offshoring back office service and IT functions from the US to India. Of the direct benefits, MGI found that every dollar of spending that US companies transfer to India creates as much as $1.46 in new wealth. India receives 33 cents - through wages paid to local workers, profits earned by Indian outsourcing providers and their suppliers, and additional taxes collected by the government. The US economy captures the remaining $1.13 - through cost savings to businesses, increased exports to India, repatriated earnings from offshore providers in which US companies have invested, and the additional economic output created when US workers are re-employed in other jobs. In other words, the US captures 78% of the incremental value.

According to McKinsey, offshoring will allow the US to capture economic value through multiple channels:

- **Reduced costs** - Savings from reduced costs can be passed to consumers or to investors to reinvest. In the US, companies save 58 cents for every dollar of spending on back office service functions and IT jobs they move to India. These savings can be reinvested in new business opportunities with higher value-added, passed on to consumers in the form of lower prices (which then spark growth in demand), or distributed to shareholders

- **New revenues** - Offshoring creates demand in destination countries for US products, especially for high-tech items. Offshoring thus boosts exports. Outsourcing providers - whether in India or in Poland and whether subsidiaries of multinational companies or independently owned businesses - buy many goods and services abroad. A call center in Bangalore, for instance, might purchase Dell computers, HP printers, Microsoft software and Siemens telephones. Not surprisingly, exports from the US to India grew from $3.7 billion in 2000 to $5 billion in 2003

- **Repatriated earnings** - Several providers serving the US market are incorporated in America, which means they repatriate their earnings to the US. An additional 4 cents of every dollar spent on offshoring services to India thus returns to the US in the form of repatriated profits

- **Redeployed labor** - US workers who lose their jobs to offshoring will take up other jobs, which will in turn generate additional value for the economy. In fact, it has been found out that many in the US whose work is outsourced move on to other, higher value-added activities. From 1979 to 1999, 69% of US workers who lost their jobs as a result of trade in sectors other than manufacturing found new work within half a year. On average, they received similar wages in their new jobs, though roughly half took pay cuts, while the rest found better-paid jobs

The current debate on outsourcing is misplaced because the problem is neither trade itself nor globalization more broadly, but rather the question of how a country should allocate the benefits of global trade. Trade in services, like other forms of international trade, benefits the US as a whole by making the economic pie bigger and raising the standard of living. Outsourcing jobs abroad can help keep companies profitable, thereby preserving other US jobs. The media, and vulnerable workers, naturally focus on jobs lost to overseas workers. But even the job shift hasn't been a one-way affair. Four and a half million Americans work for European companies in the US; a million-plus work in companies involved in global trade. And, foreign companies are continuing to invest in America, despite higher wages. There's investment in the auto sector, with plants like Mercedes-Benz, Honda, BMW, and Toyota. Then there's foreign investment in financial services, pharmaceutical, chemical, and energy companies. They're all growing. And this is on top of the $600 billion invested annually in the US to support its trade deficit.

There is understandable anxiety in the US now that it no longer controls the high-tech, white-collar openings that were supposed to absorb those who lost manufacturing work. Everybody is aware of a new, global, highly skilled labor force that earns as little as a tenth of what the US pays. The fuss over outsourcing must not be allowed to obfuscate the real reason for the disappointing job and wage numbers. It's productivity. The increase in output per worker has, until recently, exceeded gross domestic product (GDP) growth. This means fewer jobs, including 800,000 management and executive positions in the past four years - jobs that would not be outsourced to other countries. Why? Companies will simply not hire new staff until they have confidence that sales will increase faster than gains in productivity.

Productivity has brought about huge job losses in manufacturing, not just in America but worldwide. Some 22 million manufacturing jobs vanished between 1995 and 2002 across the globe. In the 1990s, the US began outsourcing memory chips, laptops, and other high-tech equipment manufacturing to China and Taiwan. The fear then was that this might lead to the loss of their technological edge. But US semiconductor makers shifted into high-value microprocessors and sparked a productivity boom. All sorts of businesses found new ways to apply this technology, resulting in multibillion-dollar Internet markets and thousands of new jobs. The same thing is likely to happen again.

History shows that as economies grow, some job categories shrink or vanish and new ones appear. There were fears in the US about the migration of its industries to Japan in the 1950s and 1960s, OPEC buying the world in the 1970s and jobs going to Mexico in the 1990s. But every time, the US was able to adapt, creating new industries and jobs that never existed, while abandoning others. The same thing is happening now as jobs in call centers, back office operations, and some IT functions move offshore. Opportunities for redeploying labor and investing capital to create higher value-added occupations will continue to emerge even if it isn't always possible to say exactly where.

According to MGI, even if the re-employment of workers remains at its current rate, the US economy gains an additional 45 to 47 cents of economic output over time for every dollar of corporate spending offshored. This is probably a conservative estimate of the value created, since white-collar service workers are more likely to find new jobs, at higher wages, than manufacturing workers. A recent International Monetary Fund (IMF) study says that India-bashing on outsourcing of jobs from America is unjustified. In fact, the US and Britain have the largest net surpluses in business services and hence would suffer the most in terms of the lost dollar value of such trade if other countries cut service outsourcing.

An article in Finance & Development, an IMF publication, said between January and May 2004, there were 2,634 reports in US media on service outsourcing, mostly focusing on the fear of job losses. Call centers and computing services in India were the most frequently reported examples. It was found that firms based in industrial countries that outsource services have been accused of exporting jobs to developing countries. But in reality, the growing outsourcing of services is simply a reflection of the benefits from the greater division of labor and trade that have been described for manufactured goods since the time of Adam Smith and David Ricardo.

According to the study, outsourcing does not appear to be leading to net job losses. Jobs lost in one industry are often offset by jobs created in other growing industries. US business service imports as a share of the GDP have almost doubled in each of the past several decades, from 0.1% in 1983 to 0.2% in 1993 and 0.4% in 2003. India itself outsources a large amount of services. Its business services grew from 0.5% of the GDP in 1983 to 2.5% in 2003. Like trade in goods, trade in services is a two-way street. In addition to being a large importer of services, the US is also a large exporter of services and it has a net surplus in all services, in contrast to its goods trade, in which it has a net deficit. Hence it would suffer the most in terms of the lost dollar value of such trade if other countries cut service outsourcing.

Liberalized, competitive economies that have flexible labor markets can cope with the natural process of job creation and destruction, and the US economy - the world's most dynamic - is arguably in the best position to do so. The US has the highest rate of re-employment among Organization for Economic Co-operation and Development (OECD) countries by a factor of almost two. Over the past 10 years, 35 million new jobs have been created, and, according to the OECD, job growth was the fastest in high-wage occupations.

Results from US and United Kingdom studies conducted by IMF suggest that service outsourcing has the potential to make firms and sectors sufficiently more efficient, leading to enough job creation to offset lost jobs. These countries have reached a stage of economic development, where productivity and efficiency gains would be the main trigger for GDP growth. Slow productivity growth has long been seen as the Achilles' heel of a service economy.

Clearly, protectionism isn't the answer. Outsourcing is a powerful way for companies to reduce their costs, improve the quality of their offerings, and extend the scope of customer services. This is also the best way for companies to stay competitive in the global market and hence save the existing jobs. For European companies, it could also create a new source of flexibility now hindered by the thicket of labor laws at home. And Europe's rapidly aging populations mean that offshore labor increasingly will be needed in coming years to make up for a dwindling workforce. Far from viewing offshoring as a threat, the political leadership should use it as a catalyst for the structural reforms that advanced economies need.

Protectionism may be an easy call, but it's also a delusional one.

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