Services Offshoring, American Jobs, and the Global Economy

LAEL BRAINARD AND ROBERT E. LITAN

Americans are worried the economy is permanently shedding jobs and compressing wages, not only in blue-collar manufacturing but also now in white-collar services once assumed immune to foreign competition. The digitization of information and expanded bandwidth abroad are enabling companies to outsource to low-wage countries services ranging from routine call center and clerical activities to higher-value software programming, medical diagnosis, and research and analytical activities.

The offshoring debate has hit in the middle of a recovery that has produced few gains for workers, at a time when anxiety about employment and trade are at fever pitch. Concern runs across political and demographic lines, with growing calls for measures to slow or even halt offshoring.

The nation still has much to learn about services offshoring; existing data provide incomplete clues. Economic theory and past performance suggest that although offshoring provides overall economic gains, it is also redistributive, with affected workers facing the prospect of job loss and wage pressures. A powerful set of policy tools can help navigate the ups and downs of this new global force, but so far most have not been deployed.

Services Offshoring: How Much, How Fast?

There is substantial confusion about the phenomenon known variously as offshore outsourcing and offshoring. The focus here is on the relatively recent phenomenon of the provision of services—often internal to the firm—in offshore locations. This analysis does not distinguish between intrafirm and third-party offshoring because the aggregate economic consequences are broadly similar and because available data are not up to the task.

Despite the headlines, we know surprisingly little about how many jobs have moved offshore, let alone how many are likely to do so in the future. Goldman Sachs estimates 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 outsourced U.S. jobs to grow from about 400,000 in 2004 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.

> We know surprisingly little about how many jobs have moved offshore.

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 at the University of California–Berkeley suggests that up to 14 million Americans—including financial analysts, medical technicians, paralegals, and computer and math professionals—are in occupations where jobs or wages are "at risk."[1]

Gathering more accurate official data about the extent of offshoring is critical. A recent workshop held by the Brookings Institution revealed important puzzles in the data collected by government agencies.[2] For instance, although Bureau of Economic Analysis data on "business, professional, and technical" services (BPTS) show rapid growth in imports through 2002 (the last year available), they also show a growing trade surplus over the same period;[3] U.S. data on imports from India in this category show virtually no growth between 2000 and 2002. Moreover, according to

01.1-64_POW.08.2.indd 9 6/8/05 3:22:40 PM

Charles Schultze of Brookings, U.S. government reports on BPTS imports from India—$209 million in 2002—are much smaller than the corresponding Indian statistics, which show exports more than doubling from $1.6 billion in 2000/1 to $3.4 billion in 2002/3 (not including contract services performed on site in the United States).[4]

The jobs of up to 14 million Americans are at risk.

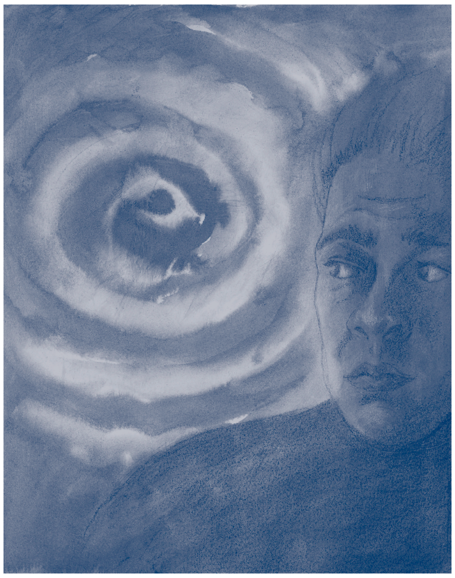
The U.S. Department of Labor (DOL) surveys employers regularly about major layoffs. The Mass Layoff Survey for the first quarter of 2004 asked whether mass layoffs were associated with movement of work either within the United States or overseas.[5] The low fraction of mass layoffs associated with relocations overseas—less than 3 percent—could be interpreted as evidence that offshoring fears are overstated. However, the Brookings workshop highlighted that these numbers capture only "mass" events where 50 or more workers are laid off in a period of less than 5 weeks for a duration of over 30 days, which applies to only a small percentage of total displaced workers during any period. Moreover, firms have been 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

Economic theory points to two conclusions about the likely economic impact of services offshoring. Overall, offshoring will offer economic gains. However, some American workers, companies, and possibly communities will lose out in the process.

Offshoring is closely related to technological advance: both are driven by competitive pressures to reduce costs and result in displacement of existing jobs. Since the nation's inception, the U.S. economy has experienced productivity gains and the displacement of jobs due to technological progress. Manufacturing productivity has increased roughly 3.5 percent a year over the last two decades, 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 like technological change. Economists such as Catherine Mann of the Institute for International Economics, who point to offshoring's overall benefits to the U.S. economy, typically argue that it helps lower costs and prices.[6] A recent study



by the consulting firm McKinsey and Co. estimates that the net cost savings of moving some jobs offshore is about 50 percent.[7] This is far lower than the sometimes 80 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 the economy can grow faster, creating the conditions for higher employment. Mann estimates that economic growth would have been lower by 0.3 percent a year between 1995 and 2002 without foreign outsourcing in information technology.[8]

Offshoring is closely related to technological advance.

Offshoring 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 into account the recent recession and 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 the total number of jobs.

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

01.1-64_POW.08.2.indd 10 6/8/05 3:22:43 PM

healthcare. 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.[9] Against the backdrop of a breathtaking acceleration in manufacturing job losses over the past few years, the jobs picture remained bleak much longer into the recent recovery than in any previous postwar recovery.

Offshoring is a process of creative destruction.

How redistributive is offshoring likely to be? Here, theory and evidence give only partial answers. As an example, the McKinsey study estimates that for every dollar of U.S. services offshored, there is a global gain of $1.47, suggesting a net gain of 47 cents. In their analysis, India captures 33 cents of the total, leaving the United States with the remaining $1.14. How is this $1.14 distributed? "Reemployed" workers get 47 cents (a substantial reduction), additional exports account for a relatively modest 5 cents, and shareholders and consumers of the firms doing the offshoring gain the other 62 cents. U.S. shareholders and consumers win while U.S. workers lose.

This plays into a broader set of distributive trends that have been quite negative for American workers since the end of the 2001 recession. As Federal Reserve Chairman Alan Greenspan noted in April 2004, "virtually all of the gains in productivity have ended up in rising profit margins and hence in a decline in the proportion of that national income going to compensation of employees."[10] Two years into the current recovery, the profit share of income grew 33 percent (on a pretax basis) compared with only 3 percent during the recovery of 1992–93; worker compensation, meanwhile, remained down 4 percent—a steeper decline than during any previous recovery in the last four decades. At the same time, the administration's tax policies have exacerbated rather than offset these trends by shifting the tax burden away from wealth and towards earned income.

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. The historical record since 1960 shows no long-term trend in the relationship between labor compensation and income going to profits.

Even so, longer-term averages often conceal what is happening to individual workers. Solid economic research now documents that the wages of low-skilled workers—those at the bottom of the 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 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 highly qualified workers in the developing world, won't they be subject to the same pressures?

In his new book, *BusinessWeek's* chief economist Michael Mandel worries that that the answer to this question is "yes," and he may well be right.[11] If Mandel's assumption is correct, 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, wages within sectors may diverge. In services, for example, some workers whose jobs are vulnerable to offshoring could suffer erosion of their wages even as others in supervisory positions see compensation gains. Thus, it is no wonder that fears about foreign outsourcing resonate across a broad spectrum of society.

Employer-based health insurance adds to the insecurity of displaced workers.

What is a Policymaker to Do?

Six important areas deserve urgent attention:

Improve the data that the government collects. Better information on services employment, trade, and productivity will result in better policy, better training and workforce education offerings, and better informed choices by American workers and students.

Ensure that America remains the most competitive location in the world for high-value services and manufacturing. Policymakers should take a hard look at distortions in the tax code that may artificially encourage offshoring, such as the current corporate tax system that permits deferral of taxation on foreign earnings but not on domestic earnings. It is also critical to strengthen support for research and development and to reduce reliance on an employer-based system of health insurance, which is costly to U.S. firms and adds to the insecurity of displaced workers.

Give American workers the knowledge and skills they need to compete in the global economy. America will not be able to hold onto the world's highest paying jobs if the number of college graduates with degrees in physical sciences, math, and engineering continue on a downward trend. This requires concerted action at all levels: strengthening the kindergarten through twelfth-grade curriculum; encouraging more American teenagers to invest in science and engineering higher education; and restoring funding to community colleges and retraining programs that have recently experienced cuts.

01.1-64_POW.08.2.indd 11 6/8/05 3:22:43 PM

Do more on trade, not less. Policymakers must make sure trade agreements are being enforced and must also regain the market-opening momentum that has disappeared in recent years. 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.

Pay attention to legitimate regulatory issues. Policymakers must address oversight of consumer privacy, cyber security, and consumer protection when services (especially those dealing with sensitive medical and financial information) are produced in other countries with different laws, 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.

Address the dislocation faced by workers in the services sector. This is the most urgent priority. Although Congress made far-reaching reforms to the Trade Adjustment Assistance (TAA) program in 2002—including adding a healthcare benefit—it ultimately rejected efforts to extend the program's reach to services workers. Software programmers are now suing the DOL 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 TAA.[12]

Wage insurance should also be a central part of the safety net for displaced services workers. In 2002, Congress amended the Trade Promotional Authority Act to include a program providing wage insurance to workers who are over fifty and can prove that trade is a "major cause" of their displacement.[13] Service workers displaced by offshoring should be eligible for that benefit, and it will almost surely be necessary to lower or eliminate the age requirement and raise the compensation limit (now $10,000 per year) to reflect the higher income of many dislocated service workers.

Notes

1. Bardhan, A. D., and C. A. Kroll. 2003. "The New Wave of Outsourcing" *Research Report* Fisher Center for Real Estate and Urban Economics (Fall). Berkeley: University of California, Berkeley.
2. Brookings Institution. 2004. "Services Offshoring: What do the Data Tell Us?" June 22. Washington, D.C.: Brookings Institution. <http://www.brookings.edu/pge/20040622_offshoring.htm>.
3. Kozlow, R., and M. Borgas. 2004. "Offshoring and the U.S. Balance of Payments." June 22. Washington, D.C.: Bureau of Economic Analysis.
4. Schultze, C. L. 2004. "Offshoring, Import Competition, and the Jobless Recovery." Brookings *Policy Brief* no.136 (August), p. 136.
5. Bureau of Labor Statistics. *Extended Mass Layoffs Associated with Domestic and Overseas Relocations, First Quarter 2004.* Washington, D.C.: Bureau of Labor Statistics.
6. Council of Economic Advisors. 2004. *Economic Report of the President*. Washington, D.C.: Council of Economic Advisors.
7. McKinsey Global Institute. 2003. "Offshoring: Is It a Win-Win Game?" August. San Francisco: McKinsey Global Institute.
8. Mann, C. L. 2003."Globalization of IT Services and White Collar Jobs: The Next Wave of Productivity Growth." Institute for International Economics *Policy Brief*, December.
9. Groshen, E. L., and S. Potter. 2003. "Has Structural Change Contributed to a Jobless Recovery?" *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, Vol. 9, No. 8 (August).
10. Greenspan, A. 2004. Testimony presented before Congress's Joint Economic Committee, Washington, D.C., April 21.
11. Mandel, M. 2004. *Rational Exuberance.* New York: Harper Business.
12. Baucus, Senator M. 2004. "Preparing America to Compete in the 21st Century and Beyond," March 3. Washington, D.C.: Brookings Institution.
13. Goals of the wage insurance program are 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. 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. See Kletzer, L. G. and R. E. Litan. 2001. "A Prescription to Relieve Worker Anxiety," Brookings *Policy Brief* no. 73, March.

Lael Brainard

Lael Brainard is director of the Poverty and Global Economy Initiative and New Century Chair in International Economics at the Brookings Institution.

Robert E. Litan

Robert E. Litan is a senior fellow in the Economic Studies program at Brookings and vice president for research and policy at the Kauffman Foundation.

01.1-64_POW.08.2.indd 12 6/8/05 3:22:44 PM