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THE ECONOMICS OF OUTSOURCING

How Should Policy Respond?

THOMAS I. PALLEY

The Outsourcing Controversy

International outsourcing of production and employment has recently attracted enormous attention in both the United States and Europe. For many, it has raised fears about the impacts on domestic labor markets (e.g., structural unemployment and the erosion of wages and benefits). For others, it is viewed as a favorable development that further extends the international division of labor and the application of comparative advantage (promising gains in wages and living standards without any adverse long-term employment effects).

Outsourcing is a central element of globalization, and policymakers need to understand its economic basis if they are to develop effective policy responses. Doing so requires two distinct exercises. The first involves defining the phenomenon, while the second assesses its likely empirical impact. The focus of this brief is on the former.

Outsourcing should be viewed as a qualitative phenomenon that is best understood as a new form of competition. Responding to it calls for the development of policies that enhance national competitiveness and establish new rules and institutions governing the nature of global competition. The challenge is to construct institutions that limit retrograde competition while preserving incentives for economic action. At the same time, these institutions must promote stable flows of demand and income, thereby addressing the Keynesian problem of inadequate aggregate demand. The challenge is compounded, however, by the lack of global regulatory institutions and by changes in the balance of political power that make it difficult to enact needed reforms.

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Global outsourcing is facilitated by technological innovations associated with computing, electronic communication, and the Internet. But it is important to recognize that the debate surrounding outsourcing is not about the benefits of technology. It is about the nature of competition and what constitutes appropriate rules for governing competition within and between countries.

The Economics of Outsourcing

Global outsourcing is an empirically and theoretically contested phenomenon. Mankiw and Swagel (2006) adopt a "job count" approach in their assessment of the impact of outsourcing on the U.S. economy, and argue that the number of jobs outsourced is relatively small compared to the total stock of jobs. They conclude that the significance of employment moving offshore has been blown massively out of proportion.

There are two problems with this naive job-count approach. The first is that the volume of outsourcing may increase significantly as firms become more globally active. The second and more important problem is that job loss is not the right measure for assessing the impact of offshore locations. Over time, the economy tends to recover some of the jobs lost, and the volume of employment always dominates the volume of unemployment. Yet outsourcing can still have significant effects on wage levels and employment conditions by affecting workers' sense of employment security and bargaining power (Bronfenbrenner 2000). These effects have been denied by mainstream trade economists who assert that labor markets are competitive, workers are paid their worth (i.e., their marginal product), and labor market competition for scarce labor protects workers from exploitation.

The benefits of outsourcing and gains from trade have been challenged by Gomory and Baumol (2000) and Samuelson (2004), as outlined in Public Policy Brief no. 86 (Palley 2006a). A country can lose if the international catch-up takes place in the export industry of the advanced country, which suffers an adverse terms-of-trade effect because the global supply of its exported product increases. However, the critique offered by these authors is static and focuses on export sector–related developments, whereas most of the concern about outsourcing seems to relate to the service sector.

An alternative, institutional approach views outsourcing through the lens of competition, with outsourcing giving rise to a new competitive trade regime in terms of both the structure of bargaining power and the margins of competition (i.e., those areas where companies and countries compete). Globalization has dramatically changed the structure of international competition, beginning with the emergence of multinational corporation (MNC) production in the 1950s. Initially, output was primarily for local markets, but since the 1980s, it has been increasingly targeted for export back to the United States.

There are two important economic features about the MNC revolution. First, it provided an arena for business to learn how to render state-of-the-art technology and production methods globally mobile. Second, it offered an initial margin within which capital put American labor in international competition with significant adverse impacts on manufacturing wages, employment, and union membership (Bronfenbrenner 2000; Bronfenbrenner and Luce 2004).

While the MNC revolution was taking place, a parallel and equally important revolution occurred in the U.S. retail sector—a new sourcing model based on big-box discount stores such as Wal-Mart.[1] Initially, the business model was based on national sourcing, which provided lower prices and was largely beneficial because all suppliers were located in the United States and operated under broadly similar laws. However, the new competition also encouraged manufacturers to move south to nonunion, "right-to-work" states, where labor costs were lower and it was more difficult to organize workers.

By the 1980s, the big-box discount stores started going global with their sourcing model. The economic logic of the model is simple: scour the world for the cheapest supplier and lowest cost—the so-called "China price"—and then require U.S. manufacturers and workers to match the price if they wish to keep your business. The commercial success of this model means that other retailers are compelled to adopt it as well if they are to remain competitive. Consequently, big-box discounting has spread to every corner of retailing and put the entire consumer goods manufacturing sector in international competition. Additionally, the model pressures domestic companies to pursue offshore production in order to compete with foreign suppliers. These dynamics erode manufacturing jobs and wages. The model does indeed deliver low prices, but it does so at high costs.

The global sourcing model is being applied in manufacturing and the service sector. Owing to improvements in electronic communication and the Internet, many services that were previously nontradable have become tradable (e.g., telephone

call centers), so this sector, too, will experience corresponding effects on compensation and employment security.

The maturation of globalization can be viewed in terms of four elements. The first is the global sourcing model discussed above, which was initially developed in the retail sector and is now applied everywhere. The second is the mobility of capital, technology, and methods of production. The third element is international economic policies that have dismantled trade barriers and promoted international economic integration, with cost arbitrage (especially wage arbitrage) a critical driver of the system. The fourth element is the addition of two billion workers to the global labor market, given the end of economic isolationism in India, China, and the former Soviet bloc countries.[2] These elements add up to downward wage and benefit pressures in U.S. labor markets and rising income inequality.

Macroeconomic Consequences of Changing Global Competition

The changing microeconomic competitive conditions associated with globalization have significant macroeconomic implications. One concerns income inequality, which has increased in almost all countries.[3] A second concerns the structure of global demand. The new global sourcing model encourages companies to shift production offshore and export back to their home base. In developing countries, there is an incentive to keep wages down, despite productivity growth, in order to retain international competitiveness; in Mexico, for example, real wages have stagnated over the past 20 years. These pressures retard domestic demand and the emergence of a large middle class, and pose long-run problems for maintaining a level of aggregate demand capable of generating full employment.

The extensive reliance on export-led growth has already contributed to a globally unbalanced economy in which developing countries with surplus labor rely on the U.S. market and compete with one another so that wage growth is retarded. This imbalance is reflected in the enormous U.S. trade deficit and a hollowing out of the middle class in the United States. The danger is that, if the U.S. economy slows, the entire global economy will slow too. Moreover, this configuration carries the risk of global deflationary pressures.[4]

Thus far, these adverse macroeconomic developments have been kept at bay by rolling stock market and housing price bubbles, and by increased access to credit for consumers. However, neither rising debt-to-income ratios nor asset price inflation significantly in excess of the general inflation rate are sustainable. The global economy could suffer a severe recession owing to accumulated financial imbalances and inadequate aggregate demand. And recovery from recession could prove difficult because of large debt overhangs and permanently atrophied structures of income and demand generation.

How Should Policy Respond? Rediscovering Keynesian and Institutional Economics

The current model of globalization delivers low prices at the high cost of undermining the structure of income and demand generation. A credit-driven boom in the United States, relative stagnation in the rest of the world, and a return in the United States to levels of income and wealth inequality that prevailed in the 1920s raise the possibility of a new era of global economic stagnation.

The problems of the Depression era were solved after World War II by applying new economic ideas originally developed in the 1930s. These ideas are relevant in the era of globalization, but economic theory has drifted back to pre–Depression era modes of thought.

One lasting contribution of the 1930s is associated with John Maynard Keynes, and that is the importance of aggregate demand for determining the level of employment and output. Keynes recognized that the price system does not automatically generate sufficient demand, and that what works in individual markets does not automatically work for the economy as a whole. Consequently, there is a reason for policymakers to step in and stabilize demand through monetary (interest rate) and fiscal (government budget) policy.[5]

A second vital intellectual contribution came from American institutional economists—including John Commons, Thorsten Veblen, and Wesley Mitchell—who emphasized the importance of the nature of competition and the problem of destructive rivalry, which resonates with today's notion of the "race to the bottom."[6] Institutional thinking constructs the policy problem in terms of "regimes of competition," with some regimes promoting societal welfare better than others. In combination with the adoption of a Keynesian macroeconomic stabilization policy, President Roosevelt's New Deal policies eventually solved the crisis of the Depression and made way for the prosperity that followed World War II (e.g., new labor laws

establishing the right to organize, the minimum wage, the 40-hour workweek, and the right to overtime pay). In the financial realm, creative reforms included the establishment of the Securities and Exchange Commission. Today's challenge is to come up with a similarly innovative set of arrangements to address outsourcing and globalization.

With regard to the rules governing worldwide competition, international labor standards are key to establishing a floor under the global labor market and to ruling out retrograde competition. At the same time, such standards are good for economic efficiency and development (Palley 2004, 2005). Unions are key to ensuring that productivity gains are shared equitably and result in a distribution of income that generates full employment. In the United States, that translates into a need for labor law reform that gives real meaning to the legal right to organize.

There is also a need for new arrangements that discourage tax competition and undervalued exchange rates. These arrangements should guarantee that there is neither an unfair shift of the tax burden onto labor incomes and underfunding of public investment and spending, nor unfair subsidies that distort the pattern of trade (by increasing exports without increasing global demand) and risk global deflation.

With regard to national competitiveness, countries need to invest in education that raises worker productivity and to support active labor market policies that help displaced workers. In the United States, health insurance coverage needs to be detached from jobs; as an example, the cost of every car made by General Motors includes $1,500 of worker health insurance. This suggests a national health plan financed out of general tax revenues.

Some Specific European Concerns

Global outsourcing affects the entire industrialized world. Europe is well positioned to meet the challenge, owing to its institutional structure. Most European states have established systems of public provision of social services, including health care. Since associated costs are not directly tied to jobs, there is less incentive to create jobs offshore.

Such systems do, however, raise Europe's tax burden—a burden that could be reduced by taxing income on a worldwide, rather than a country, basis. This policy could help finance public expenditures, while not providing an incentive for European companies to locate offshore purely for tax reasons. Moreover, the European Union's (EU) commitment to a "common markets" approach to economic integration aims to standardize systems of market regulation and competition, thereby avoiding race-to-the-bottom tendencies. This contrasts with the U.S. free trade approach, which removes tariffs and quotas without leveling the economic playing field across countries.

The EU's rules-based common markets approach may in fact help new Eastern European member countries. With low-wage economies and full access to the European market, these countries are potentially attractive locations for outsourcing (even though they are higher-cost economies than China or India). They may serve as a buffer for the EU, because outsourcing directed to them will be better for Europe as a whole than outsourcing to China.

Although this redirection would diminish the adverse impacts of outsourcing, it could also amplify the impact on EU economies that are in direct competition with their Eastern member countries. Europe's adoption of the euro already poses some problems because of divergences in international competitiveness across member countries. Europe faces two additional exchange rate challenges: (1) the outsourcing challenge posed by new EU members would be aggravated if these countries maintained undervalued exchange rates or joined the euro system at undervalued parities; and (2) China's exchange rate represents a serious threat because it is linked to the dollar at an undervalued parity and is increasingly undervalued against the euro. This trend increases Europe's trade deficit with China and creates incentives for European companies to locate and outsource goods from there.

Europe's Achilles heel is inadequate aggregate demand, which has been the root cause of high unemployment over the past 25 years (Palley 2006b). Outsourcing and loss of international competitiveness can have significant adverse consequences for aggregate demand, and European policymakers have failed to address the problem. This means that there could be a further increase in unemployment, which could then be politically exploited to attack Europe's trade unions and unravel the social and employment protections within European institutions. This result would be a tragedy, as these institutions are even more vital in the era of globalization.

Conclusion: The Politics of Policy Response

The emergence of global outsourcing enormously complicates policy issues. The ability to outsource worldwide calls for new forms of international regulation because it undermines the effectiveness of many existing national arrangements. Yet construction of an acceptable regime of international competition has to be accomplished in a political environment that lacks effective institutions of international economic governance and in which national governments are weakened and corporations strengthened by the enhanced mobility of capital. Neoliberal globalization has also sharpened the divide between capital and labor, to labor's disadvantage and capital's benefit.

Workers' desires for higher wages and lower prices have always been in conflict. In the past, this identity split has been exploited to divide union from nonunion workers, with antilabor advocates accusing union workers of causing higher prices. Globalization amplifies the rift between people's interests as workers and consumers by promising ever-lower prices. This means we all must be made aware that the benefits of low prices have to be considered in light of global impacts on wages, work conditions, and the balance of political power.

Globalization also affects an economy unevenly, hitting some sectors sooner than others. Manufacturing was the first sector to experience this process, but technological innovations associated with the Internet are putting service and knowledge workers in the firing line as well (e.g., Amazon.com has opened customer support and technology development centers in India).

Balanced against this process, globalization also impacts capital by creating a split between big international and small national firms. In the United States, this division has been brought into sharp focus by the debate about the trade deficit and the overvalued dollar. Whereas U.S. manufacturing as a whole previously opposed trade deficits and an overvalued dollar because of the adverse impact of increased imports, it is now divided—multinational corporations support an overvalued dollar, while domestic manufacturers oppose it.

This disunity opens up the possibility of a new alliance between labor and nationally based manufacturers and businesses. However, such an alliance will always be problematic because of underlying tensions between business and labor over the wage/profit division. Moreover, business may try to address its own internal schism by promoting a domestic "competitiveness" agenda aimed at weakening regulations, reducing corporate legal liabilities, and lowering employee wages and benefits.

Solidarity is key to mastering the politics of globalization. A main ingredient is a coherent story about the economics of neoliberal globalization around which working people can coalesce. Neoliberal economists tell stories about the economy, but there is a need for an alternative story with an institutional-Keynesian perspective. Moreover, international solidarity is needed to support new forms of international economic regulation, such as labor and environmental standards, capital controls, exchange rate coordination, and tax harmonization.

Notes

1. The seminal article on the emergence of this sourcing model is Gereffi (1994). The use of this model by the retail sector is documented by Hamilton (2005).
2. Freeman (2004) has emphasized the significance of the addition of two billion workers to the global labor market. However, he believes that globalization is being driven by classical comparative advantage, so the wage effects of increased global labor supplies can potentially be offset by the production gains that come from reallocating global production in accordance with the principle of comparative advantage.
3. The increase in global income inequality within and between countries is documented by Milanovic (2005). The increase in U.S. family income inequality is documented by Mishel et al. (2005). Krugman (1995) attributes 10 percent of the increase in U.S. wage inequality in the 1970s and 1980s to trade. Cline (1997) attributes 37 percent of the increase in inequality to trade. Palley (1999a) examines overall income inequality (using the U.S. family income Gini coefficient) and finds that 24 percent of the increase in inequality between 1980 and 1997 is directly attributable to increased openness, and that this percentage rises to 34 percent if the negative effect of trade on union density is taken into account. Kletzer (2001) has documented the direct wage losses of workers who lost jobs to trade.
4. The global deflationary risks of export-led development are explored in Palley (2003) and Blecker and Razmi (2005).
5. Tobin (1975, 1980) and Palley (1999b) have examined why generalized price deflation can be unstable.
6. Atkinson (1997) has also emphasized the relevance of American institutional economic thinking to globalization.

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