THINKING ABOUT OUTSOURCING

Our Outsourced Future

By Stephen S. Cohen and J. Bradford DeLong

Politically, today's fears about job losses and international trade got their start last summer; they will heat up during the campaign and cool off in a year or so. Economically, they are just starting, and are likely to develop over the next years into serious questions of economic theory and policy.

In 2001, 2002, and 2003 the Bush administration used concerns about recession and stagnant employment to fuel its successful effort to pass tax cuts that did little to cure the recession or stimulate employment. The big and, critically, permanent tax cuts for the $300,000+ a year crowd, the cut in dividend taxes—these were things that powerful factions within the Bush administration wanted but that would do next to nothing to cure a sick macroeconomy. The Bush administration placed a bet. It believed that it was very likely that the labor market would strengthen and employment would grow on its own. So why bother with a real employment stimulus package? They gambled, and the rest of us—America—lost.

So come the summer of 2003 the Bush administration needs an explanation for why the number of jobs in America is not growing. They don't dare say, "Our 'jobs and growth' package wasn't really a jobs package. We thought the labor market would recover on its own, you see. We were wrong. Sorry." So, instead, they begin to talk about China's undervalued exchange rate, and how China isn't playing by the rules of the international trading system, and how unemployed manufacturing workers in Ohio should recognize that their problems were made in Beijing. The Bush administration soon eases off: Don Evans's speeches about how trade with China doesn't benefit America because China doesn't play by the rules are (i) politically ineffective, and (ii) offensive to large chunks of the establishment.

Nevertheless, over the subsequent nine months this meme grows. Not just manufacturing jobs, but white-collar service-sector jobs as well. Not just China, but India—with its pool of well-educated English-speakers. Not just traded goods coming via container ship, but traded services arriving via fiber-optic cable as a result of "outsourcing." And not just Republicans, but Democrats—and by now more Democrats than Republicans, for Democrats believe that Jobs can be their big issue. For each Speaker Hastert talking about "Benedict Arnold CEOs" there are two Democratic counterparts (For most Democratic representatives and senators believe that they need to be two steps more protectionist than their Republican counterparts in order to be politically viable.)

Thus the political debate over "outsourcing" will burn for the rest of the barely-started 2004 campaign season. We will hear about Benedict Arnold CEOs. We will hear about Indians and Chinese willing to work for semi-starvation wages who are stealing the jobs that are rightfully ours. We will hear lots about undervalued exchange rates. And we will be told that the real solution is education, education, education: to upgrade the skills of America's labor force so that we can productively work in those occupations that cannot be outsourced and be the bosses of the overseas workers in those occupations that can.

This issue will burn fiercely. TV newscasters, newspapers, and magazines will respond to the demand for stories about outsourcing. We will see and read about how "outsourcing" is performing a magic trick and making lots of white collar jobs disappear. And as likely as not the jobs shown vanishing will be jobs for highly educated, high paid financial analysts and software engineers as well as jobs for single moms in call centers and for tech-support people whom you desperately need to communicate with when your computer just will not compute. Call centers; software; travel reservations; getting, tracking, organizing and interpreting the data for financial analysis; reading MRI scans and X-rays; tracking overdue bills; on and on it it will go—and it will come nerve-wrackingly close to what many of us, perhaps most of us, do for a living. Every other day we will see or read a feature piece profiling nice men or women in the U.S. whose jobs went to India. And we will see a photo of very nice, well-educated, clean, hard-working, and ambitious young people in India with college educations who have gotten those jobs at between 1/5 and 1/10 the pay, and who are now working on the details of perfecting their accent and slang, and learning typical seasonal weather patterns in American cities.

And then, come 2005 or at the very latest 2006, the political debate about outsourcing will die away.

With the end of the election season, the benefits from polarizing the electorate on "outsourcing" will vanish. With the recovery of employment—which will come someday—and the return of the amount of slack labor in our economy and the duration of unemployment to more normal levels, there should no longer be a Great Fear on the part of Americans that the jobs that ought to be theirs are (or are about to be) done in Bangalore. Forrester Research, first out of the gate with an exciting outsourcing Number, estimated that over the next decade some 4 million jobs in business processes are likely to go offshore. That is 30,000 per month—not a huge amount in an economy of 130,000,000 jobs where we need an average rate of job growth of 150,000 per month in order to hold the unemployment rate steady, and where every year some 1.5 million net jobs are destroyed between December 20 and January 12 as we step-down from the Christmas season. some 250,000 per year. In context, "outsourcing" is not a first-order feature of the U.S. labor market.

Moreover, it is a truth universally acknowledged (except in campaigning seasons) that the level of employment in the United States is not set by levels of imports and exports, but by whether the Federal Reserve's monetary policy manages to tune the level of aggregate demand to that sweet spot where there is neither high unemployment nor accelerating inflation. (And whether the Federal Reserve is properly supported by fiscal stimulus in those rare occasions—like today—where it finds itself out of ammunition.) "Outsourcing" is neither cause nor cure for the large gap between the number of Americans who have jobs and the number who want jobs. And as that gap closes over the next several years, concern over outsourcing will diminish.

But concern over outsourcing will return, perhaps very quickly; perhaps it will not be a huge deal for many years.. But eventually it will become a huge deal indeed, because though not the number of jobs, it is the wages they pay, that's at play.

The basic facts are simple enough: The second half of the nineteenth century saw the invention of the steel-hulled steam-powered ocean-going steamship and the submarine telegraph cable. You could use the telegraph cable to tell your agents in ports on the other side of the world what to ship, and you could use the steel-hulled steam-powered ocean-going steamships to ship not just precious goods (rare porcelains, jewels, spices, foodstuffs with interesting neurochemical properties) but staple manufactures and agricultural products: grain, hides, meat, wool, furniture, machines, and eventually motor vehicles, computers, and consumer electronics. We got accustomed over the twentieth century to the spectacle of industrial workers or agricultural workers losing their jobs to foreign competitors, who could produce more cheaply abroad and then export. Malaysia could produce rubber more cheaply than Brazil (which, as the home of the rubber plant, had lots of pests and parasites that had evolved to eat rubber plants). Illinois could grow wheat more cheaply than Prussia could grow rye. And, in the 1970s and 1980s, we learned that Yokohama could make better and cheaper cars than Detroit.

Now the first half of the twenty-first century is seeing a transformation quite as great. The trans-oceanic fiber optic cable, the communications satellite, and the internet are making much of white-collar service work as potentially tradeable as anything else. Broadband cables and satellites can connect India or China or Bulgaria to the US instantly, seamlessly—and almost costlessly. A huge, new swatch of our jobs will become vulnerable to foreign competition over the next years. (?). This new set of potentially tradeable jobs are in many cases jobs held by people who are not accustomed to lay-offs. Often they are high paying, clean, good jobs. Some are the best jobs. The people who hold them are quite convinced that they are on top—that they have these jobs and that these jobs are well paying—because they are the best people who deserve to have them: they are smart and industrious. In school they worked, hard while others screwed around. Sacrifices were made in order for them to attend college. They worked hard in college.

The economists say that this wave of service trade-driven globalization will, like the last wave of goods trade-driven globalization, be a positive-sum game. There will be more winners than losers, and the winners will win more than the losers. As long as the Federal Reserve does its job to make Say's Law (the claim that the demand will always appear to soak up increases in supply, and so higher productivity means higher incomes and not higher unemployment) true in practice even though it is not true in theory, the most that the losers will suffer in the long run is a fall in their incomes. And other workers and consumers will see their incomes rise and their spending power increase to make the process taken as a whole a good thing for the country, and for the world.

The economists are right. In response to Forrester and to the wave of political upset, McKinsey (as well as others) have hurried out quick pro-"outsourcing" studies. McKinsey (using its truly proprietary—that is, opaque—methods) calculates that every $1 spent on offshoring business practices generates 50 cents in business cost reductions—which show up as higher profits and higher investment in America, generates higher exports to the offshore site, and calculates that displaced American workers do find new jobs, and suffer on average only small wage losses.

But the economists are also wrong. For we have not, we do not as a country make the investments in retraining and rebuilding needed to transfer some of the gains from the winners to the losers, and so make the process of economic change truly a win-win one. There were no regional adjustment funds provided to the cities of Lowell and Fall River Massachusetts in the 1940s and 1950s as their textile manufacturing base pulled up stakes and headed for the lower-cost Carolinas. There was little money spent on Flint and Detroit in particular and Michigan in general in the late 1970s and 1980s to cushion the economic impact of the coming of Toyotas and Hondas to America's shores. Consumers in Boston and San Francisco drove their Accords and Corollas and pocketed the gains rather than having them diverted to rebuilding the Midwest.

As Paul Krugman puts it, free trade is a salable policy only if accompanied by a well-built social safety net and confidence in full employment. Our safety net is full of holes, and confidence right now that employment will be full is shaky. Preserving free trade in the 1970s and 1980s was a near-run thing, even though the magnitude of imports was not that great and the shock to America's distribution of income and employment not that large.

This is worth thinking hard about, for when "outsourcing" truly arrives—whether in one or two or three decades—it is likely to deliver a shock an order of magnitude larger to the American economy.

Consider: the income gaps in the case of "outsourcing" will be much greater than in the case of trade in manufactured goods. The income gap between Japan in and America in the 1970s was a matter of one-to-two. The income gap between India and America tomorrow will be one-to-ten. On the one hand, economists will say that the gains from trade will thereby be that much greater for the economy as a whole. On the other hand, the potential downward pressure on loser workers in rich countries will be that much greater as well.

Consider: trade in services potentially affects a much larger proportion of the labor force. Sectoral trade deficits in manufactured goods have rarely, rarely exceeded 3% of

GDP. But what is the upper limit to the sectoral trade deficit in long-distance document-image pushing?

Consider: the assault by manufactured imports on American mass-production manufacturing in the 1970s and 1980s was something done to American workers and firms standing together. The process of outsourcing will look very different: it will be something done by internationalized American firms to American workers. The politics of GM, Ford, and UAW asking for help together to deal with foreign competition will be very different from the politics produced by workers vs. CEOs.

And, conversely, consider India. Put 10 million people in India to work at $26,000 a year providing white-collar services to the industrial core, and you have boosted India's standard of living by 50%. And you have displaced only 4% of the potential target industries, for there are 240 million service-sector workers in the First World today.

Because this is an economic transformation that is going to hit not in one shot next year but over the course of the next generation, we have plenty of time: time to build the social safety net, the education and retraining programs, the social and economic institutions needed to turn the coming of trade in white-collar services from a win-lose to a win-win affair for America and Americans; time to rebuild confidence that employment will be full and the duration of unemployment spells short. But we will need all this time, because the magnitude of the approaching economic trade shock will be much larger than anything in our historical memory.

What confidence do we have that the shock will be large? A lot. Consider this: There is nobody in America who in the early 1990s worried more about the impact of trade on the wages of Americans in industries that came under pressure from foreign competition than H. Ross Perot. In his political career as advocate of deficit reduction and foe of NAFTA, there was nobody who clearly and visibly cared more about the long-run economic destiny of average Americans than H. Ross Perot. Yet on February 7, 2004, the Times of India reported that Perot Systems is going to double its employment in Asia from 3,500 to 7,000–which will then be half of Perot Systems' worldwide employment. Remember how H. Ross Perot used to talk about the "giant sucking sound" of U.S. jobs going to Mexico? It's not giant, but it is a sucking sound as people working for Perot Systems process medical bills and design software for other outsourcing operations in India. If the economic logic of "outsourcing" is the overwhelmingly powerful consideration for H. Ross Perot, for what American businesses will it not prove irresistible?