Econ 340

Lecture 22
Outsourcing and Offshoring

Outline:
Outsourcing and Offshoring
• Definitions of OS
• Causes of OS
• Effects of OS
• Facts about OS
• Policies

Definitions
• Outsourcing = Movement of an activity to outside of firm
  (Not necessarily outside country)
• Offshoring = Movement of an activity to outside of country
  (Not necessarily outside firm)
  – Could be
    • Subsidiary abroad (FDI if outside country)
    • Subcontracting with another firm
    • Arm’s-length trade
  – Often refers to services
  – Sometimes called “trade in tasks”
Definitions

• Both could be called:

OS = OutSourcing / OffShoring

• I’ll use “OS” to refer to OffShoring, since that’s the one that is clearly international

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Causes of OS

• Blinder identifies two causes of the increase in OS over recent decades:
  – New technologies
    • Information
    • Communication
  – Entry of new populations into world economy
    • China
    • India
    • Former Soviet states
  – These make OS possible for jobs that can be done at a distance
Causes of OS

• Otherwise, causes of OS are same as causes of other trade
  – Activities are offshored if they can be done more cheaply elsewhere
  – Thus OS occurs due to
    • Comparative Advantage
      – Due to technology differences
      – Due to factor-endowment differences
    • Economies of Scale

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Effects of OS

• Disagreements
  – Bivens (not assigned), like other trade skeptics,
    • is largely negative
    • He defines offshoring as “substituting foreign for domestic labor”
  – Many mainstream trade economists
    • see offshoring as ordinary trade
    • are largely positive
  – Blinder (a very well-respected macro economist)
    • sees OS as beneficial overall
    • but worries about effects on US labor
Effects of OS

• Effects that are Like trade:
  – All of the effects of trade that we have studied, are valid for this. OS is trade.
  – Thus
    • Countries as a whole gain, due to comparative advantage, economies of scale, etc.
    • Some people within the countries lose – especially those whose jobs are lost
    • Theory says that “scarce factors” are hurt by trade, and thus also by outsourcing.

Effects of OS

• Effects that are Unlike trade
  • i.e., effects that don’t occur with other trade, or at least weren’t mentioned
  – Increased insecurity: workers feel more threatened
    • New groups (white collar, in high-income countries) are seeing the threat
  – Employers can “move jobs”; workers can’t
    • Thus employers gain in bargaining over wages

Effects of OS

• Effects that are Unlike trade
  – (Possible) loss of technological advantage
    • Poor countries acquire the knowledge that rich countries previously had exclusively.
    • Thus
      – Poor countries become more productive
      – Their incomes rise
      – Therefore OS helps economic development
Effects of OS

- Effects that are **Unlike** trade
  - (Possible) loss of technological advantage
    - Terms of trade of rich countries worsen, costing them some of their gains from trade
      - Thus rich countries may lose from the loss of exclusive technologies due to OS
      - But what they are losing are the gains from trade. Refusing to trade would only make things worse.

Effects of OS

- OS from US may create jobs in US
  - OS can make a firm or industry viable that would not have been viable without OS
  - Example: US software company, IMC.
    - (IMC = Information Management Consultants. Makes software to exploit human genome research.)
    - Became viable only with coding done in India.
    - Now it employs six engineers in the US for every one in India.

Effects of OS

- OS raises productivity (see Amiti and Wei)
  - They estimated the causes of US productivity growth over 1992-2000
  - 11% of it was due to "service offshoring"
  - Only 3-6% was due to imported material inputs
  - Why the gain? Because firms choose to offshore the less efficient parts of what they do.
Effects of OS

- OS threatens some occupations more than others (see Blinder’s examples)

<table>
<thead>
<tr>
<th>Offshorable</th>
<th>Not offshorable</th>
</tr>
</thead>
<tbody>
<tr>
<td>electronic service</td>
<td>personal service jobs</td>
</tr>
<tr>
<td>tax accounting</td>
<td>onsite auditing</td>
</tr>
<tr>
<td>computer programming</td>
<td>computer repair</td>
</tr>
<tr>
<td>architects</td>
<td>builders</td>
</tr>
<tr>
<td>radiology</td>
<td>pediatrics and geriatrics</td>
</tr>
<tr>
<td>lawyers who write contracts</td>
<td>litigators who argue cases in court</td>
</tr>
</tbody>
</table>

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Facts about OS

- Blinder estimates that 30-40 million US jobs are potentially offshorable.
  - Compare to civilian employment in Jun 2008: 145.9 million
  - So Blinder is estimating that up to a quarter of US employment is potentially threatened by offshoring
  - Thus it “rattles” him
Facts about OS

- But the actual amount is still relatively small
  - Brainard and Litan say OS accounts for only 2% of those who involuntarily lose their jobs. (It would be a much smaller share of all job turnover)
  - But they were writing in 2004
  - One more recent source, though critical of OS, seems to give an even smaller estimate.

Facts about OS

- OS is moving into services
- There are flows in both directions
- Flows out of US are mostly low value jobs
  - So far. But Blinder worries & sees threats to higher value jobs

Facts about OS

- Brainard and Litan say OS is not shifting the proportion of incomes more towards profits
  - See graph below
Facts about OS

- Brainard and Litan say OS is not shifting the proportion of incomes more towards profits
  - See graph below
  - Other data (below) show that labor’s share
    - Has declined in recent decades
    - Increased in the crisis, as profits fell
    - Then fell in recession
Facts about OS

• Wages and employment have recently stagnated, according to Bivens at Economic Policy Institute (not assigned)
Facts about OS

- Wages and employment have recently stagnated, according to Bivens at Economic Policy Institute
  - This may not be due to OS
  - But people naturally think that it is

Facts about OS

- One explanation (see Mandel): Phantom GDP
  - Puzzle: Why has US productivity risen, but wages have not?
  - Possible Answer: OS
    - Raises measured GDP more than actual output
    - Lowers measured GDP less than actual output
Facts about OS

• Examples of Phantom GDP
  – Switch from expensive imported inputs to cheaper imported inputs:
    • \( M \) falls, so \( Y = C + I + G + X - M \) rises
    • But our actual output didn’t change
  – Switch from expensive domestic inputs to cheaper imported inputs
    • \( M \) rises, and \( Y \) falls, but by less than actual output fell

• Implication of Phantom GDP
  – GDP 
    • Overstates actual output
    • Thus overstates productivity
  • Does this mean that OS is hurting us?
    – No!
    – It means that gains from trade are being misinterpreted as increased productivity

Tom Friedman’s View of OS

• Tom Friedman (author of *The World Is Flat*)
• CEOs no longer think of outsourcing (or offshoring) at all, because
  – They don’t think of “in” or “out”
  – Things are “Made in the World”
  – They produce “anywhere through global supply chains”
Tom Friedman’s View of OS

• Friedman thinks the US has advantages that will let us prosper in this new world:
  – protection for intellectual property
  – secure capital markets
  – government funding for science
  – strength in logistics (FedEx, UPS)

Facts about OS

• Recently, some offshoring has been reversing (see Economist):
  – Some companies are bringing operations back to the US
  – Called “reshoring”

Facts about OS

• Examples of reshoring
  – General Electric has “returned production of fridges, washing machines and heaters from China back to Kentucky.”
  – Lenovo is starting to make PCs in North Carolina
  – GM is shifting its IT back to Detroit
  – Apple is making some Macs in the US
Facts about OS

• Reasons for reshoring
  – China’s cost advantage is shrinking due to
    • Rising wages
    • Appreciating currency
  – Increased use of automation (robots) has reduced reliance on labor
  – Production abroad is increasingly to serve foreign markets, not to export back to US

Facts about OS

• Most recently – see Schuman NYT 2016
  – While US did lose jobs to China before 2011, now China itself is losing jobs:
    • To its slowing economy
    • To its neighbors
    • Back to the US

Facts about OS

• Most recently – see Schuman NYT 2016
  – While US did lose jobs to China before 2011, now China itself is losing jobs
  – Why?
    • Wages in China are 29% higher than 3 years ago
    • Wages are lower in
      – Vietnam (1/2)
      – Bangladesh (1/4)
    • Costs in China are now about the same as in US
Facts about OS

• Most recently – see Schuman NYT 2016
  – While US did lose jobs to China before 2011, now China itself is losing jobs
  – Why?
  – Where are jobs from China going?
    • To neighboring low-wage countries
    • Back to US: Survey found 24% of US manufacturers “reshoring” or planning to
    • Apple’s manufacturer, Foxconn, is building 12 new factories in India

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Policies Suggested for OS

• Get more data
• Expand adjustment assistance
• Invest more in education
• Require transparency by publicly owned firms.
• Remove artificial (i.e., tax) incentives that encourage OS.
Policies Suggested for OS

• Trump:
  – Provide tax incentives to keep production here (as done last fall for Carrier)
  – Threaten a tax on exports back to US from OS factories
  – Good ideas? NO!

A final note on Outsourcing

• [http://www.youtube.com/watch?v=YaZ57Bn4pQ](http://www.youtube.com/watch?v=YaZ57Bn4pQ)

Next Time (Last Class)

• Environment, Labor Standards, and Trade
  – The Issues
  – Environment
    • Examples
    • Policies
    • International Problems
    • Role of the WTO
  – Labor Standards
    • Fundamental ILO Conventions
    • United States Role
    • Issues