

Outsourcing Benefits Michigan Economy and Taxpayers

By Daniel T. Griswold and Dale D. Buss

Introduction

Lawmakers in Congress and in more than 30 state legislatures have targeted foreign outsourcing as a threat to U.S. employment and prosperity. Along with certain critics in the news media, such as CNN's Lou Dobbs, they charge that U.S. companies are firing American workers in significant numbers and replacing them with foreign service workers in low-wage countries such as India. Legislative proposals in Michigan and elsewhere have focused on barring federal or state contracts with companies that would "offshore" the work to call centers or information technology providers abroad.

Foreign outsourcing has become a lightning rod for controversy. At a press conference in February, the chairman of President Bush's Council of Economic Advisors, Professor Gregory Mankiw of Harvard, found out just how controversial outsourcing has become. The president's economic advisor described foreign outsourcing as "something that we should realize is probably a plus for the economy in the long run." Far from being a new and unique threat to employment, he noted, "Outsourcing is just a new way of doing international trade. We're very used to goods being produced abroad and being shipped here on ships or planes. What we're not used to is services being produced abroad and being sent here over the Internet or telephone wires." Mankiw concluded, "I don't think [foreign outsourcing] is the primary thing driving the recent business cycle developments."¹ Republican and Democratic politicians alike criticized Mankiw for favoring "economic theory" over displaced workers.

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Economic Benefits of Foreign Outsourcing

Despite the criticism, the president's chief economic advisor was right. Outsourcing itself is nothing new. U.S. companies and governments have been outsourcing domestically for decades by contracting out such services as payroll, database management, and janitorial services. The new twist has been the recent increase in foreign outsourcing, or offshoring, in which companies buy services from foreign-based providers. Foreign outsourcing has been made increasingly cost-effective because of the personal computer, which has digitized much of our work, and high-speed and deregulated transmission of that information through broadband and the Internet. Informational technology (IT) companies are increasingly outsourcing routine programming, data entry, and system monitoring. Call centers are shifting more of those thankless jobs abroad.

If anything, Mankiw was guilty of understating the benefits of outsourcing. Foreign outsourcing almost certainly benefits the U.S. economy in the short run as well as the long run. Like more conventional forms of trade, foreign outsourcing allows U.S. companies to dramatically cut the cost of certain information technology services. As a result, U.S. companies become more competitive in what they do best, their "core competencies." Better and more affordable services become available for consumers and taxpayers. Outsourcing allows companies to operate on an around-the-clock, "24/7" production cycle, further adding to productivity. Outsourcing is even making possible work that simply wouldn't exist otherwise, such as chasing down delinquent accounts receivable that were thought to be beyond collection.

According to a 2003 study by the McKinsey Global Institute, outsourcing delivers large and measurable benefits to the U.S. economy. It reduces costs for IT and other services by as much as 60 percent, keeping U.S. com-

panies competitive in global markets, benefiting workers and shareholders alike. It stokes demand abroad for the export of U.S.-supplied computers, telecommunications hardware, software, and legal, financial, and marketing services. It returns profits to the United States from U.S.-owned affiliates abroad, and it allows U.S. companies to re-deploy workers in more productive jobs here at home. In fact, McKinsey calculates that every \$1.00 spent on foreign outsourcing creates \$1.12 to \$1.14 of additional economic activity in the U.S. economy.² Another study by Global Insights estimated the U.S. economy will be \$124 billion larger in 2008 if outsourcing continues compared to no outsourcing.³

Foreign outsourcing could eventually deliver the same scale of productivity gains to the IT services industry that it has to the hardware industry. Many of the components in a typical computer sold in the United States today are sourced from around the world, especially East Asia. According to a study by Catherine Mann at the Institute for International Economics in Washington, global sourcing for IT hardware cut the final costs to businesses and consumers by 10 to 30 percent, accelerating the diffusion of computer technology through the U.S. economy. That diffusion added three-tenths of a point to GDP growth and a cumulative \$230 billion to U.S. gross domestic product.⁴ Foreign outsourcing, by spreading lower IT costs to service sectors that make up 80 percent of the U.S. economy, could have an even bigger impact on growth than the outsourcing of IT hardware. Outsourcing could help control spiraling costs in such sectors as health care and education.

Outsourcing Job Losses in Perspective

One of the frustrations of the outsourcing debate is the lack of hard numbers. Nobody really knows how many jobs have been outsourced overseas. Unlike bushels of soybeans or slabs of steel, jobs are not counted at a dock and loaded on a ship for India or China. The best estimates from the industry are that perhaps 300,000 to 400,000 jobs previously performed in the United States are now done overseas through contractors. A recent update of the much-cited 2002 study by Forrester Research Inc. projects that the number of U.S. jobs outsourced abroad will increase from an estimated cumulative total of 315,000 in 2003 to 3.4 million by 2015.⁵ That would mean an average of 257,000 additional jobs outsourced each year.

Even if accurate, those numbers are just a few drops in the big bucket of an \$11 trillion economy that employs

138 million people and creates and destroys millions of jobs every month. Even in times of healthy employment growth, 350,000 people file for unemployment insurance *every week*. The U.S. Department of Labor reports that during the past decade our economy created an average of 32.8 million new jobs each year while eliminating 31.0 million, for a net annual gain of 1.8 million.⁶ If only half, or 15.5 million, of those annual job losses are permanent, that would mean that the quarter of a million jobs supposedly lost from foreign outsourcing each year account for less than 2 percent of the total jobs eliminated each year. Jobs lost to outsourcing are but a small rivulet in the torrential “job churn” normal for a dynamic market economy such as ours.

Far more Americans lose their jobs to technology, domestic competition, and changing consumer tastes than to foreign outsourcing or other forms of international competition. Think of all the former typists, telephone operators, and bank tellers whose work has been replaced by computers and other machines. For example, Kodak announced in January of this year that it would lay off as many as 15,000 workers, or one-fifth of its global workforce, not because of foreign competition but because the popularity of digital cameras have depressed the sale of film. Montgomery Ward, K-Mart and other retailers have laid off tens of thousands of workers in recent years, not because of foreign competition but because of domestic competition from rivals such as Wal-Mart. Between 1988 and 2000, a net half-million jobs for typists and word processors were eliminated, not because they were outsourced but because they were made redundant by computers.⁷ But it appears that job losses catch the attention of politicians only if they can be blamed on a foreign bogeyman.

Even the recent job losses in information technology have not been driven primarily by foreign outsourcing. Instead of blaming IT providers in India, displaced high-tech workers should blame the bursting of the dot-com and telecom bubbles in 2000, the subsequent plunge in the NASDAQ, the recession and decline of business investment in 2001, the September 11 terrorist attacks and the uncertainty that followed, corporate scandals, and slow growth abroad.

The Fall and Recovery of the IT Sector

A fundamental mistake made by many critics of foreign outsourcing has been to confuse the passing pain of the IT recession with an alleged long-term decline in the sector. That mistake is compounded when current output

and employment levels are compared to the peak of the boom in 2000 rather than to the more normal levels from the late 1990s. A more accurate and less alarming picture of the industry emerges if we compare the state of the industry a few years after the bubble burst to its state a few years before.

Beginning in the early 1990s, with the takeoff of Windows-based computing and the Internet, employment in the IT industry surged. Employment in software and related services grew by one million between 1993 and 2000, before dropping by 166,000 between 2000 and 2002.⁸ The story has been much the same across other IT sectors: stupendous growth throughout the 1990s, then a pullback in employment of 10 to 20 percent during the recession. In the IT industry as a whole, employment levels even after the recession are still no lower than in 1998. During the past decade, annual employment in the industry has still grown at a rate twice as fast as employment in private industry in general.

Despite the turbulence of the past four years, the U.S. information technology services sector remains a major force in the U.S. economy. The domestic software, computer, and communications industries accounted for a combined \$621 billion of GDP in 2003, up from \$510 billion in 1999. IT services that are moving offshore are more than offset by increased output here at home. Any sluggishness in employment growth has been because of rising productivity, not because of falling production.⁹

The jobs that have been lost in the U.S. IT sector tend to be the lower skilled and lower paid jobs in the industry — just as trade theorists would predict. From 1999 through 2002, total employment in the IT industry did drop by more than a quarter-million, from 6.24 million to 5.95 million. But declining employment was concentrated in those occupations requiring relatively low or moderate levels of training and education.

In contrast, the number of IT jobs that require a relatively high level of training and education declined more slowly. In the year before the dot-com and telecom bubbles burst, the industry employed 3.43 million workers whose jobs required at least an associate's degree and work experience. After a surge of hiring in 2000, followed by a painful shakeout, the number of such highly skilled workers stood at 3.51 million in 2002, still up 2.3 percent from 1999.¹⁰ The number of high-technology jobs overall has actually been increasing since the end of 2003, according to the Bureau of Labor Statistics.¹¹ Contrary to the popular angst over "our best jobs going overseas," the best jobs are staying here.

The recovery and expansion of job creation that has already begun in the IT sector should continue into the future. According to the U.S. Department of Labor's bi-annual projections, the number of jobs in computer and mathematical science occupations is expected to increase from three million to four million in the next decade, a rate of growth that will be twice as fast as employment in the rest of the private economy. Seven of the 30 fastest-growing occupations will be in the computer field.¹² Despite the lingering slackness in IT employment, those jobs still pay an average of \$67,000 a year.¹³

Michigan Companies Illustrate the Dynamics

Two Michigan-based companies well illustrate the rich and often complicated dynamics involved in offshoring jobs and in evaluating the results of the practice. Delphi Corp., based in Troy, Michigan, is one of the world's largest suppliers of high-tech components to automotive and other industries. Covansys Corp., based in Farmington Hills, Michigan, is a provider of technology services that has one of the largest payrolls of offshore employees of any American company in its industry.

Formerly the parts-making subsidiary of General Motors Corp., Delphi became an independent company in 1999 and, since then, has pursued a tough-minded strategy not only for remaining one of the world's most technically advanced automotive suppliers but also for penetrating other industries with its electronic components and systems. As a result, Delphi has been successful in increasing the non-GM parts of its business to about half of its expected \$30 billion in revenues this year, compared with just 20% of its revenues at the time of the spin-off. This advance has included huge new portions of business from rival auto makers in the United States as well as around the globe. But Delphi's diversification push also has gained customers in a wide variety of other technology-intensive industries, including other transportation sectors (design and manufacture of the complex stabilization devices in Segway scooters), consumer electronics (development and production of both leading brands of satellite radios), and medical devices (manufacture of state-of-the-art electronic wheelchairs and other products).¹⁴

The success that Delphi has achieved so far on its own has required vast adjustments throughout the company. Delphi has eliminated thousands of high-wage manufacturing jobs in the United States that were no longer tenable in the face of much cheaper foreign competition; and with a desire to hang on to as many such jobs as

it could, the United Auto Workers union just this year agreed to a significantly lower wage structure for any new production workers hired by Delphi, a historic concession by the union. Delphi also has spread its white-collar work all over the world, establishing and expanding technical centers in China, Korea, India and Mexico, close to its global customers. In fact, more than 70% of Delphi's workforce now is employed outside North America.¹⁵

But unlike the trend in Delphi's manufacturing jobs, the offshoring of technical work actually has served to benefit the company's IT-related workforce in America. Since 2000, Delphi actually has expanded the ranks of its scientists and engineers around the world to more than 16,000, compared with just under 15,000 as recently as 2000. Many of these new hires are software engineers in Asia and in Mexico who, indeed, are handling coding, maintenance and other relatively mundane tasks that previously were performed at Delphi locations in the United States. But by helping Delphi control its costs while yielding work of quality equal to their American predecessors, these offshore specialists buttress the company overall. Perhaps even more important to Delphi employees in America is that, even with extensive offshoring, Delphi has not dislocated any of its American software engineers or other IT employees. Most of these highly educated and experienced workers actually move on and up to other, higher-value-added functions that still can be performed only in North America. Such functions include mathematics-based modeling that allows Delphi to reduce the use of expensive laboratory equipment for testing.¹⁶

"If I can take advantage of some of these lower-cost countries to do things I can't do here in the U.S., we grow the business more easily," says Tony Kayyod, who helps make sourcing decisions as the director of Delphi's global engineering and manufacturing "footprint." "I can either do two programs completely engineered in the United States, or ten in the U.S. — with some of the engineering done in low-cost areas elsewhere."¹⁷

Thus, to no small degree as a result of its offshoring strategy, Delphi, its shareholders, and its thousands of employees in Michigan are prospering. Indeed, Delphi has become a formidable redoubt of technological superiority in the heart of the old industrial Midwest.

The second firm, Covansys, handles information-technology work that is outsourced to it by local clients including auto makers and state government who simply want their data-crunching, telephone technical support and other needs handled capably and as inexpensively

as possible to help them cope with cost pressures and competition. While the recent recession years battered Covansys's finances (its revenues have remained flat to date in 2004), the company announced a transaction in April that bodes well for future growth. It landed a five-year contract with Fidelity Information Services, a unit of the giant mutual-fund concern, to become the primary provider of outsourced IT services to Fidelity. The arrangement is expected to increase Covansys's revenues by more than five percent in 2005. Fidelity also purchased a 29% equity stake in Covansys.¹⁸

The company employs about 375 people at its headquarters in Michigan as well as more than 1,800 additional staffers at 16 other offices scattered across North America. Covansys also employs more than 2,000 IT workers in Bangalore and its two other offices in India, where they perform most of the same digital functions as their U.S. counterparts, with the same quality of results at a fraction of the cost. Covansys clients continue to specify that the company conduct more of its work in India. Two examples are PeopleSoft Inc., which recently directed Covansys to expand PeopleSoft's development center in India, and BearingPoint, the accounting and consulting firm that contracted Covansys to help it open and operate BearingPoint's first development center in India. About 26% of Covansys's revenues in the first quarter of 2004 came from India compared with 15% a year earlier.¹⁹

"This is a play we've been through before," says Martin Clague, former president and CEO of Covansys. "It's just in a different sector. We've been through it with manufacturing, with all of the gnashing of teeth and short-term protectionism here that greeted the rise of Japan Inc. But at the end of the day, economics win. And even in Detroit, many people stopped buying American cars in favor of imports. Then at the end of the day, Detroit said, 'We have to make cars that are as good as if not better than Japanese cars.' But many of the parts for those cars are made and outsourced overseas. And at the end of the day, the consumer has won."²⁰

Foreign Outsourcing Is a Two-Way Street

Another reality lost in the outsourcing debate is the amount of work the rest of the world outsources to the United States. We are far and away the world's top "provider" of outsourcing in the form of information technology, financial, communications, and other business services. In 2003, Americans sold \$131 billion in private business services to the rest of the world. Those

services include such outsourcing tasks as legal work, computer programming, management consulting, telecommunications, banking, and engineering. At the same time, Americans were buying, or importing, \$77 billion worth of business services from the rest of the world, including call center and data entry services from developing countries such as India and the Philippines. In other words, when it comes to outsourcing of business services, the United States ran a \$54 billion surplus with the rest of the world last year. As a Wall Street Journal report concluded, “The numbers suggest that congressional efforts to restrict outsourcing by U.S. companies may backfire, if they provoke retaliation by U.S. trading partners. Economist also say that U.S. service exporters — insurers, for instance — might lose some competitive edge if they can’t use foreign suppliers for call centers or other back-office operations.”²¹

In the more specialized area of IT services, America’s edge is even more pronounced. In 2002, according to the most recent figures, U.S. companies exported \$14.8 billion worth of computer, data processing, research, development, construction, architectural, engineering and other IT services. During that same year, Americans imported \$3.9 billion of those same kinds of services.²² So for every dollar Americans sent abroad for IT outsourcing in 2002, the world sent more than three dollars to the United States for “insourcing.”

The same general story applies to foreign direct investment. The United States remains a magnet for direct investment from foreign multinational companies. In 2003, the rest of the world invested \$82 billion in directly owned U.S. assets, including foreign-owned affiliates.²³ According to the Commerce Department, more than 6 million Americans work for foreign-owned affiliates in the United States.²⁴ It is fundamentally misleading to complain about U.S. companies investing abroad without considering foreign investment in the United States. Indeed, if Congress and state legislatures declare war against foreign outsourcing, American companies and workers will be among the first casualties.

Many of those casualties could come specifically in Michigan. The state has gained just as the nation has from direct foreign investment, particularly — and not surprisingly — that clustered around the auto industry. In the Eighties, for example, Mazda Motor Corp. built a brand new automotive assembly plant in Flat Rock, Michigan, which still employs several hundred people in well-paid, UAW-represented jobs. Dozens of foreign-owned automotive manufacturers and suppliers have opened technical, sales, marketing and distribution cen-

ters as well in metropolitan area, helping to a significant extent Detroit’s continuing efforts to remain the world automotive capital.

Japanese auto makers alone employ thousands of Michiganders in their technical centers. Nissan Motor Co., for example, employs about 800 people at its technical center in Farmington Hills, Michigan. South Korean auto maker Hyundai is to employ nearly 100 people at its new tech center near Ann Arbor, Michigan. Suzuki Motor Corp. has opened a development nexus in Wixom, Michigan, and Mitsubishi Heavy Industries located one in Sterling Heights, Michigan. Toyota Motor Co. earlier this year opened its new Toyota Technical Center USA in Ann Arbor Township, where it now employs more than 500 people, about 80% of them Americans — a ratio that has flipped from 80% Japanese about a decade ago. And the company has added a new styling center in Ann Arbor as well.²⁵

Outsourcing Is a Win-Win Arrangement

Outsourcing, like trade in general, is reshaping the world in favorable ways beyond our borders. In a classic win-win from trade, outsourcing invigorates the U.S. economy at the same time it builds a pro-American middle class in India and other developing countries. The Indian high-tech sector is flourishing because that nation has adopted the U.S. model of zero tariffs on imported software and hardware, no restrictions on foreign investment, and an emphasis on post-secondary education.

While most of the jobs outsourced from the United States are on the lower end of the pay and status scales in the United States, they are among the best jobs available in Indian and other developing countries. In such cities as Bangalore, Calcutta, and New Delhi, hundreds of thousands of young Indian college graduates, men and women alike, are realizing the fruits of middle-class life that we take for granted. Although the \$6,000 paid to an Indian programmer sounds ridiculously low in American terms, it can buy about five times as much in India because of lower domestic prices, enabling Indian programmers to rent their own apartments, own cell phones, make car payments, and travel abroad.

As the United States seeks to win friends and influence events in South Asia and elsewhere, it would be hard to find a more naturally pro-American enclave than the Indian high-tech sector. It would be terribly short sighted to disrupt our growing, mutually beneficial trade and security relationship with the world’s most populous de-

mocracy to save a relatively small number of jobs that are not among the more well-paying in the United States.

Restrictions on Outsourcing Are Self-Defeating

So far the rhetoric against outsourcing has been worse than the any legislative action. The main vehicle against outsourcing has been restrictions on government contracts. Earlier this year, Congress enacted a temporary ban on certain contracts with companies that would outsource the work abroad, and 30 states including Michigan are considering similar language for state contracts. Those restrictions on government procurement would come at a high price for the few jobs that would be saved.

First and most obvious, imposing anti-outsourcing restrictions on state contracting will waste state resources. Limiting the bidding for state contracts will only limit the state's ability to find the best deal for taxpayers, resulting in higher costs for state services. Restrictions on state contracts will force taxpayers either to pay more for the same services or to receive fewer services for the same cost. Taxpayers in several states are waking up to the fiscal impact of restrictions on outsourcing. A proposal in North Carolina would cost an additional \$1.2 million to repatriate 30 modestly paid call center positions, at an extra cost of \$40,000 per job "saved." The state of New Jersey spent an extra \$1 million to hire even fewer domestic call center workers. Lawmakers in Kansas wisely reconsidered an outsourcing bill when the full cost became apparent. According to a recent news report, "When Kansas officials learned that food-stamp questions were being answered by workers in India under a contract with an Arizona company, state senators added language to the budget requiring that the work be done in the United States. But that changed when negotiators learned it would boost costs by \$640,000 — about 38 percent."²⁶

In Michigan, Governor Jennifer Granholm signed two such directives last spring. One of them prohibits state departments and agencies from spending state or federal funds to provide a financial incentive to induce a business located in the United States to relocate outside the country, if shifting production offshore will reduce jobs for U.S. workers. The other directive gives preferences to Michigan-based job providers in the state-government contracting process and, for the first time, requires the state's Department of Management and Budget to consider whether or not a bidder is engaged in exporting jobs or in using an offshore tax shelter when determining

if that bidder's proposal provides the best overall value to the state. Similar provisions had existed in state law but had not been actively enforced.

Second, restrictions on outsourcing will invite retaliation against the juicy target of U.S. service exporters and make a mockery of the U.S. government's calls for more opportunities for U.S. companies to bid competitively for government contracts abroad. Restrictions on outsourcing make the United States look even more hypocritical to the rest of the world. How can we urge other countries to lower their trade barriers and open bidding for government contracts to U.S. companies when we are trying to close our markets and government procurement to foreign suppliers?

Third, state restrictions on outsourcing may violate the U.S. Constitution and international law. Such laws could be challenged in court for usurping the power of the federal government to determine U.S. foreign policy and regulate international commerce. Similar state purchasing laws that had banned contracts with companies that do business in Burma (Myanmar) were nullified after being successfully challenged in the U.S. Supreme Court. As one recent legal study concluded, "Proposed state and federal legislation to restrict outsourcing may violate the U.S. Constitution and jeopardize U.S. obligations under international trade agreements."²⁷

Fourth, restrictions on outsourcing will reduce demand for U.S. products abroad. It will hinder development in countries such as India, slowing the expansion of a middle class able to afford U.S. goods and services. It will also deprive people outside of the United States of the additional dollars they could use as foreign exchange to buy U.S.-made goods and services or to invest in the U.S. economy. A barrier to imports is really a barrier to exports.

Conclusion

It's difficult to gauge the true intensity of Americans' alarm over the job-offshoring phenomenon, both because the economy is only still recovering from a recession that especially pinched IT workers and because the issue emerged strongly into public discussion only during 2003, and thoroughly bathed in presidential politics.

Like changes in technology or consumer tastes, offshoring can disrupt the lives of certain workers, companies, and even entire communities. Michigan shares with the rest of the states in both the temporary and localized pain

but also in the far greater and more lasting opportunities. And in all likelihood, the adjustments and the opportunities in this state and across the country created by offshoring will only grow in the years ahead.

Yet as participants and decision-makers in the greatest economy the world has ever known, the changes brought by offshoring are just the most recent manifestation of a process that has always been an integral part of our dynamic, market-driven economy. Along the way, nearly all Americans — blessed with the best educational system and the most opportunity-laden marketplace ever known to man — will make the necessary changes in their own vocations and lives.

If the United States, its companies and its workers are to remain leaders in the global economy, offshoring must remain a tool available to our corporations — just as harnessing electricity was in the late Eighteen Hundreds, just as perfecting mass production was in the first half of the Twentieth Century, and just as the development of today's digital economy has been over the past few decades. Any shorter view of offshoring ultimately will prove self-defeating.

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