McKinsey Global Institute

Exploding the Myths About Offshoring

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Exploding the Myths About Offshoring

Total U.S. employment has fallen by over 2 million since 2000. While employment is rising again as the economy recovers, the pace of job growth has been agonizingly slow. Many people blame “offshoring,” or the nation's growing trade in services with emerging markets. Because of the digital revolution and the dramatic fall in international telecommunication costs, white-collar jobs that once were insulated from global competition can now be performed in low-wage nations like India for as little as one-tenth of the cost of U.S. labor. Employees with jobs as diverse as call-center agents, data processors, medical technicians, and software programmers are thought to be at risk.

Even self-proclaimed free-trade advocates have wavered in their beliefs, and critics warn that as hiring favors the enormous supply of highly educated Indian and Chinese workers, millions of Americans will become jobless. In response to these concerns, Congress included in the fiscal 2004 omnibus spending bill a provision that prohibits federal agencies from outsourcing some kinds of work to private companies that use workers abroad. Over thirty states are considering similar restrictions; at least four have already passed them. Jobs and trade have become the hot-button issues of the 2004 presidential election race.

However, the current debate is misplaced, because the problem is neither trade itself nor globalization more broadly, but the question of how the nation should allocate the benefits of global trade. The global labor market, like other international trade, benefits the nation as a whole by making the economic pie bigger and raising the standard of living. For some businesses, outsourcing jobs abroad will allow them to remain profitable, thereby preserving other U.S. jobs. Many companies use the savings from outsourcing to lower prices and offer consumers new and better types of services. By increasing productivity, offshoring enables companies to invest more in the next-generation technologies and business ideas that will create new jobs. With the most flexible and innovative economy in the world, the United States is uniquely positioned to benefit from the trend. After all, despite a large overall trade deficit, the United States has consistently run a surplus in its international trade in services.

Many people believe that the money U.S. companies spend on services abroad is lost to the U.S. economy, but a 2003 study by the McKinsey Global Institute shows that offshoring creates wealth for the United States as well as for the country receiving the jobs.[1] For every dollar of corporate spending that is

1. "Offshoring: Is it a win-win game?" The McKinsey Global Institute, August 2003.

outsourced to a low-wage nation, the spending economy captures more than three-quarters of the benefit and gains as much as $1.14 in return. Far from being a zero-sum game, offshoring is instead a story of mutual economic gain.

Of course, what is good for the economy as a whole may not be good for particular individuals. Based on economic history, we can expect that some U.S. workers will indeed lose their jobs. But this painful reality does not weaken the case for free trade. The United States can enjoy the significant benefits of free trade while protecting individuals with programs that help workers make the transition to new jobs. These programs might include job retraining opportunities and generous severance packages, portable health and pension benefits, and wage insurance. Given the benefits of offshoring, the logical response is to make the U.S. labor force and economy more flexible and able to cope with change.

HOW THE U.S. BENEFITS

The offshoring trend prompted us to look into what happens to a dollar of U.S. corporate spending when a company moves a service job to India. We found that the receiving economy (India) captures 33 cents, in the form of wages paid to local workers, profits earned by local outsourcing providers and their suppliers, and taxes collected from second- and third-tier suppliers to the outsourcing companies. (Today, both foreign and local outsourcing providers in India enjoy a tax holiday from the government).

Corporate savings. The gains to the U.S. economy are much larger. The most obvious source of value is the cost savings enjoyed by U.S. companies. For every dollar of corporate spending that moves offshore, U.S. companies save 58 cents. Companies can reinvest the savings in new business opportunities, pay additional earnings out to shareholders, or both. Often, U.S. companies and customers obtain better-quality services from abroad. Because wages are lower, companies can hire more and more highly qualified people to do the same job, and spend more on supervision and training. Some companies have found that offshore workers are more highly motivated and perform better, particularly for low-skilled jobs that lack prestige and suffer from high turnover in the U.S. One British bank's call-center agents in India process 20 percent more transactions than their counterparts in the United Kingdom and have a 3 percent higher accuracy level.

Ultimately, in a competitive economy such as the United States, consumers benefit as companies pass on savings in the form of lower prices. Consumers also benefit directly from trade, since they can acquire goods and services at lower prices. New research by Catherine Mann of the Institute for International Economics found that global sourcing of components in the computer hardware industry has reduced the cost of IT hardware by as much as 30 percent, thereby boosting demand and adding up to $230 billion to U.S. GDP since 1995.[2] Trade in services will do the same. A technician in India, for instance, can read an MRI or CT scan at a fraction of the cost to do the job in the United States. Transferring that position to India may cause an American medical technician to be laid off, but lower prices for these life-saving technologies will enable many more sick people to receive them.

Additional exports. Offshoring benefits the U.S. economy in other ways as well. First, Indian companies that provide offshore services will also buy goods and services, ranging from computers and telecommunications equipment to legal, financial, and marketing expertise. Often, they buy these from U.S. companies. A call center in Bangalore is likely to be filled with HP computers, Microsoft software, and telephones from Lucent and to be audited by PricewaterhouseCoopers. We estimate that for every dollar of corporate spending that moves offshore, suppliers of offshore services buy five cents' worth of goods and services from the United States. Furthermore, young Indian workers employed by outsourcing firms also buy goods imported from abroad. Thanks to these corporate and individual buyers, exports from the United States to India stood at $4.1 billion in 2002, compared with less than $2.5 billion in 1990. In the last quarter of 2003, exports to India grew by 26 percent.

Repatriated profits. In addition, the U.S. economy benefits because many Indian outsourcing firms are owned in whole or in part by U.S. companies such as GE and EDS, which repatriate their earnings back to the United States. Such companies generate 30 percent of the revenues of the Indian offshore industry. In this way, another four cents of every dollar spent on offshoring returns to the U.S. economy.

Productivity and new jobs. The direct benefits to the United States from corporate savings, new exports, and repatriated profits total $0.67 – twice the

2. Catherine Mann, "Globalization of IT services and white collar jobs: The next wave of productivity growth," IIE Policy Brief, December 2003.

benefit to India. But the gains don't end here. Corporate savings can be invested in new business opportunities, and this investment will boost productivity as well as create new jobs. Based on historical experience, these new jobs will have on average higher value-added than the ones they replaced. Carriage makers were replaced by auto assemblers, and farmers by factory workers. Indeed, this is exactly the pattern over the past two decades as manufacturing jobs moved offshore. The Bureau of Labor Statistics reports that U.S. manufacturing employment shrank by two million jobs in the past 20 years – but net employment increased by 43 million jobs in other areas, such as educational and health services, professional and business services, trade and transport, government, leisure and hospitality, and financial services. Over the same period, manufacturing output has increased, meaning that factories are more productive than before. Higher productivity means more national income and a higher standard of living for Americans.

The same thing is likely to happen again as jobs in call centers, back-office operations, and some IT functions go offshore. Opportunities to redeploy labor and invest capital to generate opportunities in higher-value-added occupations will appear, although we can't predict exactly where. The Bureau of Labor Statistics estimates that from 2000 to 2010, there will be a net creation of 22 million new U.S. jobs, mostly in business services, health care, social services, transportation, and communications. The BLS also predicts that computer-related occupations – often thought to be at high risk of offshoring – will be among the fastest-growing jobs in the country. While code writing can be done abroad, many other IT functions, like systems integration, cannot. In addition, there will undoubtedly be jobs we can't even fathom today. Twenty years ago, for example, no one could have imagined the ubiquity of the cellular phone, an industry employing nearly 200,000 workers in the United States.

The view that new jobs will be created as old jobs disappear is not an article of faith; it is based on repeated experience. Most recently, in the 1990s, trade expanded rapidly, with increases in offshoring of both manufacturing and service-sector jobs. At the same time, overall employment soared, unemployment fell to 4 percent, and real wages increased.

We estimate that offshoring will create an additional 45 to 47 cents of value to the U.S. economy as labor is redeployed.[3] This is a conservative estimate, based on historical figures of job loss due to trade. White-collar employees at risk of offshoring today are generally more highly educated and tend to find jobs faster than do workers in the service sector as a whole. Far from being bad for the United States, offshoring thus creates net value for the economy – to the tune of $1.12 to $1.14 for every dollar that goes abroad.

OFFSHORING IN PERSPECTIVE

To assess offshoring's impact on employment rationally, we must put it in perspective. Forrester Research predicts that by 2015, roughly 3.3 million U.S. business-processing jobs will be performed abroad.[4] Even though this number may seem startlingly large, it is only a piece of a much larger picture.

The United States today has more than 150 million employed workers. Technological change, economic recessions, shifts in consumer demand, and other changes result in continuous job turnover. Each month, roughly 2 million Americans change jobs – a figure that dwarfs even the most aggressive predictions of job loss due to offshoring. The number of service jobs that may be lost to free trade is small even compared with the mass layoffs prompted by corporate mergers and restructuring when the economy is growing.[5] In 1999 alone – at the peak of the bubble economy – 1.15 million workers lost their jobs through mass layoffs as companies restructured their operations. Job churn is part of life, even in a growing economy.

Liberalized, competitive economies with flexible labor markets can cope with the natural process of job creation and destruction. The U.S. economy, the world's most dynamic, is arguably in the best position to do so. According to the Organisation for Economic Co-operation and Development, the United States has the highest rate of reemployment of any OECD country by a factor of almost two.

3. Lori Kletzer of University of California – Santa Cruz (formerly BLS) reports that between 1979 and 1999, 69 percent of nonmanufacturing workers who lost jobs due to free trade found new ones within one year, and on average earned 96.2 percent of their previous wages. These figures, combined with the fact that 72 cents of every dollar offshored had previously been spent on US wages, means that the additional value to the US economy of redeploying workers would be 45 cents to 47 cents.
4. John McCarthy, "3.3 million US services jobs to go offshore," Forrester Brief, November 11, 2002.
5. The Bureau of Labor Statistics defines a mass layoff as 50 or more worker claims against an establishment's unemployment insurance account during a five-week period.

Most workers who lose their positions find another within six months. Over the past ten years, 3.5 million private-sector jobs have been created each year, on average, for a total of 35 million new jobs – and job growth was fastest, according to the OECD, among high-wage jobs.

A flexible job market and the mobility of U.S. workers will enable the United States to create new jobs faster than offshoring eliminates them. Consider how the U.S. semiconductor industry reinvented itself after losing out to Japanese competitors that entered the market during the late 1980s. The Japanese quickly dominated many segments, including memory, and spurred a public outcry over "unfair" Japanese competition and the loss of high-paying, white-collar U.S. jobs. The big U.S. players – Intel, Texas Instruments, and Motorola – all exited the memory business. But this prompted them to invest more aggressively in the production of microprocessors and logic products – the next growth wave in semiconductors. Intel became the dominant global player in microprocessors, Texas Instruments in DSPs (Digital Signal Processors, the "brain" in mobile phones), and Motorola gained a strong position in communications devices. Throughout this shift toward higher-value-added activities, the total number of U.S. jobs in semiconductors and closely related electronics held constant at around half a million.[6]

SEPARATING FACT FROM FICTION

Muddling the public debate over white-collar offshoring are a number of myths and half-truths. Most troubling are statements by self-proclaimed free-trade advocates who argue that the current offshoring phenomenon is different. The overwhelming evidence among economists is that trade contributes to faster economic growth.[7] Skeptics argue that trade in services is somehow different from trade in goods and will be less beneficial to the U.S. economy, but given the strength of the U.S. services industries, increased trade in services is even more likely to be a substantial plus for Americans.

The United States has always and continues to run a trade surplus in services, even with India. It has the most productive and developed service sector of any country in the world, and unlike manufacturing, it continues to hold a comparative advantage in these knowledge-based industries. American banks, law firms,

6. Employment data from the Semiconductor Industry Association and the Bureau of Labor Statistics.
7. See, for instance, Jeffrey Williamson, World Economics, Volume 4, Number 4, October-December 2003, pp. 95-138.

accounting firms, IT integrators, and consultants, to name a few, have established themselves as global competitors. As a result, U.S. trade policy has consistently demanded more openness on the part of other countries in these areas. The declining U.S. dollar will undoubtedly help boost service exports even higher.

Others argue that the massive number of potential workers in China and India is so massive that integrating them into the global economy will cause persistent unemployment in the United States and Europe. Certainly, both countries have a large supply of productive workers. But they also have fast-growing appetites for goods and services. The great majority of the enormous workforces in these economies will be producing goods and services for their own economies. They are bringing new demand to the world economy about as fast as they are adding to supply. As is true in other countries, only a small portion of their workforce produces goods for export. Provided they allow their exchange rates to adjust, China and India will not be a net drain on economic activity or jobs in the rest of the world.

Equally untenable is the notion that low-wage nations are taking American jobs. The fact is that many of the jobs in India today are viable only in a low-wage environment and would not exist in the United States. That half a million people are now employed in India's outsourcing industry does not mean that there could be 500,000 more jobs in the United States. Without offshoring, companies would scale back or stop offering services like 24/7 customer help. Companies are also using technology to replace many of the jobs at risk in the United States. Automated voice response units are replacing call-center workers, online hotel and airline booking systems are replacing live operators and travel agents, and imaging software is replacing data-entry workers.

A related myth is that service-sector offshoring is responsible for the anemic job creation during this economic recovery. Critics frequently point out that more than two million American jobs have been lost since 2000. But nearly all jobs lost were actually in manufacturing, not service sectors. Moreover, employment in IT, which is supposedly one of the hardest hit by offshoring, has actually grown since 1999. While it is true that 70,000 computer programmers have lost their jobs, most of these losses were due to the bursting of the IT bubble. In addition, more than 115,000 higher-paid software engineering jobs were created during that period. Jobs for computer support specialists and systems analysts and administrators grew by roughly 83,000.

THE CHALLENGE FOR POLICYMAKERS

Arguments about the greater good and the long-term health of the economy do not, of course, ease the plight of people who lose their jobs or find themselves in lower-wage employment. While free trade creates wealth and improves a nation's standard of living, not all groups benefit, particularly in the short term. Today, globalization is creating a higher level of turnover in the workforce than ever before. Rather than a single career with just one or two companies, as those in previous generations could expect, most people today will have many employers, and a growing number will switch their careers as well. Job change is a much larger part of life than it used to be, and the challenge for policymakers is to make it easier and less painful.

According to historical data, a sizable portion of workers who lose their jobs because of free trade do not easily find new ones or must accept jobs with lower wages. From 1979 to 1999, roughly 30 percent of the people who lost jobs as a result of cheap imports in sectors other than manufacturing had not found jobs a year later.[8] And for those who found new jobs, the wages in the new jobs varied considerably. About a quarter actually found better-paid jobs, and on average, wages in the new jobs were about the same as the wages in the jobs that had been lost. Nevertheless, 55 percent took lower-paid jobs, and about 25 percent took pay cuts of 30 percent or more.

Public policy can help such workers make the transition. Job-retraining programs and continuing-education grants can help workers gain new skills as the economy evolves. Generous severance packages can help, and increased portability of health benefits and pension plans between jobs is essential. Tax credits might be offered to companies who hire workers who lost their last job because of trade.

Wage insurance also would help. For a small percentage of the savings from offshoring, companies could purchase insurance covering the wage losses of displaced workers. Building upon an insurance proposal that Lori Kletzer and Robert Litan developed for workers displaced by trade in manufacturing,[9] we estimate that for as little as 4 to 5 percent of the savings companies realized from

8. See Lori Kletzer, "Job loss from imports: Measuring the costs," Washington, DC: Institute for International Economics, 2001. Kletzer matched Bureau of Labor Statistics figures on nonmanufacturing jobs with trade data to assess job displacement in sectors prone to foreign competition.
9. Lori Kletzer and Robert Litan, "A prescription to relieve worker anxiety," Policy Brief 01-2, Institute for International Economics, February 2001.

offshoring, they could insure all full-time workers who lost jobs as a result. The program would compensate those workers for 70 percent of the difference between the wage rate they received on the job they lost and the wage rate they received on the new job, as well as offer health care subsidies for up to two years.

These policies would help make the U.S. labor force more flexible and thus allow the economy's wealth creation engine to flourish. Protectionism, in contrast, may save a few jobs in the short run but will stifle innovation and job creation in the long run. And practically speaking, protectionism makes little sense, given how enmeshed the U.S. economy already is with the rest of the world. When Congress was debating one of the initial versions of the Dodd Amendment (which prohibits federal agencies from contracting with companies who outsource work abroad), it found that under the terms being discussed, procurement for the Department of Defense would grind to a halt. The amendment that finally passed is a weaker version that hardly constrains any activity. Similarly, the state of Ohio considered a law to prohibit state contracts from going to companies with ties abroad – only to find that it would exclude virtually all of the current contractors in the state. Facilitating change, not stopping it, must be policymakers' goal.

EMERGING MARKETS MUST DO THEIR PART

The current debate on offshoring focuses on the impact on American jobs, but it is important to take a broad and long-term view of what best serves the interests of the United States. We also have an interest in promoting a healthy and stable world economy, particularly in emerging markets. Research over the last 12 years at the McKinsey Global Institute has shown that real poverty alleviation comes from growth of the private sector. And foreign direct investment by multinational companies is one of the best ways to promote private-sector growth.

Consider investment's impact on India. The IT and business-process-outsourcing sector in India now earns more than $10 billion annually and employs a half million workers. Suppliers to those companies employ an equal number of people. On average, wages in the sector are 50 to 100 percent higher than those for other white-collar jobs in the economy. This employment is creating a new middle class of educated workers. Foreign direct investments made by multinational companies played a key role in the sector's development. The fast-growing Indian vendors that now dominate the sector got a start only after multinational companies pioneered the approach and trained a critical mass of local employees. (The CEO of Spectramind, for instance, started out at GE, and the CEO of Dakh came from Motorola.) Also, foreign companies continue to provide healthy competition that forces Indian companies to continuously improve operations.

The Indian outsourcing sector is just one example of how foreign direct investment can benefit emerging markets. In 2003, the McKinsey Global Institute conducted a study of the impact of foreign direct investment (FDI) on local service and manufacturing industries in India, China, Brazil, and Mexico.[10] We found that it had an unambiguously positive impact in 13 of the 14 industries we looked at (and a neutral impact in 1). FDI boosted productivity and output in the sectors involved, thus raising national income while lowering prices and improving quality and selection for consumers. Foreign players improve the local industry's efficiency and productivity by bringing in new capital, technology, and management skills. Equally important, they increase competition, driving improvements across the sector and forcing less efficient domestic companies to improve their operations or go out of business.

Just as specific groups of workers in the United States may lose out from offshoring, foreign direct investment poses a threat to some incumbent companies who stand to lose market share. But the cost to specific local producers is outweighed by the benefits to a much larger group of consumers. In case after case, consumers enjoyed significantly lower prices and often better selection and quality of goods after the market was opened to foreign investment. The price of passenger cars in China, for instance, declined by more than 30 percent from 1995 to 2001, years when Ford, GM, and Honda entered the market. In Mexico, Wal-Mart's “everyday low prices” ended a long history of hefty margins for the country's leading retailers and reined in fast-rising food prices – so much that some analysts credit the company with helping to reduce the country's inflation rate. In India, the price of air conditioners, televisions, and washing machines fell by roughly 10 percent in 2001 alone after foreign companies entered the market. The price of all types of cars in India declined by 8 to 10 percent annually during the 1990s, after the government opened the market, and there are now more than 30 models for sale, compared with just a handful before liberalization. Lower prices have unleashed a pent-up demand, and the auto sector has grown at 15 percent each year.

10. "New horizons: Multinational company investment in developing countries," McKinsey Global Institute, November, 2003.

Unfortunately, too many emerging markets today remain skeptical of openness and close off large parts of their economy to foreign companies. They are missing out on a tremendous growth opportunity that would benefit themselves as well as the broader global economy. In return for asking developed countries to continue allowing free trade in services, they would do well to continue to liberalize and open the full range of their own domestic markets.

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The current debate over offshoring of U.S. jobs is missing the mark. Short-term disruption from job losses must be weighed against the much broader benefit to U.S. consumers and businesses, and the consequences of resisting change. If U.S. companies can't move work abroad, they will become less competitive – weakening the economy and endangering still more jobs – and miss the chance to raise their productivity and concentrate resources on the creation of higher-value jobs. Some workers will need help to make the transition. But globalization's reputation as the enemy is now the real threat to the U.S. economy.

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