Do What You Do Best, Outsource the Rest?

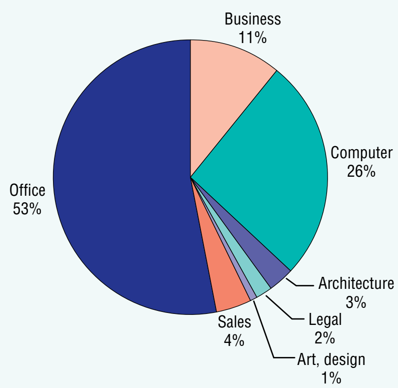
International trade generates higher overall output by redirecting jobs to those who create the most added value—that is, to those who maximize their productive abilities. Put simply, the benefits of free trade can be summarized as: "Do what you do best. Trade for the rest." But times are changing, and so are many traded commodities.

The newest U.S. trade commodity is skilled white-collar work, with an estimated 60 percent of these outsourced jobs going to India. As with most traded commodities, outsourcing work abroad is the product of lower foreign labor costs and potentially higher future profits. And like free trade, outsourcing has become controversial.

Outsourcing's critics see only the elimination of work previously done in the United States and view outsourcing as exporting white-collar jobs to other countries. What they fail to recognize is that attempting to protect these jobs would mean higher prices for consumers and the unrealized potential for more productive jobs in new industries.

Chart 1

A Variety of Jobs Being Outsourced



NOTE: Percentages computed on estimates for 2000.

SOURCE: John C. McCarthy (2002), "3.3 Million U.S. Services Jobs to Go Offshore," TechStrategy Research Brief, Forrester Research Inc., November 11.

What is outsourcing? Why is India the leading country in attracting outsourced work? And what are the economic and political implications as firms do what they do best and outsource the rest?

Outsourcing: What It Is and Why It Is Done

Outsourcing occurs when an organization transfers some of its tasks to an outside supplier. In many recent cases, businesses in India have served as suppliers. A variety of jobs are being outsourced, including routine office work, computer-related work, business (accounting and finance), architecture, legal, art and design, and sales (*Chart 1*). The availability of real-time information via the Internet, satellite and transoceanic communications allows businesses to be sustained instantaneously around the globe. New information technologies let fewer people do more work and also help quickly bring new skills to learners everywhere.

Specialized tasks—such as software development, financial research and call centers—can often be accomplished elsewhere in the world at a fraction of U.S. costs. Through outsourcing, it is not uncommon for companies to realize net cost savings of 30 to 50 percent (*Chart 2*). As a result, it is often in a firm's best interest to outsource certain tasks and use the abilities of its remaining workers in other, more productive activities.

Why India?

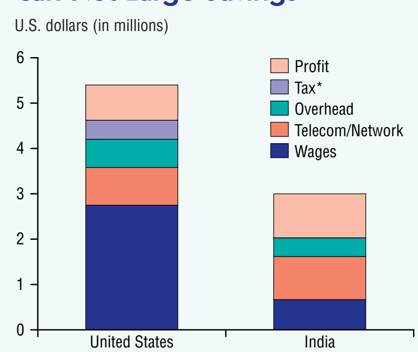
Many countries offer low production and labor costs. But to make outsourcing viable, other business-promoting factors must be considered as well, such as the number and quality of skilled workers, maturity of the outsource market, government support, the legal system, political stability, location and accessibility, education, infrastructure, time differentials, technological modernity and English language skills.

For myriad services, India has emerged as the most appealing country in many of these areas. India has the second-largest English-speaking population in the world (after the United States) and an educated technical workforce pool of more than 4.1 million workers. In addition, the outsourcing market in India—especially for information technology (IT) services—has had time to mature and gain support from U.S. businesses.

India's 1991 Statement on Industrial Policy facilitated foreign direct investment and technology transfers, ushering in a new era with fewer of the regulatory burdens that had previously kept foreign firms from establishing business operations there. In the decade since this policy reform, foreign direct investment in India has increased more than fiftyfold. And even though India's basic infrastructure is among the worst in the world, businesses in India have found ways to compete globally in the IT arena, making India one of the world's leaders in software exports. The city of Bangalore—home to many IT outsourcing firms and

Chart 2

Outsourcing to India Can Net Large Savings



* India exempts taxes for exports, including call centers for foreign businesses.

NOTE: This comparison is based on annual costs for a 100-seat call center.

SOURCE: Antonio Riera, Janmejaya Sinha and Alpesh Shah (2002), "Passage to India: The Rewards of Remote Business Processing," The Boston Consulting Group.

U.S. corporations—contributed $2.5 billion last year to India's total software exports of $9.5 billion.

Furthermore, promoting IT is one of the Indian government's top priorities. The Ministry of Information Technology was established in October 1999 to accelerate the implementation of IT projects in government, education and the private sector. India has many universities dedicated to maintaining state-of-the-art IT curriculums, and more than 70,000 software engineers graduate annually from Indian institutes.

Innovations that create economic growth simultaneously destroy specific jobs as new technologies replace older ones.

Outsourcing's Implications

As long as there are workers in India (or elsewhere) willing and able to perform the same work for less pay, U.S. firms will increasingly examine outsourcing as an option to hold the line on costs and remain globally competitive. Forrester Research estimates that the number of outsourced jobs will increase to nearly 600,000 by 2005 and to 3.3 million by 2015, including jobs requiring management and life science skills. This is unwelcome news to U.S. workers whose jobs will be lost. But history suggests that this phenomenon will also generate many better, higher-paying jobs at home as long as the United States can keep its competitive advantage in innovation. Entrepreneurship and innovation depend on a broadly educated workforce committed to continuous learning and risk-taking.

Even though these are anxious times for U.S. workers, consumers are sure to benefit from outsourcing. In 1776, Adam Smith emphasized that "it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest."[1] Following Smith's ideas, modern companies participate in the international market and pursue their own interests by making the most productive use of their resources. By pursuing profit maximization, firms remain competitive.

For U.S. consumers, competition leads to more and better economic choices. And the desire to meet consumer demand is the reason for all productive activity. Competition sustained through outsourcing has positively affected the well-being of consumers and producers. By participating in international trade, we increase our ability to consume the goods and services we value most, and we can do so at lower cost. If firms did not pursue outsourcing, or if governments placed barriers or limits on outsourcing in an attempt to "help" American workers, there would be less motivation to produce (because of lower profit potential) and higher prices for consumers.

International competition is often blamed for job losses and depressed sales. But protecting lost jobs is always harmful to consumers. Even so, several states are contemplating legislation that would prohibit their state government from contracting with foreign firms to perform services. Such actions cost taxpayers more by taking away opportunities for significant savings.

Think Globally, Act Globally

With specialization comes trade. Work once sheltered from faraway competition is no longer secure. Innovations that create economic growth simultaneously destroy specific jobs as new technologies replace older ones. The fact is, the Internet creates jobs and the Internet destroys jobs.

Businesses in India and elsewhere are developing an important competitive advantage in outsourcing by providing quality services at low costs. In the Internet Age—where a company's physical location is of little relevance and information travels quickly and cheaply—firms will continue to boost productivity and keep costs low by doing what they do best and outsourcing the rest.

And consumers reap the benefits.

—Thomas F. Siems
Adam S. Ratner

Siems is a senior economist and policy advisor in the Research Department of the Federal Reserve Bank of Dallas. Ratner is a student at DePauw University.

Note

1 Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations* (1776), reprint, ed. Edwin Cannan (New York: Modern Library), 1937, p. 14.