

# Exploding the Myths of Offshoring

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Far from damaging the economy of the United States, offshoring should enable its companies to direct resources to next-generation technologies and ideas—if public policy doesn't get in the way.

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With the digital revolution and the dramatic fall in international telecommunications costs comes the prospect that white-collar jobs—once insulated from global competition—can be performed offshore, in low-wage nations such as India, where labor can be hired for as little as one-tenth its cost in the United States. Call-center agents, data processors, medical technicians, and software programmers could all find their jobs at risk from the nation's growing trade in services with emerging markets. In fact, offshoring is frequently blamed for the agonizingly slow pace of job growth in the United States, despite a recovering economy.

Even free traders have wavered in their beliefs. Critics warn that millions of people in the United States will become jobless. The response from Congress has been to include in a fiscal 2004 spending bill a provision prohibiting federal agencies from outsourcing some kinds of work to private companies that use workers in foreign countries. Indeed, 23 states are considering similar restrictions; 4 have already passed them. Jobs and trade have become the hot-button issues of the 2004 presidential election race.

The current debate is misplaced, however, because the problem is neither trade itself nor globalization more broadly but rather the question of how the country should allocate the benefits of global trade. Trade in services, like other forms of international trade, benefits the United States as a whole by making the economic pie bigger and raising the standard of living. Outsourcing jobs abroad can help keep companies profitable, thereby preserving other US jobs. The cost savings can be used to lower prices and to offer consumers new and better types of services. By raising productivity, offshoring enables companies to invest more in the next-generation technologies and business ideas that create new jobs. And with the world's most flexible and innovative economy, the United States is uniquely positioned to benefit from the trend. After all, despite a large overall trade deficit, the country has consistently run a surplus in its international trade in services.

A 2003 study by the McKinsey Global Institute (MGI) showed that offshoring creates wealth for the United States as well as for India, the country receiving the jobs.<sup>1</sup> For every dollar of corporate spending outsourced to India, the US 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 creates mutual economic benefit.

True, some US workers will lose their jobs, but this painful reality doesn't weaken the case for free trade. Given the benefits of offshoring, the logical response is to make the US labor force and economy more flexible and able to cope with change.

## How the United States benefits

The offshoring trend prompted us to investigate what happens to a dollar of US corporate spending when a company moves a service job to India. We found that India captures 33 cents, through 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. (Foreign and local outsourcing providers in India enjoy a tax holiday from the government.) The gains to the US economy, however, are larger.

## Corporate savings

The cost savings enjoyed by US companies are the most obvious source of value. For every dollar of corporate spending that moves offshore, US companies save 58 cents, and the quality of the services they buy is often higher: wages are lower, so companies can hire better-qualified people and spend more on supervision and training. Offshore workers are often more highly motivated than US workers and perform better, particularly in low-skilled jobs that lack prestige and suffer from high turnover in the United States. One British bank's call-center agents in India not only process 20 percent more transactions than their counterparts in the United Kingdom but also do so 3 percent more accurately.

## A better deal for consumers

Ultimately, in a competitive economy such as that of the United States, consumers benefit as companies pass on savings in the form of lower prices. New research by Catherine Mann, of the Institute for International Economics, in Washington, DC, found that the global sourcing of components has reduced the cost of IT hardware by up to 30 percent since 1995, boosting demand and adding as much as \$230 billion to the US GDP in that period.<sup>2</sup> Trade in services will have similar effects. A technician in India, for instance, can read a magnetic-resonance-imaging (MRI) scan for a fraction of what it would cost in the United States. Transferring that position to India might cause a US medical technician to be laid off, but lower prices for life-saving technologies mean that more sick people can receive them.

## Additional exports

Indian companies that provide offshore services also *buy* goods and services ranging from computers and telecommunications equipment to legal, financial, and marketing expertise. Often, they buy these from US companies. A call center in Bangalore, for instance, could use HP computers, Microsoft software, and telephones from Lucent Technologies, and it may be audited by PricewaterhouseCoopers. We estimate that for every dollar of corporate spending that moves offshore, companies that provide the offshore services buy five cents of goods and services from the United States in return. On top of that, young Indian workers employed by outsourcing firms buy imported goods. Thanks to such corporate and individual buyers, exports from the United States to India stood at \$5 billion in 2003, compared with \$3.7 billion in 2000; they rose by 22 percent from 2002 to 2003 alone.

## Repatriated profits

Many Indian outsourcing firms are owned in whole or in part by US companies, such as GE and EDS, and repatriate some of their earnings. Operations owned by foreign (mostly US) companies generate 30 percent of the Indian offshore industry's revenues. In this way, an additional four cents of every dollar spent on offshoring returns to the US economy.

## Productivity and new jobs

The direct benefits to the United States from corporate savings, new exports, and repatriated profits total 67 cents—twice the benefit to India. But the gains don't end there. Corporate savings can be invested in new business opportunities, and this investment will boost productivity and create new jobs. Experience suggests that these jobs will on average have higher value added, as auto assemblers did when they replaced carriage makers and factory workers when they replaced farmers.

Indeed, this is exactly the pattern that developed over the past two decades as manufacturing jobs moved offshore. US manufacturing employment shrank by 2 million jobs over 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 increased despite the decline in the number of manufacturing workers, because factories became more productive. Higher productivity means a higher national income and a higher standard of living. As jobs in call centers, back-office operations, and some IT functions move offshore, the same thing is likely to happen again. Opportunities to generate higher-value-added jobs by redeploying labor and investing capital will appear, though we can't predict exactly where. The Bureau of Labor Statistics estimates that 22 million new US jobs, mostly in business services, health care, social services, transportation, and communications, will be created in the period from 2000 to 2010. It also predicts that computer-related occupations—often thought to be at high risk of moving offshore—will be among the fastest-growing job categories in the country, for while code can be written abroad, many IT functions, such as systems integration, can't be exported. And 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, yet it spawned an industry that now employs almost 200,000 workers in the United States.

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

Even on conservative estimates, for every dollar offshored, an extra 45 to 47 cents of value will be created in the US economy as labor is redeployed.<sup>3</sup> White-collar employees who hold the types of jobs now being moved offshore 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 creates net value for its economy—to the tune of \$1.12 to \$1.14 for every dollar that goes abroad.

## Putting offshoring in perspective

Offshoring's impact on employment calls for a rational assessment. Forrester Research predicts that, by 2015, roughly 3.3 million US business-processing jobs will be performed abroad.<sup>4</sup> Although this number might seem startlingly large, it is only a small 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 make jobs turn over constantly, so that each month roughly two million people in the United States change them. Even the gloomiest predictions suggest that the number of jobs lost to offshoring will be far lower. It will also be small compared with the mass layoffs prompted by corporate mergers and restructuring when the economy grows.<sup>5</sup> In 1999 alone—at the peak of the economic bubble—1.15 million workers lost their jobs through mass layoffs as companies restructured operations. Job churn is part of life, even in a growing economy.

Liberalized, competitive economies that have flexible labor markets can cope with the natural process of job creation and destruction, and the US economy, the world's most dynamic, is arguably in the best position to do so. According to the Organisation for Economic Cooperation and Development, the United States has the highest rate of reemployment of any OECD country by a factor of almost two. Over the past ten years, 35 million new jobs have been created, and, according to the OECD, job growth was fastest in high-wage occupations.

A flexible job market and the mobility of US workers, along with the entrepreneurial and innovative spirit of US businesses, will enable the United States to generate new jobs faster than offshoring eliminates them. Consider the way the US semiconductor industry reinvented itself after losing out to Japanese competitors, in the late 1980s. The Japanese quickly dominated many segments, including memory chips, and spurred a public outcry over unfair competition and the loss of high-paying white-collar US jobs. The big US players—Intel, Motorola, and Texas Instruments—abandoned the dynamic-random-access-memory (DRAM) business. But this exit prompted them to invest more heavily in the production of microprocessors and logic products—the next growth wave in semiconductors. Intel and Texas Instruments became the significant global forces in microprocessors and digital-signal processors (the "brain" in mobile telephones), respectively. Motorola gained a strong position in microcontrollers and automotive semiconductors. Throughout this shift toward higher-value-added activities, the total number of US jobs in semiconductors and closely related electronics fields held constant, at around half a million.<sup>6</sup>

## Exploding the myths

A number of myths and half-truths are muddling the public debate over white-collar offshoring. Most troubling is the argument that trade in services is somehow different from trade in goods—less beneficial to the US economy. Given the strength of US services, however, increased trade in them is actually more likely to be a substantial plus for the country.

The United States has always run a trade surplus in services, even with India. It has the world's most productive and developed service sector and continues to hold a comparative advantage in these knowledge-based industries, unlike those based on manufacturing. US banks, law firms, accounting firms, IT integrators, and consultants, to name just a few, are global competitors, and US trade policy has consistently demanded more openness on the part of other countries in these fields.

Others argue that the number of 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. Both China and India do have a large supply of productive labor, but they also have a fast-growing appetite for goods and services. The great majority of workers in China and India will produce goods and services for their own markets, because they are generating new demand about as fast as they are adding to supply. As happens elsewhere, only a small portion of the workforce of these countries produces goods for export. Provided that China and India allow exchange rates to adjust, they will not be a net drain on economic activity or jobs in the rest of the world. (For an assessment of how offshoring will affect them, see the sidebar, "[Emerging markets must do their part.](#)")

Equally untenable is the notion that China and India are taking work from the United States because of their low wages. The truth is that many jobs in India today are viable only in a low-wage environment and wouldn't exist in the United States. Thus the fact that half a million people are now employed in India's outsourcing industry doesn't mean that there could be 500,000 more jobs in the United States and Europe. Without offshoring, for instance, companies would scale back or withdraw services such as round-the-clock customer help. Moreover, technology is putting many US jobs at risk even without offshoring. 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 the notion that offshoring in the service sector has been responsible for the anemic rate of job creation during the current economic recovery. Critics point out that more than 2,000,000 US jobs have been lost since 2000. But almost all of these were in manufacturing, not services. Moreover, employment in IT—supposedly one of the sectors hardest hit by offshoring—expanded from 1999 to 2002 by 108,000 positions (out of roughly 3,000,000).<sup>2</sup> While 71,000 computer-programming jobs disappeared (mostly after the IT bubble burst), jobs in other computer fields multiplied. The number of higher-paid positions for software engineers increased by 115,000, while the number of jobs for systems analysts and network administrators rose by 40,000 and 27,880, respectively.

## The challenge for policy makers

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. For while free trade creates wealth and improves a nation's standard of living, not all groups benefit, particularly in the short term. Job change is a much larger part of life than it used to be, and the challenge for policy makers is to make it less painful.

A sizable portion of the workers who lose their jobs because of free trade don't find new ones easily or must accept jobs with lower wages. From 1979 to 1999, roughly 30 percent of the people who were unemployed as a result of cheap imports in sectors other than manufacturing hadn't found jobs a year later.<sup>3</sup> For those who did find them, average wages were about the same as before. Within that average, however, wages varied considerably. About a quarter of these people were better paid, but 55 percent took lower-paid jobs and as many as 25 percent of this group 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 provide them with new skills as the economy evolves. Generous severance packages can help as well, and making health benefits and pension plans more portable between jobs is essential. Tax credits might be offered to companies that hire workers who lost their last jobs because of free trade.

And for a small percentage of the savings from offshoring, companies could purchase insurance against wage losses for their displaced workers. Building upon an insurance proposal that Lori Kletzer and Robert Litan developed to help workers displaced by trade in manufacturing,<sup>2</sup> we estimate that for as little as 4 to 5 percent of the savings realized from offshoring, companies could insure all full-time workers who lost jobs as a result of it. The program would compensate those workers for 70 percent of the difference between their old and new wages and offer health care subsidies for up to two years.

These policies would help produce a more flexible labor force and allow the economy's wealth creation engine to accelerate. Protectionism, in contrast, might save a few jobs in the short run, but in the longer term it will stifle innovation and job creation. And, practically speaking, protectionism makes little sense, given how enmeshed the US economy already is with the rest of the world. Earlier this year, Congress considered an amendment (to a trade bill) that in one of its initial versions would have prohibited federal agencies from contracting with companies that outsource work abroad. Congress 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, which hardly constrains any activity. Similarly, Ohio considered a law to prohibit state contracts from going to companies that offshore some of their services—only to find that it would have excluded virtually all current contractors in the state. Facilitating change, not stopping it, must be the goal of policy makers.

The current debate over the offshoring of US jobs misses the mark. Short-term disruption from job losses must be weighed against the much broader benefit to US consumers and businesses, as well as the consequences of resisting change. If US 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 productivity and to concentrate resources on the creation of higher-value jobs.

## Emerging markets must do their part

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

Consider how India has benefited from foreign direct investment. Outsourcing IT and business processes generates more than \$10 billion a year for the country and gives employment to half a million workers. Suppliers to the companies that provide outsourced services employ another

half million people. With wages in the sector 50 to 100 percent higher on average than those for other white-collar occupations, a new middle class of educated workers is being formed. Foreign direct investment played a key role in the creation of these industries: the fast-growing Indian companies that now dominate the global sector got started only after multinational companies pioneered the approach, showed the world that India was a viable outsourcing destination, and trained a critical mass of local employees. (The CEO of Wipro Spectramind, for instance, started out at GE, and the CEO of Daksh came from Motorola.) Today foreign companies continue to provide healthy competition that forces Indian companies to improve their operations continually.

But the success of outsourcing in India is only 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 investment on local service and manufacturing industries in Brazil, China, India, and Mexico.<sup>1</sup> MGI found a positive impact in 13 of the 14 industries examined (and a neutral impact in the remaining industry). Foreign direct investment boosted productivity and output in the sectors involved, raising national income while lowering prices and improving both quality and choice for consumers. Overseas companies honed the efficiency and productivity of the local industries by bringing in new capital, technology, and management skills. Equally important, they increased the level of competition, forcing less efficient domestic companies to improve or go out of business.

Much as specific groups of workers in the United States might lose out from offshoring, foreign direct investment in emerging markets does pose a threat to some incumbent companies that stand to lose market share. But the cost to specific local producers is outweighed by the benefits to a much larger group: consumers. In case after case, they enjoyed far lower prices, and often more choice and better goods, after markets were opened to foreign investment.

The price of passenger cars in China, for instance, fell by more than 30 percent from 1995 to 2001, years when Ford Motor, General Motors, and Honda Motor entered the market. In Mexico, the "everyday low prices" of Wal-Mart Stores ended a long history of hefty margins for leading domestic 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, television sets, and washing machines fell by roughly 10 percent in 2001 alone after foreign companies entered the market. Similarly, prices for cars declined by 8 to 10 percent a year during the 1990s after the government opened the door, and the number of models available has now risen from a handful to more than 30. Lower prices have unleashed demand, and India's auto sector has grown by 15 percent a year.

Unfortunately, too many emerging markets remain skeptical of openness and therefore close off large parts of their economies to foreign companies. These nations are missing out on a tremendous growth opportunity that would benefit them as well as the broader global economy. In return for asking developed countries to go on allowing free trade in services, emerging markets would do well to go on liberalizing and opening the full range of their own domestic markets.

## Notes

<sup>1</sup> "New horizons: Multinational company investment in developing economies," McKinsey Global Institute, October 2003.

## About the Authors

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## Notes

<sup>1</sup> "Offshoring: Is it a win-win game?" McKinsey Global Institute, August 2003.

<sup>2</sup> Catherine Mann, "Globalization of IT services and white-collar jobs: The next wave of productivity growth," Policy Brief 03-11, Institute for International Economics, Washington, DC, December 2003.

<sup>3</sup> Lori Kletzer, of the University of California–Santa Cruz (and formerly of the Bureau of Labor Statistics), reports that from 1979 to 1999, 69 percent of nonmanufacturing workers who lost their jobs because of free trade found new ones within a year, and on average they 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, mean that the additional value to the US economy from redeploying workers would be 45 to 47 cents.

<sup>4</sup> John C. McCarthy, "3.3 million US services jobs to go offshore," Forrester Brief, November 11, 2002.

<sup>5</sup> 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.

<sup>6</sup> Employment data from the Semiconductor Industry Association and the Bureau of Labor Statistics.

<sup>7</sup> Department of Commerce, annual occupational-employment survey data.

<sup>8</sup> Lori G. Kletzer, "Job loss from imports: Measuring the costs," Institute for International Economics, Washington, DC, September 2001. To assess job displacement in sectors prone to foreign competition, Kletzer matched Bureau of Labor Statistics figures on nonmanufacturing jobs with trade data.

<sup>9</sup> Lori G. Kletzer and Robert E. Litan, "A prescription to relieve worker anxiety," Policy Brief 01-2, Institute for International Economics, Washington, DC, February 2001.