

The Importance of
Outsourcing & Offshoring
In the United States

Hank Fennell
Senior Honors Project
Dr. Phillip Daves
April 27, 2007

Introduction

Imagine a really difficult assignment you had, perhaps, in college. Say your professor made you write a thirty page paper that was necessary for you to graduate and you had to write it in two days. It sounds mildly appetizing, right? Now, imagine a company in India that would write that paper for you. Yes, they would do all the research, come up with an attention getter, write a thesis statement, the whole nine yards, and have it ready for you by the time you needed it. That sounds extremely enticing (besides the fact it would be cheating and no respectable college student would ever *really* consider it), does it not? This is an example, although an extreme one, of outsourcing. On a different note, imagine you drive through McDonald's one day and realize that they actually got your order correct. It could have been a miracle, or it could be because the person taking your order through the microphone was not actually around the bend at the first window but was a professional order-taker at a call center halfway across the county that specializes in taking orders (Friedman 40-2). Or it could have been both. These are only two of the many examples of outsourcing. This paper seeks to explore what outsourcing is, what effects it has on individuals, countries and the world as a whole, the controversy surrounding outsourcing, trends of outsourcing and the necessity for it. Outsourcing, and in particular offshore outsourcing, is absolutely and indisputably essential to the growth, stability, and competitiveness of our country's firms and economy in the ever expanding world market.

Definition of Outsourcing

What is outsourcing? A book called Outsourcing Insourcing defines outsourcing as “the process of shifting tasks and services previously performed in-house to outside vendors” (Jenster 1). At an even more simplistic level though, outsourcing is essentially the same concept as being resourceful. Individuals and families are most efficient if they specialize in what they do best and use the resources around them (other individuals or families) to produce things they do not make well themselves. Adam Smith wrote, “It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy” (Taylor 1). This obviously applies to firms as well.

The ideas of comparative advantage and specialization allow outsourcing to function. The economist David Ricardo is traditionally given credit for the idea of comparative advantage. In a simple example, imagine two countries and two products, say, chairs and tables. If there is no trade between the two countries (autarky), both countries will spend their resources (labor) to produce both products. However, it is likely that one country is better at producing chairs and the other better at producing tables, or one country is better at producing both goods. In either situation, there would be benefits to each country if they opened their borders to trade and could specialize in the manufacturing of the product they produced more efficiently. In both cases, the country that produces more efficiently has an absolute advantage in the good. But if country A has an absolute advantage over country B in both goods, the theory of comparative advantage says that country A should not produce both goods while the other does

nothing. Instead, both countries will produce the good in which it has the lowest opportunity cost of production (Drezner 5). This also applies if both countries have a clear competitive advantage in producing the opposite good. So, country B will be producing a good in which they have a relative advantage compared to country A and vice versa. This is the theory of comparative advantage, and it allows countries to specialize in the production of the good in which they are most skilled.

Both countries will reap benefits when they specialize in production and trade with each other. The most obvious benefits are an increased quantity and quality of goods produced (Jenster 3). If country A has a comparative advantage in the production of chairs, and they specialize in production of that product, they will not be wasting time producing a good for which they are not as efficient at producing. This, in turn, allows them to spend more time producing chairs in larger quantities and likely at a better quality as well. Another, less obvious, benefit is the 'learning curve effect'. This refers to the situation wherein "the amount of time needed to produce a product would have diminished as more experience was gained" (Jenster 3). Thus, more time can be spent innovating and thinking of ideas for new chairs or perhaps how to make the chair manufacturing process even more timely and efficient. Without specialization and trade of comparative advantage goods, output and quality would be lower and innovation lacking (Jenster 4). Of course, these benefits apply to firms as well, and the ultimate benefit of outsourcing is to increase the bottom line.

Outsourcing is a type of trading that allows for the exchange of goods and services for payment between a firm that specializes in the production of a comparative advantage good or service and a firm that is willing to buy this good or service.

Outsourcing is very prevalent and can be seen just about anywhere. At UT there are many examples of outsourcing. UT's core competency (what it has a comparative advantage in, or specializes in) is primarily the education that the University provides students. They aren't necessarily the best cooks, cleaners, retirement fund managers, marketers, builders, and bus drivers. Therefore, they outsource these services to companies who specialize in them. For instance, Aramark provides on-campus dining services. Another firm was hired to provide janitorial services. TIAA Cref manages professors' retirement funds. The athletic department hired an advertising agency to advertise UT's athletic teams. A local construction company is renovating the Glocker business building. Knoxville Area Transit (KAT) was hired to shuttle students to and from class in a timely (or untimely) manner. And this is only a short list of the many functions that are outsourced.

The Knoxville city government also outsources, so they can focus on their core competency of governing the people of the city. They do not take the trash to the dump, put out fires, take sick people to the hospital, respond to emergencies, build or pave roads, but they find people who will do those things for them. Outsourcing is more prevalent than you might know, and it is very vital to our economy.

Typical Outsourcing Decisions

Applying the ideas of specialization and comparative advantage to firms, we run into make-or-buy decisions, the traditional view of outsourcing, as we see from the examples above. Firms will stop production of a non-comparative advantage good or service and instead will specialize in what they do have a comparative advantage in and buy the other goods and services that they need. For instance, UT hired Aramark to provide dining services. The deciding factor of the make-or-buy decision is quite obvious

for a firm: are they doing something in-house that could be bought from someone else who will do it for less? Are they presently outsourcing a good or service that could be done in-house for less? (Jenster 4-5)

The make-or-buy decision dealing with traditional activities such as components or the least vital services of a firm is the most elementary type of outsourcing and also the most basic. Firms evaluating make-or-buy decisions for traditional activities are basically looking to cut costs. However, they may also be looking to consolidate suppliers or free up factory space by outsourcing a manufacturing process. Firms supplying the good or service mainly look to increase overall sales but may also be looking to strengthen a relationship with a client by providing even more goods or services to them. These are often the motives to buyers and suppliers of traditional activities in the make-or-buy decision.

Outsourcing Insourcing recognizes outsourcing for three more classes of goods and services (Jenster 16-17). Beyond traditional activities, firms may also choose to outsource peripheral activities. Peripheral activities are “services that have to be undertaken but which, for the most part, require little industry-specific capability” (Jenster 18). This includes the janitorial services at UT, dining services at UT, and for other firms it includes warehousing, tailored training courses, and subassemblies. Outsourcing these activities allows management to focus on more important core competencies. For instance, UT’s board of trustees will be able to focus more on how the university will be financed in the coming year instead of who will be sweeping the floors and providing freshmen their meals. On the other side of this outsourcing deal, the

suppliers of services will increase business, possibly venture into new business opportunities, and increase relations with current customers (Jenster 19-20).

Beyond peripheral activities, firms may outsource critical activities and processes such as securing data backup, data processing, total facilities management, and internal audit. If buyer and seller enter such an agreement, they need to have a very good relationship and be very knowledgeable of each other. Critical activities and processes are 'critical' for a reason, and if something happens to go wrong there can be major repercussions. So, the buyer must be willing to incur a lot of risk when entering into critical activities and processes outsourcing agreements. If UT outsourced a human resource management activity such as recruiting or staffing to an outside firm, this would be an example of critical activities outsourcing. Firms that are buyers in critical activities outsourcing are really looking to free management of busy work and utilize their scarce skills for more important activities. In addition, they are really depending on the supplier to provide a higher level of service and to become a strategic partner. Firms acting as the supplier in this outsourcing relationship typically enter into such a contract to increase business, establish deeper customer relationships and add to volume of services. In effect, their employees will become even more efficient at what they do and possibly reap the learning curve effect and economies of scale (Jenster 20-22).

The last type of outsourcing agreement includes strategic and problem-solving activities or core competencies. This could be anything from research and development (R&D) to total information technology (IT) management to new product development. Even though these may seem like core competencies, some firms still outsource them, so they can focus on even more core competencies (Jenster 22-23). For example, Wyeth

Pharmaceuticals outsourced its clinical-testing operation to Accenture Ltd. in 2004 (Engardio 2). An example of this at UT would be if the board decided to let another college or university teach UT students their core classes, and UT instructors would only teach classes specific to each major (to some extent this is done when UT allows transfer students). UT professors would be able to focus more on classes they teach within a particular major, and the outside college or university would obviously gain more business and revenue as well as a strategic relationship with UT.

Definition of Offshore Outsourcing

As evidenced, outsourcing takes place on many different levels within firms and can become a very important strategy a firms use to get ahead and stay ahead of the competition. So what's the problem with outsourcing? Why are so many people up in arms about it? Why was outsourcing a major political issue in the last presidential election in 2004? Perhaps the real problem is not outsourcing. Outsourcing has been around and relatively accepted for many years, but it was never really controversial until recently. The real problem is being caused by a different type of outsourcing: offshore outsourcing (also referred to as offshoring or global sourcing). Sometimes the two terms, outsourcing and offshoring are confused by everyone from politicians to businessmen to students and are often wrongly used interchangeably. However, the two terms should not be used in place of one another because they are two different things. As stated above, our simple definition defines outsourcing as the process of shifting tasks and services previously performed in-house to outside vendors. Offshore outsourcing adds the word 'foreign' to that definition and places it in front of the word 'outside.' The addition of this

seven letter word has sparked a lot of controversy since the beginning of the new millennium in the US. Offshore outsourcing is an important trade technique for the US and its quest to be atop the world economy hierarchy, but it can also be a dangerous idea to those who do not understand it and hold on to every last word of politicians who do not understand the concept either.

Recently, a trend of US firms has been to outsource jobs offshore to foreign countries. Many manufacturing jobs go to places like Mexico, China, and other Southeast Asian countries where unskilled workers are abundant and will work for pennies a day. Many service jobs go to places like India, the Philippines, New Zealand, and even Canada (Ryans 29) where there are young, extremely eager college graduates looking for any service job they can find and will work for a fraction of the cost an American would. The common thread in both situations is that these people are willing to work for a considerably less amount of money than Americans could or would. Cheap labor is the comparative advantage for these foreign countries, and they are trying to exploit it to the fullest. This scares many Americans who fear their job is at risk to be offshored.

The Benefits of Offshoring

Cheap labor in foreign countries has caused many jobs to be offshore outsourced, particularly jobs involving a low-skill level. A recent trend, though, is of outsourced jobs involving a higher skill level. For instance, in India, firms provide engineering services, human resource services, accounting services, information technology services, and legal services. Thomas Friedman, in his book The World is Flat, suggests that virtually every type of job in America could be threatened by offshore outsourcing (Friedman 15). While

some may believe that is true (while intuition tells us it is not), we know that the effects so far of offshoring are not as terrible as they are made out to be.

Statistics show that the effect of offshoring on the United States' overall job level is virtually insignificant. A few years ago, Forrester Research estimated "that a cumulative total of 830,000 jobs would be moved offshore by the end of 2005, and that a total of 3.4 million additional US jobs would move overseas in the decade through the end of 2015" (Mankiw 15). Compared to the 160 million US job positions expected to be filled by the year 2015 (as calculate by the Bureau of Labor Statistics or BLS), the number 3.4 million does not seem so big (in fact, it is only 2% of all job positions). The number is also put in perspective by the fact that there was a net increase of 35 million jobs over the last decade with even bigger swings in additions and deletions of jobs that produced the net 35 million (Mankiw 16). Too much attention is put on a gross loss of jobs instead of the net gain in jobs by opponents of offshoring.

The BLS did further research on US firms that had layoffs of over fifty employees for a time span of at least thirty days. Jobs were moved to foreign countries only 1.6 percent of the time, and only 3.3 percent of the times were jobs moved to different parts of the U.S. This is not conclusive evidence that the loss of jobs overseas is numerically insignificant, however, because the study did not take into account layoffs of less than fifty employees, nor did it take into account statistics for layoffs of less than thirty days (which accounts for about two-thirds of mass layoff events) (Mankiw 16). Regardless, these statistics imply that the majority of jobs lost are not going overseas, and that the whole of lost jobs to offshore outsourcing is not really significant in the big picture.

In addition to the normal gains from trade such as efficiency and productivity, there are other upsides to offshore outsourcing. Evidence has shown that, contrary to popular belief or what some popular people (such as politicians against offshore outsourcing and free trade) want the general populous to believe, moving jobs overseas may actually create jobs in the US. Rather than replacing or substituting domestic jobs, US firms' activity in foreign countries can actually complement their domestic activity. Researchers have shown that "higher sales in foreign affiliates lead to increased labor demand in US parents" (Mankiw 18).

There are many examples suggesting offshoring creates domestic jobs. For instance, Paper Converting Machine Co. (PCMC) in Green Bay, a manufacturing company, experienced a 45% decrease in labor force over the past five years because of offshore outsourcing. However, this year, PCMC plans to experience a turnaround because they are shifting some design work to India while keeping the remaining design work in the US. This will allow designers to collaborate around the clock with their counterparts in India and will hopefully "slash development costs and time, win orders it often missed due to engineering constraints, and keep production in Green Bay" (Engardio 1). Winning more orders will allow PCMC to hire more workers all because they are offshoring some of their design work (Engardio 1).

On the same note, Delta Airlines has added jobs at home by offshoring their call-center to India. By sending these 1,000 jobs overseas to India back in 2003, Delta saved \$25 million dollars and was able to reinvest it at home in 1,200 new reservation and sales positions (Drezner 4). IBM offshored 3,000 IT jobs in 2004, but was able to add 4,500

positions domestically (Drezner 4). The evidence is clear that offshoring can free up money for firms to add jobs at home.

A study done in 2005 also shows that US firms' activity in foreign countries complements domestic activity. The study examined the years 1982-1999 and found that for every ten dollars invested in foreign countries by US manufacturing firms, there was investment of fifteen dollars back into the United States. Also, for every ten dollars of additional foreign employee compensation there was an addition of eighteen dollars into domestic employee compensation (Mankiw 18).

Gregory Mankiw, the former chair of the Council of Economic Advisors (CEA) to President Bush, suggests further that offshore outsourcing of jobs might be beneficial. He explains, "It could be that hiring workers overseas allows a US firm to expand US employment, or even that a US firm would shut down but for the ability to lower costs through offshore outsourcing. In this latter case, outsourcing could be said to save rather than destroy jobs in the United States" (Mankiw 17). Unfortunately, there is no conclusive evidence to prove that all US firms offshoring jobs also add jobs at home (evidence by the BLS numbers presented above). However, the existing numbers and evidence shows that the number of jobs outsourced to foreign countries does not comprise much of the overall job level in the US, and that it can possibly create or save jobs.

Offshore outsourcing also allows firms to become more profitable. The McKinsey Global Institute study in 2003 shows that for every dollar of work offshored to India, the total gain to the United States was \$1.12-\$1.14 (Mankiw 25). In addition, India gained \$.33 on every US outsourced dollar. Collectively, the gain from every dollar invested was

a net of \$.47 or a gross of \$1.47 (Marchant 382). Daniel Drezner, in his article “The Outsourcing Bogeyman” summarizes this effect saying, “Thanks to outsourcing, U.S. firms save money and become more profitable, benefiting shareholders and increasing returns on investment” (Drezner 5).

Offshoring also increases real wages of American jobs in general because it allows more jobs to be created in high skilled areas. The U.S. has a comparative advantage over other countries in high skilled labor. Thus, jobs in America naturally pay more. Through trading lower skilled, lower income jobs like manufacturing and call center jobs overseas via offshoring, more resources are able to be put into more high skilled, higher paying jobs. According to Drezner, in the IT sector between 1999 and 2003, over 70,000 computer programmers lost their jobs in America, but over 115,000 computer engineers were able to acquire higher paying jobs because of it (Drezner 5).

When comparing outsourcing to offshoring, some say offshoring has significantly better benefits. The CEO of Genpact, a former subsidiary of GE said, “It used to be that companies struggled for a few years to show a 5% or 10% increase in productivity from outsourcing. But by offshoring work, they can see savings of 30% to 40% in the first year” (Engardio 3). Firms using offshoring as a strategic advantage can really use it as a competitive advantage.

Indisputable evidence shows that outsourcing jobs to foreign countries benefits US firms as well as our entire economy through gains from trade mentioned earlier in the paper. There is not conclusive evidence to suggest that US firms create jobs domestically by simultaneously adding them overseas. However, from an economic perspective, “international trade is not, fundamentally, about job creation” (Mankiw 14). If an

economy is open or autarkic, it does not really indicate anything about unemployment levels. Since an economy without trade is not going to experience gains from trade, it can safely be said that the overall state of an economy that sends jobs to foreign countries will be better off and will experience a higher standard of living over those that do not. So, even if the statistics do not conclusively show that offshore outsourcing creates more domestic jobs, it does not really matter because the gains from trade for the whole economy will outweigh the loss of jobs to foreign countries which affects relatively few.

The Offshoring Controversy

Despite the information presented above, there is still huge opposition to the offshoring of jobs because of the relatively few people it has affected so far, and the potential of the relatively few people it will affect in the future. These few people (remember, which are expected to account for 2% of all jobs existing in 2015), however, have a large voice because of politicians who do not understand the economics behind the issue or who are simply looking for a vote. For instance, during 2004 Presidential election campaigning, President Bush caught a lot of flack from the media and other politicians because of his administration's economically consistent stance on offshoring.

In the Economic Report of the President (ERP), released on February 9th, 2004 and written by N. Gregory Mankiw, the head of the CEA wrote this excerpt on international trade:

“One facet of increased services trade is the increased use of offshore outsourcing in which a company relocates labor-intensive service industry

functions to another country. For example, a US firm might use a call center to India to handle customer service-related questions. The principal novelty of outsourcing services is the means by which foreign purchases are delivered. Whereas imported goods might arrive by ship, outsourced services are often delivered using telephone lines or the Internet.

The basic economic forces behind the transactions are the same, however. When a good or service is produced more cheaply abroad, it makes more sense to import it than to make or provide it domestically” (Mankiw 5).

At first glance, there are no problems with this statement, especially since it is economically right-minded. However, the LA Times twisted the meaning of these statements and subsequently ran this headline in their paper the next day: “Bush Supports Shift of Jobs Overseas” (Mankiw 7). Democratic candidate John Kerry pounced on the opportunity to use this statement against President Bush in his campaign. Senate Majority Leader Tom Daschle said, “If this is the administration’s positions, I think they owe an apology to every worker in America” (Drezner 1). Speaker of the House Dennis Hastert offered his opinion as well, “Outsourcing can be a problem for American workers and the American economy” (Drezner 1). He also added that Mankiw’s words “failed a basic test of real economics” (Mankiw 8). Apparently there were many politicians who objected to Mankiw’s statement after the LA Times’ headline.

It is evidenced how words can be interpreted and then twisted to say something almost completely different. Neither Mankiw nor Bush were advocating sending jobs overseas to spite the American worker but instead were advocating sound economic

decisions made by firms who could become more efficient by offshoring. However, this information fell on the sensitive ears of individuals who were out of work because of the ongoing U.S. recession and loss of jobs. It also hit home with people who feared their jobs were going to be offshored. However, the loss of American jobs and the higher unemployment rate at the time “had little relation to outsourcing,” according to Mankiw, “since there was no evidence that outsourcing had contributed meaningfully to US job losses” (Mankiw 9).

Even though offshoring improves the lifestyle and wages of the US majority, it has lowered real wages of low skilled U.S. manufacturing workers. One study found that two-thirds of those laid off because of offshoring earned less money upon reemployment, and almost 25% of them earned at least 30% less (Marchant 383). Consequently, this increases the wage gap in America between low skilled and high skilled workers.

Offshoring can easily be attacked by those who ignore its benefits because of the obvious loss of domestic jobs it causes. It is also easy for public figures to claim that buying American goods and stressing government protection of US jobs against offshoring is patriotic. However, if American goods are being made inefficiently compared to goods made in foreign countries because due to cheaper inputs (lower labor costs), continued support of domestic goods allocates resources to producers who do so inefficiently. This makes America weaker because it prevents the US from reaping gains from trade, costs US consumers more money (and likely provides them with a lesser quality product), prevents firms from specializing in core competencies, and keeps inefficient producers in business. Government protection of US industries is detrimental to the economy.

The majority of the American public believes, however, that international trade is, in fact, about job creation; that exports are good because they create jobs, and imports are bad because they allow foreigners to steal US jobs (Mankiw 14). The American people as a whole do not have the foresight to see the benefits to the economy from this form of trade. That is why it is so vital for people to understand outsourcing in general and the economics behind it, and for public figures to explain it to them instead of misleading them for ephemeral benefits to their public image.

Dangers & Risks to Firms of Outsourcing and Offshoring

Let us turn our attention to how outsourcing and offshoring can actually be dangerous to a firm. As of yet, there is no evidence that outsourcing or offshoring can hurt an economy. Basically, US firms and firms worldwide use outsourcing as a strategic tool because it allows them to lower costs and focus on their core competencies. In turn, this increases the bottom line and makes shareholders happy. Shareholders are not going to be happy if their firm runs into problems and loses money because of outsourcing ventures. Firms can put themselves in danger if they outsource too much; that is, they outsource too many (it could be just one) essential core competencies and become what is called a “hollow” company.

Some argue that hollowing is very serious and can lead a firm to self-destruction. Speaking of critical activities and some core competencies such as R&D, recruitment and IT, John K. Ryans, Jr. in his article titled “Outsourcing, Intellectual Property Rights and Corporate Hollowing Concerns” writes, “Clearly, as these types of functions are outsourced, the corporation’s management potentially gets further and further away from

the firm's day-to-day operations" (Ryans 33). However, as long as these activities and competencies are not the most vital to the firm, the ones from which it gains its competitive advantage, hollowing may not be a problem.

For instance, publishers could be considered hollow companies. Most do not "write books, make a detailed review of books and proposals, design books, print books, copy edit and proofread, bind books, or, sometimes, market, sell and distribute books" (Jenster 13). Even though they do not perform these activities that may seem crucial to their success, publishers still retain vital core competencies such as finding authors, choosing books worthy of selling, financing the book writing process, and, usually, marketing their books. Publishers and other companies who outsource this many functions and do so successfully may be referred to as virtual instead of hollow. Virtual firms "run a business and grow it to significant size without it owning the assets or employing the people who are used to produce the products and services it requires to function and ultimately to deliver value to the customers" (Jenster 13). Firms that do this can either be called hollow or they can be called virtual. Either way, as long as it holds on to its most vital core competencies, a firm can survive.

However, if a firm does, in fact, happen to outsource more than it should, it can run into some serious problems. A firm can become too dependent on a supplier which is bad in itself. In addition to that, if the supplier turns out to be undependable and is untimely in deliveries or makes a bad product, the firm is going to be in serious trouble. What makes this situation even more egregious is if the firm entered into a long term contract with the supplier. It would be hard to back out of the contract and reverse their offshoring decision (Ryans 33). Firms could also have other problems with their

suppliers such as conflicting objectives, communication problems, issues with contracts, lead time variability increases, exchange rate risk on repatriated funds, and political risk as well as market risk of the supplier's home country (Clark 9). All of these problems and others can be very dangerous to a firm's success and profitability.

As if that were not enough, there are some hidden costs associated with offshoring as well. Firms that are distanced from their suppliers are going to have to keep larger inventories. This increases the risk of those inventories becoming obsolete because of fire, theft, technological improvements, etc. and thus raises operating costs. Firms that outsource overseas also face higher administration costs partly because of expensive expatriate packages for managers and also because of expensive foreign travel for administrators who check on overseas operations. Offshoring firms will also face higher transport charges (when transferring goods, not services) and a cost to train foreign workers (Clark 9). Services are transported back to the home country via the internet of computer, so transport charges for services do not really apply.

Perhaps one of the biggest issues US firms have when outsourcing or offshoring is the risk to intellectual property. "When a firm considers the protection of intellectual property it might receive in a country, it needs to consider not only the legislation which the country has enacted, but also its history of and attitude toward its enforcement" (Ryans 30). Just recently, China has enacted many intellectual property laws, but the history and attitude of the country suggest that the idea of protecting intellectual property is not really important. This is evidenced from all the stories of people that travel to the country and come back with hoards of "knock-off" products such as clothes, sporting equipment, etc. In fact, "knock-offs" are so prevalent in China that the International

Intellectual Property Alliance estimates that they make up 90% of the domestic Chinese market! (Ryans 33) Intellectual property is a potentially huge issue for offshoring firms.

General Motors is one firm familiar with China's lack of intellectual property rights (IPR). One of their models is being replicated by Chery, one of GM's own manufacturing *partners* in China. Chery is not only trying to sell their pirated GM model to Chinese consumers but is also producing and selling the car in Malaysia and the Middle East. To add insult to injury, Chery had announced at the time (2005) that it planned on exporting its car to the US! (Ryans 34) Obviously, US firms encounter costly intellectual property risks when offshoring and must weigh these risks with the benefits when making important offshoring decisions.

As mentioned before, the outsourcing decision is all about the bottom line, but to make any improvements to the bottom line, outsourcing and offshoring firms must put the customers first, even above shareholders. Without customers, shareholders do not mean anything and will never earn a return on their investment. Unfortunately, some firms fail at the outsourcing and offshoring decision and appear to value cost savings more than their customers.

Example of Corporate Hollowing

Thomas Friedman praises Toshiba for its apparent outsourcing prowess in repairing its customer's laptops. Describing the process, instead of Toshiba repairing your laptop, UPS will ship your laptop to its *own* service center the day you bring it to one of their retail outlets. A UPS employee will fix it for you the next day, and send it back to you on the third day. This has cut down on customer complaints "drastically",

Friedman says (Friedman 168). However, Toshiba has become a hollow company and has significantly distanced itself from its customers by doing this.

What Friedman fails to explain is that when you call Toshiba to get your laptop repaired, you first have to talk to a blindly enthusiastic Philippino in a call-center halfway around the world. This customer service representative more or less warns the UPS retail store (formerly, Mail Boxes Etc.) near you that you are bringing your laptop to them, so they can ship it to their repair hub in Louisville, Kentucky. This is not necessarily bad in itself except you have to explain to this person in the Philippines who knows too little about computers what you think is wrong with your laptop. Then they have to explain to the repairman in Kentucky what they think you think is wrong with your laptop. It is confusing even to explain, so you can already guess what is likely to happen. Since there is no direct contact between the customer and the repairman, it is extremely difficult to relay the real problem to him. Thus, the repairman ends up “fixing” what he believes the problem is which may or may not be what the actual problem is. This causes long hours on the phone and much anguish to the customer who has to repeatedly get his laptop serviced.

From the customer’s viewpoint, who wants an employee from UPS fixing his laptop? Yes, he might be certified by Toshiba to work on Toshiba products, but he likely is NOT the most knowledgeable person dealing with Toshiba products. Therefore, he likely is NOT the most efficient at servicing Toshiba products either. It makes sense that most Toshiba customers would want someone actually from Toshiba fixing their laptop.

To put the icing on the cake, when the customer is trying to find other solutions to his laptop problems because Toshiba is inept at repairing it, he cannot go back to where

he bought it because the retail store passes on all liability for the product to the UPS service center once the product is bought and the warranty takes effect. The customer cannot contact anyone in the United States because Toshiba does not have any customer relations centers in the U.S. The customer cannot even contact local sales representatives from Toshiba because they only refer him to the call center in the Philippines. And as previously mentioned, the customer cannot even talk to the person fixing his laptop. When Toshiba isolates itself from the customer in this manner because of ill-advised offshoring and outsourcing decisions, it creates resentment in the customer and a disgruntled customer is a dangerous customer. Toshiba has lost at least one retail outlet in Knoxville in the last year because of its defective products and its atrocious customer service. Companies who outsource and, in particular, offshore outsource, must pay paramount attention to customers at all times.

The Importance of the Outsourcing/Offshoring Decision

Because customers do not like to be taken advantage of and are actually quite powerful in free market economies, firms are under increasing pressure to please customers. This is one of reasons the offshoring decision is so important. With more countries opening its borders to freer and less inhibited trade and outsourcing, welfare for people all over the world has gone up. Therefore, customers in many different places have become more demanding and expect a higher standard of living. “With higher expectations, and more choice, it is not surprising that the individual consumer is less tolerant of poor products and service and is more vocal in expressing dissatisfaction” (Jenster 7). If this holds true, hollow firms like Toshiba who, as Ryans says, have

distanced themselves too much from day-to-day operations will not be able to survive much longer.

Another reason the offshoring/outsourcing decision is so important is because competition is increasing at the hands of globalization. Nowadays, firms compete not only within their own geographic region or with other firms within their industry; they must also compete with firms in different countries and across different industries. Technological advances have made industry lines almost disappear in the sense that “computers, cameras, video, typewriters, copiers and telephones have all crossed into each other’s territories” (Jenster 7). Boundaries are also disappearing in the services industry as well. Disappearing boundaries means larger markets and globalization. Firms who want to compete must take advantage of the global marketplace via outsourcing. (Jenster 7) When speaking of offshoring, the managing director for Deutsche Bank’s global businesses said, “The issue is that if you don’t do it, you won’t survive” (Engardio 1-2).

Outsourcing and offshoring allow firms to compete better by enabling them to keep up with technological advancements. If a firm does not have an advantage in technology, it can outsource this function to another firm that does. Without technology, firms would not be able to produce at a rate to keep up with shortening product lifestyles. Shorter product lifecycles mean firms will not be able to exploit new innovation as long as they used to. For example, Outsourcing Insourcing says “innovation of software and hardware now means that few office computer systems have a useful life of more than about two or three years, leaving manufacturers of PCs with model lifecycles of between

six and nine months” (Jenster 9). Therefore, firms must use outsourcing and offshoring to allow them to focus on core competencies and keep up with the times. (Jenster 8)

Outsourcing and offshoring can also be an important strategic decision to a firm if it helps create shareholder value. Management must always be looking out for the needs of the business while simultaneously trying to produce a profit that makes shareholders happy. Studies show that during the 1980s, many firms were actually reducing shareholder value with their strategic decisions (Jenster 9). More recent research done by KPMG in 2001 shows firms are still struggling with creating shareholder wealth from their strategic decision making. KPMG studied firms who were on the buying side of acquisitions and found that only 30% of these decisions added value for shareholders (Jenster 9).

Therefore, managers need to be aware of the fact that the outsourcing/offshoring decision is a very delicate tool that they can use as a strategy to improve their firm’s position. However, it is just one strategic tool they have in their briefcase to add value to their firm. With all of the costs, risks, and benefits associated with outsourcing, a firm must dissect every detail of a potential outsourcing agreement. Most companies nowadays even outsource the outsourcing decision. Just Google ‘outsourcing’ and links to various websites will come up from consulting firms that will help you decide where to and what functions or operations to outsource. Firms must consider outsourcing agreements carefully and avoid basing a decision solely on the lowest cost country or the most popular country used for offshoring by other firms. Nor can they base their decision entirely on labor cost savings. No detail can be overlooked and no detail can be examined

too much because this decision is very vital to a firm's success and can have major benefits or detriments.

In some cases, offshoring just does not pay off. Some might say that Toshiba should make an effort to reconnect with its customers by perhaps moving their customer call center to the US. However, others like Thomas Friedman might disagree. It really depends on how the firm views these effects and if it is willing to live with them. If outsourcing or offshoring negatively defines how a firm operates, it may want to reconsider and reverse its outsourcing or offshoring decision. In fact, some firms like Dell and Lehman Brothers have done this. Because of customer complaints, both firms moved their call centers back to the United States (Drezner 4).

Trends in Offshoring

There are many trends in offshoring. One trend is the change in the types of jobs that are being outsourced. From previous discussion, we know that firms started out mainly sending low-skilled manufacturing jobs overseas, but as time has passed, firms are sending higher-skilled service jobs overseas including peripheral activities, critical activities, and strategic and problem solving activities. Basically more critical and important jobs (service jobs) are being offshored. Some predict that carmakers in Detroit will find firms across the world to do their designing for new models, not just manufacturing these models (Engardio 2). Proctor & Gamble now has about 20% of its new products coming from outside partners and wants that number to rise to 50% by 2010 (Engardio 2). US Pharmaceutical companies such as Eli Lilly are offshoring molecular research and clinical testing operations to partners in India, China, and Russia

and expect to bring new drugs to the market at a fraction of the current cost (Engardio 2). Based on these examples, it is clear that a more diverse group of American workers will be threatened by offshoring in the near future.

For the most part, different kinds of jobs are offshored to different parts of the world. However, this trend is also changing as we see countries competing for offshored outsourcing contracts. For instance, China is traditionally a manufacturing country, but it is trying to close the technology gap between itself and more technologically advanced countries such as India. China's recent passing of laws attempting to protect intellectual property rights may reflect a changing attitude in China to make a concerted effort to protect copyrights and patents of foreign firms operating in their country. China knows it must improve this situation if it is to attract new foreign direct investment (FDI) such as research and development projects that must have their patents protected. In addition to improving the intellectual property situation, China is trying to improve the infrastructure of its country in general by building roads, airports, and the like. Countries' competing for offshoring contracts is an important trend.

If countries continue to compete like this, we could see a total transformation of the makeup of offshoring locations. Already new countries are adding themselves to this makeup including the Czech Republic, Hungary, Morocco, Tunisia, Malaysia, Ghana, and Uruguay, and more are expected to follow their lead (Arnn 1).

Another trend in offshoring is its growth and magnitude. In the IT industry alone, "the combined value of the 1,814 outsourcing deals contracted by U.S. firms in 2004 rose 37 percent to over \$163 billion" (Ryans 29). TPI, one outsourcing consulting firm, helped structure 15 major outsourcing agreements in 2005 worth over \$14 billion (Future 2).

Firms across all industries are taking part in the act, too. DuPont, Proctor and Gamble, Cisco Systems, Marriot, and Unilever have all entered into offshoring contracts worth billions (Future 2). It is usually large multinational corporations (MNCs) like these that use offshoring the most. Brofenbrenner and Luce show that between January and March 2004, about 78% of manufacturing job offshoring was undertaken by MNCs (Marchant 381). It is a good indication that offshoring is very beneficial at the firm level when the largest firms are using it the most.

Adding to this trend, MNCs are not just offshoring these jobs to contractors. Instead, they are vertically integrating their suppliers through FDI in particular countries. Once inputs are manufactured by offshore subsidiaries, they are sent to the home country of the MNC via intra-industry trade. Levels of intra-industry trade have risen significantly recently which shows an increasing trend in the use of FDI (Marchant 381).

American firms are not the only ones that offshore outsource. Foreign firms from places like Japan and Eastern Europe offshore jobs to places the United States! Some even argue that more jobs are ‘insourced’ in America than jobs are offshored. Foreign multinationals like Honda, Toyota, and Fuji have brought thousands of manufacturing jobs to the United States. In fact, foreign multinationals employed 5.4 million US workers in our own country in 2004, and they also pay higher wages compared to US companies to the tune of 31% (Marchant 382). In the US manufacturing sector, jobs created by foreign firms accounted for 11% of all manufacturing jobs in the US 1997. By 2002, that percentage had risen to 12.7% (Marchant 382). The goods produced from these jobs also help our balance of trade, accounting for 20% of US exports of goods (Marchant 382). Even statistics from the BLS show that the increase in the number of

jobs being insourced is higher than the increase in the number of jobs being offshored (Drezner 5). Insourcing of jobs is a positive trend to individuals who find those jobs and to the American economy as a whole.

Firms using offshoring perhaps most strategically will break up the manufacturing of different parts of larger goods and send responsibility for the manufacturing of different components to different countries (Marchant 381). According to the World Trade Organization's (WTO) annual report from 1998, the majority of an American car's production value is added by firms outside the country (Marchant 381). Hence, US auto makers are sending the majority of the car making process to places like China. In fact, a lot of firms are doing this. A study by Hummels, Ishii, and Yi and Yeats found that trade worldwide of components has grown faster than worldwide trade of finished goods (Marchant 381).

Another trend in offshoring is that firms are not using cost cutting as their ultimate goal in deciding where to outsource jobs abroad. Some firms are trying to find and utilize foreign labor that is distinctive in hopes this will provide them a comparative advantage (Ryans 34). Others are just concerned about their firm growing rather than how much it will cost them (as long as it is not too much, of course). Peter Allen, the CEO at TPI, says, "Many CEOs are saying, 'don't tell me how much I can save. Show me how we can grow by 40% without increasing our capacity in the U.S.'" (Engardio 2). Regardless of what these CEOs are specifically trying to achieve by offshoring, they are really just looking for an upper hand on the competition.

The Role of Technology and Free Trade in Outsourcing

Two major topics that set the groundwork for the offshoring and outsourcing revolution are technology and free trade. First, ever increasing technological advances have increased outsourcing and offshoring opportunities. They have changed the outlook of many jobs in the United States and all over the world. Jobs that used to be considered safe from outsourcing or offshoring and not tradable are now not safe from outsourcing and offshoring and are tradable (Drezner 5). This is easily observed in the increase of service jobs being sent abroad. Who would have thought 20 years ago that, today, we would be letting people in India do our taxes?

Computers have been stealing jobs from Americans for a long time now because they can perform jobs that require following directions to a T (Mankiw 23). Bardhan and Kroll “assume that jobs are potentially subject to outsourcing if they require no face-to-face interaction, have high-information content, and involve a work process that can be structured to involve telecommunications or the Internet” (Mankiw 24). Manufacturing and service jobs are both subject to outsourcing when technological advances reach places like China and India where cheap labor is abundant. Friedman explains that many IT jobs were created in India in 1999 because of the Y2K scare. The technology was then in place that enabled Indian IT workers to fix practically every computer in the world to safeguard it from resetting itself to the year 1900 and thus creating suspected mass hysteria (Friedman 132). In summation, technological advances will continue to take jobs but has also enabled outsourcing to take place in more places and at a higher rate.

The second major topic that set the stage for the revolution is free trade. Free trade is absolutely necessary for offshore outsourcing to work. Drezner points to the

example of candy cane manufacturers being offshore outsourced. Even though 90% of the world's consumption of candy canes takes place in the U.S., most of the manufacturing process has been moved south of the border to Mexico in the last decade. Why? Because of U.S. import quotas on sugar, U.S. prices of sugar are 350% higher than world prices (Drezner 6)! No company in their right mind would ever want to keep production in America if input prices like sugar are going to be that much more expensive. So, candy cane manufacturers make their goods in Mexico and send them to the United States. This might cause them to pay an importing duty and higher shipping costs, but anything is worth avoiding exorbitant input prices in the U.S. caused by protectionist policies. In effect, almost 10,000 people in the Midwest lost their jobs (Drezner 6) that would not have lost them otherwise if quotas on sugar had not been in place to protect the domestic sugar industry. Free trade policy would have helped in this situation.

Like we mentioned earlier, inefficient producers are extremely bad for an economy. The reason quotas, tariffs, and the like are usually put in place by the government is to protect American producers who produce inefficiently. So, a tariff on sugar is a protectionist tool much like the temporary tariff on steel was from March 2002 until December 2003 enacted by the Bush Administration. The tariff was meant to help steelworkers sell more steel domestically because some (but not all) could not and still cannot produce as efficiently as firms in other countries like Japan. Consequently, the government enacted a tariff on all imported steel. However, tariffs always hurt everyone 'downwind' from the producer or manufacturer that uses steel in their business. In effect

of this tariff, between 45,000 and 75,000 Americans lost their jobs to save a few steelworkers' jobs (Drezner 6).

Protectionism is an extremely inefficient and expensive way to keep jobs in the US. In 1982, the U.S. government established another protectionist tool, a voluntary export restraint (VER) with Japan and some European countries. VERs are bilateral agreements between two governments voluntarily restricting the amount of exports one can send to the other. In this case, the U.S. was trying to protect our domestic auto industry by restricting the amount of imports received by the aforementioned countries. However, foreign producers tend to send more expensive products to us when there are restrictions on how many they can export. Therefore, they charge higher prices, and the American consumer loses. Because of this particular VER, Japanese and European auto producers were able to charge American consumers an extra four *billion* dollars in 1982. Fortunately, the VER was estimated to have saved about 22,000 domestic jobs but at a cost of \$180,000 per job. That is about six times the average wage in the auto industry! (Kreinin 105-6) Protectionism costs consumers a lot of money, but perhaps the worst part is that it is an avoidable loss.

Trade protectionism may allow US producers to continue what they are doing or stay in business. However, it raises domestic prices, causes others “downwind” to lose their jobs, and subsidizes inefficient US manufacturers who shouldn’t be producing. Notice all of these consequences occur in the US. Tariffs do not really hurt foreign producers because they can usually find new markets or sell in higher volumes to current markets. Tariffs and other protectionist tools hurt the US. Drezner adds, “It preserves jobs in less competitive sectors while destroying current and future jobs in sectors that have a

comparative advantage. Thus, if barriers are erected to prevent offshore outsourcing, the overall effect will not be to create jobs but to destroy them” (Drezner 6-7).

Another enabling factor of offshoring is a stable government. Remember, political stability was a hidden cost of offshoring. A firm would have no recourse if they established a supplier in an unsettled nation through FDI, and the government was overthrown. Other times, governments nationalize certain industries and shut down offshoring activities in the country. For instance, the Mexican government nationalized oil and natural gas some time ago. So an open economy with minimal protectionist barriers in a stable country with an established government is vital to offshoring activities.

The Future of Offshoring in America

Unfortunately, some predict the future of offshoring in America is going to be a struggle. Drezner says, “The problem of offshore outsourcing is less one of economics than of psychology” (Drezner 7). When Americans feel threatened on a personal level like some do now about losing their job to outsourcing or offshoring, they will want security from the government in some form, and they usually voice their opinion somehow. Many organizations such as Rescue American Jobs, Save U.S. Jobs, and the Coalition for National Sovereignty have formed recently with the interest of saving jobs at home (Drezner 6). Powerful representatives in the Senate and Congress have heard the voice of these people and are trying to take action against offshoring. As of 2004, Connecticut Senators Christopher Dodd and Nancy Johnson tried to pass the USA Jobs Protection Act that would prevent U.S. firms from offshoring when American workers

were available (Drezner 6). Over 20 state legislatures have at least considered bills that would prohibit many different kinds of outsourcing (Drezner 6).

As we have seen, protectionist measure only hurt our economy. However, there are many Americans who are not educated in free trade and outsourcing, or are being deceived by others who claim outsourcing and offshoring are bad, or just do not care about the negative effects our economy would experience without free trade. Whatever the reason for so much opposition to offshoring, individuals such as politicians who are in the public eye and can make a huge difference because of their political power need to make an effort to understand the situation in full.

Helping Those Displaced by Outsourcing/Offshoring

Granted, outsourcing and offshoring hurt many individuals in the U.S. despite how relatively low the number might be. It is hard for them to find new jobs, especially ones that are comparable in pay to their previous one. Low-skilled workers are hurt the most since the U.S. is mainly high skilled labor intensive. However, there will always be jobs that cannot be outsourced or offshored, and the government is also ready to help these people.

At the present moment, the federal government has already enacted the Trade Adjustment Assistance (TAA) program to help those who have lost their jobs because of outsourcing or offshoring. The TAA provides qualifying workers with “supplementary unemployment compensation, retraining services, job search allowance, and relocation allowance” (Kreinin 127).

However, the TAA doesn't help as many as it could because of how it is set up. Qualifying workers must have lost their job in an industry which is seeing overall production and sales decline. However, if an individual loses his job to offshoring, their former employer is not likely to lose sales or productivity since offshoring decisions are meant to make firms more cost efficient. Therefore, some suggest the government loosen the rules to allow the program to help more displaced workers (Drezner 7). Firms could also purchase insurance policies for their employees that would help support them for a while if they happened to lose their job because of outsourcing or offshoring (Drezner 7). Something must be done to reassure Americans who feel their job is at risk. However, protectionist policies are not the answer. Honestly, the government should not get involved at all besides educating the American people about the true effects of outsourcing and offshoring and sitting back and watching free trade take its course. Then, as the public mindset changes about the issue, protectionist policies can be repealed and our economy can reap even more benefits from outsourcing and offshoring.

Conclusion

The point is that there are jobs leaving this country, and there are jobs entering this country. Since the US's comparative advantage is higher skilled labor, jobs that require higher skills are generally going to be offshored by foreign firms to our country. Jobs that require lower skilled labor are going to leave this country and go to lower wage countries. When one looks at the economics of offshoring, he must consider it a two way street. Just because some people are losing jobs, doesn't mean other people aren't finding new ones. Just because a minority of people is losing jobs and taking the brunt of

offshoring detriments, does not mean the majority cannot and should not gain from offshoring. Drezner writes in his article, “the benefits of trade diffuse across the economy, but the costs are concentrated” (Drezner 5). In a country where the minority is sometimes and perhaps often overly protected, offshoring and outsourcing in general are going to be two concepts that are not digested well. However, the evidence is significant and overwhelming that offshoring is beneficial to the U.S. at the firm level and at the national level.

Outsourcing and offshore outsourcing are a very vital part of this nation’s economy and will continue to be so in the future. Despite some detriments to firms who offshore outsource, the benefits can easily outweigh the costs if a careful and strategic decision is made. Despite the loss of jobs to a minority of individuals in the economy, the overall benefits to the economy and the American people as a whole extremely outweigh the detriments. Politicians and other public figures must attempt to understand and defend outsourcing and offshoring in the future, as they both become increasingly popular tools in international trade for firms and economies as a whole. That is why outsourcing, and in particular offshore outsourcing, is absolutely and indisputably essential to our country’s firms and economy in the every expanding and complex global marketplace.

Bibliography

- Arnn, Barbara. "Offshore Outsourcing Isn't Where It Used to Be." Multichannel Merchant 22 December 2004. 11 April 2007
<<http://multichannelmerchant.com/opsandfulfillment/advisor/Kearney-outsourcing/>>
- Clark, Don. Class Lecture. International Economics 329. College of Nursing Building, University of Tennessee, Knoxville. Spring 2006.
- Drezner, Daniel W. "The Outsourcing Dreznerman." Foreign Affairs. May/June 2004. 11 April 2007: 1-8.
<<http://www.foreignaffairs.org/20040501faessay83301/daniel-w-drezner/the-outsourcing-Dreznerman.html?mode=print>>
- Engardio, Pete, Michael Arndt, and Dean Foust. "The Future of Outsourcing." Business Week Online 30 January 2006. 11 April 2007: 1-4.
<http://www.businessweek.com/print/magazine/content/06_05/b3969401.htm?chan=gl>
- Friedman, Thomas L. The World is Flat. New York: Farrar, Straus and Giroux, 2006.
- Jenster, Per, et al. Outsourcing-Insourcing: West Sussex: John Wiley & Sons Ltd, 2005.
- Kreinin, Michael E. International Economics: A Policy Approach. Mason, OH: Thomson Higher Education, 2006.
- Mankiw, Gregory N. and Phillip Swagel. "The Politics and Economics of Offshore Outsourcing." Journal of Monetary Economics 53.5 (2006). 9 April 2007: 1-32.
<http://www.sciencedirect.com.proxy.lib.utk.edu:90/science?_ob=ArticleURL&_udi=B6VBW4KGPPNN1&_user=422010&_coverDate=07%2F31%2F2006&_rdoc=1&_fmt=&_orig=search&_sort=d&view=c&_acct=C000019958&_version=1&_urlVersion=0&_userid=422010&md5=80acf33bfec60d25592b7499580d89da>
- Marchant, Mary A., and Sanjeev Kumar. "An Overview of U.S. Foreign Direct Investment and Outsourcing." Review of Agricultural Economics 27.3 (2005): 379-386.
<<http://web.ebscohost.com.proxy.lib.utk.edu:90/bsi/pdf?vid=5&hid=103&sid=28acc4e5-23db-4ddf-8b1d-d56569ee3912%40sessionmgr107>>
- Meta, Anju, et al. "Challenges and Opportunities of Business Process Outsourcing In India." Journal of Labor Research. 27.3 (2006). 9 April 2007: 323-338.
<<http://web.ebscohost.com.proxy.lib.utk.edu:90/bsi/detail?vid=3&hid=103&sid=28acc4e5-23db-4ddf-8b1d-d56569ee3912%40sessionmgr107>>

Ryans Jr., John K, and Linda C. Ueltschy. "Outsourcing, Intellectual Property Rights and Corporate Hollowing Concerns." Journal of Asia-Pacific Business 7.2 (2006): 27-35.

<www.haworthpress.com/web/JAPB> (through an interlibrary loan)

Taylor, Timothy. "In Defense of Outsourcing." Cato Journal 25.2 (2005): 367-377.

<<http://web.ebscohost.com.proxy.lib.utk.edu:90/bsi/pdf?vid=3&hid=103&sid=28acc4e5-23db-4ddf-8b1d-d56569ee3912%40sessionmgr107>>