The Economics of Outsourcing: How Should Policy Respond?

By Thomas Palley | March 2, 2006

Abstract

Outsourcing is a central element of economic globalization, representing a new form of competition. Responding to outsourcing calls for policies that enhance national competitiveness and establish rules ensuring acceptable forms of competition. Viewing outsourcing through the lens of competition connects with early 20th century American institutional economics. The policy challenge is to construct institutions that ensure stable, robust flows of demand and income, thereby addressing the Keynesian problem while preserving incentives for economic action. This was the approach embedded in the New Deal, which successfully addressed the problems of the Depression era. Global outsourcing poses the challenge anew and calls for creative institutional arrangements to shape the nature of competition.

"A wild horse can do a lot of damage, but a bridled horse can be an invaluable asset."

Posted by Proud UAW Member in response to "Politics of Globalization" at www.thomaspalley.com, December 27, 2005.

I. Understanding outsourcing

Outsourcing is a central element of globalization, and policymakers need to understand its economic basis if they are to develop effective policy responses. The practice of outsourcing should be understood as a new form of competition, and responding to it calls for the development of policies that enhance national competitiveness and establish new rules governing the nature of global competition.

Viewing outsourcing through the lens of competition connects with early 20th century American institutional economics. The policy challenge is to construct institutions that ensure stable flows of demand and income, thereby addressing the Keynesian problem while preserving incentives for economic action. This was the approach that was embedded in the New Deal, which successfully addressed the problems of the Depression era. Global outsourcing poses our current economic challenge and its solution requires a new set of institutions. The task is compounded by problems associated with a lack of global regulatory institutions and changes in the balance of political power that make it difficult to enact needed reforms.

Global outsourcing is enormously facilitated by technological innovations associated with computing, electronic communication, and the Internet. However, it is important to recognize that the debate surrounding outsourcing is not about the benefits of technology. It is a debate about the nature of competition and what constitute appropriate rules for governing competition within and between countries. Failure to recognize this can distract and confuse the issue.

II. The economics of outsourcing

Globalization has dramatically changed the structure of international competition. In many regards the process of change can be identified as beginning in the 1950s and 1960s with the emergence of multinational corporation (MNC) production. Initially, this output was primarily for local markets, as evidenced by the activities of such companies as Ford Europe and General Motors Europe, which manufactured for the European rather than the U.S. market. However, in the 1980s and 1990s the pattern changed significantly, when MNC production became increasingly targeted for export back to the United States. This change is exemplified in Mexico and China, which have become MNC production platforms.

There are two important economic features about the MNC revolution. First, MNC manufacturing has provided an important arena for business to learn how to render state-of-the-art technology and production methods globally mobile. Second, MNC activities offered a first margin within which capital was able to put American labor in international competition, and this competition has had significant adverse impacts on manufacturing wages, employment, and union membership (Bronfenbrenner, 2000; Bronfenbrenner and Luce, 2004).

The MNC revolution has received considerable attention. However, while this was taking place, a parallel and equally important revolution was occurring in the retail sector. This retail shake-up was linked to a new sourcing model based on big-box discount stores.[1]

Stage one of the retail revolution started 40 years ago with the emergence of large-volume discount stores like Wal-Mart, which was created in 1962. Initially, the business model was based on national sourcing, with the big-box stores buying from the cheapest national manufacturer. Such stores pitted producers against each other nationally, so that companies in New York were forced to compete with those in California. This new national rivalry provided lower prices, and it was largely beneficial because all suppliers were located in the United States and operated under broadly similar laws. However, even then there were negative effects, as the new competition encouraged manufacturing to move South to nonunion “right-to-work” states where organizing workers was more difficult and labor costs were lower.

Stage two of the retail revolution began in the 1980s, when the big-box discount stores started going global with their sourcing model. As a result, U.S. suppliers were not just in national rivalry, they were now in an international bidding contest. No longer was New York just competing with California; U.S. producers were now measured against companies in Mexico, Indonesia, and China. The economic logic of this global sourcing model is simple. Scour the world for the cheapest supplier and lowest cost—the so-called “China price”—and then require U.S. manufacturers and workers to match it if they wish to keep your business.

This new global sourcing retail model has had profound effects. The commercial success of the model means that once one retailer adopts it, others are compelled to also adopt it in order to remain competitive. Consequently, big-box discounting has spread to every corner of retailing, putting the entire consumer goods manufacturing sector in international competition. Additionally, the model pressures domestic companies to pursue offshore production (i.e., become multinational) in order to compete with foreign suppliers. These dynamics, though originating in the retail sector, have also eroded manufacturing jobs and wages. The model does indeed deliver low prices, but it does so at a high cost.

Outsourcing can be viewed as an application of the retail sector's global sourcing model to manufacturing. In effect, manufacturers are now also looking to source globally, and they too are asking their suppliers to meet the "China price." The spread of global sourcing is exemplified by auto component giants Visteon and Delphi. Initially spun off from their respective parent companies, Ford and General Motors, Visteon and Delphi engaged in national competition. In 2005, Ford and General Motors both announced that they were shifting to a global sourcing model and that their spin-offs would in future have to meet the China price if they wished to keep business. Given their higher union wages and benefits, both Visteon and Delphi have been shedding jobs and shifting production offshore, including to China. However, both have found it increasingly difficult to compete, and Delphi filed for Chapter 11 bankruptcy in October 2005.

It is now becoming clear that the global sourcing business model can also be applied to the services sector. Owing to improvements in electronic communication and the Internet, many services that were previously nontradable have become tradable. These include basic computer systems maintenance and software programming, tax preparation and accounting, architectural planning, and telephone call centers. Even retail sales is potentially tradable, as indicated by the success of the Amazon.com business model. This means that services will be the next area where the global sourcing model will be applied, with corresponding effects on compensation and employment security.

III. Outsourcing and the maturation of globalization

The maturation of globalization can be viewed as combining the developments of the last several decades into a highly synergistic system. There are three facets to this mature system. The first element is the global sourcing model discussed above, which was initially developed in the retail sector and is now being applied everywhere. The second element is the mobility of capital, technology, and methods of production. This mobility combines MNC experience in foreign production platforms with policies that have dismantled trade barriers and promoted international economic integration. Whereas the initial globalization era was one of classical free trade involving the movement of goods across international boundaries, the new era also includes mobile capital and technology. Consequently, all countries have access to similar methods of production, so cost arbitrage (especially wage arbitrage) becomes a critical driver of the system. The third element of mature globalization is the addition of two billion workers to the global labor market, given the end of economic isolationism in India, China, and the former Soviet bloc countries.[2]

Putting the pieces together, changed competition (the Wal-Mart business model) plus changed technological conditions and policy (globalization of production) plus two billion new workers (the end of economic isolationism) add up to downward wage and benefit pressures in U.S. labor markets and rising income inequality. The economic logic is simple. When two swimming pools are joined together, the contrasting water levels will equalize.

Free trade theorists (Stolper and Samuelson, 1941) have long acknowledged that when a rich capital-abundant country engages in free trade with a poor labor-abundant country, wages in the rich country fall. By combining global sourcing with globalization of production, the new system puts the Stolper—Samuelson effect into hyperdrive.

IV. How should policy respond? Rediscovering the economics of American institutionalists

If we view global outsourcing as an evolution in the structure of competition, we link with the thinking of early 20th century American institutionalist economists.[3] The leading lights of institutionalism were John Commons, Thorsten Veblen, and Wesley Mitchell. The leading living proponent is John Kenneth Galbraith.

Institutionalists emphasized the importance of the nature of competition and the problem of destructive rivalry—what Commons (1909, 68-69) termed the "competitive menace." This idea resonates with today's notion of the "race to the bottom." What appears to maximize well-being from an individual perspective can be suboptimal once the competitive interplay of actions is taken into account.

Institutionalist thinking constructs the policy problem in terms of "regimes of competition," with some regimes promoting societal welfare better than others. In the 1930s the New Deal embodied institutionalist thinking. In combination with the adoption of a Keynesian macroeconomic stabilization policy, the New Deal solved the crisis of the Depression era and made way for the prosperity that followed World War II. The innovations of the period included new labor laws establishing the right to organize, the minimum wage, the 40-hour work week, and the right to overtime pay. In the financial realm, creative reforms included the establishment of the Securities and Exchange Commission to oversee financial markets. Today's challenge is to come up with a similarly innovative set of arrangements that addresses globalization and outsourcing.

The New Deal incorporated a collection of bold policies that fashioned an acceptable regime of competition. Responding to global sourcing will also require an insightful array of policies. As with the New Deal, there is no silver bullet. With regard to rules governing worldwide competition, international labor standards are key to establishing a floor under the global labor market and ruling out retrograde competition. At the same time, they are good for economic efficiency and development (Palley, 2004, 2005). Concerning domestic issues, unions are key to ensuring that productivity gains are shared equitably and result in a distribution of income that generates full employment. This calls for labor law reform that gives real meaning to the legal right to organize.

There is also a need for new arrangements—both within the United States and between countries—that prevents tax competition. Such competition is generated by corporations shopping for tax abatements and lower rates as conditions of making investments. The result is either an unfair shift of the tax burden onto labor incomes or an underfunding of needed public investment and spending when corporate tax avoidance strips the public purse of revenue.

Another area requiring new institutional arrangements is exchange rates. Here, the need is to prevent countries from using undervalued exchange rates as a means of competing. Engaging in competitive devaluation is a form of beggar-thy-neighbor economics wherein countries rely on demand in foreign markets rather than building domestic markets. Undervalued exchange rates are an unfair subsidy that distorts the pattern of trade. They also risk causing global deflation because they promote increased supply of exports without increasing global demand.

With regard to national competitiveness, countries need to invest in education that raises worker productivity. There is also a need for job loss assistance and active labor market policies that help displaced workers cope with income losses and obtain training that prepares them for productive future employment. In the United States there is a special need to attend to the problem of health insurance, which is currently a job cost, since premiums are tied to employment. This crisis is exemplified by General Motors, where the cost of each car includes $1,500 of worker health insurance. Health insurance coverage needs to be detached from jobs, and this suggests a national health plan financed out of general tax revenues.

V. Conclusion: the politics of policy response

The emergence of global outsourcing enormously complicates policy issues, both intellectually and politically. The ability to outsource worldwide calls for new forms of international regulation because it undermines the effectiveness of many existing national arrangements. Yet, construction of an acceptable regime of international competition must be accomplished in a political environment lacking effective institutions of international economic governance and in which national governments are weakened and corporations strengthened by the enhanced mobility of capital.

Creating a political climate that can secure the needed policy responses calls for the development of popularly shared understandings of globalization. That is why economics is so politically important. Economists tell stories about what is going on in the economy. Today there is need for a different story than that spun by neoliberal economists.

Dr. Palley (www.thomaspalley.com) is the author of Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism *(Princeton University Press) and* Post Keynesian Economics *(Macmillan Press) and is a regular contributor to Foreign Policy In Focus (www.fpif.org). This policy report is a shortened version of a paper presented at a conference on "The Political Economy of Governance" held at the University of Bourgogne, Dijon, France, December 2-3, 2005. His weekly economic policy blog is published at www.thomaspalley.com.*

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End Notes

1 The seminal article on the emergence of this sourcing model is Gereffi (1994). The use of this sourcing model by the retail sector is documented by Hamilton (2005).

2 Freeman (2004) has emphasized the significance of the addition of two billion workers to the global labor market. However, he believes that globalization is being driven by classical comparative advantage, so the wage effects of increased global labor supplies can potentially be offset by the production gains that come from reallocating global production in accordance with the principle of comparative advantage.

3 Atkinson (1997) has also emphasized the relevance of American institutionalist economic thinking for understanding globalization.

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