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OUT-SOURCING AS AN ENGINE OF GROWTH FOR THE UNITED STATES

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Out-sourcing as an Engine of Growth for the United States

Presenter: Craig Martin, is presently a candidate for a PhD in business with emphasis in international business at North Central University. His research is focused on establishing a direct, positive relationship between the employment of Foreign Direct Investment by organizations headquartered in the US and the subsequent creation of jobs within the US as a benefit of this FDI outflow.

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Abstract

Proponents of out-sourcing cite numerous benefits accruing to those organizations pursuing out-sourcing. Yet, opponents decry the practice as the primary cause of job loss in the United States. This paper will demonstrate that the critics' perceptions are not supported by the actual experiences of organizations. Research has found, instead, that out-sourcing leads to the creation of more jobs (due to capital flows resulting from the beneficial impacts of out-sourcing) than are eliminated due to the process.

The discussion concludes with a proposal for creation of partnerships between the Federal government, state governments and non-governmental entities to advance the skills and knowledge of those persons unemployed due to out-sourcing to prepare them to reenter the workforce in newly created future positions.

Introduction

OUT-SOURCING AS AN ENGINE OF GROWTH FOR THE UNITED STATES

The recent 2004 presidential campaign highlighted the ongoing debate over out-sourcing and whether it is beneficial or detrimental to the American workforce. Business executives, laborers, economists and scholars are all voicing their opinions in the continuing discussion, arguing the benefits of out-sourcing activities versus the costs and adverse consequences.

While recognizing the negative outcomes of out-sourcing, this paper will focus on the many benefits derived from out-sourcing acquisitions of products and services.

Benefits of out-sourcing take the form of enhancing innovation, producing value-added outcomes, advancing technology and providing additional funds for reinvestment. Trade among organizations and countries results in economic growth, and it will be demonstrated in this study that such activity leads to positive growth in employment at the macroeconomic level in the United States.

Perceived detrimental consequences of out-sourcing are usually limited to arguments regarding job loss and the loss of control by the organization participating in out-sourcing. Other research has shown that the latter is effectively addressed by employing modern management techniques to measure performance against desired outcomes. In the case of the former, this researcher has concluded that, while some job loss does occur within organizations or industry segments due to out-sourcing, the activity at the macroeconomic level can be shown to drive positive employment growth in the United States. Further, with the introduction of innovative and/or governmental programs to motivate the use of educational resources to assist in the transition of workers adversely impacted by out-sourcing, various case studies have indicated that most adverse impacts of out-sourcing relative to employment can be mitigated at the microeconomic, or organizational, level.

GLOBAL OUT-SOURCING BENEFITS AT THE MACROECONOMIC LEVEL

Out-sourcing—acquiring products or services from an entity independent of the organization—is not a new concept. Even when families and clans were the largest form of organized government, it made sense to out-source in order to take advantage of the skills of others outside the family unit (division of labor) and to employ outside labor to assist the family unit in the production of all the necessities for survival (labor saving).

On a larger scale, the Scottish economist David Ricardo advanced the theory of comparative advantage of production between countries as a reason to out-source. Ricardo's theory holds that greater growth in the Gross National Product (GNP) occurs if each county produces and trades those products for which it holds the comparative advantage of adding value to than if each country produces all products and does not trade (Ricardo, 1817, 163-164).

That Ricardo's theory is valid can be seen in research that illustrates that countries participating in trade in the 20 years prior to 1997 experienced GNP growth of 4.9% on average, while those that did not participate grew at a rate of less than 0.7% (Hill, 2003, 145-152).

Researchers logically ask: Did capital flows lead to similar beneficial results? Again, research shows that the flow of capital, or Foreign Direct Investment (FDI), *from* the United States results in positive flow of capital *to* the U.S. in the forms of profits, component products, services and investment.

The inflow of products and services to the U.S. directly related to FDI rose to 34% of total imports by 1993, and this percentage has remained fairly constant ever since (Aquilar, 1996). Profits and cash flow returning to the U.S. from subsidiaries of U.S. multinationals have grown substantially since the 1970s, as measured by Bureau of Economic Analysis (BEA) annual data (BEA, 2004).

Positive investment flow as a direct result of trade and FDI has also come in the form of FDI from foreign investors. Entities that are at least 50% owned by non-U.S. citizens contributed about 10% of all investment capital in the U.S. in 2003, enabled 5.1% of all U.S. employment in that year, purchased over $1.0 trillion in goods and services from U.S. entities and made major contributions to American research and development (Slaughter, 2004).

Out-sourcing in the form of capital also has been shown to lead to intellectual benefits. By out-sourcing software development to India, among other countries, U. S. developers have been able to allocate an additional $30 billion since 2003 to other research and development projects that will drive innovation and productivity (www.amrresearch.com).

In-sourcing of FDI, which has been positively correlated to the out-flow of FDI in the US, has resulted in over 14% of the annual US research and development expenditures flowing from foreign subsidiaries located within this country (Slaughter, 2004, 6-7).

While our primary purpose in this study is to explore the benefits of outsourcing for the US, it is interesting to note that research confirms similar benefits to other countries from similar flows of capital. This research demonstrates the positive contributions of trade and capital flows between Japan and the US, between the EU (European Union) and the US, between the three North American Free Trade Union (NAFTA) countries, and between Mexico and Malaysia.

ORGANIZATIONS BENEFITING FROM GLOBAL OUT-SOURCING

The macroeconomic benefits discussed above can be apportioned, on a microeconomic basis, to individual organizations, including private and public entities. For example, profits and cash flows from subsidiaries flow to the US parent, as do components for insertion into products in the US and finished goods ready for resale. While research confirms this on a case-by-case basis, this writer has not identified a comprehensive study demonstrating the anticipated conclusion.

Initially, a primary benefit of out-sourcing from the US, especially to developing countries, was the growth in profits from reduction in labor costs. Though these savings were partially offset by increased transportation costs, wage differentials were substantial enough to justify FDI. However, with the average life of a labor-rate-advantage study now being less than five years, a more recent study has found that adequate Return on Investment (ROI) cannot be earned based on labor-cost savings alone (Bartlett, 2004, 7-13).

In 2003, McKinsey & Company, a global consulting firm, found that shifting jobs off-shore was driven more by technological advancements in telecommunications and productivity enhancements than by efforts to shift to lower wage areas. The research found benefits to the US economy from cost reductions, the creation of new revenues as a result of new services offered at lower prices, and increased value added to firms as a result of US workers shifting positions, all of which led to increased profits (Geewax, 2004).

Foreign capital invested in plants and equipment and to procure inventory from US companies will naturally benefit the American entities, and technology advancements and innovation flowing to US entities are an immediate and direct contribution to the increased value of those entities, public and private. Moreover, FDI into the US resulted directly in the growth of the workforce by 5.1% in 2003. Two subsidiaries of foreign investors experiencing such job growth were GKN Aerospace, located in St. Louis, Missouri, and Saint-Gobain, located in the suburbs of Atlanta, Georgia (Slaughter, 2004, 4-5).

Similarly, Federal and state governments accrue benefits in the form of taxes resulting from positive investments and profit flow. In particular, the Department of Defense (DoD) has benefited directly from foreign capital flow in the past. Surplus equipment is sold to entities overseas, and services in the form of training are provided within the US to members of foreign military.

Just as private firms realize benefits from the procurement of services from foreign firms, cost savings and value-added activities are likely to be realized by the DoD when non-strategic services are procured off-shore. For example, in the DoD's competitive sourcing program, research shows savings of 44% in labor costs while the DoD still effectively improves quality of services added (Gansler, 2004). There is no reason to suspect that similar outcomes cannot be realized whenever bidding is employed.

In summary, there are multiple benefits emanating from out-sourcing goods, services and capital from the US to overseas locations. Though the above discussion is not comprehensive, it is an overview of the kinds of benefits that can be reasonably expected by those who participate in outsourcing.

DETRIMENTAL CONSEQUENCES OF OUT-SOURCING

The perception that out-sourcing leads to the loss of jobs is long-standing. Governmental bodies around the globe have long cited this argument to justify the enactment of trade barriers against imports or against the in-flow of investment capital (Hill, 2004, 181). Labor unions have routinely bargained job retention when companies have introduced out-sourcing as a means of acquiring new technology or knowledge. And the continuing political and economic debate is centered on the conviction that out-sourcing does indeed lead to job loss. But is this a valid perception? And, if it is shown to be valid, to what extent are the consequences detrimental? Do detrimental outcomes in fact outweigh the benefits enumerated above?

At the macroeconomic or national level in the US, evidence does not support the contention that out-sourcing is basically detrimental. Careful review of the two employment series maintained by the Bureau of Labor Statistics (BLS) since their inception suggests a different conclusion. As we shall see, each of these labor employment series demonstrates continual annual growth in the number of persons employed, thus illustrating that more jobs are created each year than are destroyed for various reasons, including out-sourcing.

Although the decade of the 2000s has witnessed much political rhetoric to the contrary, using either of the two BLS series, we can see the total number of public- and private-sector jobs has increased quarterly and annually. And growth has occurred in most sectors, with the primary exception of manufacturing (www.bls.gov/cps/home.htm).

Compiled since 1946, the payroll survey, which statistically extrapolates total and sector employment by sampling 300 thousand companies monthly, has continually trended upward in each decade, regardless of the point in the economic cycle in which the country resides (www.bls.gov/ces/home.htm). However, as the nature of work has shifted from the plant or office to include the home office, economists have come to realize that the population survey, which samples 60 thousand households monthly, provides a more accurate picture of total and sector employment than the payroll survey. In its totals, the population survey adds the following sectors to all sectors contained in the payroll survey: Agriculture, self-employed small business owners, and all persons who work under contract with the government or private firms (Fraser, 2004). Taken since 1998, the population survey has likewise trended upward continually.

A particularly vocal industrial segment, whose rhetoric has contributed to the perception that out-sourcing leads to job loss, has been the US manufacturing sector. That job losses have occurred in manufacturing cannot be argued, and this condition has persisted in every country with a substantial industrial sector, even while manufacturing out-put has continued a growth trend (Geewax, 2003). However, studies have found that the loss of less-skilled jobs in manufacturing and other sectors due to out-sourcing has not necessarily led to a reduction in total jobs. A World Bank study found that large, developed countries such as the US and Canada and developing countries such as China and Mexico were only marginally affected by such job losses because there was a corresponding increase in skilled jobs created. Firms employing higher-productivity strategies (such as digital technology) created a greater number of replacement jobs than those that did not (Batra, 2000).

Another study supported the concept that manufacturing jobs are continually "churning," with marginally more jobs being created than being destroyed. While this study did not relate its findings to out-sourcing and in-sourcing, it demonstrated that churning has occurred for many decades; therefore, the study called for further exploration of the causes (Klein, 2003).

Economist Paul Ormerod discovered the positive, exponential relationship between growth in corporate profits and retention in the percentage of profits—which is then used for reinvestment and growth in employment (Ormerod, 1997). So, it would seem that the ever-increasing flow of profits from foreign subsidiaries during the past 30 years, which is in contrast to the declining percentage of dividends being paid (Fama, 2001), has created a very powerful driver for employment growth in the US.

Further, substantial research by this writer strongly suggests that a direct, positive correlation exists between the growth in FDI flowing outward from the US and the flow, in the forms of capital investment, the importation of inventory and the retribution of profits, toward the US. All of these flows have contributed to the growth in profits in the past 30 years for the US-based multinational corporations. As noted above, this growth has been directly related to the growth in home-based employment in the US.

Finally, a study released in 2004 using the Commercial Activities Management Information System (CAMIS) database illustrated that, while approximately 5 percent of DoD jobs which competed successfully in the Department's competitive-sourcing programs since 1995 were involuntarily eliminated, competitions led to savings on average of 44% and to improvements in quality of services provided to customers (Gansler, 2004, 6-7). The conclusions contained in the above comprehensive study appear to parallel many of the results (cited previously) obtained from the research into private activities.

EMPLOYEE TRANSITION FROM JOB LOSS TO JOB GAIN

Research and analysis of job loss versus job creation lead this writer to conclude that:

- The benefits derived from the use of out-sourcing are numerous and beneficial to national organizations based in the US.
- While job loss due to out-sourcing has occurred within organizations, at the microeconomic level, benefits usually outweigh the detrimental consequences to employment within the organization.

- While some job loss has occurred due to out-sourcing from the US, the total number of jobs has continually demonstrated an upward growth trend since the beginning of data collection shortly after the culmination of WW II.

While these conclusions may be good news on the macro- and microeconomic levels, if one is an unwilling participant in a reduction in workforce, it can be inferred that a serious, if not critical, problem confronts that individual. Historically, initiatives to provide unemployment assistance and more jobs of the same kind have been seen as a solution, but these no longer address the core problem. The complicating feature is identified in numerous futuristic economic forecasts: while products and services will not be of less value than those of the present, the requisite labor skills and knowledge will often not be possessed by the workforce in the US (Klein, 2003).

Both President Bush and Federal Reserve Chairman Alan Greenspan have called for educational initiatives to address the problem of persons whose employment is terminated due to out-sourcing. Certainly, organizations participating in the changing workplace will be well positioned to identify the skills and knowledge needed by employees, at least within their own domains. Indeed, the argument can be made that these decentralized voices are superior to the centralized voice of the Federal Government in identifying their potential employees' educational needs.

It is this author's conclusion that a variety of partnerships between non-governmental entities and the Federal government could be formed to establish effective programs that would enhance the requisite skills and knowledge of those individuals involuntarily separated from existing positions. The government's role would be limited to establishing policies to financially motivate organizations to provide assistance in the form of training or education; these programs would make it possible for individuals to identify and acquire the knowledge and skills for employment which would best serve them in the future.

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