

# Outsourcing: A Primer

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By

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## **What FREE Does**

FREE advances conservation and environmental values by applying modern science and America's founding ideals to policy debates. We are intellectual entrepreneurs, explaining how economic incentives, secure property rights, and responsible prosperity can foster a healthy environment.

While our seminars are explicitly pro-environment, they explain why ecological values are not the only important ones. We stress that trade-offs among competing values are inescapable. We show why it is ethically and materially irresponsible to pretend such choices can be avoided.

## “Outsourcing” What Are We Really Talking About?

### Globalization

- The international movement of human and financial capital; free markets; capitalism.

### The Compression of Time and Space

- Revolutions in telecommunications and the Internet, combined with steep declines in transportation costs allow **individual entrepreneurs and businesses** real-time **access to global markets**.
- **Physical location is ever more irrelevant**. Industries once sheltered from competition by geographic isolation are no longer.
- While consumers reap the benefits, **a dynamic, open economy creates opportunity for some and hardship for others**.
- **Losers bitterly resist these forces**. Ameliorating the unsettling effects of global markets is possible in the short run, but very costly.

### Politics

- Council of Economic Advisers Chairman Greg Mankiw, observed that outsourcing is an inevitable byproduct **of free trade**.
- Sen. John Kerry, decries the “Benedict Arnold CEOs [who] **send American jobs overseas**.”

The H.J. Heinz Co. of Pittsburgh operates 22 factories in the United States and 57 in foreign countries

- Lou Dobbs of CNN has a series called “Exporting America,” and a book, *Why Corporate Greed is Shipping Jobs Overseas*.

- A worrisome trend: opposition to free trade that fuels **xenophobic feelings towards foreigners.**
- How can **societies cope with rapid technological and social change in a globalized economy?**

## Reducing the Angst about Free Markets and Globalization

- Virginia Postrel noted in *The Future and Its Enemies*, “**The most important challenge to markets today is...the ideology of stasis**, the notion that the **good society** is one of **stability, predictability, and control.**”
- We find Green Party presidential candidate Ralph Nader siding with populist paleo-conservative Pat Buchanan. Both oppose free trade, technological innovation, the expansion of some industries and the contraction of others. They see every manifestation of our **competitive, dynamic economy leading us to an impoverished future.**

### First Principles

- Market forces are indeed powerful. They evolve through trial and error, experimentation and feedback. Their constant search for fitness subjects ideas (both new and old) to ruthless and unsentimental testing. This often **painfully rearranges existing social structures.**
- But economic competition is **not a zero-sum game.** The economic pie is not fixed, i.e., my gain is not at your expense. **Both parties benefit from voluntary exchange and the pie gets bigger.**
- Entrepreneurs succeed by creating products that **improve social well-being.** They specialize in moving resources to higher valued uses. If they're successful, they'll **attract both human and financial capital from other places.**

- This process transforms lives. The revolution in **information technology** (i.e., from the printing press to the Internet) **closed factories and displaced workers, just as international trade does.**
- **Free markets disperse power.** Dictators like Fidel Castro and Hugo Chavez oppose free markets. Why? because they understand that inevitably free markets **erode state power.** Any society with even a modicum of political freedom uses the market process to organize its economic activity.
- “Fundamentally, there are only two ways of coordinating the economic activities of millions. One is central direction ... [with] coercion—**the technique of the army and of the modern totalitarian state.** The other is **voluntary cooperation of individuals—the technique of the marketplace.**” Milton Friedman

Q. What do you call someone who opposes free markets?

A. A conservative.

**Def: Favoring traditional views and values; tending to oppose change.**

- **There is nothing conservative about free markets. Business groups** and others commonly posture as defenders of the free market. But in fact, they are generally **raving hypocrites** who **argue for special privileges and protections** (e.g., automobile import quotas, steel tariffs, and condemnations of private land for industrial and commercial parks).

## Historical Roots and Economic Concepts

### Comparative Advantage

- Scottish political economist and moral philosopher **Adam Smith** (1723–1790). In *The Wealth of Nations* (1776) Smith wrote:

*“It is the maxim of every prudent master of a family never to make at home what it will cost him more to make than to buy.”*

- British political economist **David Ricardo** (1772-1823) advanced his theory of **Comparative Advantage**. The idea is this:

*“Do what you do best. Trade for the rest.”*

- A doctor who can type faster than a secretary will still use a secretary. Why? Because the **doctor’s time is more profitably spent practicing medicine than doing typing.**
- The doctor has a **comparative advantage** in practicing medicine, and the secretary has a **comparative advantage** in typing.
- Comparative advantage **determines the most efficient way to allocate scarce resources.**
- **Comparative advantages exist even on the ideal commune.** The commune fails to exploit the opportunities for efficiency that would come from specialization.

### **Creative Destruction**

- In 1942, economist **Joseph Schumpeter** (1883–1950) wrote *Capitalism, Socialism and Democracy*. In it, Schumpeter recognized capitalism’s destabilizing effects on social systems, and coined the phrase “creative destruction.” Schumpeter believed **creative destruction was essential for economic progress.**
- As entrepreneurs discover and apply innovations, old ideas, technologies, skills, and equipment become obsolete. **In some cases whole communities are displaced** (e.g., steel workers in Pittsburgh and copper miners in Butte).

- **Losers** often use their **political power** to seek **governmental protection**, e.g., American automakers demanded import quotas when facing superior Japanese products.

### **The Obvious and the Hidden**

- French economist **Frederic Bastiat** (1801-1850) wrote an essay, *That Which is Seen and That Which is Not Seen*.
- In it he introduced his concept of the **broken window fallacy**. Here it is: A boy breaks a shop window. Onlookers believe this stimulates economic activity by forcing the shopkeeper to pay a glazier for a new pane of glass. The conclusion? Instead of being guilty of **vandalism**, the boy was a **public benefactor, creating economic benefits for others**.
- The **fallacy** in this argument is that only the **positive benefits** of purchasing a new window are considered. **Ignored** are the **hidden costs** to the shopkeeper and others., Bastiat notes the boy has not created a net increase in wealth, but merely redirected it to the glazier away from where the shopkeeper would have otherwise have spent it, such as on a new pair of shoes—or saved it .The **money** spent on a new window **could not be spent on bread, benefiting the baker**, who would have bought shoes. Instead of a window and bread, he had only a window. The boy did not bring any **net benefit to the town**. Instead, he made the town **poorer by the value of one window**.
- We **see** that when we buy foreign goods, Americans in the competing domestic industries will lose jobs. **Unseen** is the power of foreign competition to induce our domestic industries to innovate. **Unseen** are the opportunities and jobs created in health care, entertainment, and the other sectors of the economy where **American skills and creativity produce the best products in the world**.

### **Is This Movie a Sequel?**

- The strength of the U.S. economy **is its dynamism. In 1900, 40 percent** of the workforce was in **agriculture**. Technological advances led to massive increases in productivity. **Today only 2 percent** of the workforce is in **agriculture**. By keeping people from escaping the farm the U.S. would be a lot poorer.
- As technology improved, **some farmers' incomes fell**. Others sold out to more efficient operations. But the **biggest changes were in the dreams of the farmer's children**. They saw a future in agriculture was not as bright as it had been for their parents and grandparents. Hence, **they made plans to become salesmen, teachers, and doctors**. This is **exactly the process** that is underway today in much of Montana.
- The **same transition that happened in agriculture is happening in manufacturing and services**. Manufacturing jobs are declining as productivity rises, but that's a decades-old trend.
- This is a **global phenomenon not limited to the U.S.** Alliance Capital Management reports that between 1995 and 2002, 22 million factory jobs had disappeared in the world's 20 largest economies. The Japanese lost 16 percent; Brazil, 20 percent; and China, 15 percent.
- Outsourcing mainly affects white collar workers, Forrester Research estimates that in the U.S. outsourced jobs will rise to 600,000 by 2005—out of a total of 140 million.

### **Where Will New Jobs Come From?**

- **Uncertainty frightens people**. Imagine telling a farmer in 1900 that in 100 years, farm jobs will only be **2 percent** of the workforce. **What jobs could possibly come along to replace the farming jobs?**
- **Federal Express** and **Motorola** and **Intel** and **Microsoft** and **General Motors**. The farmer couldn't **imagine the products that these companies would make**.

- Imagine being told a decade ago that some people would make their living writing software for **iTunes**. “What’s iTunes? Oh, it’s a place where people download music into their iPods. **What is downloading music?**”
- Think how much the world has changed in just 10 years, and all the jobs we **couldn’t have imagined** that are now here.
- **A quarter of all Americans** now work in jobs that **didn’t exist in the Census Bureau’s occupation codes in 1967**. President Clinton’s Secretary of Labor, Robert Reich, understands the big picture:

*“We should stop pining after the days when millions of Americans stood along assembly lines and continuously bolted, fit, soldered or clamped.... Those days are over. And stop blaming poor nations whose workers get very low wages. Of course their wages are low; these nations are poor. They can become more prosperous only by exporting to rich nations. When America blocks their exports by erecting tariffs and subsidizing...domestic industries, we prevent them from doing better. Helping poorer nations become more prosperous is not only in the interest of humanity but also politically wise because it lessens global instability.”*

## Ingredients of Success

### Productivity

- Increasing productivity (i.e., more output for the same quantity of input) is **essential to higher wages**. Why? Because producing the **same good with less input** not only makes it more **affordable**, but **importantly frees human and physical resources for use in other areas**.

*“It can be said without exaggeration...in the long run probably nothing is as important for economic welfare as...productivity growth,”*

- U.S. labor productivity has grown about 2 percent a year for the past century. That means living standards have doubled, on average, every thirty-five years. Throughout history the number-one country in the world has always been the productivity leader. From the **thirteenth to the sixteenth centuries** it was **northern Italy**. Then the **Dutch republic** in the **seventeenth** and early **eighteenth**. **Britain** led in the late **eighteenth** and most of the **nineteenth**. Finally, it's been the **United States** for the entire **twentieth century**.

### The Knowledge Problem

- We understand **economics** as a **branch of evolutionary biology**. Like biological systems, **economic life evolves as people and organizations learn, respond, and innovate**. **Markets, like DNA-driven organisms, are highly efficient information-processing systems**. The realization that **prices transmit and process information** was a great insight of the 20th century.
- Nobel Prize winner **F.A. Hayek** (1899-1992) observed that **every society faces two central challenges**: how best to allocate **scarce resources** and how to **coordinate the actions of millions of self-interested individuals**.
- In modern societies, **knowledge** of time- and place-specific conditions is **dispersed among millions of individuals**. Consumers and producers **communicate** their desires through **prices**. Markets then allocate resources—labor, capital, and human ingenuity—in a **manner that can't be anticipated or mimicked**.
- To fully understand the **value of markets** we must recognize them as a **natural process**. They are mechanisms by which **people** can, **without coercion, communicate** and **coordinate** their actions.

### Education & Institutions

- In an age of freely flowing information, “capital will always go where it is welcome and stay where it is well-treated.” Walter Wriston, *The Twilight of Sovereignty*.
- There are **two major ingredients** in a nation's recipe for **wealth**. First, it must use its resources wisely. Far more important than natural resources (e.g., oil, land, and minerals) are the **talents, educational levels, and ingenuity of it's people**. Second, **political and social institutions** must be in place to give people incentives to **work hard**, to **innovate**, and to take **risks**.
- Entrepreneurship and innovation depend on a **broadly educated workforce** committed to **continuous learning and risk-taking**.
- **Human capital** has the highest payoff among the **investments** a country can make to accelerate its economic development.

### **Corruption**

- Economist Peter Bauer said foreign aid to developing countries often results in the three M's: Mercedes, machine guns, and monuments. Aid usually enriches dictators, outfits their armies, while common citizens suffer poverty and oppression. **See the “Road to Hell: Niger Delta Dispatch,” by Peter Maass. *The New Republic*, January 31, 2005. pp. 15:17**
- “I once hitched a ride on a beer truck in Cameroon. We started on the coast and set off, with 30,000 bottles of Guinness strapped to the back, for a town in the middle of the rainforest. The journey was no further than from Edinburgh to London, but it took us four days. The unpaved roads were passable so long as they were dry, but we were in a rainforest, where, as the name suggests, it rains often and hard. We had to stop three times when the road turned to swamp, and once for a bridge that collapsed after too many floods and not enough repair work. But the worst delays were caused by 47 police roadblocks. Cameroon is not at war, so there is no reason for these roadblocks, other than to give the police an

opportunity to fleece motorists. Every few miles, we would see a pile of tyres or a couple of oil drums in the middle of the road, and a plump gendarme relaxing in the shade of a palm tree. Some would make a show of checking to see if our tail-lights worked. Others would go through our papers looking for faults, so they could demand bribes not to arrest us. This sort of thing is sadly quite common in Africa. The gendarme at the 31st roadblock shared with me a pithy explanation as to why Africans put up with it. He had invented a new law about not carrying passengers in beer trucks, and charged us with breaking it. When I suggested to him that the law he was citing did not, in fact, exist, he patted his holster and asked me if I had a gun. **‘I have a gun,’ he pointed out, ‘so I know the rules.’**” “The road to hell is unpaved”, *Economist*, December 19<sup>th</sup>, 2002.

## Compared to What?

- **Globalization creates social stress.** But **angst over the real problems of globalization** would be lessened if critics addressed one question: “Compared to what?”
- **The record over the past 150 years is clear.** In market-based democracies, living standards rise ever higher, faster, and more inclusively. **No other system compares.** Developing countries that adopt **market reforms and open their economies to global trade make as much progress in one generation as industrialized nations did in a century.** Those that don’t either stagnate or regress.
- The World Bank notes that globalization is responsible for a **“spectacular” decline in poverty in East and South Asia.** In 1990, there were roughly 472 million people in the East Asia and Pacific region living on less than \$1 a day. By 2001, the number living in such extreme poverty had dropped by half. At current projections, by 2015, there will be only 19 million Asians living under those conditions. In one generation Asians will witness a 95 percent reduction in extreme poverty.

- **This economic progress is responsible for declines in illiteracy, child labor rates, fertility rates, and for improving environmental quality.**
- The model of the **European welfare state** has serious problems. It produces high unemployment (especially among the young) huge pension liabilities, and discontented minorities.

## The Long Run

- “Free trade is the best **long-run** policy.” While this response is valid, it is unsatisfying. Let's see if we can do better.
- **Protectionism**, like free trade, reshuffles jobs. This protects some jobs, but **precludes development of others**.
- The **difference** is that **free trade reshuffles workers toward those jobs at which workers have a comparative advantage**—and, hence, will earn **generally higher wages**.
- Skeptics of free(r) trade frequently respond “Sure, in the long-run new jobs will be created. **But what about workers who are unemployed now?** The long run is no good to them.”
- This justifies protectionism because it reduces dislocation and anxiety today. **Should short-run consequences take precedence over long-run consequences?**
- If one really believes that **long-run effects** should be ignored in favor of **short-run effects**, one would also support **eliminating environmental laws** because these impose substantial costs today in return for benefits that arise mostly in the long-run.

## The Environmental Connection

- Free-trade promotes economic progress. **Prosperity drives the demand for environmental quality**.
- North Americans worry about minute levels of pesticide residues on vegetables, while the **developing world** seeks access to safe drinking water. They want alternatives to the **horribly unhealthy** cow dung used for cooking and heating fuel.
- **Hungry folks** don't have the luxury of investing in the preservation of endangered songbirds.

- “These wild things,” **Aldo Leopold** reminds us in *A Sand County Almanac*, “had little **human value** until mechanization assured us of a good breakfast.”
- Economic progress is a prerequisite for improving environmental quality. **The real enemy of the environment is poverty, not affluence.** Consider U.S. air quality.
- Between 1976 and 1997, U.S. **GDP increased 158 percent, energy consumption 45 percent, and vehicle miles traveled 143 percent.**
- During that same period the EPA reports that ozone levels—the major contributor to urban smog—**decreased 30.9 percent.** Sulfur dioxide—the primary component of acid rain—**decreased 66.7 percent;** nitrogen oxides **decreased 37.9 percent;** carbon monoxide **decreased 66.4 percent;** and lead decreased **97.3 percent.**
- This success flows from **federal regulations** (e.g., the Clean Air Act), **technology**, and **affluence.** The Department of Interior concluded in 1999, “Cleaner air is a direct consequence of better technologies and the **enormous and sustained investments that only a rich nation could afford.**”

## Conclusions

- At the heart of the fears of outsourcing and globalization is a **misconceived theory** about how nations prosper.
- **Our wages depend on our skills and the amount of capital we have to augment those skills.** Opening our economy to trade in goods and services allows us to use our **skills and capital as productively as possible.**
- If a nation’s **skill level is low**, making **computer chips** makes you **poorer, not richer.** This is like **Haiti** trying to jump-start its economy by **creating a domestic pharmaceutical industry** because pharmaceuticals are very profitable, or me at 6’ 2’,

195 pounds deciding to be a jockey because jockeys have high salaries.

- There are **two ways** to earn the material things in life. **The first is to make them for yourself. The second is to let someone else make it for you and trade for it.** When others can make something more cheaply than you can make it for yourself, it makes sense to **outsource** it. You specialize in what you do most productively and swap for the rest of your desires. That specialization creates **wealth and social well-being**.

## Resources

This primer was compiled from the following sources:

### Economic Research

World Bank Research <http://econ.worldbank.org/>

Federal Reserve Bank of Dallas <http://www.dallasfed.org/>

Institute for International Economics <http://www.iie.com/>

United Nations Development Program <http://www.undp.org/>

National Bureau of Economic Research <http://www.nber.org/>

### Internet

Marginal Revolution <http://www.marginalrevolution.com/>

Invisible Heart <http://invisibleheart.com/index.html>

Knowledge Problem <http://www.knowledgeproblem.com/>

FREE <http://www.free-eco.org/publications.php>

### Books

*In Defense of Globalization*, by Jagdish Bhagwati

*Why Globalization Works*, by Martin Wolf

*Globalization and Its Discontents*, by Joseph E. Stiglitz

*In Defense of Global Capitalism*, by Johan Norberg

*Development as Freedom*, by Amartya Sen

*The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, by Hernando Desoto

*The Commanding Heights: The Battle for the World Economy*, by Daniel Yergin and Joseph Stanislaw

*The Wealth and Poverty of Nations: Why some are so rich and some so poor*, by David Landes