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Right-Sizing the Outsourcing Debate

There is a general perception that US companies have moved hundreds of thousands of domestic jobs to cheaper markets overseas over the past several years. And many warn that millions more jobs could be outsourced in coming years.

Our analysis indicates that such fears are out of line with the facts. For starters, employment levels at US affiliates overseas have declined more than private employment levels in the US (**Display 1**), belying the view that US jobs are being moved abroad. According to the Department of Commerce, more jobs were slashed at US affiliates than at home between 2000 and 2002.

That is true for most industries, including the manufacturing sector, where outsourcing concerns have been so concentrated. No doubt some "offshoring" is being handled by non-affiliated third-party companies, so these employment figures don't capture all outsourced jobs. However, hard estimates of how many jobs are being created at these third-party establishments are not available.

Meanwhile, potential manufacturing labor-cost savings—frequently cited as evidence of outsourcing—also appear to be exaggerated. Payroll costs as a percent of manufacturing output have fallen to a record low of 30%, or roughly half the 1950s level, our analysis shows (**Display 2**). And while service imports are rising and US affiliates have added a small number of jobs in specific areas, the US still runs a substantial external surplus in service trade. This means more service jobs are being created in the US from exports—in other words, are being "in-sourced"—than are lost through outsourcing and the importation of various services.

Job destruction has long been a trait of the US economy. But so, too, has job creation. During the 1990s, government data show that gross job losses ran between seven million and eight million a quarter in the 1990s, but gross job gains ran even higher. We think that estimates of outsourcing are far too grim—for the simple reason that critics have focused almost exclusively on jobs lost rather than those that are created through the benefits of globalization, lower cost, and higher productivity.

Debunking Outsourcing Myths

In October 2003, we issued a special study which found that manufacturing employment had been declining globally for several years. The report debunked a popular belief that US manufacturing jobs were being lost to cheaper markets overseas. In other words, we found no evidence that the decline in US manufacturing employment was due to rising employment in other parts of North America, Europe or Asia. Rather, we found that manufacturing employment was declining on a global basis—that these losses were not specific to the US market.

While manufacturing employment levels were also declining overseas, at the time we could not state categorically that this was also happening among US affiliates. But now, with the benefit of additional data, we can state that they were, and the decline was even greater than what occurred at various industries in the US (Display 3). Information on employment levels at US affiliates for 2003 will not be available for several months, but in our view employment patterns have probably not changed much. Even last year, layoffs attributable to overseas relocation, about 13,000 in all, were just 0.9% of overall mass layoffs, according to the Department of Labor.

Most studies also appear to greatly overstate potential savings from labor costs overseas—an important reason why the scale of outsourcing in the manufacturing industry is, in our view, so exaggerated. Using data from the Census of Manufacturers, we were able to document the share fall in labor costs in the manufacturing sector. In the early 1950s, payroll costs for manufacturers were the equivalent of about 55% of total output; in 2003, they had fallen to a record low of 30%.

A recent McKinsey study found that labor costs are a much smaller part of the production process than many think. Direct labor costs for many manufacturers stand around 7% to 15% of the cost of goods sold, the report found; for many hard-good and high-tech manufacturers, labor costs are simply not important. Our data from the Census of Manufacturers confirms this, showing that materials cost are much more important than labor costs in many industries.

Cost vs. Productivity

Of course, manufacturers nonetheless have an incentive to cut labor costs even further by shifting jobs and production overseas. But that decision must be weighed against productivity—US manufacturing workers are the world's most productive—materials costs, currency swings, transportation networks and customer-response time. In other words, cheap labor does not necessarily equal a competitive advantage. Moreover, given the declining share of labor in production costs, the value of any labor savings is dwindling.

Labor costs are more important in the service industries, and there is considerable concern that many service-sector jobs will be moved overseas in the next few years. While globalization makes it much easier for companies to do so, so far the incidence has been relatively small. According to government data, service-sector employment at US affiliates was up a mere 11,000 between 2000 and 2002**,** hardly enough to warrant fears of an exodus.

Despite the angst that outsourcing has caused, private service-sector job growth in the US has not slowed. In fact, it has jumped by 1.2 million since the start of the year—the fastest gain since 2000. This compares to an increase of only 500,000 jobs in the private sector during 2003. While this gain is impressive, what is even more so is that 379,000—or roughly one-third of the total gain—was concentrated in professional and technical services and administrative and support services, the two industries that are purportedly expected to see the greatest outsourcing of jobs.

While outsourcing is still at an early stage, the initial evidence runs counter to conventional wisdom: US firms simply have not shifted jobs to foreign affiliates at the pace that many claim and outsourcing has not stopped the impressive US job-creating machine even in industries most prone to outsourcing. This reflects the strong international competitiveness of US service firms, which is evident in the big surplus that the US enjoys in external trade in services.

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Display 1: Job Loss at US Affiliates Is Greater Than Loss in US Payrolls

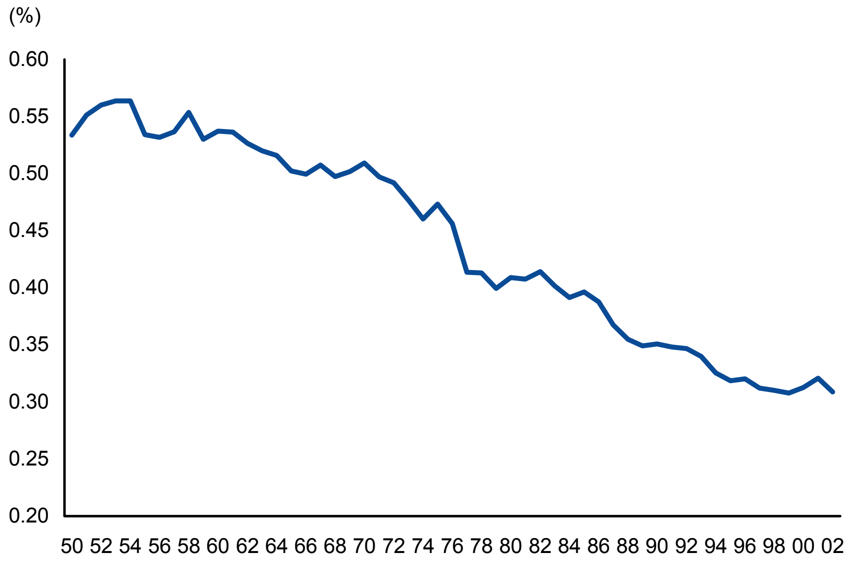
Total Change in Employment at US Companies and US Affiliates from 2000 to 2002

	US Private Payrolls	Payrolls of US Affiliates
Total	**-2.00%**	**-4.18%**
Total Manufacturing	-11.64	-13.12
Food	-1.83	-22.35
Chemicals	-5.40	-3.06
Plastics & Rubber	-10.98	-4.97
Nonmetallic Mineral Products	-7.04	-7.48
Primary Metals	-18.14	-20.21
Fabricated Metal Products	-11.69	-2.67
Machinery	-15.49	-11.59
Computer & Electronic Products	-17.21	-27.92
Electrical Equipment, Appliances & Components	-16.02	-11.42
Transportation Equipment	-11.03	-17.56
Furniture & Related Products	-11.06	-16.56
Service Producing	-0.10	0.20
Wholesale Trade	-5.18	6.09
Retail Trade	-1.66	-5.59
Transportation & Warehousing	-4.22	16.75
Information	-6.50	-2.35
Finance	2.08	-11.74
Administrative & Support Services	-6.70	-7.46
Professional—Scientific & Technical Services	-0.89	10.35

Source: Bureau of Economic Analysis, Haver Analytics and Alliance Fixed Income, October 22, 2004

It is popularly believed that US firms have reduced employment at home and moved these jobs to affiliates around the world. But evidence suggests otherwise. Between 2000 and 2002, employment levels at US affiliates fell at a faster rate than did US private payrolls.

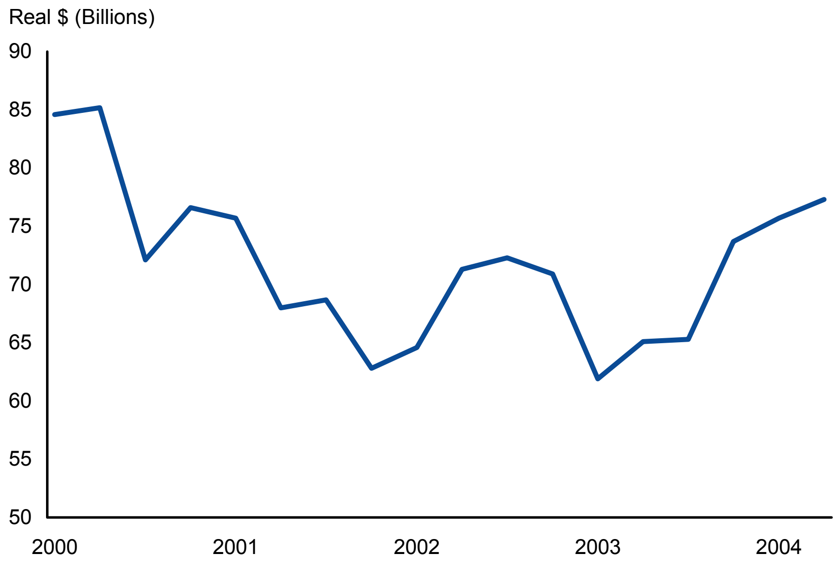
Display 2: Labor's Role in Production Process Has Declined Sharply
Cost of Manufacturing Payrolls as a Percent of Output



Source: Census Bureau, Haver Analytics and Alliance Fixed Income, October 22, 2004

According to the US Census of Manufacturers, total payroll costs as a percent of manufacturing output have fallen dramatically the past few decades. When also considering the extra expense of currency and material costs, the value of wages saved from moving jobs and production overseas appears to be overstated.

Display 3: US Runs Relatively Large Surplus in Services
US External Trade Surplus in Services



Source: Bureau of Economic Analysis, Haver Analytics and Alliance Fixed Income, October 22, 2004

The US continues to run a very large surplus in the service part of international trade. This implies that the amount of service jobs being generated at home is greater than those lost to foreign competitors.