



Demystifying Outsourcing

The numbers do not support the hype over job losses

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THE OUTSOURCING of services has received a huge amount of attention in the media and political circles in recent months, largely because media reports seem to equate outsourcing with job losses. In just five months, between January and May 2004, there were 2,634 reports in U.S. newspapers on service outsourcing, mostly focusing on the fear of job losses. But outsourcing, let alone its consequences, does not appear to be widely understood. The dictionary

defines it as “the procuring of services or products . . . from an outside supplier or manufacturer in order to cut costs.” However, it is not clear what is meant by “outside.” Some people interpret it to mean outside the firm, and others outside the country. Media and political attention seems firmly focused on international outsourcing, even though domestic outsourcing is also common. Firms based in industrial countries that outsource services have been accused of “exporting jobs” to developing

Photo above shows employees at a call center in the southern Indian city of Bangalore.

countries, with call centers and computing services in India the most frequently reported examples.

Many people would argue that outsourcing has been a normal part of international trade for decades—and they would be right. The growing outsourcing of services in industrial countries is simply a reflection of the benefits from the greater division of labor and trade that have been described for manufactured goods since the time of Adam Smith and David Ricardo. What is tradable depends on technology, and advances in technology (especially in information processing, communication, and transportation) are increasingly making it possible to trade services that previously were too costly to trade. Although, for a typical industrial economy, the international outsourcing of material inputs is still far greater than that of services, the current wave of anxiety is largely about services.

In the past, the service sector was largely considered impervious to international competition. For example, accountants could benefit from the cheaper imported manufactured goods that open trade allowed without fear that someone abroad would take their high-paying jobs. For this reason, service sector professionals were likely to be staunch supporters of open trade. With improvements in communication technology, such as the Internet, services can cross political borders. Jobs in fields ranging from architecture to radiology consequently seem much more at risk. Although firms were able to relocate abroad in the past, they had to give something up—their closeness to important markets, for example. With the new technologies, they can retain these links while also obtaining access to cheap but well-trained labor.

As a result, there does appear to be a backslide in support for free trade policies, particularly among white-collar workers. A study conducted by the University of Maryland found that, among individuals in the United States with incomes over \$100,000, those actively supporting free trade slid from 57 percent in 1999 to 28 percent in January 2004. Furthermore, there has been a push in some industrial countries—for example, the United States and Australia—to introduce legislation that would limit the outsourcing activities of firms with government contracts. Given that little empirical work has been done to distinguish facts about outsourcing from exaggerated claims, we thought it would be useful to examine the trends in outsourcing and whether it really means job losses. On the whole, welfare should improve, but in the process some groups or individuals could be made worse off. The finer the disaggregation of data in the analysis, the more likely we are to observe “winners” and “losers.” Drawing on the experiences

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of the United States and the United Kingdom, we can say that, in the aggregate, outsourcing does not appear to be leading to net job losses—that is, jobs lost in one industry often are offset by jobs created in other growing industries.

Trade in services

How extensive is service outsourcing? All the media hype would lead one to believe that service outsourcing is exploding. But the data reveal that, although service outsourcing has been steadily increasing globally, it is still at very low levels in industrial countries like the United States.

In its balance of payments statistics, the IMF reports imports of services, which include the categories that are most closely related to outsourcing—other business services and computing and information services. Other business services comprise accounting, management consulting, call centers, and other back-office operations; computing and information comprise hardware consultancy, software implementation, and data processing. According to these statistics, U.S. business service imports as a share of GDP have roughly doubled in each of the past several decades, from 0.1 percent in 1983 to 0.2 percent in 1993 and 0.4 percent in 2003 (see Chart 1). In the United Kingdom, the share is about 1 percent of GDP. India, reported to be the recipient of significant outsourcing, itself outsources a large amount of services. Its business services grew from 0.5 percent of GDP in 1983 to almost 2.5 percent of GDP in 2003.

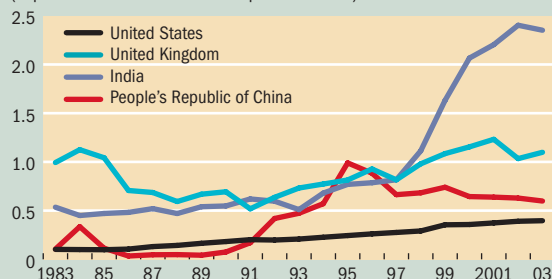
In value terms, the United States is the largest importer of business services. But, as a proportion of GDP, trade in

Chart 1

Who's outsourcing?

Known as a major recipient of outsourcing, India is also a large outsourcer of business services.

(imports of business services as a percent of GDP)



Source: IMF, *Balance of Payments Statistics Yearbook*, 2003.

Top outsourcers

Small countries often outsource more business, computer, and information services as a share of their GDPs (2003).

Business services		Computer and information services	
Country	Share of GDP (percent)	Country	Share of GDP (percent)
Angola	44.50	Luxembourg	1.06
Mozambique	34.74	Guyana	0.91
Congo, Republic of	21.55	Belgium	0.43
Mali	21.35	Croatia	0.43
Vanuatu	17.32	Sweden	0.42
Ireland	13.90	Ireland	0.39
Seychelles	11.78	Slovenia	0.36
Singapore	10.68	Cape Verde	0.34
Azerbaijan	8.57	Namibia	0.32
Luxembourg	8.03	Hungary	0.29

Source: IMF, *Balance of Payments Statistics Yearbook*, 2003.

business services—like trade in goods—is low compared with that of the rest of the world. In smaller countries, trade generally accounts for a larger share of GDP. Among the top 10 outsourcers of business services are small developing countries, such as Angola, Republic of Congo, Mozambique, and Vanuatu (see table). The pattern is similar for imports of computing and information services. Among the top outsourcing countries in that category are Guyana and Namibia but also small developed countries, like Belgium and Sweden. This should not be surprising since industrial countries have the capacity to produce domestically a large proportion of the services they need, whereas many of the developing countries do not have this capacity.

Trade is a two-way street

Like trade in goods, trade in services is a two-way street. In addition to being a large importer of services, the United States is also a large exporter of services. The United States has a net surplus in all services, in contrast to its goods trade, in which it has a net deficit. In fact, the United Kingdom and the United States have the largest net surpluses in business services (see Chart 2) and hence would suffer the most in terms of the forgone dollar value of such trade if other countries cut service outsourcing.

But that is not true of all industrial countries. The data reveal no clear pattern of developing countries being net service exporters and industrial countries net service importers or vice versa. For example, in addition to the United Kingdom and the United States, India also has a net surplus in business services. Indonesia has a large net deficit in business services, but so do Germany and Ireland.

Who's trading with whom? Contrary to popular perception, most U.S. trade in services actually takes place with other industrial countries rather than with developing countries. Using statistics from the U.S. Bureau of Economic Analysis, we found that the share of imports of "private services" from developing countries to the United States is low. (The category "private services" comprises education, finan-

cial services, insurance, telecommunications, business, professional and technical services, and other services.) In 1992, only 28 percent of U.S. imports of private services came from developing countries. Although this share increased between 1992 and 2002, it still remains quite low at 32 percent; 68 percent of these service imports originate in other industrial countries. Interestingly, only a very small proportion comes from India. In 1992, imports of private services from India were only ½ of 1 percent of total U.S. imports of private services. In 2002, imports of private services from India to the United States increased to nearly 1 percent of total imports of these services. There was a larger increase in U.S. imports from India in business services—a subcategory of private services—which has been the focus of most of the media attention. They increased from 0.45 percent in 1992 to nearly 2 percent of total imports of business services in 2002. The largest supplier of private services to the United States is, in fact, Canada.

Similarly, the bulk of U.S. exports are destined for industrial countries. Only 39 percent of total U.S. exports of private services go to developing countries. This fraction remained relatively constant between 1992 and 2002.

U.S. and U.K. realities

Are more jobs disappearing than are being created as a result of outsourcing? To gain some insights, we studied the effects of foreign outsourcing of services on employment and labor productivity in U.S. industries between 1992 and 2001. The sample included all manufacturing services and five service industries for a total of 100.

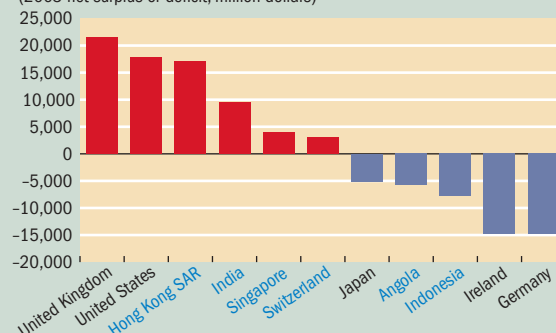
Our results show that increases in service outsourcing in U.S. manufacturing and services sectors go hand in hand with greater labor productivity. Why might this be? This is likely due to firms relocating their least efficient parts of

Chart 2

Two-way trade

The rest of the world outsources more to the United States and United Kingdom than the other way around.

(2003 net surplus or deficit, million dollars)



Source: IMF, *Balance of Payments Statistics Yearbook*, 2003.

Note: Names in blue denote countries or territories whose data are projected based on previous year's data.

production to cheaper destinations. For manufacturing firms, the largest category of outsourced services is, indeed, business services. Even if outsourcing leads to some shedding of labor, the increased efficiency could lead to higher production and an expansion of employment in other lines of work. For example, a firm might let some employees go because it imports its information technology services but then, as it becomes more efficient, it may decide to expand its research and development department, thereby creating new jobs.

When jobs in one sector are outsourced, other sectors could also be affected. As firms that outsource become more efficient, they produce more cheaply and, hence, can provide inputs to other sectors at lower prices. This, in turn, lowers other firms' costs, reducing their prices and leading to higher demand for their products. This higher demand could be met by the increased productivity of existing staff, or, if demand growth is sufficiently strong, it could lead to further job creation, which could, in principle, offset the direct job losses caused by outsourcing. Of course, there could be a change in the skill mix of jobs.

In the final analysis, outsourcing does not lead to net job losses. Rather, our results indicate that, when looking at finely disaggregated sectors, you find that only a small number of jobs are lost as a result of service outsourcing. For example, when disaggregating the U.S. economy to 450 industries, there is a small negative effect on employment. But aggregating up to 100 sectors, there were no job losses associated with service outsourcing. This implies that a worker could lose her job due to outsourcing but then she, or an unemployed worker, may find a job in another firm within the broader industry classification. Hence, aggregated data would indicate that there are no net job losses when there is sufficient job creation in another sector, which indeed seems to be the case.

Are these results applicable to European and other advanced economies? To answer that question, we did a case study of the United Kingdom, examining data for 78 sectors (69 manufacturing and 9 service), between 1995 and 2001, which was the most disaggregated data available. There, too, we found no evidence to support the notion that sectors with higher growth of service outsourcing would have a slower rate of job growth. In fact, no uniform pattern emerged between service outsourcing and employment growth. For example, the "other transport equipment" sector (which includes the manufacture of bicycles

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and railway) had the second highest growth in employment and one of the highest growth in service outsourcing, yet the "preparation and spinning of textile fibers" sector experienced negative employment growth over the period and was ranked one of the biggest outsourcing sectors. In contrast, both the "man-made fiber" and the "machine tools" sectors experienced a large decline in employment growth, yet the "man-made fiber" sector experienced high service outsourcing growth and the "machine tools" sector experienced a rapid decline in service outsourcing.

Our results from the U.S. and U.K. studies suggest that service outsourcing not only would not induce a fall in aggregate employment but also has the potential to make firms and sectors sufficiently more efficient, leading to enough job creation in the same broadly defined sectors

to offset the lost jobs due to outsourcing.

Outsourcing doesn't equal job losses

Although service outsourcing is growing rapidly, it still remains a small fraction of industrial countries' GDP. And it is not dominated by lopsided, one-way outsourcing from developed to developing countries. In fact, most industrial countries do not outsource more (when adjusted for economic size) than many developing countries. The United States, for example, which is a large importer of business services, is also a large exporter of these services and, as has been noted, has a growing net surplus in business service trade.

As for fears about job loss, our studies show that jobs are not being exported, on net, from industrial countries to developing countries as a result of outsourcing. In fact, the evidence suggests that job losses in one industry often are offset by jobs created in other growing industries. ■

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