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Why We Can All Stop Worrying About Offshoring and Outsourcing

By: Ben W. Heineman Jr.
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The old math no longer applies when it comes to where multinationals choose to open shop.

Labor markets have for the past quarter century been at the center of the globalization disputes under the "off-shoring and out-sourcing" rubric. How many jobs were lost at home to cheap labor abroad? What were conditions for those overseas workers? But the rapidly changing nature of the global economy has changed much, though not all, of that "off-shoring/out-sourcing" debate. Today, cheap labor is only one of many factors leading global companies to choose where to do business in diverse nations across the world. Major economic changes like the internal growth of emerging markets have scrambled debates about the global economy, posed challenges for international business, stimulated contradictory public policies and confused the general public.

It was often cheap labor in emerging markets that, more than two decades ago, led companies in developed markets to move company jobs away from the home country either to company owned facilities (off-shoring) or to third parties (out-sourcing) in developing markets. The broad idea was that less expensive manufacturing or inexpensive white collar workers would create goods and services in developing nations that would serve world markets. China, especially, would be the global product-manufacturing center; India, via the web, would be the global service provider.

The well known debate ensued between free-trade (more competition, cheaper goods in U.S., growth in developing markets) and fair trade (only wealthy benefit, hollowing out of U.S. middle class, exploitive labor standards overseas). The debate heated up in political years (including 2012), when "outsourcing" became an especially a dirty word. But, in addition to dramatic economic growth in emerging markets, four recent trends have significantly modified this old off-shoring and out-sourcing schematic.

First, labor costs for many businesses may no longer be the critical or even primary factor in global location decisions. Wages are rising in many emerging markets due, in part, to increased demand, new labor laws, and greater worker voice. Wages are declining in developed markets like the U.S. where depressed economic conditions for workers have led to lower wage and benefit packages, especially for lower entry level workers, and often through negotiations with organized labor. New technology, such as robotics, and higher productivity have also lowered the price of labor as a percentage of total product or service costs. When labor cost differences are not as dramatic or important, other costs like materials, energy, transportation, currency, capital, government imposed costs (tariffs, regulation) -- which were always important -- may have as great (or greater) impact on the location as cheap workers.

Second, companies are retaining but modifying their global supply chains by selectively reversing the long-term trend of outsourcing. They are "making" important parts of the products or services rather than "buying" from third parties, as described recently by U.S. business people and journalists, Companies are recognizing that closely interrelating, even co-locating, research and development, design and marketing, manufacturing and assembly close to the markets served can lead to much faster response to market shifts and to much faster innovation. The old practice of designing at home and then manufacturing abroad can slow the pace of innovation and product change to a crawl. So companies are making complex trade-offs between "making" and "buying" -- and between the need to develop technology at connected global R&D centers and the need to apply it in a variety of local settings in a variety of ways.

Similarly, companies which were enamored of outsourcing key service functions like information technology to nations like India are discovering that these, too, are key to fast-paced innovation and should be "made" not "bought" -- bringing them back in-house, with corporate units integrated across the world under global/local management. The "de-verticalizing" outsourcing process - when a company sent many of its functions between raw materials and the finished product to third parties - is now being partially reversed with "re-verticalization." But, even with changes, global supply chains, even if owned more by the company and less by third parties, will remain critical.

Even when labor is a still a significant portion of the cost of a product (e.g. textiles, toys, some electronics), there is a growing movement among major, developed world companies, as I have detailed elsewhere, to engage in responsible off-shoring and out-sourcing by adopting labor and quality standards which aim to create decent wages, working conditions and environmental protections as well as more rigorous quality checks. The apparel industry has an off-shoring/out-sourcing code of conduct monitored

by a third party, the Fair Labor Association (FLA), a practice now followed by Apple, but not the electronics industry as a whole.

But it must be emphasized: there are still great problems in supply chains for low cost products (as demonstrated by last year's deadly factory fire in Bangladesh) and there is a great deal yet to do. Most brand-name, iconic multi-nationals, however, do understand that labor and quality standards are needed -- both in their own overseas facilities for their own employees and in their supply chains -- which will either increase costs or ameliorate some of the worst practices. And, at least for these major companies, this is another factor which may means that decisions about location and employment are not made purely on the cheapest possible labor.

Finally, companies' choice of where to do business across the globe is heavily influenced by a witches brew of complex, often contradictory governmental policies at national, regional and local levels. Governments may seek to attract foreign investment yet also discriminate against it. They may promote non-protectionist policies for economic growth (infrastructure, R&D, more open immigration, skilled work force) or they may, especially in a recession, enact protectionist measures. They may, like China, engage in a host of illicit activities - pay-offs, piracy, hidden subsidies -- to promote national champions. Or to counter state capitalism like China's, they may engage in explicit subsidies or tax breaks or subsides or preferences or soft loans to promote domestic business's ability to compete overseas against state supported or state owned companies -- trade promotion ideas which teeter between reasonable competitive measures and bad crony-capitalism.

Ultimately, governments may recognize that virtually every other government has its thumb on the scale of economic activity and thus frustrate real global competition which can mean new jobs at home (even if old jobs may suffer). As a result, they may seek new free trade agreements to knock down tariffs and other trade barriers -- as in current major trade talks in the Atlantic (between the U.S. and the EU) and in the Pacific (involving the U.S., Japan and others) -- to stimulate economic growth and also to counter the rising power of China's state capitalism. All these currents and cross-currents in present and evolving government policy have significant impact on location of global business activity.

These four trends take place in the context, as noted, of one central change: faster economic growth in developing markets than in developed markets. Much activity of global companies is now an attempt to sell in those new markets by having a powerful new local presence, even as they retain global supply chains. This is called "on-shoring" because it involves creating new, additive economic efforts in emerging markets which are far different than "off-shoring" jobs to cheap markets to export products back to expensive ones. Take China. Foreign auto makers (Japanese, European and American), have roughly 60 percent of a 15 million unit per year market, with tens of production facilities frequently owned with Chinese partners. GM is the leading car-maker in China with about 20 percent of sales (selling more units than in the U.S.) and has 11 assembly plants and four power-train plants in eight Chinese cities. For many

U.S. multi-nationals approximately half their revenues, and 30-50 percent of their work-force, are outside the United States, reflecting the need to serve overseas markets.

Similarly, foreign companies have been "on-shoring" in the United States for years. . Foreign automakers built more than 3 million cars at 16 facilities in the United States in 2011 with the 70 percent of Japanese cars sold in the U.S. made in North America. Announcements of acquisitions or new plants in the U.S. are made almost every day by a non-U.S. companies, like Airbus, Siemens, Lenovo, Infosys, Ikea, and Foxconn. Indeed, foreign companies employ nearly 6 million Americans, account for 13 percent of manufacturing jobs and about 18 percent of exports.

Stories of foreign investment in the U.S. have been matched in the past few years with the "re-shoring" of overseas work back to the U.S. Iconic American companies like Apple, Google, Caterpillar, Ford, Emerson, GE, and Intel are adding plants and jobs in the U.S. or North America. The decisions are driven by some of the economic trends noted earlier (competitive overall cost for U.S. markets, desire to "make" not "buy" and integrate corporate functions for innovation close to customer). "Re-shoring" also helps symbolically and politically to counter, to an extent, the old "off-shoring" critiques. But, while "re-shoring" may slow the decades long decline in U.S. manufacturing jobs, from 20 percent of the workforce in 1980 to about 9 percent today, it is not likely to reverse it, much less herald a return to the glory days (the Bureau of Labor Statistics estimates that only 7 percent of the workforce in 2020 will be in manufacturing).

For most of the public, this significant modification in the off-shoring, out-sourcing debate is not well understood and people still revert to the old schematic This is because of politics. Companies are struggling to adjust to new global realities but generally try to present a strong nationalist face in their home countries (now aided by modest "re-shoring"). Importantly, nations that practice some version of "market capitalism" (less government intervention than "state capitalism") are schizophrenic: torn between government policies to support real global competition and policies to support national companies and local workers. Broad adjustments in knowledge and attitudes about changes in global economic integration is necessary in developed "market capitalism" to reach the right balance of policies promoting the long-term ideal of global competition, adopting near term measures that counter state capitalism without engaging in crony capitalism, recognizing that with competition new domestic jobs may replace old ones and protecting domestic workers whose jobs may be lost due to technology and productivity - not just changes in trade.

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