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The heated debate over offshoring might suggest that jobs in the world's major economies are moving en masse to China and India, but the reality is quite different. In fact, only about 4 percent of all jobs lost in the United States over the last few years can be attributed to offshoring and free trade.[1]

Rather than destroying jobs, offshoring is unlocking tremendous long-term economic value around the world. Outsourcing jobs abroad can help keep companies profitable, thereby preserving jobs. It can also generate substantial cost savings, which in turn can be used to lower prices and offer consumers new and better services. By raising productivity, offshoring enables companies to invest more in the next-generation technologies and business ideas that create new jobs.

But not every country is reaping the benefits of offshoring. New research has shown that for every dollar of cost outsourced to India, the United States receives as much as $1.14 in economic gain. In Germany, however, offshoring leads to just €0.80 in value for every euro in cost moved abroad to places like India and Eastern Europe. In short, as their companies globalize operations, Europe's leading economies are leaving significant value on the table due to lack of flexibility in their labor and product markets.

Globalization today is creating greater job turnover in the developed world than ever before, and there are clearly winners and losers. But protectionism is not the answer. Instead, policymakers should create programs for wage insurance, transferable health benefits, and job retraining to reduce the adjustment costs to those who lose their jobs. In Europe, policymakers will need to adopt wholesale reform of labor and product market regulations that are currently stifling economic growth.

Rich Countries Can Benefit. In 2003, the McKinsey Global Institute (MGI) analyzed the economic benefits of offshoring back-office service and IT functions from the United States to India.[2] Results showed that, rather than losing out, the United States gained as much as $1.14 in new wealth for every dollar of spending that U.S. companies transfer to India. This value comes from cost savings to businesses, increased exports to India, repatriated earnings from offshore providers in which U.S. companies have invested, and the additional economic output created when U.S. workers are reemployed in other jobs. India, in contrast, receives just 33 cents of new wealth, through wages paid to local workers, profits earned by Indian outsourcing providers and their suppliers, and additional taxes collected by the government.

However, not all rich countries reap as substantial rewards from the practice as the United States. A similar analysis for Germany, Europe's largest economy and one of the leaders in offshoring, shows that the country benefits much less from offshoring than the United States does. In fact, German businesses lose €0.20 for every euro of spending on service functions moved offshore.[3] To understand why, consider how offshoring creates wealth for an economy.

Rich countries benefit most from the cost savings to businesses. In the United States, companies save $0.58 for every dollar of spending on back-office service functions and IT jobs they move to India. In Germany, however, companies save only €0.48 for every euro of corporate spending on jobs that they offshore. This occurs largely because differences in language and culture make it more expensive to coordinate projects. In addition, German companies send much of their offshore work to Eastern Europe, where wages and infrastructure costs are higher than in India.[4]

Offshoring can also boost exports from rich countries to poor countries because outsourcing providers—whether they do business in India or in Poland—buy many goods and services abroad. A call center in Bangalore, for instance, might purchase Dell computers, HP printers, Microsoft software, and Siemens telephones. MGI estimates that for every dollar of U.S. corporate spending that moves to India, U.S. exports increase by $0.05. For Europe, the boost in high-tech exports is somewhat smaller (Germany gains just €0.03 in new exports) mainly because U.S. companies dominate the sector.

The United States also benefits from the repatriated earnings of outsourcing providers, since many are wholly or partly owned by U.S. companies. This amounts to an additional profit of $0.04 for every dollar spent on offshoring services to India. German companies miss out on this revenue since few hold ownership stakes in foreign outsourcing operations; however, as outsourcing gains in popularity, this may change.

Offshoring does help European companies more than their U.S. counterparts in one respect: the added flexibility that offshore workers provide. In Germany, as elsewhere in Europe, strict laws about laying off workers and creating new job categories make it more difficult for companies to adjust their use of labor than U.S. firms do. As a result, German and other European companies use labor less efficiently and struggle to cope with fluctuations in demand. Foreign operations can be used to cushion changes, but the magnitude of this benefit is difficult to quantify, and it is excluded from this analysis. Interviews with German and other European CEOs, however, suggest that it can be substantial for many companies.

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Redeploying Workers Pays Dividends. The crucial difference between the economic impacts of offshoring in the two countries lies in their ability to reemploy workers who lose their jobs. In the United States, many people whose work is outsourced move on to other, higher value-added activities. From 1979 to 1999, 69 percent of U.S. workers who lost their jobs as a result of trade in industries other than manufacturing found new work within half a year.[5] Roughly half of these people took pay cuts, while the remainder found higher paid work, but on average they received similar wages in their new jobs.

The result is that for every dollar of corporate spending on jobs offshored, as much as $0.47 in indirect value is created in the U.S. economy as workers find new jobs.[6] Corporate spending on wages can be invested in new business opportunities, and this investment boosts productivity and creates new jobs. Experience suggests that jobs created from redistributed labor will, on average, create more value, as happened when auto assemblers replaced carriage makers and factory workers replaced farmers.

As jobs in call centers, back-office operations, and some IT functions move offshore, other jobs will appear. The Bureau of Labor Statistics has estimated that 22 million new U.S. jobs—mostly in business services, health care, social services, transportation, and communications—will be created between 2000 and 2010. Opportunities will emerge to generate higher value-added jobs by redeploying labor and investing capital in new ways, although we cannot predict exactly where these opportunities will arise. Twenty years ago, for example, no one could have foreseen the giant cell-phone industry that exists today, yet it now employs almost 200,000 workers in the United States alone.

In Europe, workers who lose their jobs to offshoring may have a harder time finding new ones because of structural rigidities in the economy. In Germany, over 5 million people are unemployed, the highest unemployment level since the depression year of 1932, when the Weimar Republic came to an end.[7] Data on reemployment rates for workers whose jobs move offshore are scarce, but for IT and service workers, the rate could be as low as 40 percent. In contrast, the United States has the highest rate of reemployment of any developed country by a factor of almost two.[8]

If Germany could increase its reemployment rate to match that of the United States, it would see €1.05 for every euro offshored. Rather than being a drain to the economy, offshoring would actually pay dividends for Germany.[9]

The Role of Emerging Markets.

The current debate on offshoring and trade focuses on jobs in developed countries and often overlooks the impact that offshoring and other cross-border activities have on emerging economies. Consider India's IT and business-process outsourcing sector, which earns more than $10 billion annually and employs a half million workers. Suppliers to those companies employ an equal number of people. On average, wages in the sector are 50 to 100 percent higher than those for other white-collar jobs in the economy.[10] This employment is creating a new middle class of educated workers. Foreign direct investment (FDI) made by multinational companies has played a key role in this sector's development. The fast-growing Indian vendors that now dominate the sector got a start only after multinational companies pioneered the approach and trained a critical mass of local employees. Also, foreign companies continue to provide healthy competition that forces Indian companies to continuously improve operations.

The Indian outsourcing sector is just one example of how cross-border activities can benefit emerging markets. In 2003, MGI conducted a study of the impact of FDI on local service and manufacturing industries in India, China, Brazil, and Mexico, and found that it had an unambiguously positive impact in thirteen of the fourteen industries studied and a neutral impact in one.[11] FDI boosted productivity and output in the sectors involved, thus raising national income while lowering prices and improving quality and selection for consumers. Foreign players improve the local industry's efficiency and productivity by bringing in new capital, technology, and management skills. Equally important, they increase competition, driving improvements across the sector and forcing less efficient domestic companies to improve their operations or go out of business.

Too many emerging markets today remain skeptical of the benefits of an open economy and close off many sectors to protect local industries. In doing so, they are missing out on a tremendous growth opportunity that benefits the local economy as well as the broader global economy. In return for asking developed countries to continue allowing free trade in services, developing countries would do well to continue to liberalize and open the full range of their own domestic markets.

Are Jobs Really on the Line?

The offshoring trend is spreading quickly around the world. Last year, Europe exceeded the United States in offshoring activity, capturing nearly half of the world's offshoring contracts.[12] A recent survey showed that 40 percent of Western Europe's 500 largest companies have already begun moving their service operations abroad.[13] In the United States, Forrester Research predicted that 3.3 million U.S. jobs in business processing would move offshore by 2015.[14]

Even so, it is important to keep in mind that these figures represent only a small part of the overall employment landscape. The United States alone has more than 150 million employed workers, and roughly 2 million people in the country change jobs *every month*. Of those who change jobs involuntarily, many are forced to leave because of technological change, automation, slowdowns in the economy, shifts in consumer demand, and a host of other factors in a fast-changing economy. In 1999 alone, at the peak of the economic boom in the United States, 1.2 million workers lost their jobs through mass layoffs when companies restructured operations.[15]

Although critics have blamed the "jobless recovery" of recent years on offshoring, almost all of the positions lost in the United States since 2000 were in manufacturing, not services. The decline in manufacturing employment has much more to do with weak domestic demand and a dollar-driven decline in exports than with trade and offshoring.[16] Moreover, U.S. employment in information technology—reputed to be one of the service industries hardest hit by offshoring—expanded from 1999 to 2003 by 200,000 jobs.[17]

The truth is that many jobs previously held in developed countries are now viable only in a low-wage environment like India. That 500,000 people are now employed in India's outsourcing industry does not mean that there could be 500,000 more jobs in Europe or the United States. Instead, without offshoring, companies might scale back or withdraw services such as round-the-clock customer help. Moreover, technology is putting many jobs at risk even without offshoring. Automated voice-response units are replacing call center workers, online hotel and airline booking systems are replacing live operators and travel agents, and imaging software is replacing data-entry workers.

Europe, for its part, faces a workforce that is shrinking because of an aging population—a trend that will hit Germany particularly hard. MGI research on demographic trends around the world indicates that, over the next fifteen years, Germany's workforce will decline by 2 million, while the elderly population that the remaining employed workers must support will grow by 5 million. To prepare for this demographic shift, the country will have no choice but to dramatically raise the productivity of its small workforce, and outsourcing business processes to workers abroad can help.

Easing the Transition. The long-term resilience of economies does not single-handedly improve the lives of people who lose their jobs as a result of trade. Although free trade creates wealth and improves a nation's standard of living, not all groups benefit, particularly in the short-term. A sizable portion of the workers who lose their jobs to offshoring may not find new ones easily or may accept jobs with lower wages.

From 1979 to 1999, roughly 30 percent of American workers unemployed as a result of cheap imports in sectors other than manufacturing had not found jobs a year later.[18] For those who did find employment, average wages were about the same as before. Within that average, however, wages varied considerably. About a quarter of people were better paid, while 55 percent took lower paying jobs and as many as 25 percent of this group received pay cuts of 30 percent or more.

Public policy can help displaced workers in the United States and elsewhere make the transition. For a small percentage of the savings they enjoy from offshoring, U.S. companies could purchase insurance against wage losses for their displaced workers. It is estimated that, for as little as 4 or 5 percent of the savings realized from offshoring, U.S. companies could insure all full-time workers who lose jobs due to free trade.[19] The program would compensate those workers for 70 percent of the difference between their old and new wages and offer health care subsidies for up to two years.

Retraining programs and continuing-education grants can also provide workers with new skills as the economy evolves. Additionally, generous severance packages can help, as can tax credits for companies that hire workers who lost their last job because of free trade. In countries like the United States, transferable health benefits and pension plans are essential.

To realize the full value of offshoring in Europe and ease the transition for workers, policymakers must reform the regulations that hinder job growth. Hiring and firing employees remains difficult in Germany, for example, because of the need for approval from worker representatives. Moreover, companies must often wait six months or longer to hire new workers and must file extensive paperwork to use temporary employees. For one multinational German company, a recent round of layoffs took two weeks to accomplish in the United States, four weeks in the United Kingdom, and three months in Germany.[20] Faced with these difficulties, German businesses are understandably cautious about adding new workers.

In addition, high minimum wages have contributed to lackluster growth in European jobs. Although Germany does not have a minimum wage, the combined impact of wage floors set through collective bargaining and social benefits for the long-term jobless create an effective minimum employment cost.[21] This reduces total employment by making many lower paid jobs economically unfeasible. U.S. retailing, for instance, employs roughly 30 percent more people per capita than German retailing does, and retailing employees in the United States work more hours on average. The creation of "minijobs" in Germany that pay €400 to €800 a month for part-time work was meant to fill this gap, but they have mainly supplanted full-time jobs rather than created new ones.[22]

Equally important, European policymakers will need to untangle the product market regulations that stifle competition and innovation. In Germany, a variety of market restrictions—price regulations, zoning laws, and subsidies, for example—distort and dampen competition and innovation. For instance, limitations on store operating hours prevent retailers from offering greater convenience and employing more workers. In the automotive, retail, road freight, and utilities industries, regulatory barriers directly or indirectly limit market access, thereby weakening competition and innovation. In retail banking, small state-owned and cooperative banks with subscale operations and little shareholder pressure prevent consolidation and competition.

Without pressure from competitors, companies have few incentives to innovate and boost productivity. Although some people might think that higher productivity means fewer jobs, the empirical evidence shows that it actually generates economic growth in mature, advanced economies like Germany and the United States.[23] Higher productivity allows companies to offer consumers lower prices and better value, which in turn stimulates demand and spurs more productive competitors to take market share from less productive companies.

Europe's labor laws and product market regulations were designed to achieve important social objectives like protecting workers' incomes and employment. However, over the past two decades, one lesson has become clear: mixing social and economic policy reduces employment and slows growth. By separating these policies, Europe could boost economic growth, employ more people, and also better finance its social agenda.

The current debate in developed countries over offshoring jobs is focused on the wrong answers to the wrong questions. Short-term job losses must be weighed against offshoring's much broader benefit to consumers and businesses. If companies cannot move work abroad, they will become less competitive, weaken the economy, and endanger still more jobs. In the process, they will miss the chance to raise their productivity and concentrate resources on the creation of higher value jobs. Rather than debating whether offshoring is good or bad, businesses and policymakers should be thinking about how to help those who may not stand to gain.

NOTES

1 Martin Neal Baily and Robert Z. Lawrence, "Don't Blame Trade for U.S. Job Loss," *The McKinsey Quarterly*, no. 1 (New York: McKinsey, 2005).

2 Vivek Agrawal and Diana Farrell, "Who Wins in Offshoring," *The McKinsey Quarterly 2003 Special Edition: Global Directions* (New York: McKinsey, 2003), 36–41.

3 See "How Germany Can Win from Offshoring", *The McKinsey Quarterly*, no. 3 (New York: McKinsey, 2004).

4 A recent survey of German business executives found that 59 percent of planned offshoring investments were headed for Eastern Europe. Because Eastern European countries import more from Germany than India does, the overall value to the German economy is slightly higher.

5 Lori G. Kletzer, *Job Loss from Imports: Measuring the Costs* (Washington, DC: Institute for International Economics, September 2001).

6 Lori Kletzer of the University of California–Santa Cruz (and formerly of the Bureau of Labor Statistics) reports that from 1979 to 1999, 69 percent of non-manufacturing workers who lost their jobs because of free trade found new ones within a year, and on average they earned 96.2 percent of their previous wages. These figures, combined with the fact that 72 cents of every dollar offshored had previously been spent on U.S. wages, mean that the additional value to the U.S. economy from redeploying workers would be $0.45 to $0.47.

7 "Five Million Reasons to Worry," *The Economist*, 2 February 2005.

8 OECD has developed an employment protection legislation index to measure the strictness of dismissal regulation in countries. Using this index, it ranks the U.S. at 0.2, lowest among all OECD nations. The U.K. and Canada, the next two most flexible countries, have an index of 0.5 and 0.6 respectively. All other European nations have an index of 2.0-3.0. See OECD Employment Outlook, 1999.

9 "How Germany Can Win from Offshoring", *The McKinsey Quarterly*, no. 3 (New York: McKinsey, 2004).

10 McKinsey Global Institute, "New Horizons: Multinational Company Investment in Developing Countries," (San Francisco: McKinsey, November 2003).

11 McKinsey Global Institute, "New Horizons: Multinational Company Investment in Developing Countries," (New York: McKinsey, November 2003).

12 Ashley Seager, "Europe Sends the Most Jobs Offshore," *The Guardian*, 15 January 2005.

13 Narendra Aggarwal, "Outsourcing Takes Off in Europe in a Major Way," *Straits Times*, 21 June 2004.

14 John C. McCarthy, "3.3 Million U.S. Services Jobs to Go Offshore," *Forrester Brief*, 11 November 2002.

15 Bureau of Labor Statistics, 2000.

16 Baily.

17 Department of Commerce, annual occupational-employment survey data.

18 Kletzer. To assess job displacement in sectors prone to foreign competition, Kletzer matched Bureau of Labor Statistics figures on non-manufacturing jobs with trade data.

19 Lori G. Kletzer and Robert E. Litan, "A Prescription to Relieve Worker Anxiety," Policy Brief 01-2 (Washington, DC: Institute for International Economics, February 2001).

20 "How to Pep Up Germany's Economy," *The Economist*, 8 May 2004.

21 Following the Hartz IV reform of unemploy-

long-term jobless are being prodded back to work.

22 Viktor Steiner and Katharina Wrohlich, *Work Incentives and Labor Supply Effects of the 'Mini-Jobs Reform' in Germany*, German Institute for Economic Research discus-

23 In developing countries, increasing the amount of capital sometimes fuels economic growth. But once optimal levels of capital intensity are achieved, as they have been in advanced economies, this avenue for growth is closed.