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An Economic and Ethical Analysis of Offshoring: Intercountry Outsourcing of IT Employment

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INTRODUCTION

The accepted notion that companies should seek to lower costs in the pursuit of higher profits has never generated more opposition than when the cost reduction involved offshore outsourcing of highly paid IT and other service industry jobs. Just when the furor over intercountry manufacturing and free trade has subsided a bit, a new cry has arisen over a more recent trend of offshoring service and knowledge intensive jobs. Perhaps the extent of the publicity given to the complaining is as much due to the nature of the victims as to the political ramifications of this trend: "As long as the American jobs going offshore were blue-collar jobs, the political issue did not attain the heat it has now that white-collar job losses frighten a more articulate, assertive social class." (Will, 2004) In fact, "Forrester Research estimates that 3.3 million American white-collar jobs will leave the U.S. by 2015." (Tapper, 2004) Clearly, the United States will be not the only nation to feel the brunt of outsourcing; any country with a strong service economy will also feel the effects of this development.

President Bush's chief economic adviser, a highly respected economist, N. Gregory Mankiw, entered the controversy by remarking: "It's something that we should realize is probably a plus for the economy in the long run …. Outsourcing [is] just a new way of doing international trade." Mankiw went on to say:

"We're very used to goods being produced abroad and being shipped here on ships or planes; what we're not used to is services being produced abroad and being sent here over the Internet or telephone wires…. But does it matter from an economic standpoint whether values of items produced abroad come on planes and ships or over fiber-optic cables? Well, no, the economics is basically the same." (Tapper, 2004)

An executive at Goldman Sachs Asia, Ken Courtis, further endorsed the idea that offshoring jobs makes good economic sense: "We pay hundreds of thousands of dollars a year to hire a good engineer…. You can hire 10 engineers for that price in India. And much of their work can be transferred back and forth over the Internet."

Thus the very telecommunications networks built by American engineers are now being used to make these same engineers obsolete. Moreover, they are urged to feel okay about offshoring. According to George Will: "for the highly competent workforce of this wealthy nation, the loss of jobs is not a zero-sum game, it is trading up in social rewards." (2004). Now a zero-sum game is an encounter in which a gain by one party or side generates a loss by another party or side. So Will evidently believes that at least everybody who is competent is a winner in the offshoring game—a conclusion that certainly invites further investigation.

The term *game* implies "a conflict involving gains and losses between two or more opponents who follow formal rules." (Weisstein, 2004) The invocation of game theoretic terms is particularly inappropriate (unless we grant poetic license), since offshoring is not a game in this technical sense: there are no formal rules, hence no "players" who follow definite rules. One also needs to specify who all the players are. On the one side we have companies, foreign workers, and perhaps worldwide customers; on the other side we have displaced domestic workers. Nor is offshoring a non-zero sum game (by the definition given earlier) even if we permit the metaphor of "game," because the players do not make payments only to each other and the total amount of money is not constant. The social rewards mentioned by Will can only be construed as lower prices, but the lower prices achieved by offshoring are not guaranteed for goods normally purchased by the workers displaced by their company's offshoring. Even if the lower prices did benefit the displaced workers, would their diminished income be a fair trade-off?

One could perhaps justify offshoring by the lights of a rudimentary utilitarianism: as conducing to the greatest good for the greatest number. After all the grand total of the company stockholders, the customers, and the offshore workers exceeds the number of displaced workers. However, there are two objections to that claim, namely,

(1) The widely dispersed reward offered by the practice of offshoring is so diluted among the beneficiaries constituting the greater number, that it does not compensate for the magnitude of the pain felt by the displaced workers. With regard to the general issue of dilution of a dispersed good: would forcible confiscation of a person's money and distributing a penny from these funds to as many different individuals as possible, make up for the injustice of totally impoverishing the deprived individual? The point is that *intensity* of one sacrificial individual's pain must be considered along with the number of beneficiaries/victims in any utilitarian calculation.

(2) If the practice of offshoring is generalized (so that the present offshorees will in turn lose their jobs to yet another country) all workers might fall to the same level of misery. There would always be the threat that some third country's workers would work for even less money.

No single ethical framework can alone support a solution here. Consequentialism is the ethical position that (long term) consequences matter most, a position that should play a roll this ethical debate.

ECONOMIC JUSTIFICATION BY THE "LAW OF COMPARATIVE ADVANTAGE"

Ofttimes one hears the opinion that whoever can do a type of work X and carry out the requisite production most efficiently should be given the job to do X, even if X is something we wish to do. This much follows from the doctrine of the specialized division of labor, perhaps first enunciated in Plato's Republic. Plato considered a division of labor only within the state and not between states. Economists have generated an intercountry corollary of this doctrine, which could be stated as follows (and clarified by the table below):

Suppose country B could produce two types of product, say P1 and P2, both absolutely more efficiently than country A could. Now if A could at least make P1 *relatively* more efficiently than it could do P2, even if not *absolutely* better than B could do P1; nevertheless, a mutually beneficial trade between A and B is advisable. In that case A should make P1 and export it to B, while B should engage in P2 and export it to A. This arrangement is thought to arise naturally—barring governmental interference—and would be mutually advantageous for both A and B.

In Table 1, to simplify the analyses, both countries have 100 hours per week to devote to production of their two products, P1 and P2. If they do not specialize in what they do best, they devote 50 hours to each product. The efficiency factors are given by product for each country: country B is more efficient in making both products, but country A is relatively better at making P1 than P2. Each product unit is assumed to be worth one dollar. When the countries specialize in the one product they make most efficiently, it is seen that the separate and joint total production values as well as the excess profit figures are higher—even when the countries import what they need.

A classic expression of such situations was given by David Ricardo (1817), who actually never claimed he had discovered a law. However, it is Ricardo's discussion from which later economists derived the above law and led them to infer the above corollary.

HOW WELL DOES THE LAW APPLY TO OFFSHORING?

Solely for the purpose of establishing Ricardo's context as being an exchange of goods between countries, let us examine an excerpt Ricardo's chapter concerning foreign trade:

"Now suppose England to discover a process for making wine, so that it should become her interest rather to grow it than import it; she would naturally divert a portion of her capital from the foreign trade to the home trade; she would cease to manufacture cloth for exportation, and would grow wine for herself." (1817)

Table 1.

		COUNTRY A		COUNTRY B		TOTAL: PRODUCTS/DOLLARS
	WORK TIME AVAILABLE	**100** hours/week		**100** hours/week		
	PRODUCT	P1	P2	P1	P2	
EFFICIENCY: HOW MANY	UNITS/HOUR	**7**	**5**	**10**	**12**	
WITH SPECIALIZED PRODUCTION:	100 HOURS FOR ONE PRODUCT	700	0	0	1200	1900
WITH UNSPECIALIZED PRODUCTION:	50 HOURS FOR TWO PRODUCTS	350	250	500	600	1700
AMOUNTS RETAINED DOMESTICALLY	(FOR EXAMPLE)	150	150	200	200	
IF SPECIALIZED	AMOUNT TO BE IMPORTED	0	150	200	0	(350)
IF UNSPECIALIZED	AMOUNT TO BE IMPORTED	0	0	300	0	(300)
IF SPECIALIZED, PROFIT IS =	AMOUNT TO BE EXPORTED	550	0	0	1000	1550
UNSPECIALIZED PROFIT IS =	AMOUNT TO BE EXPORTED	200	100	300	400	1000

His hypothetical example compares the effects of different efficiencies in England of producing wine (originally not so efficient) and cloth (highly efficient) vis-à-vis those in Portugal, in which country the efficiencies are reversed, thus conducing to a *trade* of wine for cloth.

The point I would like to make with respect to offshoring software/services production is that, for the law of comparative advantage to apply, there should be some comparable *exchange* of *similar* goods or services. When country A exports *jobs* to country B, country A is getting goods (say software) in return. Ricardo considered only cases in which labor and capital to stay put (i.e., are immobile) in his analyses. These items are not in the same category. This is not the type of exchange Ricardo discussed. Country B is not depending on Country A to supply some *nonmonetary* good/service that it *needs* or may then safely stop producing. Country B is getting only money. Moreover, country B would probably be expected to use its newly gained funds to buy items from A; but B might use the money it receives from A to buy goods *exclusively* from other countries C and D, in which case country A does not realize all the benefits it anticipated. Furthermore, country B, once it got the knack of producing *original* or similar software, could then market that software on its own, thus cutting A out of the picture altogether. In that case, country A would have enjoyed only a temporary advantage and would soon be out in the cold with respect to software, in addition to losing an entire industry to employ its populace. One could, of course, retort that new industries in A could take its place, but then they too would fall victim to offshoring. Even so the displaced programmers are not necessarily going to be suitable for work in another industry.

Incidentally, it is unprecedented that when one country contracts with another country for trade, that the first country create the *expertise* that will displace its own workforce, as Microsoft and IBM have done in building computer centers from scratch in India.

Frequently, persons justifying offshoring propound an overly general version of what the law of comparative advantage is, and then conclude without intervening logical steps, that it applies as stated to our issue.

Some additional *dis*analogies with offshoring are brought to light, thanks to Prof. Boudreaux's perspicuous example: he is not training his secretary to be department chair, that is, to displace him, unlike the offshorers who are training replacement programmers. Thus his actions are not harming anyone. Furthermore, the job he is exporting is neither his mainstay nor one that the secretary might one day take over.

BENEFITS TO THE OFFSHORE-OUTSOURCER

Outsourcing, whether intercountry or intracountry, takes place to reduce costs and fulfill the obligation of management to its stockholders. It sometimes is the only way to obtain skilled employees who may not be available locally. Offshoring, on the other hand, involving as it does, training workers who will accept a lower wage, is merely designed to lower costs—still something good management is expected to do. A former American Express Co. employee recently put it straightforwardly: "I was the guy training these [offshore-worker] greenhorns. They're asking me to transfer my skills to someone making $4 an hour." (Mearian, 2004)

Not only are wage costs reduced in the outsourcee country, but also fringe benefits can be lower (and even non-existent). The offshorer also expects a grateful, more docile work force in the foreign land and one that will cause fewer labor problems.

George Will is even more sanguine; for him, it is not just a matter of cost savings, for there is a *concomitant benefit of new job creation*: "How many of the 4,500 U.S. jobs that IBM is planning to create this year will be made possible by sending 3,000 jobs overseas?" (Will, 2004) What he does not clarify is whether the newly created local jobs will be as highly remunerative as the ones lost or whether there wouldn't be an even more numerous workforce at IBM, if so many jobs had not bee sent offshore.

BENEFITS TO THE OUTSOURCEE

Clearly, the country in which new jobs are created would seem to be a beneficiary of offshoring. If, however, *presently employed* workers are hired away from other jobs, the net effect will be to cause inflation in the outsourcee country. But as a rule additional job opportunities would be created. More jobs can certainly boost the economy and raise the standard of living, but again inflation in the outsourcee may result.

Offshoring companies could think of themselves as exporting not only production-type jobs but also management skills; thus they are helping to develop a class of executives in the outsourcee country who will someday run the entire operation. There is no charge for this training, a fact that makes it even more valuable to the outsourcee.

HARMS TO THE OUTSOURCING COMPANY

Offshoring, not only lowers the morale of existing workers but lowers the desire of potential job candidates to work in a company, if it be known that the company continually intends to replace present and newly hired employees with others outside the company (whether by intercountry outsourcing or intracountry outsourcing). Undeniably, software programmers are at risk, Aviva Litan, an analyst with Gartner Inc. reports: "This is the IT development and maintenance staff for their credit card stuff, including risk management, chargeback and all the applications associated with that…. It's going to make everyone [in Amex's IT department] really nervous. It's very scary to the employees." (Mearian, 2004)

The companies are also worried about the local consequences of offshore plans, again, according to Litan: "The reason people at American Express are so scared to tell the IT employees that they may lose their job is those employees can wreak havoc with the systems…." (Mearian, 2004)

Although companies like Amex want to maintain quality in the workforce, probably only the most desperate job applicants, those having the most trouble obtaining jobs, would apply to American Express, given the publicity about its plans.

There are those like Overby (2003) who claim that offshoring does not really save money:

"For months now, the business press has been regurgitating claims from offshore vendors that IT works costing $100 an hour in the United States can be done for $20 an hour in Bangalore or Beijing. If those figures sound too good to be true, that's because they are.

As just one example, United Technologies, an acknowledged leader in developing offshore best practices, is saving just over 20 percent by outsourcing to India."

A not unlikely scenario is that with a large enough reduction in the number of employees and, consequently a severe reduction in the number of consumers in the outsourcing country able to afford the goods and services outsourced, profits would go down despite the cost savings in production.

HARMS TO THE SOURCE COUNTRY

Unless George Will is correct, there will be a net loss of jobs in the foreseeable short run, if not the long run as well. In fact, offshoring might change the whole nature of the domestic economy, leaving as the only home industry, that which physically cannot be exported, e.g., farms! Further, the domestic economy would be in ruins as the severed employees become unable to keep up payments on mortgages and other loans or buy as many products.

ETHICAL CONSIDERATIONS

There is a surprising, altruistic result stemming from the division of labor among nations. Ricardo's law seems "to demonstrate what the consequences of the division of labor are when an individual or a group, more efficient in every regard, cooperates with an individual or a group less efficient in every regard." (Anonymous, 2004). Praxeology may reveal how it happened that, even in humankind's early history, ostensibly self-serving acts like offshoring can bear wholesome social fruit:

"If and as far as labor under the division of labor is more productive than isolated labor, and if and as far as man is able to realize this fact, human action itself tends toward cooperation and association; man becomes a social being not in sacrificing his own concerns for the sake of a mythical Moloch, [namely] society, but in aiming at an improvement in his own welfare." (Anonymous, 2004)

Although there is normally no written contract specifying company loyalty to employees, it is probably implicit. Companies would only fire employees for cause or exigency. So there is a desire of companies for loyalty from their employees, but they treat the employees as disposable commodities whenever lucrative company contracts are terminated or the pressure to increase the bottom line transcends expected reciprocal obligations. Offshoring is not undertaken as a result of some fault of the severed employee or even of harsh business conditions, but rather to strive for profit at all costs.

While there are few career guarantees in life, one would expect that promises of diligent and continuing knowledge acquisition, as long as the knowledge is not obsolete, would lead to a degree of job security. Companies might offer their employees options other than being severed.

As was stipulated earlier, companies have an obligation to their stockholders to increase company revenues and drive down costs. At first the stockholders may outnumber the number of laid off employees, and perhaps the utilitarian dictum of always acting to achieve "the greatest good for the greatest number" is used to support offshoring. But eventually as the practice of intercountry outsourcing spreads, the balance will shift. Such a state of affairs suggests that we revise the philosophical dictum of always acting to achieve the immediate greatest good for the greatest number to read "the greatest good for the greatest number in the foreseeable future, without doing evil." Additionally, one might posit an economics "law of long-term disadvantage": *What appears to be an unalloyed immediate advantage can become a long-term disadvantage*.

Can this practice of intercountry outsourcing be defended by saying that new inventions will always appear to give birth to new industries, and new products will be demanded in the outsourcing country, which will absorb the ("temporarily") unemployed? What is to stop these new industries from offshoring in turn, shortly after they form?

CONCLUSION

Companies should not look to offshoring IT as a way of solving their major financial problems. IT does not constitute that great a part of a company's expenses. Studies have shown that poorly run companies do not gain much by intercountry outsourcing. (Strassman, 2004)

The final accounting of whether offshoring is beneficial or detrimental, and to whom, has yet to be tallied; but George Will (2004) suggests a way out of a critical ethical dilemma:

It is sound social policy, and simple justice that the parties who benefits from free trade—the nation as a whole—should be taxed to ameliorate the discomforts of those who pay the short-term price of progress.

Of course, this solution may not be especially gratifying to proud ex-employees, nor does it cover the possibility that there may not be enough employed taxpayers to handle the proposed additional burden. On the other hand, if instead of offshoring, if domestic employers encouraged cooperative competition in quality of production with the foreign workers—in other words a fair game—it might yield better products, something not realized by the present state of affairs. If, in addition, education of present and prospective workers were enhanced both domestically and abroad, the "game" might turn out to be win-win.

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