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978-1-107-02699-5 - Outsourcing Economics: Global Value Chains in Capitalist Development

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Excerpt

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## ONE

### Introduction

#### 1.1 The Public Debate versus the Economics Profession

##### 1.1.1 “Ricardo Is Still Right . . .”

In his bestselling account of globalization, *The World is Flat*, Thomas Friedman (2005) describes standing in Bangalore one morning in front of the gates of the Infosys Corporation – a major Indian provider of software and office services to U.S. corporations – and watching as young employees stream in to work. “Oh my God,” he thinks to himself,

There are so many of them, and they all look so serious, so eager for work . . . How in the world can it possibly be good for my daughters and millions of other young Americans that these Indians can do the same jobs as they can for a fraction of the wages? I struggled over what to make of this scene. I don’t want to see any American lose his or her job to foreign competition (Friedman 2005, 226).

Yes, Friedman is concerned about the future of the American workforce, but he is also grappling with his faith in Ricardo’s principle of comparative advantage, a harmonious view of globalization in which all countries can gain from trade liberalization. The sight of so many energetic young Indians, “all looking as if they had scored 1,600 on their SATs,” is alarming because it would seem that the success of Infosys can only mean fewer jobs for their American counterparts, including Friedman’s daughters (Friedman 2005, 225). But if Friedman is a true Ricardian, he can calmly consider the bustling activity of Infosys without worrying that it bodes ill for American enterprise. He writes:

No book about the flat world would be honest if it did not acknowledge such concerns, or acknowledge that there is some debate among economists about whether Ricardo is still right. Having listened to the arguments on both sides, though, I

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come down where the great majority of economists come down – that Ricardo is still right (Friedman 2005, 264).

This belief in the positive welfare effects of trade liberalization makes Friedman a rarity among journalists who write about globalization and offshoring. We define offshoring as all purchases of intermediate inputs from abroad, whether done through arm's-length contract – offshore outsourcing – or within the confines of a single multinational corporation (MNC) – intra-firm trade.

More typical of popular views of offshoring are those of Lou Dobbs. Dobbs is a populist who distinguishes the national interest of the United States from the profitability of American corporations – the stakeholders not just the stockholders, as Dobbs puts it in his 2004 book, *Exporting America: Why Corporate Greed is Shipping American Jobs Overseas*. Dobbs identifies himself as a lifelong Republican and a capitalist. However, when it comes to U.S. trade policy, Dobbs takes the side of American workers rather than corporations. “Incredibly,” he writes,

The proponents of outsourcing and free trade will tell you that it's all a win-win proposition. It's been my experience that you should reach for your wallet when anyone says “win-win” (Dobbs 2004, 64).

Dobbs asserts that offshoring hurts American workers and should thus be seen as against American interests. For Dobbs, the growth of offshoring reflects how corporate interests have taken control of the political process.

In his musings over the effects of the Indian information technology (IT) sector boom on U.S. industry and employment, Friedman comes down on the side of traditional economists who endorse the primacy of comparative advantage and the ease of adjustment to payments balance and full employment. But his angst – his head tells him one thing and his heart another – more than Dobbs' populist resistance, is an indication of the gap between academic and public discourse on the issue of offshoring.

Why is there such a gap? Why do economists have such little credibility in the popular discourse about offshoring? The problem is not a lack of awareness by economists of popular views. Economists are keenly cognizant of public sentiment on offshoring and, in fact, much academic writing on the issue of offshoring is motivated by a stated goal of quelling “fear” or dispelling “myth.”<sup>1</sup> The motivation for this extensive body of scholarly research is to explain that public fears are unjustified. The public does

<sup>1</sup> Examples are Amiti and Wei (2005) “Fear of Services Offshoring,” Harrison and McMillan (2006) “Dispelling Some Myths about Outsourcing,” Blinder (2007a) “Offshoring: Big Deal, or Business as Usual,” and Jensen (2011) “Global Trade in Services: Fear, Facts, and Offshoring”.

not grasp the theory of the optimality of free trade. Despite their efforts, economists have gained very little traction in public discussion.

Is it simply that the American public doesn't get it? Our glance at the writings of Thomas Friedman and Lou Dobbs shows this is not the case. The U.S. presidential campaign of 2012 gives additional evidence that public debate over offshoring can go beyond the question of its direct effect on employment and consider also the longer-run investment issues that are at stake when companies are under the control of a private equity firm like Bain Capital. Nonetheless, the economics profession has largely viewed the popular skepticism about offshoring as a continuation of the anti-free trade sentiment rooted in special interests that economists have fought against for decades, if not centuries (Irwin 1996, 2005).

At a press conference, Harvard's Gregory Mankiw, then George W. Bush's chief economic advisor, was asked about the economic effect of corporate offshoring of services. His now famous response is excerpted here:

I think outsourcing is a growing phenomenon for white-collar workers, but it's something that we should realize is probably a plus for the economy in the long run. We're very used to goods being produced abroad and being shipped here on ships or planes. What we are 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 (Andrews 2004, 93–94).

Mankiw's matter-of-fact optimism outraged the public – leading to considerable effort at pre-election damage control by the White House – but was widely supported by economists. Once again, the economics profession found itself stunned by the public's concern over the labor market effects of growing international trade in intermediates.<sup>2</sup> According to one economist, “free traders are trapped in a public policy version of [the movie] ‘Groundhog Day,’ forced to refute the same fallacious arguments over and over again, decade after decade” (Sanchez 2003, cited in Irwin 2005, 5).<sup>3</sup>

An alternative view is expressed by Alan Blinder, who writes:

If we economists stubbornly insist on chanting “free trade is good for you” to people who know it is not, we will quickly become irrelevant to the public debate. Compared with that, a little apostasy should be welcome (Blinder 2007b).

<sup>2</sup> For a blow-by-blow account of how Mankiw saw the events, in which he thought his words were taken out of context and subject to inaccurate press reports, see Mankiw and Swagel (2005).

<sup>3</sup> This amusing Hollywood reference is perhaps more revealing than the author intended, because the point of the movie was that the day would repeat itself until the protagonist (played by Bill Murray) gets it “right”!

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Ruccio and Amariglio (2003) argue that academic condescension toward popular views on the economy reflects an underlying insecurity about the alternative views of economic life expressed in popular culture, that is, “the differences in content between academic and everyday economics” (Ruccio and Amariglio 2003, 276). The field of international economics exemplified this in the 1990s and again in the 2000s. In the 1990s, economists sought to ridicule popular calls for trade protection and industrial policy. At the same time, traditional free trade theories were being overturned by the New International Economics that found conditions under which state intervention in international trade and technology development could raise national (and in some cases global) welfare. In a heated debate in the pages of the journal *Foreign Affairs* in 1994, Paul Krugman accused those supporting government intervention in the form of trade protection or industrial policy as suffering from a “dangerous obsession.”

In the 2000s, as the offshoring issue heated up in public debate, economists attacked other economists for not defending the traditional free trade line – when the welfare gains from offshoring were questionable even by their own standards. Dissent by Paul Samuelson and Alan Blinder over the importance of offshoring and its beneficence for U.S. economic welfare was met by outrage from colleagues who perceived them as traitors against economic faith. Samuelson reported back to the editors of the *Journal of Economic Perspectives* on the response to his article. His essay expressed considerable skepticism about the beneficial welfare effects of offshoring, and strong doubts about the potential Pareto welfare criterion that often underpins the assertion of such benefits. Responding to the many criticisms he received following the publication of this article, Samuelson writes that

none of my chastening pals expressed concern about globalization’s effects on greater inequality in a modern age when transfers from winners to losers do trend politically downward in present-day democracies (Samuelson 2005, 243).

Gregory Mankiw criticized two very prominent economists for not defending him publicly after he was attacked for minimizing the effects of job losses occurring from offshoring. Mankiw writes that,

Notable in his initial silence was Paul Krugman . . . Notable as well for his silence was then-Harvard President Larry Summers . . . Summers declined when journalists asked him for an on-the-record comment on the outsourcing controversy, even

though as Harvard President he had shown considerably less reluctance to engage in the public debate on other issues (Mankiw and Swagel 2005, 12–13).

At the core of the conflict between academic and public sentiment is not simply ignorance on the part of non-economists. What we propose in this book is that there are considerable limits to the economists' own models. In particular, the economists' views on offshoring are closely tied to an outmoded theory of comparative advantage and to an implausible criterion for assessing social welfare. The models of comparative advantage on which the economists' views are based have conceptual, historical, and ethical limitations that generally fail to capture the broader institutional context – including corporate strategies, labor market segmentation, buyer-supplier asymmetries, and government regulations – which are key to understanding the social welfare and economic development consequences of globalized production. Profits, their sources and their uses, have largely disappeared from the analysis, despite their centrality in determining the international division of labor and in driving the dynamic gains from offshoring. As a result of these shortcomings, economists have ceded the academic voice in the debate over offshoring – to sociologists and geographers, experts in management, development studies, labor relations and, yes, to journalists and popular writers. Economics, it would appear, has been outsourced to the non-economists.

Therefore, this book has – among others – the following two purposes: First, to provide an alternative, and institutionally grounded, theory of offshoring and, second, to offer a critique of the role that the economics profession has played in the course of decades of public debate over the economic and social consequences of globalization.

### 1.1.2 Perceived and Actual Effects of Globalization

Americans have become increasingly skeptical of the effects of offshoring on employment and wages in the United States. A recent *New York Times* poll of 951 Americans showed their view that,

Outsourcing is . . . clearly a cause of fewer jobs domestically. And two-thirds of the public wants American companies to shoulder a lot of responsibility to keep manufacturing jobs in the United States (Conelly 2012).

International comparisons of sentiment toward globalization also shows strong American pessimism about its labor market consequences. Surveys show that about half of Americans and Europeans think that “freer trade”

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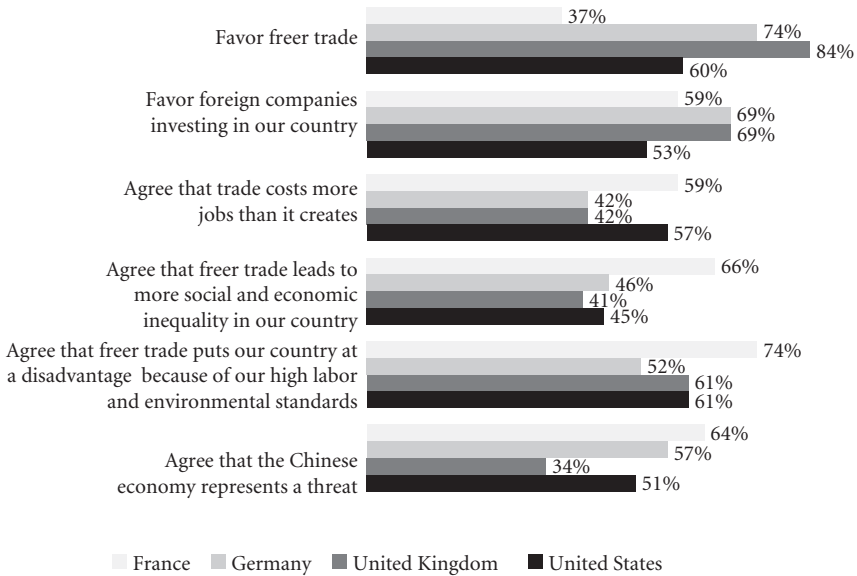
*Outsourcing Economics*

Figure 1.1. Concerns about Free Trade (% of Respondents). *Source:* Own illustration. Based on Milberg and Winkler (2011a, 182). Data: German Marshall Fund (2007), Trade and Poverty Reduction Survey, Topline Data October 2007.

results in more job loss than job creation, although between 2005 and 2007 American sentiment turned against freer trade while European sentiment became less skeptical of the employment benefits of trade liberalization. Half of Americans and a higher percentage of French and Germans “agree that the Chinese economy represents a threat” (see Figure 1.1). Of all countries surveyed, France and the United States showed the highest percentage of those who “did not favor foreign companies investing in our country,” with 40 percent of Americans and 38 percent of French (not shown in Figure 1.1). This contrasted with 69 percent of English and German respondents who were favorable to foreign direct investment (FDI).<sup>4</sup>

In the United States, 40 percent of Americans expect that the next generation will have a lower standard of living, 62 percent said job security had declined, and 59 percent said they have to work harder to earn a decent living. Most striking is that 75 percent of Americans said that “outsourcing work overseas hurts American workers” (Anderson and Gascon 2007, 1). Although this expression of economic insecurity was greatest among those

<sup>4</sup> Scheve and Slaughter (2003) find that in the United Kingdom between 1991 and 1999, perceived economic insecurity was higher in those sectors with greater outward FDI.

with less education, expressions of a rise in economic insecurity as a result of offshoring were found for all educational categories.<sup>5</sup>

Do the perceptions of the effect of globalization on economic security bear any relation to the actual impact of trade and FDI on industrialized countries? In Chapter 5, we estimate the impact of offshoring on the labor share of income for fifteen countries in the Organisation of Economic Co-operation and Development (OECD), and we compare these results to the survey evidence of the perception of the impact of globalization. We find that concerns over globalization are heightened in those countries where the negative effects on the labor market are greatest. The negative correlations support the notion that perceptions and reality are, in this case, linked. This conclusion is consistent with the findings for the United States by Scheve and Slaughter (2003), in which low-skill workers were found to be more skeptical of globalization and trade liberalization than workers with higher skills.

Our estimates in Chapter 5 for the United States suggest that offshoring – measured in over thirty manufacturing and service sectors from 1998 to 2006 – led to a drop in employment of approximately 3.5 million full-time equivalent jobs. A 10 percent increase in services and materials offshoring is associated with a 2.6 percent reduction in the share of value added going to workers, one indicator of the level of inequality in America.

Economists who express great surprise at these conclusions either don't believe that their theories could possibly be falsified by data or they believe that people have misperceived reality. Our evidence indicates that these economists are wrong on both counts: Popular perceptions of globalization are not rooted in fantasy, but in the actual experience of heightened economic insecurity.

### 1.1.3 The “Kletzer Effect”

To further complicate the matter, there is an epistemological challenge to economists coming from the empirical studies of job loss from trade. One of the strengths of many of the theoretical models of offshoring is the indeterminacy of their results (Bhagwati et al. 2004; Grossman and Rossi-Hansberg 2008). In these cases, the ultimate assessment of the gains from offshoring hinges on results of empirical research. This is all well and good, except for

<sup>5</sup> Even on the issue of perception of insecurity, there is conflicting evidence. Kierkegaard (2007) shows that among European countries there is not a statistically significant relation between “public anxiety” over offshoring (as measured by the Eurobarometer 63 of 2005) and the intensity of offshoring.

the fact that empirical evidence rarely resolves a debate among academic economists, especially when there are deep-seated differences of vision on an issue. The problem is partly due to the inherent nature of empirical analysis, limited as it necessarily is in terms of sample size and variable choice. For example, we have seen that much analysis of offshoring focuses on the impact on “high-skill” and “low-skill” workers. Yet even the standard way of operationalizing “high skill” and “low skill” – associating high-skill with non-production workers and low-skill with production workers – is highly contentious (Howell 2005).

The classic problems of induction, that is, of the impossibility of drawing general conclusions from observation, already well understood in the nineteenth century, is exacerbated in the era of econometrics where results are also contingent on model specification and estimation technique.<sup>6</sup> In their econometric study of offshoring and employment, for example, Amiti and Wei (2006) report that the employment effects of services offshoring in the U.S. manufacturing sector are negative when they use a disaggregated industry breakdown but show no negative effect when the aggregated industry classification is used. In contrast, we find a negative relation using more recent data at the aggregated level, as we report in Chapter 5. This is a standard empirical debate, where results can change with the choice of unit of observation and time period.

The offshoring debate, however, raises empirical argumentation to a new level of complication: Different sides in the debate *give very different interpretations of the same exact empirical study*. Those who support the expansion of offshoring and who think that its effect on U.S. labor markets is not important cite Kletzer’s (2001) study to bolster their view. Those who find the detrimental labor market effects of offshoring to be unacceptably high cite the very same study. We call this phenomenon “the Kletzer effect,” because it revolves around the research of Lori Kletzer, professor of economics at Colby College and author of the study in question, *Job Loss from Imports: Measuring the Costs*, published through the Peterson Institute for International Economics.

Bhagwati et al. (2004) introduce the Kletzer study by calling it “one of the most influential studies of the costs of trade displacement” (Bhagwati et al. 2004, 111). They see the study as justifying their claim that displacement from trade is like any other job displacement, and all displacement is rooted in technological change:

<sup>6</sup> Mirowski and Sklivas (1991) calculated the variation across estimates (“birge ratios”) for some of the supposed “constants” in economics and found very large ranges, especially in comparison with the ranges typically found in the natural sciences and even psychology.



Kletzer (2001) divides manufacturing industries into low, medium and high import competing, based on the change in import share during 1979–1994 . . . Across all three groups of industries, about two-thirds of those displaced are reemployed within two years, with about half of that group ending up with a job that paid roughly as much or more than their previous job and the other half experiencing a wage cut of 15 percent or more . . . Thus, the rate of reemployment and wage changes for workers that Kletzer characterizes as trade displaced are quite similar to those for other workers. In other words, a common factor, most likely technological change, is behind the displacement in all categories (Bhagwati et al. 2004, 111–112).

Farrell and Agrawal (2005) also cite the Kletzer report in support of their view that the labor market effects of services offshoring are minimal.

David Levy (2005) has a different interpretation:

The notion that trade enables industrialized countries to specialize in highly skilled well-paying jobs is widespread. The data, however, are mixed at best. In an extensive study of workers displaced by imports, Kletzer (2001) concluded that (p. 2) ‘the earnings losses of job dislocation are large and persistent over time.’ She found that 63.4 per cent of workers displaced between 1979 and 1999 were reemployed with an average earnings *loss* of 13 per cent. Workers displaced from non-manufacturing sectors did a little better: 69 per cent found reemployment, with average earnings losses of only 4 per cent, though 55 per cent took lower paid jobs, and around 25 per cent suffered pay cuts of 30 per cent or more. In other words, 86 per cent were worse off after displacement, 56 per cent were greatly so (Levy 2005, 687).

Somewhere in between the views of Bhagwati and Levy are those of Amiti and Wei (2005), who are slightly more tempered in their view of the implications of the Kletzer study for the offshoring debate. They write:

The McKinsey report [which relies on Kletzer’s study] indicated that more than 69% of workers who lost jobs due to imports in the United States between 1979 and 1999 were re-employed . . . Of course, this means that 31% were not re-employed, highlighting that there may be some rigidities in the labor market (Amiti and Wei 2005, 317).

In this view, it is “labor market rigidities” (presumably meaning institutions which make firing workers costly) rather than offshoring *per se* that are keeping labor markets from clearing more quickly. In fact, in Chapter 5, our estimations show that a country’s level of labor market flexibility and labor support matter for the labor market effects from offshoring.

Economists all present themselves as objective; to do otherwise would jeopardize the claim for scientificity. But all empirical assessment requires norms or standards which allow for a serious conversation among experts. With the use of econometrics for hypothesis testing this becomes even more important. The lack of such norms is one of the reasons that

econometric analysis alone has rarely clinched an argument, even among economists themselves. Without accepted conventions for what constitutes “big,” “important,” or “significant,” it is inevitable that economists will make competing claims about a single estimate.

Underpinning the Kletzer effect is the importance of economists’ prior beliefs that they bring into even the most scientific-seeming analysis. Schumpeter (1994[1954]) referred to this as “vision,” which he described as the “pre-analytic cognitive act.” Schumpeter writes:

Analytic work begins with material provided by our vision of things, and this vision is ideological almost by definition. It embodies the definition of things as we see them, and wherever there is any possible motive for wishing to see them in a given rather than another light, the way in which we see things can hardly be distinguished from the way we wish to see them (Schumpeter 1994[1954], 42).

Vision is an inevitable aspect of science, but especially in social sciences, where the “observer” is also a clear “participant.” Whereas the adoption of norms and conventions of assessment in themselves reflect vision, in the absence of such norms and conventions the interpretation of analytical results becomes even more prone to the whimsy of vision.

## 1.2 A Global Value Chain Approach to Offshoring

By globalization we mean not simply a quantitative increase in international economic activity: it is also characterized by a qualitative shift. Production has become increasingly organized within global value chains (GVCs), led by large firms based typically in the industrialized countries, and relying often on complex networks of suppliers around the world. GVCs, sometimes called global supply chains or global production networks (GPNs), are defined by Sturgeon (2001) as “the sequence of productive (that is, value added) activities leading to and supporting end use” (Sturgeon 2001, 2). While sourcing in GVCs goes back centuries, it has increased since the 1970s to become the dominant mode of international trade.<sup>7</sup> From the Chevy Cobalt to the Mattel Barbie Doll, from the Boeing 777 to the JP Morgan Chase Bank Visa credit card, and now to the IBM “smart grid” computer network, the production process has been broken up into parts, with different parts performed in different countries.

Low-wage countries are now able to produce high-quality manufactured goods and U.S. companies have taken advantage of this process by offshoring

<sup>7</sup> Hamilton (2006) discusses U.S. retail firm offshoring beginning in the 1960s. Lazonick (2009) documents that U.S. firms began sourcing the production of semiconductors overseas in the 1960s. Clarence-Smith and Topik (2003) discuss the coffee supply chain dating back to the 1800s.