

IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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U.S. ECONOMIC STRENGTH BELIES OUTSOURCING CONCERNS

Introduction

The apparent slowness of job growth in the initial stages of the economic recovery has led to concerns about job outsourcing. There has been intense publicity over jobs shifted by major multinational companies from domestic to foreign plants. These jobs have included many in the high-tech end of the service sector, most notably software and information technology, as well as jobs in the older manufacturing industries. Outsourcing is now the principal scapegoat for job losses and the perception that fewer high-value-added, high-paying jobs are being generated in the United States.

The fears about outsourcing are related to a rising fear of trade and the widening U.S. trade deficit, the long-term decline in manufacturing employment, and the opening of the service sector to intense foreign competition. How important are these concerns? What is the real impact of outsourcing on our labor markets and economy as a whole? What, if anything, can and should be done?

This paper will try to put some of these concerns about outsourcing into perspective by examining economic trends at home and abroad. The paper will look at the position of U.S. employment and output in the global economy, the current and historical state of the U.S. manufacturing sector in an international perspective, and the U.S. global trade in services.

Cyclical Events and Secular Trends in Employment and Production

The outsourcing concern, if it is to mean anything, ought to relate to the permanent shifting of

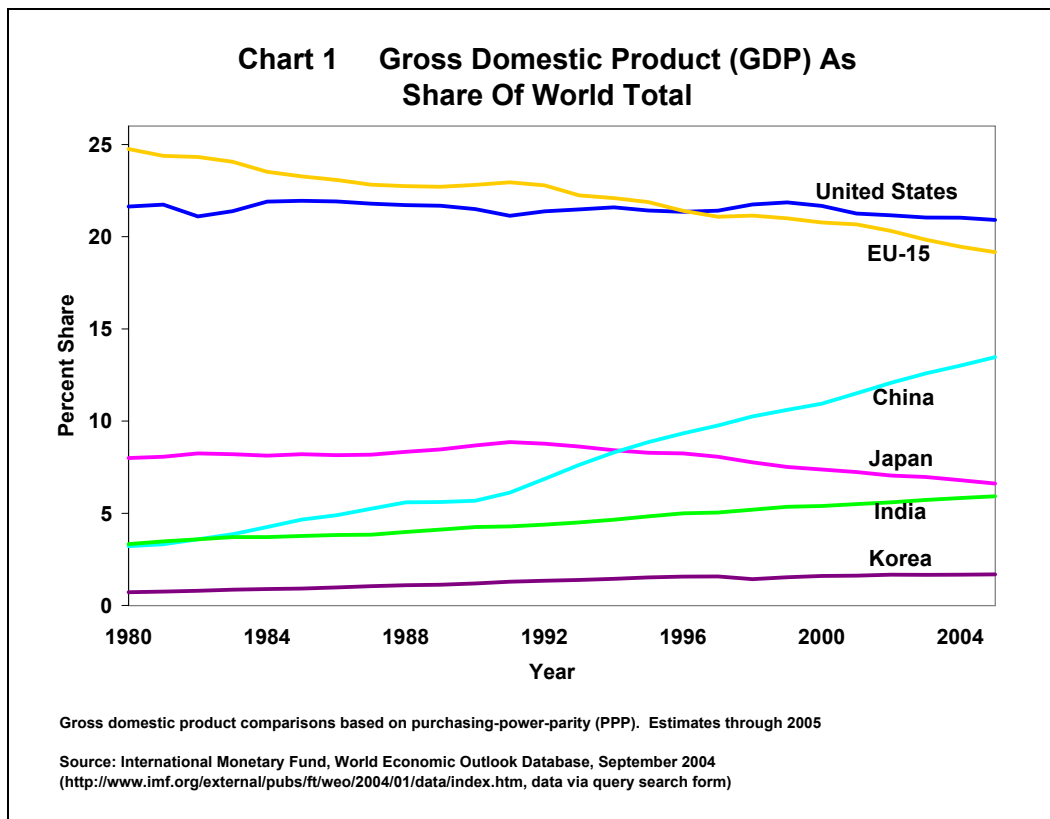
jobs abroad. It should not be confused with employment shifts that are due to the business cycle and, therefore, are temporary in nature.

The United States has just been through a cyclical downturn, which affected much of the developed world. Part of the job losses in manufacturing and key services over the last three years was due to the recent recession, and some of these jobs are being restored as the recovery proceeds. Employment is a lagging indicator, and concerns about job creation often linger after a recession into the beginning stages of a recovery.

The current recovery displayed weak job growth until early 2004, with big increases in productivity possibly slowing recovery of employment. However, job growth has been much stronger in the last several months, and as investment recovers from the recession, the problem will ease in intensity and duration.

The U.S. unemployment rate peaked at 6.3 percent in June 2003, but had dropped to 5.4 percent by September 2004. The September rate is below the average unemployment rate of 5.5 percent experienced in the booming 1990s, and well below the averages of the 1970s and 1980s.

There may also have been some significant measurement problems in this last cycle. An unusually large gap has developed between the Labor Department's establishment survey (a survey of a sample of businesses), which shows slow job growth during the recovery, and the household survey (a telephone sample of residences), which indicates more rapid job growth. Some researchers believe that the establishment survey understates



actual job growth by being slow to include new start-up businesses and by recognizing only with a lag the increasing numbers of self-employed workers.

International Comparisons

Shares of world output. Recent economic weakness, coupled with the publicity over outsourcing, has led some people to conclude that the United States is declining as a world economic power. This is not correct. The United States is maintaining global leadership.

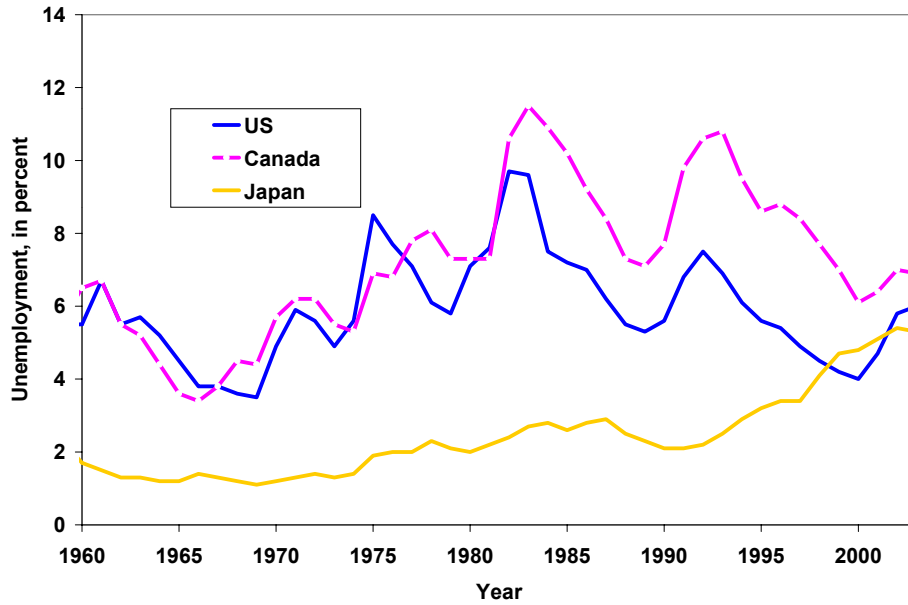
Chart 1 plots the percentage share of world GDP of the United States, other developed countries/regions (Japan and the EU-15¹), and three developing nations (China, India, and Korea). This graph indicates that the United States is maintaining its share of world GDP at about 21 percent,² with very minor fluctuations, even in the aftermath of a recession.

The EU-15 share of world GDP, once several percentage points higher than that of the United

States, has been declining for the past two decades (from nearly 25 percent in 1980 to a projected 19 percent in 2005). Japan’s vaunted economy of the 1970s and early 1980s slumped badly in the 1990s following a series of tax increases on saving, capital gains, and land in 1988 and 1990. These led to the collapse of Japanese stock prices and real estate values, which crippled its financial institutions. Japan’s share of world GDP declined from about 8 percent in 1980 to a projected 6.6 percent in 2005. The U.S. share remained steady in the 1990s, even rising before the 2001 recession.

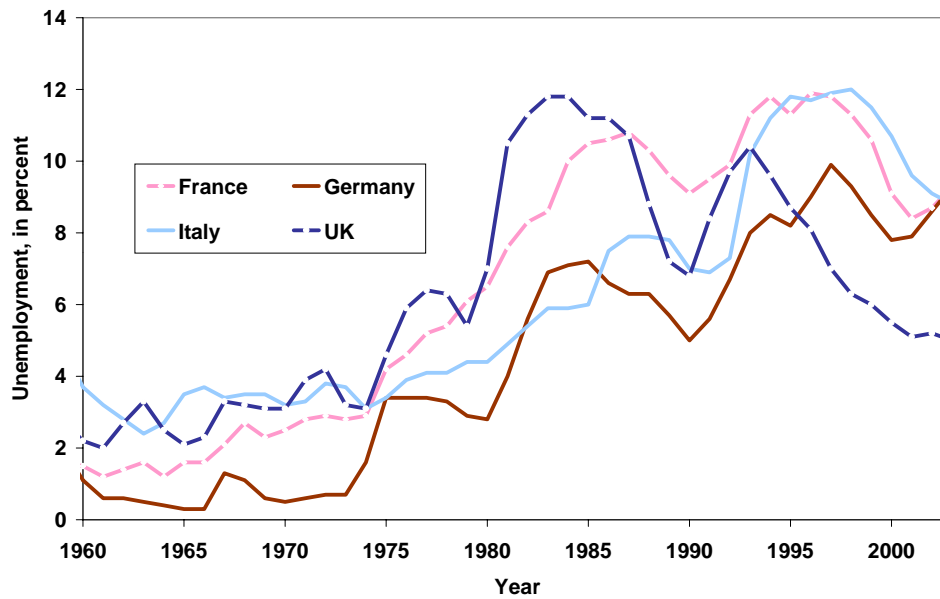
Chart 1 shows the increasing share of world GDP of three developing economies: China, India, and Korea. China has more than quadrupled its share from 1980 (roughly 3.2 percent) to 2005 (projected as roughly 13.5 percent). Korea and India have roughly doubled their shares. Many of the people who warn most loudly about job losses due to outsourcing claim that such countries are becoming more competitive, and are reducing America’s share of world output, or even weakening the U.S. economy in absolute terms. Again, the data do not support this claim.

**Chart 2a Civilian Unemployment Rate
(approximating U.S. concepts)**



Source: International Monetary Fund, World Economic Outlook Database, April 2004

**Chart 2b Civilian Unemployment Rate
(approximating U.S. concepts)**



Source: International Monetary Fund, World Economic Outlook Database, April 2004

First, China, Korea, and India have boosted their share of world GDP because their economic output has grown much faster than that of the EU-15, Japan, or the former Soviet Union, whose shares have been falling. The U.S. share has been steady.

Second, the very fast growth of China and India has been due to their very low starting points and to dramatic changes in their economic policies which enabled them to modernize and advance rapidly. Korea was further along to begin with, and improved on a generally favorable set of economic policies.

China and India were heavily state controlled economies with high barriers to international capital flows and trade. Both have loosened the rigid government controls on their economies, increased their reliance on market forces and private enterprise, and reduced their protectionism. In short, they have thrown off their self-imposed shackles and joined the modern world, and are rapidly making up for their self-inflicted backwardness. This burst of catch-up has boosted their growth rates well above those of more developed nations, especially those with relatively high tax and regulatory burdens, and of the Soviet Union, which has had a rougher transition to a market economy.

Second, economic growth is not a zero sum game. Gains in Asia have not slowed growth in Europe and Russia, and have not damaged the growth rate of the United States. The growth of Asia has done more than provide additional goods and services for the United States to buy. The higher incomes of Asia have also opened new markets for products from the United States and other nations, which in turn have benefited from the Asian growth. The fact that the U.S. share of total world output remained stable and constant shows that the United States is taking advantage of the new global economy and that our markets are adapting to the new challenges and opportunities offered by the Asian tigers.

The United States has had over two decades of good growth, matching the global average. The steady growth and the flexible labor market in the United States have translated into strong employment

gains. Measured over the business cycles (cyclical peak to peak), the United States has enjoyed a return to the generally lower levels of unemployment of the 1960s. The unemployment picture in the United States compares very favorably with that of the rest of the developed world.

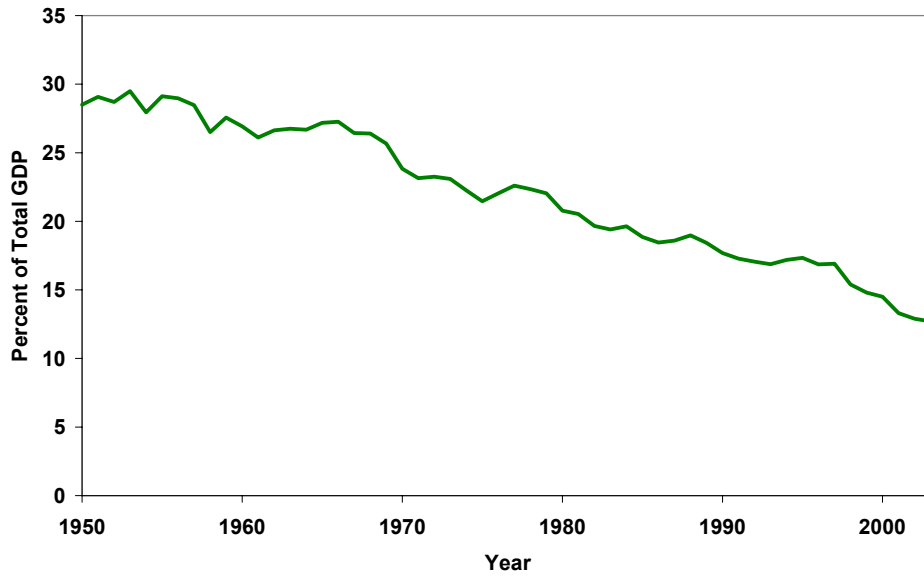
Unemployment rates. Charts 2a and b show the civilian labor unemployment rates, in percent, of the G7 nations – the United States, Canada, Japan, France, Germany, Italy, and the United Kingdom. The U.S. unemployment rate is improving over time relative to most other G7 nations. Business cycles affected all these rich countries. On the other hand, there has been no significant long-term trend in the U.S. unemployment rate, while several other G7 members have experienced a very pronounced long-term trend toward higher unemployment rates.

Whereas the United States had nearly the highest unemployment rate among G7 members in 1960, now it has one of the lowest. Over the period, Japan's unemployment rate has climbed from only about two percent to nearly the U.S. rate. Italy, France, and Germany now have unemployment rates almost double the U.S. rate. The U.K., which has a tax and regulatory climate somewhat closer to that of the U.S., has a lower unemployment rate than the continental nations. In brief, the U.S. has performed much better than most other G7 members in keeping unemployment under control. Recent and current U.S. unemployment rates are not reasons for alarm.

A Special Focus of Concern: Manufacturing. Manufacturing was particularly hurt by the investment slump that triggered the economic downturn, but there is now a cyclical rebound in progress. Nonetheless, there is a longer term downtrend in manufacturing as a share of the economy that should be examined. Chart 3 shows that value added by the manufacturing sector in the United States has been declining as a share of GDP for fifty years.

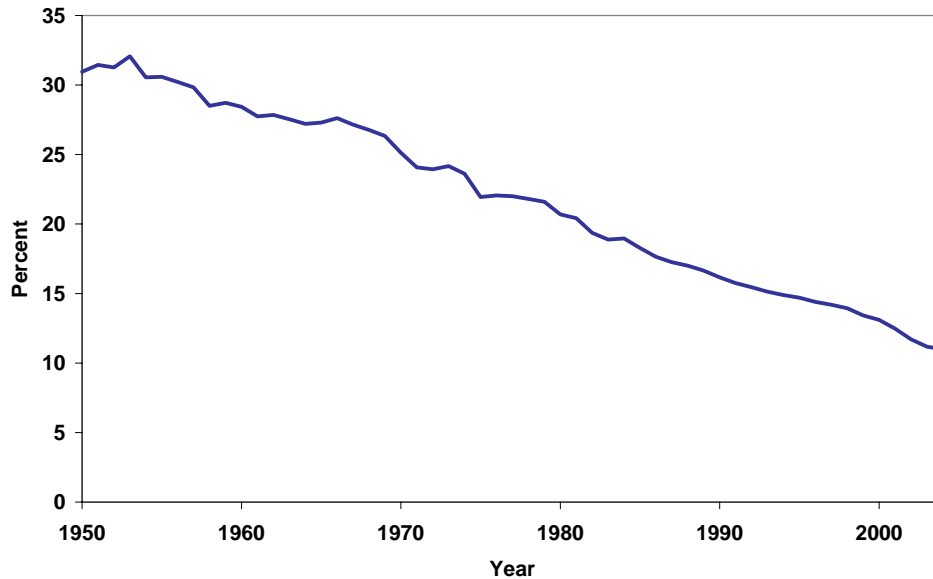
Chart 4 shows that manufacturing sector's share of U.S. nonfarm employment has also been declining over the past fifty years. Is U.S. manufacturing on the ropes?

Chart 3 Value Added by Manufacturing Sector in the United States (Percent of GDP)



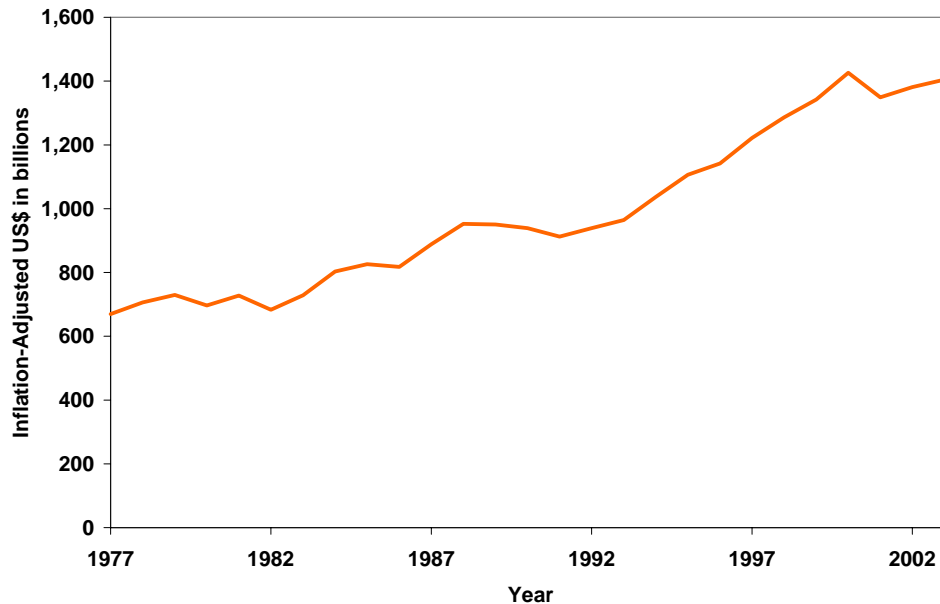
Source: U.S. Bureau of Economic Analysis, Historical SIC Data for 1950-1997 and NAIC Data for 1998-2003, accessed via http://www.bea.gov/bea/dn2/gdpbyind_data.htm.

Chart 4 Manufacturing Employment as Percent of Total Nonfarm Employment



Source: Calculated using U.S. Bureau of Labor Statistics data for total manufacturing employment and total nonfarm employment, both accessed via <http://data.bls.gov/cgi-bin/surveymost?ce>.

Chart 5 Real Value Added by Manufacturing Sector in the United States (2000 dollars)



Source: U.S. Bureau of Economic Analysis, Historical SIC Data for 1950-1997 and NAIC Data for 1998-2003, accessed via http://www.bea.gov/bea/dn2/gdpbyind_data.htm; authors' calculations to determine real values.

These declines in manufacturing's share of GDP and employment have been cited as evidence that the United States is losing its economic vigor. These declines are real. The interpretation that the United States is on the economic ropes is wrong.

Chart 5 helps put the issue in perspective. It shows the real value added by the U.S. manufacturing sector to the economy (in 2000 dollars).

The real output of U.S. manufacturing is clearly rising over time. The rest of the economy is growing even faster, however, which explains why manufacturing's share is becoming smaller relative to the overall economy. Nor is the industry being shipped overseas. In fact, from 1995 to 2002, U.S. manufacturing output climbed nearly 25 percent, roughly in line with global manufacturing output, which increased by 30 percent over the same period, according to an Alliance Capital Management study³ on global manufacturing trends.

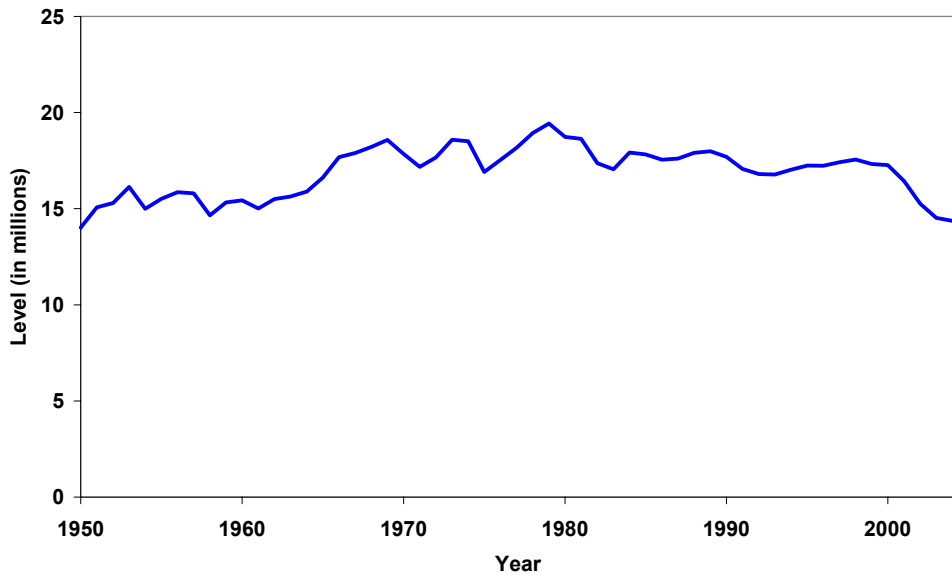
This evidence suggests that outsourcing is not primarily responsible for the decline in manu-

facturing jobs — rapid productivity growth is. Companies and factories are incorporating new technologies and systems that produce more goods with fewer workers.

Just as looking at U.S. manufacturing's declining share of GDP masks the sector's growing real output, looking at the declining share of manufacturing employment is similarly misleading. As Chart 6 illustrates, the *level* of US manufacturing jobs in the economy has been quite constant for the past fifty years, with very minor fluctuations. The 2001 recession caused a downturn in the absolute number of manufacturing jobs, but manufacturing jobs have been increasing during recent months as the recovery has gained steam, although they still have a way to go. Manufacturing jobs are losing their relative share in total employment because the number of jobs is getting larger in other sectors. The number of employees in manufacturing has been quite stable, even with higher productivity growth in manufacturing than in other sectors.

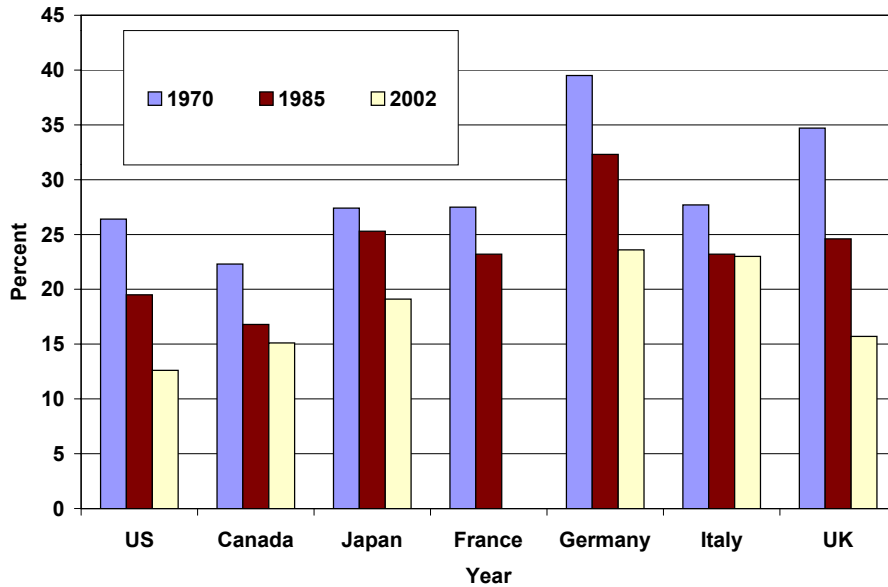
If outsourcing merely represented a transfer of manufacturing production and employment from the

Chart 6 US Manufacturing Employment (Annual Averages)

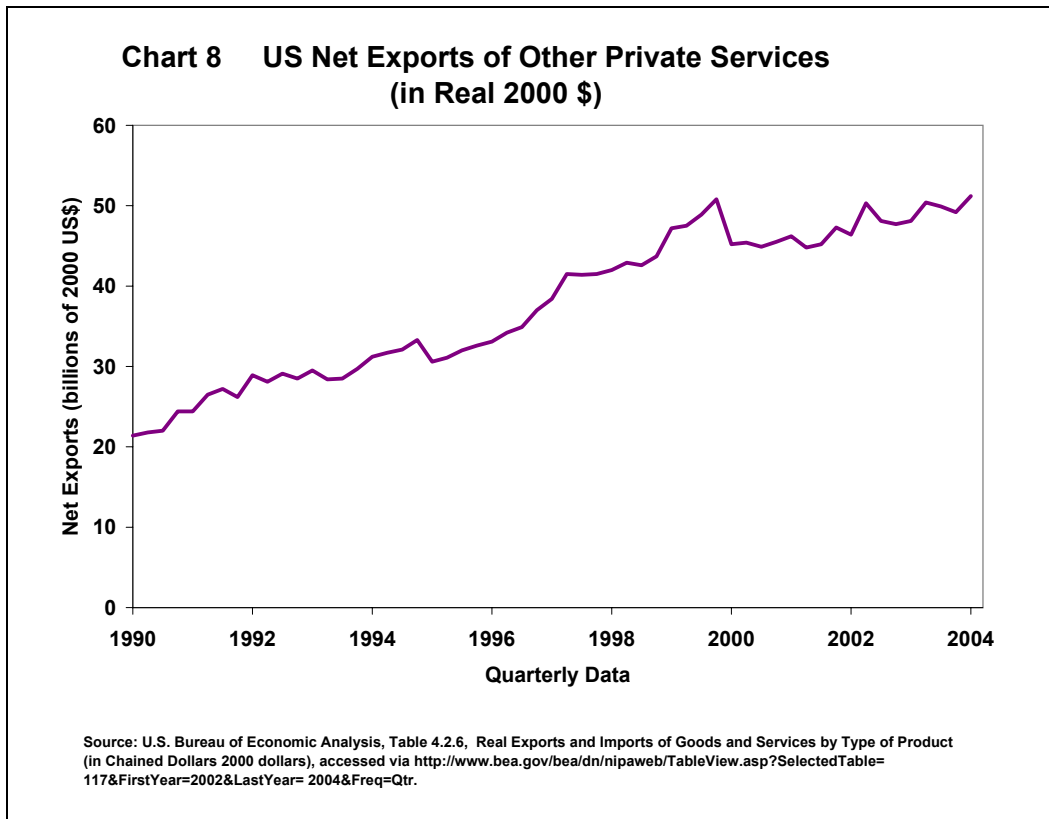


Source: Calculated using U.S. Bureau of Labor Statistics data for total manufacturing employment and total nonfarm employment, both accessed via <http://data.bls.gov/cgi-bin/surveymost?ce>.

Chart 7 Percent Distribution of Civilian Employment in Manufacturing Across Countries



Source: U.S. Bureau of Labor Statistics, Comparative Civilian Labor Force Statistics, Ten Countries (1959-2003), accessed via <http://bls.gov/fls/home.htm>. (No data for France in 2002.)



United States to foreign locations, we would expect to see an increase in manufacturing jobs in developing nations. Again, the data say otherwise. According to the aforementioned Alliance Capital Management study, China experienced a 15 percent decrease and Brazil a 20 percent decrease in manufacturing employment from 1995 to 2002, compared to only an 11 percent decrease in the United States. Indeed, around the world, we observe a decline in manufacturing's share of civilian employment as modern production methods are adopted around the world and productivity rises in nation after nation.

Chart 7 shows the percentage of civilian employment working in the manufacturing sectors of the G7 nations. All G7 nations are experiencing declines in the share of total employment occurring in manufacturing. In all cases, the primary explanation is the same: rapid productivity growth is enabling fewer workers to produce far more output.

There are three key points to bear in mind. First, technology and high productivity, not outsourcing or global trade, is responsible for the

decline in manufacturing employment. Second, manufacturing is not a languishing sector. Its output is increasing rapidly. Third, the trends in manufacturing are not unique to the United States, but are being experienced worldwide.

There is no doubt that the manufacturing sector is undergoing remarkable changes in its operation due to new technologies that yield higher productivity. The changes do displace some workers, and those workers are hurt, at least in the short term. However, the steadiness of the U.S. unemployment rate over time indicates that the decrease in traditional factory jobs is counterbalanced by the creation of new jobs elsewhere in the economy. A protectionist attitude would not correct the problem; it would only hurt the economy and the manufacturing sector even more.

Growth of Trade in Services. Outsourcing of services has been the source of recent concern. Many people are afraid that the United States is shipping abroad traditionally safe and good "white collar" jobs. There has also been special worry over

the "exporting" of information technology (IT) and computer service positions, an area in which many people thought that the United States would enjoy domination for all time.

As with manufacturing, the data indicate that concerns over the outsourcing of services are overblown. Chart 8 shows U.S. net exports of other private services from 1990 to 2004 (quarterly data). The U.S. Bureau of Economic Analysis (BEA) has labeled the imports of "other private services" as the NIPA component most relevant to outsourcing.⁴ "Other private services" includes business, professional, and technical services, the latter being important in the outsourcing debate. This graph shows that *the United States enjoys a large and increasing surplus in the trade in services*. This means that most service jobs are staying in the United States, and, in fact, that the United States is "insourcing" jobs by selling more services to foreign buyers. The data indicate that the U.S. is still maintaining its leadership in the service sector.

Conclusion

Many people are worried that outsourcing is a sign of reduced U.S. economic competitiveness in the world economy. There are claims that the U.S. is losing its economic edge as emerging countries get stronger.

There are four key points that should put this worry to rest. First, the U.S. share of total world

GDP has been steady and has not been declining, compared to other rich economies such as those of Europe and Japan. While developing economies such as those of China and India have been quickly increasing their shares, they are doing so at the expense of Europe and Japan – not the United States. Second, over the years, there has been generally downward trend in the U.S. unemployment rate while many of the G7 nations have experienced a notable increase in their unemployment rates, which are much higher than in the United States. Third, it is true that certain sectors of the U.S. economy are coming into contact with foreign competition for the first time. This may alter the mix of traded goods and reallocate some of the pain in adjusting to the numerous changes in the global economy. However, it does not alter the fundamental position of the U.S. economy on the world stage, nor does it suggest there is any diminution of the net gains from trade. Fourth, the manufacturing sector is still robust. Its real output is increasing. The declining trend of manufacturing jobs as a percent of total employment in the United States is simply a part of a global phenomenon stemming from rapid growth of productivity in the manufacturing sector.

Stephen J. Entin
President and Executive Director

Norman P. Ho
Intern (Summer 2004)

Endnotes

1. The EU-15 consists of the 15 members of the European Union before its recent expansion.
2. The 21 percent figure is based on the purchasing power parity method of comparing international incomes and output. Comparisons based on the exchange rates of the national currencies show the United States to be at about 30 percent of world output. The latter method puts more weight on internationally trade goods, the former may place more weight on the cost to local citizens of non-traded goods and services. Though different in the levels of shares of the major nations, both methods show similar patterns of change over time, and show the United States as maintaining or improving its share of world output.
3. The Alliance Capital Management Study here was cited in Daniel W. Drezner, "The Outsourcing Bogeyman," *Foreign Affairs*, 83.3 (2004), pp. 22-35.
4. United States Department of Commerce, Bureau of Economic Analysis, "Information on Gross Domestic Product and Outsourcing," available <http://www.bea.gov/bea/dn/GDP_outsourcing.pdf>.