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Outsourcing: Meeting the Challenges Without Destroying the Benefits

Executive Summary

- Recent media attention has focused on the debate over the implications of U.S. companies "outsourcing" manufacturing, and now service, functions to foreign companies.

- Referred to by a variety of terms – "outsourcing," "offshoring," and "worldwide sourcing" – economists widely agree that outsourcing is an important component of a free-market economy, holding significant benefits for businesses apart from mere labor-cost saving.

- Foreign-owned corporations such as Siemens, Toyota, and Novartis are also taking advantage of outsourcing to bring valuable jobs *into* the United States, amounting to 6.4 million American jobs in 2000.

- Despite its economic benefits, outsourcing has an inescapable consequence – jobs previously performed in the United States are moving to developing nations.

- In this situation, the government has a role in addressing these dislocations by helping the individual worker develop the skills for available jobs.

- The Senate should consider both short-term and long-term solutions:

  - Most immediately, dislocated workers need help finding new employment. A variety of public- and private-sector programs are already available, and additional options exist to expand such worker assistance.

  - More broadly, the Senate must address the underlying issues in the U.S. business environment that are motivating American companies to embrace worldwide sourcing and hindering their ability to create new jobs in the United States. These issues are concentrated in the areas of employee-benefits costs, tax rates, regulatory-compliance burdens, litigation costs, and energy prices.

Introduction

While introducing the 2004 *Economic Report of the President* last month, Greg Mankiw, chairman of the Council of Economic Advisors, ignited a debate about U.S. companies engaging foreign companies to handle certain business functions.[1] No matter what term is used – "outsourcing," "offshoring," and "worldwide sourcing" – this is not a new concept. The current debate over outsourcing[2] stems in large measure from the fact that the trend has moved beyond the manufacturing sector and is now affecting white-collar, service-sector positions.[3]

Advocates of outsourcing argue that it is an important component of the free market in a global economy, and that it holds significant long-term economic benefits for individual businesses, consumers, and the U.S. economy. Opponents largely focus on the short-term effects of outsourcing – that U.S. workers have been displaced by workers in China, India, and the Philippines.

To stem this economic trend, opponents call for isolationist legislation. Not only is this ill-advised, but it denies the U.S. economy the ability to build on the opportunities that outsourcing represents. Moreover, by treating the symptom rather than the cause of the problem, it distracts Congress from addressing the fundamental reforms necessary to make our economy more competitive without having to outsource so many jobs. The immediate challenge is to address displaced workers' pressing need for re-employment in a manner that does not hinder the economic vitality of American businesses or their ability to respond to the global marketplace.

Outsourcing: What Is it and How Did it Arise?

By one account, outsourcing is as old as the corporation: "One business arranges with another to make a widget or provide a certain service that it cannot do itself, or does not wish to do, so that it can focus on the parts of the business it does best."[4] In essence, outsourcing is simply the subcontracting of work by one company to another.

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[1]"I think outsourcing is a growing phenomenon, but it's something that we should realize is probably a plus for the economy in the long run," Remarks by Greg Mankiw, Chairman, Council of Economic Advisors, as reported in *The New York Times*, February 10, 2004.

[2]This paper will use the term "outsourcing" to describe the movement of business functions abroad. Its recent pejorative connotation notwithstanding, this term has long been used to encompass both the positive and negative implications of this concept.

[3]Federal Reserve Chairman Alan Greenspan, "The critical role of education in the nation's economy," remarks delivered at the Greater Omaha Chamber of Commerce 2004 Annual Meeting, February 20, 2004, available at http://www.federalreserve.gov/boarddocs/speeches/2004/200402202/default.htm ("concerns have arisen that an increasing number of our better-paying white-collar jobs will be lost to outsourcing, especially to India and China. Many of these jobs are in the service sector, and they were previously perceived as secure and largely free from the international competition long faced in the manufacturing sector.").

[4]Knowledge@Wharton, "It's Time to Talk Sense about Outsourcing," The Wharton School, University of Pennsylvania (February 25-March 9, 2004 Issue) – http://knowledge.wharton.upenn.edu/.

In the 20th century, outsourcing took on its international aspect: at first, it was through the outsourcing of American manufacturing functions, and most recently, it has been through the outsourcing of service activities, including a growing number of white-collar positions.[5] Outsourcing has also become an increasingly important aspect of U.S. trade, with American firms importing significant amounts of goods, and now services, into the United States.[6]

The Economic Reality of Outsourcing

In too many cases, an economic analysis of outsourcing begins and ends with the cost savings that businesses achieve by moving a production facility to Malaysia or a call center to India. Few would dispute that businesses are able to use their limited capital resources in a more cost-effective manner when they outsource labor. But this fact is only one piece of the economic picture.

There is sufficient evidence to show that outsourcing of manufacturing operations has resulted in lower-cost goods for U.S. customers. For example, globalized production and international trade made information technology, such as computers, "some 10 percent to 30 percent less expensive than it would have been."[7] As a result of such inexpensive computer hardware, outsourcing boosted U.S. productivity growth "from 2.5 percent to 2.8 percent a year from 1995 to 2002, a gain that in turn added at least $230 billion to the country's total output of goods and services."[8]

Outsourcing of services holds similar potential to affect the U.S. economy positively. Dramatic improvements in technology and telecommunications, such as the Internet and fiber optics, have made the outsourcing of service jobs feasible. As a result, American companies can now provide 24-hour-a-day service to a worldwide customer base, and health-care institutions utilizing radiologists in countries such as India can improve efficiency and reduce the costs of health care delivered in the United States.[9]

An added benefit is that outsourcing creates new markets for U.S. exports. Case in point: A *New York Times* columnist who recently visited a call center in Bangalore, India, discovered that the computers were all from Compaq, the software was from Microsoft, the phones were from Lucent, the

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[5]Outsourcing of *service* jobs was well underway during the 1990s, but its effects were masked by "the economic boom and abundant job growth" of that decade; hence it received little public attention. Carolyn Lochhead, "*Outsourcing: Fed Chairman Warns U.S. Against 'Protectionist Cures,'" The San Francisco Chronicle*, February 21, 2004 (citing economist Catherine L. Mann).

[6]Carl Steidtmann, "The Macro-Economic Case for Outsourcing," Deloitte Research, 2003, pp. 2-4.

[7]Catherine L. Mann, "Globalization of IT Services and White Collar Jobs: The Next Wave of Productivity Growth," *International Economics Policy Briefs*, December 2003, at p. 3.

[8]Eduardo Porter, "The Bright Side of Sending Jobs Overseas," *The New York Times*, February 15, 2004 (citing Mann). In addition, such lower-cost technology is likely to enable U.S. businesses, including many small and medium-sized businesses, health services, and construction companies that have not invested in productivity-enhancing technology, to become more efficient, which translates directly into job creation and retention, not to mention continued productivity gains in this country. Mann at pp. 4-6.

[9]*The Economist*, "The great hollowing-out myth," February 19, 2004.

air-conditioning was by Carrier, and "even the bottled water is by Coke, because when it comes to drinking water in India, people want a trusted brand."[10]

Most significantly, outsourcing allows a business to focus on its core competencies – what it does best. A company that is able to subcontract its standardized functions, like call centers and back-office operations, is thus able to unleash its resources on the critical aspects of the business – creating innovative new products and services. It stands to reason that such an expansion of core competencies inevitably requires additional employees who will need to be more skilled (and who thus will receive higher wages) than the standardized-function positions moved abroad.[11] Moreover, as part of the core function of the business, these new positions are likely to remain in the United States.[12]

Putting this all together, it is estimated that a dollar spent on outsourcing creates $1.45 to $1.47 in the global economy, with $1.12 to $1.14 returning to the U.S. economy.[13]

The Flip Side of Outsourcing: Foreign Firms Moving Jobs *into* the United States

A flip side to the consequences flowing from outsourcing is that foreign firms are also using this practice to move jobs *into* the United States, which provides additional benefits to U.S. workers and the economy.

Through outsourcing in the manufacturing industry, and now the service sector, U.S. companies have been gradually shifting from operations that require a large workforce to operations that are heavily dependent on technology. This shift has made America "an attractive location for the siting of plants matching advanced technology and equipment with highly skilled labor and modern research."[14] Examples of this trend abound:

- Germany's Siemens AG employs roughly 70,000 American workers, making it one of the top 100 employers in the United States. With operations in all 50 states, Siemens uses its American facilities and workforce to develop products, systems, and services in the areas of information and communications, automation and control, power, medical solutions, transportation and lighting.[15]

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[10]Thomas L. Friedman, "What Goes Around . . . ," *The New York Times*, February 26, 2004.

[11]Mann at p. 6.

[12]Adam Kolawa, "Outsourcing is Not the Enemy," *Wall Street Journal*, February 24, 2004.

[13]Diana Farrell, "Offshoring: Is it a Win-Win Game?" McKinsey Global Institute, August 2003 at pp. 7-9. The author estimates that the dollar spent on outsourcing will result in 58 cents of company cost savings, 5 cents of additional U.S. goods and service purchased, 4 cents for repatriated earnings (when the outsourcing is to the subsidiary of a U.S. company), and 45 to 47 cents from new jobs created by the outsourcing company).

[14]Michael L. Walden, "A potent 'insource' of U.S. jobs," *The News & Observer* (Raleigh, North Carolina), February 2, 2004.

[15]Siemens USA company website, http://www.usa.siemens.com/index.jsp.

- Japan's Toyota employs more than 20,000 Americans in its U.S.-based manufacturing divisions alone. Its American workers are located at vehicle- and parts-manufacturing plants in Kentucky, Indiana, California, West Virginia, Missouri, and Alabama.[16]

- Switzerland's Novartis AG employs nearly 20,000 Americans in its pharmaceuticals, consumer health, generics, eye-care, and animal-health divisions. The company has significant operations in New Jersey, Georgia, and North Carolina, as well as the Novartis Institutes for BioMedical Research in Cambridge, Massachusetts.[17]

- Japan's Honda employs more than 24,000 American workers, with more than 12,000 employees in its five Ohio manufacturing plants alone. Honda also has facilities in South Carolina, North Carolina, Alabama, California, Michigan, and Colorado.[18]

Other examples can be found right on U.S. borders. Mexican companies have created 145,000 U.S. jobs in manufacturing and services.[19] In all, the most recent Census Bureau estimates indicate that more than 6.4 million American jobs in 2000 were provided by U.S. subsidiaries of foreign companies.[20]

The Cost: Dislocated Workers

While outsourcing is a normal aspect of economic development that economists widely agree will benefit the U.S. economy as a whole, it is not without its costs for individuals– jobs previously performed in the United States are moving to developing nations. According to data from the Bureau of Labor Statistics (BLS), between March 2001 and January 2004, the United States lost a net 2.625 million manufacturing jobs. During the same period, the nation actually gained a net 376,000 service-sector jobs.[21] But the gains are small comfort to those individuals who find themselves out of work.

Government data on the number of jobs in each sector that have moved abroad is not readily available since such information is not currently compiled by the BLS.[22] According to one private-sector research estimate, however, 882,000 manufacturing jobs were lost in the United States due to outsourcing between March 2001 and January 2004. In contrast, 240,000 service-sector jobs were moved abroad during the same interval.[23]

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[16]Toyota company website, http://www.toyota.com/about/operations/manufacturing/index.html.

[17]Novartis 2003 Annual Report and company website, http://www.novartis.com/annualreport2003/.

[18]Honda company website, http://www.hondacorporate.com/america/.

[19]Joel Millman, "Foreign Firms Also Outsource–To the U.S.," *The Wall Street Journal*, February 23, 2004.

[20]U.S. Census Bureau, *Statistical Abstract of the United States*, 2003, p. 806.

[21]BLS data on total number of employees in manufacturing and service-providing sectors (January 2000 through December 2003).

[22]The absence of reliable data also makes it difficult to quantify the effects that outsourcing have by state and region of the United States. It stands to reason, however, that states with a large manufacturing presence or a large number of service-sector businesses will be disproportionately affected.

[23]Data provided by Mark Zandi, Ph.D., updating "Off-Shoring Threat," published by Economy.com, October 24, 2003. An estimated 70 percent of U.S. service jobs – like retail, restaurant, hotel, and personal-care services – are geographically fixed and not in danger of outsourcing. Farrell at p. 5.

Looking forward, a widely cited study by Forrest Research estimates that from 2000 to 2015, some 3.3 million service jobs will be moved offshore.[24] These jobs are expected to be concentrated in the following service areas: office and administrative, computer and mathematical, business and financial, management, and sales.[25]

A Course of Action

Republicans believe that our economic system must make it as easy as possible for employees to move from one job to another, especially in areas where job losses occur. While economists expect that re-employment will eventually offset the service jobs lost, there is likely to be a time delay between job loss and re-employment, and the new jobs may require different skills or even mobility. Senators must be cognizant of the effects that large-scale dislocations have on American workers when corporations utilize outsourcing. The challenge is to address these dislocations in a way that offers hope to the individual worker without hindering the benefits that outsourcing – and free trade – hold for the nation.

It makes sense to focus on the strengths of our society and its inherent flexibility when responding to outsourcing's dislocations. This objective takes on a short-term and long-term perspective. Most immediately, the government must deal with the human aspect by helping the dislocated workers find new employment opportunities through training and education. More broadly, Congress and the Administration must address the underlying issues in the U.S. business environment that are motivating American companies to embrace worldwide sourcing and hindering their ability to create new jobs in the United States.

The Near Term: Better Training and Education

The first priority for displaced workers is finding a new job. The United States has tremendous resources – both public and private – available to help achieve that goal. According to the Government Accounting Office (GAO), there are 44 federally funded programs that provide employment and training services. In 2002, Congress spent more than $12 billion on employment and training activities, aiding 30 million Americans with job-search assistance, employment counseling, basic adult literacy, vocational training, and the like.[26]

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[24]John C. McCarthy, "3.3 Million US Service Jobs to go Offshore," *Whole View TechStrategy*, Forrester Research, November 11, 2002. To put this estimate in perspective, the job turnover (or churn) in the U.S. produces between 7 and 8 million job losses, and generally a larger number of job gains, every *quarter*. BLS data on seasonally adjusted gross job losses and gains (1995-2003). This quarterly figure is more than twice the 3.3 million jobs estimated to be lost over the next *15 years* due to outsourcing. It is also difficult to determine the extent to which these jobs would eventually be eliminated through automation whether or not they are moved abroad. Kirkegaard at p. 13.

[25]McCarthy at p. 4; Jacob F. Kirkegaard, "Outsourcing – Stains on the White Collar?," Institute for International Economics, February 2004, at p. 4.

[26]GAO, *Multiple Employment and Training Programs: Funding and Performance Measures for Major Programs* (GAO-03-589), April 2003.

The Trade Adjustment Assistance (TAA) Act was expanded in 2002 to provide even more generous assistance for workers who lose their jobs due to import competition or shift of production to another country. TAA now provides job training assistance, extended unemployment compensation (up to 130 weeks of unemployment benefits in some cases), an allowance of $1,250 for job search in another area, an additional allowance of $1,250 for job relocation, a tax credit for 65-percent coverage of a health-insurance premium, and even wage insurance.

In order to qualify for TAA benefits, displaced workers or their employer must apply to the Department of Labor (DOL). In 2001, more than 160,000 individuals received benefits under the program. While displaced manufacturing workers are the primary recipients of TAA benefits, secondary workers are also eligible, and so displaced service-sector workers could be covered in certain circumstances. In FY 2004, some $1.3 billion will be spent on TAA benefits.

Similarly, Congress has invested almost $27 billion in training under the Workforce Investment Act (WIA) since it went into effect in 2000 to replace the old Job Training Partnership Act. WIA's hallmark is its One-Stop Career Center, which provides job seekers with a single location to access a host of resources, including unemployment insurance, job market information, job training, and job search assistance.

The Labor Department also disburses National Emergency Grants (NEG) to groups of workers who experience sudden job losses. From 2000 to 2003, DOL granted $614 million in NEG grants to 48 states for employment and job training assistance to workers who lost their jobs due to layoffs, plant closings, or import competition.[27]

In addition, most states have adopted worker-training programs of their own. Almost half of all states fund such programs through employer taxes. In 2002, states spent $278 million to address their specific workforce needs, such as shortages of health-care workers.[28]

With these existing programs, the challenge is to ensure that they are meeting the needs of workers affected by outsourcing. Further options include the following:

***Workforce Investment Act (WIA) Improvements* –** WIA's program authorization expired in 2003. The Senate should move forward on needed improvements to the WIA program, such as encouraging the involvement of local businesses in local job-training decisions and promoting the use of technology to improve access to services. Despite the Senate's passage of a bipartisan WIA reauthorization bill (S. 1627) last year, the Senate Minority leadership has blocked the bill from going to conference, holding up vital improvements to a program that spends more than $5 billion a year on job training and other valuable assistance for workers dislocated by outsourcing.

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[27]GAO, *National Emergency Grants: Services to Dislocated Workers Hampered by Delays in Grant Awards, but Labor is Initiating Actions to Improve Grant Award Process* (GAO-04-222), November 2003.

[28]GAO, *Workforce Training: Almost Half of States Fund Employment Placement and Training Through Employer Taxes and Most Coordinate with Federally Funded Programs* (GAO-04-282), February 2004.

Jobs for the 21st Century Initiative **–** In his 2005 Budget Proposal, President Bush proposed a 5.6-percent increase in funding for the job training programs administered through the Department of Labor, and he proposed a new program specifically targeted to help current and future workers receive the skills they need to succeed in highly skilled industries. Named the Jobs for the 21st Century initiative, its total estimated cost is $500 million per year.[29]

Personal Re-employment Accounts – President Bush also renewed his call for Personal Re-Employment Accounts to provide unemployed workers with up to $3,000 to use for job training, child care, transportation, moving costs, or other expenses associated with finding a new job. Each worker would be allowed to keep excess funds if a new job is found within 13 weeks. The total estimated cost of this pilot program is $50 million for 2005.[30]

In addition to these government initiatives, the private sector should apply more resources and ingenuity to retrain workers. While U.S. businesses' spending on training increased slightly in 2003 to 2.2 percent of payroll, it is still lagging behind many of their foreign competitors.[31] Yet, there are numerous examples of U.S. employers who make training a priority – and benefit from it. For example, IBM recently spent $200 million to train 100,000 employees for jobs that may otherwise have been outsourced abroad.[32]

In the end, the success of any effort to re-employ workers depends largely on the flexibility of the individual worker. This country has the benefit of a very mobile society – both geographically as well as educationally – which bodes well for the prospect that most dislocated workers will move into new and better jobs.[33]

Longer-term: Structural Problems in the U.S. Business Environment

Much can be done to foster the inherent flexibility of U.S. businesses, not only to re-employ displaced workers, but also to reduce the motivation to turn to outsourcing. That undertaking requires the government to mitigate certain factors that constrain job growth within the United States.

For U.S. businesses, five cost factors – employee-benefits, taxation, regulatory compliance, litigation, and energy – play a significant role when considering the option of moving manufacturing or service functions abroad. According to a recent study, these costs place American businesses at an 18-percent competitive disadvantage as compared to the nation's nine largest trading partners.[34] If policymakers are serious about reducing the number of displaced workers, these five cost factors, discussed below, must be quickly addressed.

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[29]Budget of the United States Government (President's Budget Proposal), FY 2005, February 2, 2004.

[30]President's Budget Proposal.

[31]American Society for Training and Development, "2003 State of the Industry Report," 2003.

[32]Lisa DiCarlo, "IBM Chief's $200 Million Bet," *Forbes*, October 30, 2003.

[33]Peter Drucker, Brent Schlender, "Peter Drucker Sets Us Straight," *Fortune*, January 12, 2004.

[34]Jeremy A. Leonard, "How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness," Manufacturers Alliance/MAPI (study prepared for The Manufacturing Institute of the National Association of Manufacturers), December 2003, at pp. 21-22.

Employee-benefit costs – For U.S. businesses to recruit and retain top-quality employees, they must offer competitive health-care and pension benefits. Yet, these benefits present some of the most significant costs to U.S. businesses. According to a PricewaterhouseCoopers' study, "In 2000, the share of [Gross Domestic Product (GDP)] devoted to health care was 13.2 percent (up from 8.8 percent in 1980) and, based on official government forecasts, that share will continue to rise and reach 16 percent of GDP in the next five years."[35] Looking at all employee benefits, the U.S. has one of the highest costs as a percentage of total compensation – 5.5 percentage points more than the United States' major trade competitors, on a trade-weighted basis.[36]

The employer-sponsored health insurance system dates back to the 1940s and is the dominant method for providing individuals with health-care coverage in the United States.[37] However, a growing number of small- and medium-sized employers find the cost of providing health insurance is prohibitively high, leaving many individuals and their families without access to coverage.

A better approach is to create individual incentives for coverage. Congress took one step toward that goal by creating Health Savings Accounts (HSAs).[38] These accounts help employees pay for their health expenses in conjunction with a high-deductible (less expensive) health-insurance policy, taking some pressure off employer-provided health-insurance plans. More importantly, HSAs provide portability, allowing employees to take their coverage from job to job; this ultimately will help take pressure off of employers. Clearly, more needs to occur, specifically with regard to addressing the underlying cost of health care, if American businesses are to remain competitive.

The cost of pension benefits has largely been addressed through the shift from defined- benefits plans to defined-contribution arrangements, like 401(k) plans. A significant number of large U.S. companies still offer defined-benefit retirement plans. However, due to the demise of the 30-year Treasury bond, they are currently having to redirect scarce capital to their pension plans in order to comply with pension regulations. Moreover, companies have turned to "cash balance" plans in an effort to moderate the cost of funding defined benefit plans, while enabling participants to accumulate benefits on a more even basis than a traditional pension plan. In light of these two issues, Congress could make significant strides in reducing this burden on American businesses by completing action on the pension reform legislation[39] and allowing the Internal Revenue Service to provide guidance to businesses converting to cash-balance plans.[40]

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[35]PricewaterhouseCoopers, "The Factors Fueling Rising Healthcare Costs," April 2002, at pp. 1-2.

[36]Leonard at p. 13.

[37]Joint Economic Committee, "How the Tax Exclusion Shaped Today's Private Health Insurance Market," December 2003.

[38]H.R. 1, "Medicare Prescription Drug, Improvement, and Modernization Act of 2003," Public Law 108-173, December 8, 2003.

[39]H.R. 3108, "Pension Funding Equity Act," passed the Senate on January 28, 2004, and is awaiting a conference with the House.

[40]As a result of efforts by Democratic Senators, provisions were added to the Consolidated Appropriations Act, 2004, Public Law 108-199, prohibiting the Internal Revenue Service from issuing final guidance on the conversion of defined-benefit pension plans to cash-balance plans.

***Taxation* –** Taxes are a multifaceted strain on American businesses, which in the end force them to redirect capital away from job-creating investments in the United States. This nation has the second highest corporate tax burden in the world – second only to Japan. As a result, it is estimated that U.S. taxes reduce the cost competitiveness of U.S. corporations by 5.6 percentage points, based on the weighted average of America's major trade competitors.[41]

In addition to its high, direct cost on U.S. taxpayers, the American tax system also imposes a significant "uncertainty" cost to businesses. The frequent changes to the Internal Revenue Code, coupled with the expiration of the changes made in 2001 and 2003, leave U.S. companies with no predictable tax rules on which to base their long-term investments in equipment and human resources.[42] Similarly, the World Trade Organization's rulings against the U.S. Foreign Sales Corporation and Extraterritorial Income (FSC/ETI) tax regimes adds to the uncertainty for U.S. companies with operations abroad.

Reducing the tax burden on U.S. taxpayers is an ongoing challenge. For businesses that operate as a sole proprietorship or pass-through entity, the individual tax-rate reductions in the 2001 and 2003 tax acts[43] were enormous steps forward because these small business owners and entrepreneurs pay taxes at the individual, rather than the corporate, level. As a result, it is no surprise that these business taxpayers account for more than two-thirds of the top-bracket income tax returns, and they receive 79 percent of the top-bracket tax relief under these bills.[44] The task remains, however, to address the expiring nature of those tax reductions to provide a degree of certainty to the business environment.

Moreover, the Senate must consider the high corporate tax rate that strains the competitiveness of U.S. multinational corporations. Replacing the FSC/ETI tax regimes is a singular opportunity to achieve that goal.

***Regulatory compliance costs* –** The inherent cost of complying with government regulations is an often overlooked burden that drains resources from businesses, and makes the U.S. business environment less hospitable. For most companies, these costs are concentrated in four regulatory areas: tax compliance, workplace (e.g., employment and safety regulations), economic (e.g., barriers to entry, price regulations, tariffs, and other trade barriers), and environmental (e.g., air and water pollution abatement and Superfund cleanup costs).[45]

A recent study estimates that total compliance costs of these four regulatory areas alone is approximately $850 billion per year, which reflects an increase of about 15 percent over the last five

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[41]Leonard at p. 12.

[42]At the state and local level, this uncertainty cost is exacerbated by the fact that most jurisdictions conform to the federal tax code.

[43]Public Law 107-16, "Economic Growth and Tax Relief Reconciliation Act of 2001," June 7, 2001; and Public Law 108-27, "Jobs and Growth Tax Relief Reconciliation Act of 2003," May 28, 2003.

[44]Office of Tax Analysis, U.S. Department of Treasury, January 7, 2003.

[45]Leonard at p. 18.

years.[46] Evidence of this dramatic increase also can be seen through the growth of federal spending on the administration and enforcement of regulations. From 1990 to 2003, federal outlays for those purposes increased from $13.7 billion to $26.9 billion in real terms.[47]

There is some irony here: government, on the one hand, imposes these enormous costs, and on the other hand, also wants businesses to reduce outsourcing (a trend that is in part a direct result of excessive regulation). Both the current and previous administrations have directed federal agencies to take steps to reduce the regulatory burdens they impose.[48] In 1995, Congress enacted the Small Business Enforcement Fairness Act in an effort to force regulatory agencies to consider the impact of new regulations on small businesses before they are promulgated.[49] Nevertheless, the number and complexity – and cost – of federal regulations continues to mount. If even a small fraction of the estimated $850 billion spent on compliance were available for investment in new products and services – and jobs – it would go a long way toward reducing the numbers of dislocated workers.

Litigation costs – The impact of the run-away cost of litigation in this country is borne by all American businesses. As the Commerce Department's recent report on manufacturing noted:

> Manufacturing firms pay 'tort taxes' in several ways. First, manufacturers pay significantly higher cost for employee health-care benefits, due to increased medical liability costs. Second, manufacturers pay as product liability and other tort claims increase the cost of general liability insurance. And third, manufacturers pay in the form of legal fees even when there is not merit to claims and manufacturers ultimately prevail in litigation – a problem that is only exacerbated by the growth of frivolous shareholder class-action suits.[50]

In most respects, the same tort taxes apply to businesses in the service sector.

To put these "tort taxes" into perspective, the total insured and self-insured tort costs in the United States in 2002 are estimated to have been $233.4 billion, a 13.3-percent increase over such costs in 2001.[51] At that level, tort costs accounted for 2.2 percent of the nation's GDP in 2002, and the growth rate in such costs was more than triple the country's 3.6-percent economic-growth rate.[52] Due to the scarcity of data on tort costs in other countries, it is difficult to make a comparison between

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[46]Leonard at p. 19. The author also estimates that of the $850 billion annual compliance cost, $160 billion falls on manufacturers, which is equivalent to a 12-percent excise tax on manufacturing production.

[47]Leonard at p. 17.

[48]Executive Order 12866, September 30, 1993, and Executive Order 13272, August 13, 2002.

[49]Public Law 104-121, March 29, 1996.

[50]U.S. Department of Commerce, "Manufacturing in America: A Comprehensive Strategy to Address the Challenges to U.S. Manufacturers," January 2004, at pp. 40-41.

[51]Tillinghast-Towers Perrin, "U.S. Tort Costs: 2003 Update; Trends and Findings on the Cost of the U.S. Tort System," February 2003, at p. 1.

[52]Tillinghast-Towers Perrin at p. 2. The authors of the Tillinghast-Towers Perrin study project that tort costs as a percentage of GDP will increase to 2.39 percent in 2004 and 2.45 percent in 2005. Tillinghast-Towers Perrin at p. 19.

the United States and its major trade competitors, although it stands to reason that many of these trade partners will have lower litigation burdens due to the development of their tort-liability laws.[53]

The task of reducing litigation costs in the U.S. business environment is daunting. Nevertheless, the Senate could make significant strides by passing legislation to restrain the growth of medical malpractice suits[54] and measures to reform class-action lawsuits that enable activist lawyers to force unjust settlements and drive up litigation expenses.[55] In addition, since a major component of the rise in tort-liability costs stems from asbestos-related litigation,[56] the Senate should pass legislation that provides proper compensation to those actually injured by asbestos exposure without bankrupting American industry.[57]

Energy costs – A rapidly growing strain on American enterprises is the rising cost of energy. U.S. industry accounts for more than one-third of the energy use in this country, including natural gas, petroleum, and electricity.[58] In June 2003, Federal Reserve Chairman Greenspan noted that the price of natural gas for delivery in July 2003 had more than doubled over the preceding three years and was expected to continuing climbing.[59] As energy costs rise, U.S. businesses have no choice but to redirect cash flow and limited capital resources simply to keep the equipment running, leading to efforts to reduce costs in other areas.

A range of possibilities exists for addressing the energy problem. Most immediately, American businesses can employ more conservation and invest in fuel-efficient technologies. Over the long-term, the supply of energy resources will have to be addressed. A fundamental step in that direction will be the development of domestic sources of energy. The Coastal Plain of the Alaska National Wildlife Refuge is estimated to contain 11.6 to 31.5 billion barrels of oil, 3.4 to 13.4 billion barrels of which is technically recoverable.[60] The United States also has tremendous natural gas resources. The Outer Continental Shelf contains more 362 trillion cubic feet (Tcf) of natural gas.[61] Another 138 Tcf is available in much of the western United States. Unfortunately, these energy resources have been tied up in bureaucratic red tape for decades.[62] Given the current state of technology, it is quite possible to

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[53]Leonard at pp. 16-17. Based on limited data from 2000, Leonard projects that tort litigation is likely to reduce the competitiveness of U.S. manufacturers by more than 3.2 percent.

[54]E.g., S. 11, Patients First Act of 2003.

[55]E.g., S. 1751, Class Action Fairness Act of 2003.

[56]The Tillinghast-Towers Perrin study reports that in 2002, out of the total $27 billion increase in tort costs, roughly $11 billion (40.7 percent) is attributable to increased insurance reserves to protect against future payments associated with asbestos claims. Tillinghast-Towers Perrin at p. 8.

[57]E.g., S. 1125, Fairness in Asbestos Injury Resolution (FAIR) Act of 2003.

[58]Commerce, "Manufacturing in America," at p. 44.

[59]Alan Greenspan, testimony before the House Energy and Commerce Committee, June 10, 2003. For more about the natural-gas situation, see RPC's "Backgrounder: Increasing the Supply of Natural Gas," July 29, 2003.

[60]Alaska Department of Natural Resources, "Oil in ANWR? It's Time to Find Out!" July 2000.

[61]Testimony of Carolita Kallaur, Associate Director, Offshore Minerals Management, Minerals Management Service, Department of the Interior, before the Subcommittee on Energy and Mineral Resources, Committee on Resources, U.S. House of Representatives, 107th Congress, 1st Session, March 22, 2001.

[62]U.S. Department of the Interior, U.S. Department Agriculture, U.S. Department of Energy, "Scientific Inventory of Onshore Federal Lands' Oil and Gas Resources and Reserves and the Extent and Nature of Restrictions of Impediments to their Development," January 2003.

utilize these resources while maintaining environmental standards. It is also imperative that Congress avoid raising further barriers to the continued use of the nation's most plentiful energy resource, coal.

Conclusion

The benefits of outsourcing are well documented. Less documented are the many programs to deal with the human side of this phenomenon – the resulting dislocation of workers. There are many worker education and training programs, though one that offers significant potential, the Workforce Investment Act, is being blocked by Democrats unwilling to allow the bill to go to conference.

Also less well understood are the many things that need to be done to address the underlying causes of U.S. competitive disadvantage. By addressing such high costs as health care, taxes, regulatory compliance, litigation, and energy, the government can create a business environment in the United States that enables American businesses to continue their success as innovators and job creators.

Pursuing the road to isolationism, as some Democrats have proposed, is clearly not the answer.[63] Enacting isolationist legislation that creates tax or other trade disincentives for companies that utilize outsourcing will only cripple the competitiveness of American business. Similarly, cosmetic changes, like requiring businesses to provide a 90-day notice before outsourcing any of their employees, do little to assist dislocated workers. In fact, these proposals merely continue the over-regulation of U.S. businesses, adding even more of a disincentive for employing Americans to work in this country.

The American economy is built on innovation and the flexibility to respond to the ever-changing marketplace. Capitalizing on those strengths is the best alternative. As Clinton Labor Secretary and economist, Robert Reich, recently put it: "Our economic future is wedded to technological change, and most of the jobs of the future are still ours to invent."[64]

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[63]Greenspan remarks, February 20, 2004 ("As history clearly shows, our economy is best served by full and vigorous engagement in the global economy.").

[64]Robert B. Reich, "High Tech Jobs Are Going Abroad! But That's Okay," *The Washington Post*, November 2, 2003.