

MSRE Roundtable 511
Assignment 3 – Investigation into Outsourcing

In a sense, global outsourcing has been present in Western society since the inception of cross-continental trade routes over 2000 years ago, in which foreign and often exotic goods produced in the Orient traveled laborious overland routes to reach Occidental markets in the Roman and Turkish empires. Later, the inception of ocean-going merchant vessels, often acting as an extension of colonial European nations, purchased and transported goods from foreign countries for a growing market at home. Although the present-day markets of international trade have grown far more complex, the basic tenet remains the same: a product or service which is not feasible to produce at home is found elsewhere on the global market, then often shipped back to the home market for consumption.

Outsourcing is an integral part of the global supply chain of almost every Fortune 500 company active today. What was a phenomenon limited to labour-intensive and heavy manufacturing fleeing high labor costs and strict environmental controls at home to nations with less onerous standards and pennies-per-day labor is now growing rapidly into knowledge-sector jobs in financial services, engineering and architectural services, IT, and even medical procedures.

There have been several drivers behind the increasing viability of outsourcing as an option for companies of almost every size. First, continued trade liberalization has made great strides in both reducing the level of tariffs on goods entering countries and streamlining the Byzantine array of bilateral agreements between individual nations into

a single, more user-friendly set of rules applicable to all members of the World Trade Organization. The WTO has been a prime driver behind the creation of key international treaties like the General Agreement on Tariffs and Trade (GATT), which deals specifically with the aforementioned issue. Generally, accession into the WTO requires a country to allow all WTO member nations the benefit of the same, low tariffs it would charge to its “most favored” trading partner. That is, every country gets to benefit from decreased rates – which benefits its exports – but in turn, has to charge lower rates on imported goods from other countries. Generally, this reduces economic ‘friction’ and allows markets to operate more efficiently. China’s 2001 accession into the WTO has been one of the primary drivers in that country’s transformation into an industrial powerhouse with consistent 9-12% annual growth in GDP (Economist.com)

Secondly, the advent of digital communications networks and IT business tools have dramatically increased the speed, quantity and reliability of information flows between businesses. Where most documentation had to be mailed or couriered only 15 years ago – cumbersome and expensive at best – companies can now send information to a business partner around the world in seconds. With transmission costs thus lowered, it is arguably just as easy to send an order to a factory in Taiwan as it is to send one to Duluth.

Likewise, improvements in the precision of supply-chain technology have reduced the need for suppliers to be in close proximity to final assembly plants or consumers; technology can track the order from its inception on an assembly line, locate it at any point in the shipment process, track inventory levels, and even send an order back to the supplier as soon as the good is sold at a checkout stand.

Thirdly, the last 15 years have seen a dramatic change in policies of nations seeking to be the recipient of foreign capital investment. China has undertaken drastic economic reforms in the past decade designed specifically for this purpose. It set up Special Economic Zones in the late 1980s (SEZs) whose sole purpose was to attract foreign investment (outsourcing), and has recently undertaken massive public infrastructure projects in a bid to increase both its attractiveness to foreign capital as well as to position itself as a global economic powerhouse. India has likewise opened up after decades of protectionism, and has the benefit of a structured legal system and being one of the world's largest democracies. Both nations have an extremely well-educated workforce. The potential for growth is staggering, simply from sheer population numbers. As one Microsoft exec noted at the grand opening of a satellite office in Shanghai, "if you're one in a million here, there are 5,000 others just like you." (*New York Times*, April 5th 2006)

But is outsourcing and increasing liberalization a good thing? Ricardo's law of comparative advantage states that (under ideal conditions) nations would benefit most by producing and exporting goods they can make more efficiently (than other countries) and import goods they are comparatively inefficient at producing (*Ricardo, Principles of Political Economy and Taxation, 1815*). For example, this theory would suggest that it is generally positive for most of the US manufacturing jobs to be going offshore to allow for the US to focus on more productive activities which ultimately bring in both more GDP and higher wages to the individual, whom can in turn purchase the offshore-

produced goods at a cheaper price than could be attained if the product was produced in the US.

There are two key flaws in this assumption, however. First, it assumes that individuals who lose those manufacturing jobs in the US can transition to more productive employment. In reality, employment transitions are not nearly as fluid, and take significant time and resources for an individual to realize; and without any regularized (government) programs to ensure that this can happen, are not guaranteed. Secondly, it assumes that the high-productivity, education-intensive jobs are the exclusive domain of the wealthier nations (US), and that offshoring will absorb the least productive, most labor intensive industries first and gradually increase absorption of technologically-intensive industries over time. However, it is increasingly apparent that that assumption is not holding true, and that developing countries – especially China and India – are developing with shocking speed the intellectual capacity to begin competing with education and skill-intensive sectors of the US economy assumed to be bastions of American competitive advantage. Architectural drafting, engineering services, medical diagnostics, as well as biotech R&D are all gaining an increasing foothold in Indian and Chinese economies, and one can't help but wonder if there are any sectors safe from outsourcing. And if too many of the skill-intensive jobs are sent overseas, who will be left in the US economy to purchase all of the goods also produced overseas?

The critique may be moot however. Economists still state that for every job outsourced to India, the United States creates 1.14 jobs in return (*Sara Drummond, "India Calls"*,

Commercial Investment Real Estate, 2006) and that the Ricardo's theory still holds true.

For example, for every programming job a company chooses to outsource, it is more likely to hire people in fields of creativity, innovation, and new product development - thus increasing its competitive advantage over firms which do not.

If economic theory is correct, outsourcing should not affect real estate markets greatly due to the net gain in employment experienced by companies that outsource. The affect outsourcing will have on real estate is difficult to predict. More investigation would need to be conducted to determine the specific sub-sectors affected by outsourcing and where the resulting growth, if any, would be experienced.