

**Outsourcing and the Political Economy of Globalization:
A Discussion Note**

Doug Nelson

Murphy Institute
Tulane University

&

Leverhulme Center for Research on Globalization and Economic Policy
School of Economics
University of Nottingham

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Outsourcing and the Political Economy of Globalization

If at this point one returns to the question of how big is global production sharing, the answer clearly is ‘very big’. (Yeats, 2001)

Outsourcing appears to have become the *vilain du jour* in the public discourse of globalization.

More than trade or international financial flows, outsourcing has become the particular target of critics of globalization and some of the most frenzied defense by defenders of globalization.¹

What is particularly interesting about this is that neither critics nor defenders can claim much in the way of systematic theoretical or empirical basis for their arguments. Not only is there no conventional definition of the phenomenon, there is not even a conventional name.² Some of the dispute over definition is just silly, but some of it is substantive.³ For some purposes, what we

¹Interestingly, even in the centers of the most aggressive anti-immigrant politics, immigration does not appear to strongly associated with globalization. Greenaway and Nelson (2004) develop some of the differences between these two policy domains in an endogenous policy framework.

²In addition to outsourcing there is: offshoring; production fragmentation; production sharing; slicing up the value chain; commodity chain analysis; globalization of production; integration/disintegration of production; vertical specialization; and surely there are others.

³Toward the silly end of the spectrum is the attempt by Bhagwati, Panagariya and Srinivasan (2004) to shift the discussion away from outsourcing in general by redefining it as what the WTO calls “Mode 1 services”, then say that outsourcing (i.e. mode 1 service trade) is really pretty small, and then to criticize confusion among the various modes of service provision. Services are unquestionably important to the discussion, both as the thing outsourced (what BPS are on about) and as part of what makes outsourcing possible in manufacturing [a core concern in both the fundamental early work by Jones and Kierzkowski (1990) and newer work in the context of division of labor models (Harris, 1995; Burda and Dluhosch, 2002; Francois and Nelson, 2000) and contract theoretic models (McLaren, 2000; Grossman and Helpman, 2002, 2003, 2004, 2005)]. However, much of the public discussion of outsourcing is only indirectly about services. Contra BPS, it seems to me that we should call Mode 1 service trade, “Mode 1 service trade”, and use outsourcing more broadly. Otherwise, we will need to find another name for what everyone else (including such economists as Arndt, Deardorff, Egger, Feenstra, Grossman, Helpman, Jones, Kierzkowski, Kohler, Samuelson, and Venables) calls some variant

are really interested in is just that part of a production strategy that involves contracting at arms length for something that was once actually produced in-house. In principle this could involve many patterns of outsourcing only some of which are of interest from the point of view of globalization, and fewer of which are the target of hostility by critics of globalization. From a firm-theoretic viewpoint, this is probably the most interesting definition. Closely related, and almost certainly part of the reason for general concern, are decisions to contract abroad even if there was no initial Home, in-house production and production abroad in the context of wholly-owned subsidiaries (i.e. multinationalization). From the perspective of public response to globalization, globalization of production, with global outsourcing only the most politically salient part (at least currently), is probably the relevant concept. Nonetheless, in this note I focus on the direct and indirect political economic effects of outsourcing proper.⁴

Before proceeding to a consideration of those effects it is useful to note that outsourcing, unlike many of the other forms of globalization, is inherently non-marginal in form. That is, in a small way, outsourcing (at least from a trade theoretic perspective) transforms the *structure* of the economy. Consider a simple version of the most common notion of outsourcing: some part

of “outsourcing”.

⁴The invitation to the workshop at Princeton mentioned firm decision making with respect to outsourcing. The main framework here would be the firm/contract theoretic approach with roots in the Coase-Arrow-Williamson theory of the firm. The most advanced work on outsourcing in this framework of which I am aware is by John McLaren (2000) and Gene Grossman and Elhanan Helpman (2002, 2003, 2004, 2005). Closely related is work on the firm’s choice between licensing and FDI (e.g. Ethier, 1986; Horstman and Markusen, 1987, 1996; Ethier and Markusen, 1996; Markusen, 2001) and the earlier work by business economists on mode of market service (e.g. Buckley and Casson, 1981; Cappel, 1992). In either of these cases what is distinctive about outsourcing relative to FDI is lower fixed costs, reduced managerial control, increased risk of appropriation of firm specific assets, and much more limited capacity to engage in strategic transfer pricing. To economize on space I will not pursue this further here.

of a production process that used to be done at home can now be outsourced. Suppose that the production function in some sector, j , can be written as:

$$y_j = f^j(g^1(K, L), g^2(K, L)),$$

and suppose that subproduction process 2 is labor-intensive relative to sub-production process 1. Finally suppose that for some reason these components become separable and the labor intensive component is outsourced to a low-wage country.⁵ Note that the dimensionality of the economy (Home, Foreign, and World) has changed. Under the standard trade-theoretic definition of industry, one sector (i.e. j) has disappeared and two new industries have appeared. As the sizable literature on outsourcing in competitive trade models suggests, the income distribution effects are ambiguous for precisely this reason (Deardorff, 2001, 2002, 2005; Egger, 2002; Egger and Falkinger, 2004; Jones, 2000; Jones and Kierzkowski, 1990, 1998; Kohler, 2001, 2003, 2004; Venables, 1999). Welfare effects are trickier still since, as the same literature suggests, outsourcing looks like (or just is) a skill-biased technical change (see also Arndt, 1997, 1998, 1999; de Groot, 2001; Dell'Amour, et al., 2000; Egger and Egger, forth.,; Ethier, 2005; Feenstra, 1998; Long, 2005; Siegel and Griliches, 1992). Both of these interfere with inference in the standard mandated wage regression methodology that is used to evaluate the effects of both trade and outsourcing (e.g. Feenstra and Hanson, 1999): the first because the HO-based econometric framework assumes fixed dimensionality; and the second because technical change is inferred

⁵For many issues it matters why the production process becomes separable, e.g.: for independent reasons, costs might fall so as to make outsourcing profitable e.g. there may be changes in labor skills, infrastructure, policy, etc. in other countries that make outsourcing profitable); there may be a technological change that makes separation possible; etc. For the point we are making here, however, it doesn't much matter.

from patterns in the errors.

I refer to the distributional effects of outsourcing as *direct* political economic effects reflecting the usual approach in endogenous policy modeling of deriving political preferences over policy directly from distributional effects. There is a growing body of empirical work suggesting that outsourcing might have sizable distributional effects (Anderton and Brenton, 1999; Anderton, Brenton and Oscarsson, 2002; Davis, 1999; Egger and Egger, 2002, 2003, 2005; Egger and Pfaffermayer, 2004; Egger, Pfaffermayer, and Wolfmayr-Schnitzer, 2001; Falk and Koebel, 2002; Feenstra and Hanson, 1996, 1997, 1999; Görg and Hanley, 2005; Miller, 2001). However, we have just seen that the theoretical foundations for much of this work is suspect; and, while most of the effects are larger than those derived from standard trade effects, they are still quantitatively rather small. Given the widespread social concern with outsourcing noted above, from a political economy perspective we are left with a couple of alternatives: we can presume that the effects of outsourcing are in fact small and try to understand how the politics of response to outsourcing work in this case; or we can seek effects that work through indirect channels.⁶

A first step toward the first alternative is to move away from the long-term perspective implied by standard trade-theoretic reasoning. For all of our attachment to the Stolper-Samuelson theorem (and its specific-factor equivalent) as the lever of political economic analysis, there is actually very little compelling evidence that such long-term distributional effects have strong explanatory power. Almost wholly absent from systematic research on the

⁶An alternative approach would be to consider the dynamics of social learning. For a very preliminary attempt at this sort of thing, with application to public opinion on NAFTA, see Hall and Nelson (2004).

political-economy of trade policy is a recognition that short-run adjustment costs are individually large, asymmetrically distributed, and follow patterns systematically different from the long-run distributional effects (Davidson and Matusz, 2004, forth.; Klein, Schuh, and Triest, 2003; Kletzer, 2002). Davidson, Matusz and Nelson (2005) argue that it is precisely this sort of shock, and the visible association of trade and unemployment, that leads to publicly successful fairness-based claims for protection. It seems arguable that outsourcing is a particular target of such claims because the job loss is both non-marginal, because whole parts of the production process are outsourced (rather than marginal adjustments in employment), and closely associated with globalization.⁷ This seems like an area in which survey research could dramatically advance our understanding of the public politics of globalization.⁸ At a minimum, considerably more work needs to be done on the role of unemployment—adding to the very small number theoretical and empirical papers that seek to examine the link between unemployment and trade policy (e.g. Bradford, 2003; Davidson, Magee and Matusz, forth.; Davidson, Matusz and Nelson, 2004; Magee, 2001).⁹

⁷Thus, outsourcing is a sort of subtle version of the sort of Schumpeterian competition modeled in much of new (now rather middle aged) growth theory (e.g. Aghion and Howitt, 1998; Dinopoulos and Segerstrom, 1999; Grossman and Helpman, 1991; Segerstrom, Anant and Dinopoulos, 1990). Models of this sort have been developed in the context of equilibrium unemployment (e.g. Grieben, 2004; Lings, 2003; Sener, 2001).

⁸Note that the issue here has to do with identifying widely held notions of fairness and how they are related to unemployment, globalization, attachment to community, etc. This sort of work might build on the important work of Hochschild (1981), McCloskey and Zaller (1984), Verba and Orren (1985), Mutz and Mondak (1997) and, in particular, Schlozman and Verba (1979).

⁹An interesting recent paper by Hartmut Egger and Udo Kreickemeier (2005) develops a model of the link between outsourcing and equilibrium unemployment in the context of a fair wage model. This seems a plausible framework for political economy analysis.

An alternative approach seeks to identify key political and economic institutions that support a given relative wage structure and the ways that globalization transforms those structures. These are indirect effects of globalization on income distribution that might be missed by standard methods because the incidence of effects is not identical to the incidence of trade, or even outsourcing. Two institutions are particularly obvious: unions; and welfare state structures. Unions play a major role in all OECD countries, in particular they have well-known labor market effects, countries with encompassing labour market institutions have: lower wage inequality (OECD, 1997); lower unemployment (OECD, 1997); higher growth (Calmfors, 1993; Danthine/Hunt, 1994); and as unionization has declined, wage inequality has increased (Freeman, 1998). There are a variety of reasons for believing that globalization in general, and outsourcing/globalization of production in particular, would have systematic effects on union power: outsourcing improves the firm's outside option in its bargaining with unions, thus increasing the bargaining power of firms; increased competition may reduce the rents available for sharing (even triggering an end to relatively cooperative bargaining); and by reducing the payoff to union membership, globalization may trigger reductions in firm membership (and thus both bargaining and political influence).¹⁰ Similarly, it is clear that welfare state institutions, particularly interventions that directly support higher wages, could be affected by globalization in general,

¹⁰A number of recent papers have begun to examine these relationships primarily in partial equilibrium environments: Perry (1997); Skaksen (2004); and Zhao (2001). There is also a much larger literature on FDI in this context that is obviously directly related. Also related is the impact of outsourcing on the terms of oligopolistic competition, and thus profits, e.g. Chen, Ishikawa, and Yu (2004); Egger and Egger (2003, 2004). There is also a sizable literature on oligopolistic competition in vertical markets that is directly relevant here. In both the firm-union and oligopoly cases there are both theoretical and empirical challenges in moving from the microeconomic to the macro-political-economic, but the potential payoffs seem large.

and outsourcing in particular.¹¹

To this point we have followed the general approach of seeking to root our political economic analysis in the preferences of citizen/voters or citizen/lobbyists. An alternative is to “bring the state back in” again.¹² Ultimately, I am not at all convinced that we can explain the most significant facts about trade policy (i.e. overall levels of protection) as preference-induced equilibria.¹³ We need much more work on the political economic foundations of change in elite preferences and the ways in which these preferences are constrained by the, rather weakly and uncertainly held, trade policy preferences of the citizenry.

¹¹In addition to the sizable political science literature which seeks to empirically identify these effects, some recent research has sought to build political economy models that capture the effects of globalization shocks on welfare state institutions. Konishi, Saggi and Weber (1999) attempt to endogenize trade policy in an environment with FDI. Rama and Tabellini (1998) and Gaston and Nelson (2004) examines the intersection of globalization, welfare states, and unions in a simple political economy model, and Gaston and Nelson then carries out a preliminary empirical analysis. Egger and Kreickemeier (2005) examine the effect of welfare state effort on unemployment in an environment with equilibrium unemployment and outsourcing.

¹²Though research on trade policy has been pretty innocent of the concerns about the state that attracted attention in other areas of political economy research, so maybe I should drop the “again”.

¹³I do think that this approach does a respectable job at accounting for variance across sectors, but this is considerably less interesting than explaining why trade policy has been so liberal for half a century, nor will it be much help in explaining why, if/when or where there will be a response to globalization. Just as an example, the currently dominant framework for explaining trade policy in economics (i.e. the Grossman-Helpman model) explains this as a matter of state taste (i.e. the weight on aggregate social welfare in the state’s objective function).

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