THE WALL STREET JOURNAL. ONLINE

June 23, 2004

COMMENTARY

Missing the True Significance Of Outsourcing

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Faced with a backlash against outsourcing in services, free-traders in Washington have demanded that India reduce its duties on imports. The argument goes that more jobs from U.S. exports would take away the argument for protectionism. For their part, Indian policy makers are betting that outsourcing has become an unstoppable trend that will soon make India an economic powerhouse regardless of what detractors say or attempt.

In fact, both views represent wishful thinking and miss the true significance of the outsourcing trade. And indeed that misconception is one of the factors that cost many Indian politicians their jobs in the elections that ended in May.

Reducing Indian import duties won't compensate for job losses in the U.S. due to outsourcing. Programmers making $5,000 a year may live like princes in Bangalore, but they simply cannot afford the same goods and services as a programmer making more than $50,000 in the United States.

Moreover Indian consumers are likely to spend only a small portion of their incomes on products made in the U.S. The opening of the Indian economy in 1991 has already led to a surge in imports. But apart from a few exceptions such Microsoft, U.S. exporters have not been the main beneficiaries. Whereas India's trade surplus with the U.S. exceeds $8 billion, its trade with all its other trading partners shows a larger overall deficit. This isn't because of discrimination against U.S. imports. Rather, as import barriers have been reduced and as incomes in India have grown, consumers have favored the type of goods produced by other low or middle-income countries. For instance, India has a trade deficit in vegetables. Even in products like soft drinks and bottled water, where companies like Pepsi and Coke are market leaders, labor and transportation costs favor local manufacturers in India. Further liberalization may increase Indian imports, but is unlikely to create many new jobs in U.S. companies that export goods and services.

In India, exaggerated hopes about service exports match the over-hyped fears about their consequences in the U.S. Revenues and employment certainly have boomed. Whereas employment in the U.S. in high technology declined after the Internet bubble burst, Indian companies exporting software services, like Infosys and Wipro, have more than doubled the number of their employees. But the truth is that writing code or answering phones for U.S. clients can provide employment to only the tiniest fraction of the Indian workforce.

The Indian software industry now employs around half a million professionals. Under optimistic projections, the industry will add another half million in the next seven years. But over the same period, 14 million students will graduate from Indian colleges. And of the more than half a billion Indians under the age of 25, most have not, nor ever will, attend college. Even in Bangalore, often called the Silicon Valley of India, nearly two out of three students in primary schools won't even go on to high school.

As with any large country, the long-run prospects for the Indian economy turn on the productivity of its domestic sector. Only city-states like Singapore can export most of what they produce and import most of what they consume. For India, the low productivity of its domestic industry has impoverished it for centuries.

Under British rule, exports of items such as tea and jute flourished but the manufacturing sector more or less missed the industrial revolution. Indian craftsmen accounted for about a quarter of the world's production of manufactured goods in 1750. But while the West adopted mass production techniques in the 19th century, most manufacturing in India remained confined to handicrafts. By the time of Indian independence, employment in large-scale factories accounted for less than 2% of the workforce. So while industrialization led to unprecedented rates of economic growth in the West, in colonial India growth rates were close to zero.

The rate of industrialization and economic growth did increase after independence. But progress was hindered by autarkical policies. The colonial government had used tariffs as a convenient source of taxes: in 1933, textile and sugar imports faced duties of up to 75% and 190% respectively. Post-independence Indian governments, which wanted to protect domestic enterprise, further increased those import barriers. They also discouraged investments by Western companies that could have brought in modern technology. Indian companies then reinvented and sold many wheels of low quality produced at high cost.

Today, although government policies no longer mandate homegrown technology, productivity remains well below modern standards. Closing the gap will require the extensive acquisition of knowledge from abroad. This is not simply a matter of licensing technology. Indian industry also needs to acquire the soft knowledge needed to sustain modern enterprises, through mechanisms such as recruitment of expatriates, joint ventures and foreign direct investment.

To be sure, India's software exports can help pay for the license fees and the salaries of expatriates. And the expectation of continued export earnings that can be applied to the repatriation of dividends should encourage multinationals to set up shop in India.

But the ability to pay for imported knowledge does not ensure the development of a modern economy -- if it did, Nigeria wouldn't be a basket case today. And in fact just as oil exports can be a curse, favoring exports over domestic activity can hinder economic development. Such a bias is evident in a variety of Indian government policies today. For instance, information-technology exporters enjoy tax holidays, duty-free imports of inputs, preferential access to industrial land and an honest, well-run government regulatory agency that shields them from the pervasive corruption that hobbles domestic companies. And it is worth noting that a multinational company can set up an outsourcing unit in a matter of months but will face significant obstacles if it tried to establish a subsidiary to serve the local market. Unless the government creates the same conditions for the domestic industry that have allowed exporters to flourish, the software campuses and call centers in India may well become like the oil company compounds in Nigeria. India's new rulers ignore this at their peril.

Trading its knowledge for Indian software services has different implications for the U.S. The U.S. cannot rely just on productivity improvements in its existing industries – in fact relentless increases in productivity have lead to far greater job losses than imports. Rather, the continued prosperity of the U.S. depends on the development of totally new industries that satisfy new wants. The license fees and dividends that U.S. companies receive from India help finance this development. Outsourcing to low cost Indian programmers also helps free up the necessary U.S. talent. So even if few Americans find jobs making goods for Indians, they also gain through this trade.[1]

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[1] This paragraph was omitted from the article published in the Asian WSJ presumably for reasons of flow and brevity.