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Meeting the Offshoring Challenge

by Robert Atkinson

The growing trend of companies moving information-based service sector jobs to low-wage nations is receiving heavy coverage in the news media and is spurring intense debate among policymakers. With unemployment and a general sense of economic insecurity coloring the presidential campaign, both candidates have tried to seize the initiative on the offshoring issue. President Bush faced a storm of criticism after his chief economic advisor expressed optimism about the economic benefits of outsourcing. Now, on the campaign stump, Bush says he is "as concerned about outsourcing as the next person. But the way to deal with outsourcing is to make America a better place to do business, not a worse place."[1] The way to do that, Bush argues, is to lower companies' cost of doing business, primarily by cutting their taxes. Meanwhile, presumptive Democratic nominee Sen. John Kerry argues that the Bush team's initial assessment of the benefits of outsourcing is a true indication of its views. Kerry says Bush and his advisors have "delivered a double blow to America's workers, 3 million jobs destroyed on their watch, and now they want to export more of our jobs overseas. What in the world are they thinking?"[2] Even with strong job growth in the last few months, this issue is not going away, because it stems from the inexorable trend of U.S. jobs—even middle and higher wage jobs—being opened up to international competition.

The truth is, the Bush administration has done little to respond to the trend, and in some cases has made matters worse. The administration's economic policy consists primarily of cutting taxes, particularly for the wealthy, while talking tough about the need to reduce non-defense discretionary spending (even as it makes huge new spending commitments, such as the new Medicare prescription drug benefit). On the global front, the administration's economic policies have been a mix of unprincipled protectionism, flaccid attempts to prevent other nations from manipulating currencies and stealing U.S. intellectual property, and annual attempts to cut funding for the International Labor Organization's efforts to raise labor standards. Meanwhile, administration policies to help workers are straight out of a Charles Dickens novel: cutting unemployment insurance, denying laid off service workers Trade Adjustment Assistance benefits, and cutting job training programs. It is no wonder that growing numbers of Americans are questioning our nation's historic commitment to free trade and open markets.[3]

The offshoring panic, meanwhile, has triggered a spate of ill-conceived legislation aimed at punishing companies that send jobs overseas. At least 35 states have proposed legislation aimed at preventing state funds from going to companies doing work overseas, either directly or through subcontractors.[4] At least six states have issued requests for proposals that require the work to be performed in this country. And the 2004 federal budget contained provisions prohibiting the federal government from awarding certain contracts to companies that perform the work overseas.[5]

Such proposals are fundamentally flawed. First, they raise costs for taxpayers, just as restrictions on imports raise costs for consumers.[6] For example, when New Jersey discovered that one of its contractors was using 12 workers in India, the state renegotiated its contract and required the contractor to use U.S. workers instead. The state gained 12 jobs, but at a cost of nearly $1 million to its taxpayers—funds that could have been better spent on boosting the state's economic competitiveness. It is also worth noting that states routinely contract with companies that are based in other states. (To disallow that practice would be a violation of interstate reciprocity compacts.) Contracting with companies that have workers overseas is no different.

Moreover, restrictions designed to curb offshoring can easily have unintended consequences. For example, legislation proposed in Pennsylvania to curb both outsourcing and offshoring[7] would have largely shut down Gov. Ed Rendell's procurement reform efforts, which had saved Pennsylvania taxpayers over $50 million through May 2004.[8] Finally, there is a risk that undue restrictions on government procurement practices could escalate into a destructive trade war as other nations close off their government procurement contracts to American firms.

Opponents of offshoring also have fanned fears that data sent to a foreign company is less secure than data handled by a U.S. company.[9] For example, legislation was introduced in California that would require companies processing data outside the United States to disclose specific information about the data they share—including the type of personal information in question, and the country where the information is stored and the countries with which it may be shared.[10] Congress is considering legislation that would provide notice to consumers that their data may be sent offshore. But to the extent that these proposed laws are motivated by the desire to protect citizens' privacy, they may be solutions in search of problems. Privacy regulations that cover how U.S. companies handle their customers' personal information will continue to apply no matter where those companies, their subsidiaries, or contractors process data.

If we are to successfully compete in the global economy—and preserve support for globalization itself—then, to paraphrase Monty Python, it is time for something completely different. In a prior report, PPI has argued that while offshoring provides some economic benefits, particularly lower prices for consumers, it is also a potential threat—to middle-wage jobs in particular.[11] It is PPI's position that neither the right's "get cheap" agenda nor the left's inclination to erect walls makes sense. Instead, the offshoring challenge requires an aggressive three-part Third Way agenda to help the U.S. economy adapt and innovate.

How to Adapt and Innovate

The Progressive Policy Institute believes that it is incumbent upon government, working with industry, universities, labor unions, and other groups, to develop and implement a national strategy for competing and winning in the global economy. We believe such an agenda must: (1) help American companies become more productive, (2) significantly reduce distortions to global trade, and (3) do a better job of assisting workers displaced by offshoring.

I. Raising Our Game: A Strategy for Helping American Companies Become More Competitive

Just as there is no law that says a company has a right to its position as market leader, there is no law that says that United States is entitled to its position as the richest nation on earth. In an intensely competitive world, we have to work just as intensely to keep our position. Unfortunately, the Bush administration has been complacent, relying on a naïve faith that the "market" will keep us number one. History strongly suggests there is a better way. When we faced a formidable challenge from overseas competitors in the 1980s, many companies rose to the challenge on their own. But federal and state governments also put in place a host of policies to boost U.S. competitiveness. Examples include the research and development tax credit, the Bayh-Dole Act to spur commercialization of university research, the National Institute of Science and Technology's Advanced Technology Program and Manufacturing Extension Partnership, the Small Business Innovation Research program, the National Science Foundation's Science and Technology Centers program, and Experimental Program to Stimulate Cooperative Research, among others. It is time that we once again redefine our nation's competitive advantage around high-value-added, knowledge-based jobs and make a new commitment to forge a 21st century competitive policy.

Regional economists have long recognized that new products and services are usually developed in higher-cost, more creative areas that may be more expensive, but are also more innovative. As products and services mature and become standardized, companies often move production to lower-cost places. This continuous process of economic birth and migration is how many higher-cost metropolitan areas thrived throughout much of the 20th century—they created new industries as older ones moved to lower-cost cities and rural areas. In the 21st century, jobs that involve standardized production and routine service delivery are likely to go to low-cost nations, not just low-cost regions within the United States. Our challenge is to ensure that the concentrating processes of creating and unleashing new innovations stay ahead of the dispersive forces of standardization. That will only happen if we adopt a conscious national innovation and competitiveness policy that keeps American companies on the cutting edge of innovation and productivity.

Some may question whether there is a "next big thing" to get into; after all, the Indians are moving into software and Taiwan is a well-established powerhouse in the semiconductor manufacturing business, with China and other Asian nations coming on strong. However, it is important to realize that the potential for innovation in all sectors of the economy is unlimited. There are a host of new products and services (some we cannot even imagine now) that companies in the United States can take the lead in developing and bringing to market. On the technology side alone, the list is impressive. Next-wave technologies include ultra-wideband spectrum devices, next-generation 64-bit computer chips, radio frequency identification devices, solid state lighting, bioinformatics, microelectromechanical systems, nanotechnology, genetic engineering, next generation super-fast Internet technologies, hydrogen fuel cells and solar cells, new biotechnology-based drugs, robotics, learning chips, and voice and handwriting recognition.

The next wave is not just about technology. It is also about innovative new business models, which the United States is particularly well positioned to develop because of its unique combination of information technology (IT) talent, entrepreneurial energy, and flexible capital markets. India boasts top-level computer programmers, but innovative companies that combine IT with creative business models, such as Yahoo!, Amazon.com, Akami, and Google, were all developed in the United States.

Some free market conservatives will argue that any attempts to establish an explicit policy to spur innovation is similar to Soviet "industrial policy," and it is best to "leave it to the market." That aphorism is overly simplistic for a host of reasons, but leaving them all aside, it is important to recognize that there is no guarantee that those optimal market outcomes will occur in the United States. Governors have long understood that while markets generate prosperity, it often happens in other governors' states. That is why both Republican and Democratic governors generally ignore neo-classical economic advice and instead actively pursue state economic development policies.[12] States are not hamstrung by the kind of ideological blinders that many Washington policymakers wear.[13] Liberal Democratic state officials know that competitive businesses are critical to accomplishing their progressive goals, and conservative Republican state officials know that smart actions on the part of governments are critical to fostering strong state and local economies. Only in Washington have these basic truths been lost.

It is time for a dose of reality. The dramatic increase during the last two decades in the share of the U.S. economy that is attributable to international trade has effectively made America more like a state in the world economy. The health of the U.S. economy's trade-reliant sectors is an increasingly important determinant of the nation's economic health. And just as all 50 states pursue economic competitive policies, the federal government needs to put in place a similar U.S. policy.

Before discussing the federal government's role, it is important to consider the role of business. In contrast to what conservatives would have us believe, businesses have obligations to society beyond simply maximizing shareholder return. At a minimum, as Hewlett-Packard CEO Carly Fiorina recently wrote, "Companies that source jobs overseas have an obligation to help workers left behind get the tools they need to find jobs and succeed."[14] The Progressive Policy Institute believes that companies have a responsibility to their workers that includes providing as much notice as possible about impending layoffs, so workers have time to find new jobs. In fact, when companies lay off workers, they should make an effort to help those workers find new jobs. To be sure, many companies already do this. For example, IBM's "Focused Learning" initiative is an effort to help its employees broaden their marketable skills.[15] Employees develop individual development plans to guide their learning, to which IBM invests an average of almost $2,500 per year per worker. More companies need to follow that example.

It is not the responsibility of companies to keep jobs in the United States at any cost. That would raise prices for consumers and hurt companies' competitive positions. But, companies do have a responsibility to respond to shareholder needs and market pressures by first automating, innovating, and diversifying here in the United States—and moving jobs offshore only as a last resort. The shoe company New Balance exemplifies that approach. While New Balance produces some shoes overseas, it continues to profitably operate five factories in Maine and Massachusetts by making aggressive use of automation and advanced employee training.[16] Dell has made a similar commitment to boosting productivity—many of the components that go into its computers are manufactured overseas, but the computers themselves are assembled in the United States to fulfill U.S. orders. Dell gains its competitive advantage in large part through its relentless focus on boosting efficiency so it can fulfill customer orders as rapidly as possible.

Boosting Innovation

While companies have a responsibility to actively incorporate new innovations into their business processes, government has a responsibility to help lay the groundwork for dynamic innovation in the broader economy. Research has shown that government-supported research can boost economic growth.[17] The list of innovations that can trace their origins to government support of research is long and impressive, including bar codes, web browsers, computer-aided manufacturing, magnetic resonance imaging, fiber optics, and tissue engineering, to name just a few.[18]

There are concrete steps government can take:

- **Invest an additional $10 billion per year in science and research.** Investments in R&D should include $1 billion per year for an advanced cyber-infrastructure program; funding for up to 100 industry-university American Ingenuity Research Alliances, each consisting of at least 10 firms that agree to develop a technology roadmap and co-fund research with universities;[19] $2 billion for an innovation infrastructure program to provide grants for university research equipment and facilities; a $1 billion productivity enhancement research fund; and $5 billion to double funding for the National Science Foundation. In addition, we should take other steps to boost competitiveness, such as doubling the federal Manufacturing Extension Partnership, as Sen. Even Bayh (D-Ind.) has proposed in S. 2588.[20] Such steps could be revenue neutral if Congress took steps to close tax loopholes.[21] If funding were ramped up over five years to $10 billion, the federal R&D funding would be restored to its 1993 levels when measured as a share of GDP.

- **Expand and modernize the R&D tax credit.** The credit should be made permanent, and the rate should be increased from 20 percent to 30 percent.[22] There should also be a flat, non-incremental, 30-percent credit for company expenditures devoted to collaborative research at universities, federal laboratories, or research consortia. The credit should be reformed so it is easier for companies that do not currently qualify for the credit under the 1984-1986 base period rules to take the credit. It should also be easier for younger, start-up companies to take the credit.[23]

- **Use the required repeal of the Foreign Sales Corporation exemption to fund a revenue-**

neutral incremental tax credit for investment in information-processing equipment, software, and industrial equipment. Because of a World Trade Organization (WTO) ruling, the United States must eliminate its Foreign Sales Corporation (FSC) exemption—which provides a tax exemption that companies can take in relation to certain exported products—or face tariffs on certain exports. In response, the House and Senate have passed separate bills that include an across-the-board reduction in the corporate tax rate on income from manufacturing operations within the United States, as well as a slew of other corporate special-interest tax breaks.[24] But simply cutting the corporate rate does little to encourage U.S. companies to make the kinds of investments needed to be more competitive and innovative. Instead, what Congress should have done is use the savings from the repeal of the FSC exemption—estimated to be approximately $50 billion over 10 years—to help pay for an incremental tax credit for new capital equipment. An investment tax credit would help companies increase investment which in turn would boost productivity. Moreover, it would make U.S. companies more likely to invest in equipment here and not overseas. Like the R&D credit, companies could take this credit only on the amount of increase in investment over a prior period (as a share of sales).

- **Develop a national information technology strategy to accelerate the transformation to a digital economy.** Policies are needed to spur the development and deployment of high-speed Internet services that offer data transmission speeds that are 10 times to 20 times faster than what is commonly available in the United States today. To ensure public demand, the federal government should give a one-time $300 tax credit to individuals who subscribe to broadband Internet access with speeds greater than 20 megabits per second. Government should work with industries—such as the health care and financial services industries—to develop sector-specific IT reinvention roadmaps. Developing a proactive national e-health strategy to transform health care will be particularly important given its potential to cut rapidly rising health care costs that drive up the cost of doing business in the United States. Government should also aggressively use IT to transform a host of governmental functions. For example, government could use IT to improve traffic flow on transportation systems, enhance law enforcement agencies' ability to share and productively use information, facilitate distance-learning programs, and roll out new e-government services.[25]

- **Expand federal programs that support early-stage company financing, including the Small Business Administration's Small Business Investment Corporation and the Small Business Innovative Research Program.** In the 1990s, Congress reformed the Small Business Investment Corporation (SBIC) program to make it a more effective partner with the private sector in generating venture capital for new start-up companies. The program essentially provides matching loans to private venture capital firms.[26] The Bush administration has since cut back on the program. It should be expanded with a mandate to focus on the gap in the venture capital market for smaller and early stage deals. In addition, we should expand the Small Business Innovative Research program, under which federal agencies set aside a portion of their research budgets for small companies.

Boosting Skills

In a knowledge-based economy, workers' skills are an important component of success. But, skills training is not an all-purpose tonic that will address all, or even a majority, of the challenges posed by offshoring. Most jobs are not moving overseas because U.S. workers lack skills. Nonetheless, investments in the skills of American workers can make it easier for U.S. companies to move more easily into higher value-added, knowledge-intensive work, particularly when companies are cutting their investments in workforce development compared to a decade ago.

While the Bush administration is touting its new Jobs for America initiative, it is unfortunately quietly “robbing Peter to pay Paul.” The administration has proposed spending $500 million for new education and job training programs, including $250 million for community college partnerships, but it has also cut the overall budget for employment and training by $122 million. The administration has proposed spending a total of $6.2 billion on workforce development in FY 2005—10 percent less than what Congress appropriated in 2002.[27] Instead of cutting funding, we need to invest more.

We should work harder to make sure that workers have the skills they need to succeed and companies have the skilled workers they need to compete. In addition, we need to do a better job of ensuring we have enough scientists and engineers. Nations like China and India are graduating large numbers of scientists and engineers, and while their quality does not appear to match U.S. graduates now, there is little doubt the gap will close over time. For the United States to maintain its technological base, we will need more high-quality scientists and engineers.[28] We can do that by “growing our own,” and bringing in others through immigration. We must start by redoubling our efforts to encourage more Americans to enter the math, science, and engineering fields—through, for example, public awareness campaigns jointly sponsored by government and industry. It is possible, however, that no matter what we do, Americans will not enter these fields as fast as we need.[29] Indeed, between 1990 and 2000, the proportion of foreign-born Ph.D.s in science and engineering in the U.S. labor force rose from 24 percent to 38 percent.[30] Clearly, we need to make it easier for these scientists and engineers with advanced degrees to bring their collective brainpower to the United States.

There are a number of things the federal government could do:

- **Create a National Skills Corporation** by consolidating funds from Labor Department employment and training programs, Education Department adult education programs, and the National Skills Standards Board into a quasi-governmental skills corporation.[31] A key reason for such significant institutional reform is that the U.S. Department of Labor does not currently have the flexibility or entrepreneurial drive needed to effectively partner with employers and unions to create a 21st century skills system.[32] This corporation would have a board of directors made up of business and labor leaders, educators, and local elected officials appointed by the president and Congress.[33] A key role of the corporation would be to develop and manage a national learning strategy for workers and focus on in-demand skills, including IT skills. The corporation would also manage the regional skills alliance initiative, the national network of learning stores, a New Economy Scholarships program (for dislocated workers), and the online Learn.gov resource.

- **Fund math and science education.** This includes providing full funding for math and science education partnerships, the Noyce scholarship program, and the Science, Technology, Engineering and Math Talent Expansion program (known as “Tech Talent”). In addition, in partnership with industry, Congress should fund math, science, and technology charter high schools focused on students in disadvantaged communities.[34]

- **Make it easier for foreign math, science, and engineering Ph.D. graduates to become U.S. citizens.** Approximately one-half of Ph.D. graduates of U.S. engineering and computer science programs are foreigners. We should make it easier for these talented individuals to stay in the United States by exempting them from the H1B visa cap and expediting the process by which they can qualify for a green card.

- **Rein in abuses of skilled worker visa programs.** One of the more controversial issues with regard to offshoring is the question of skilled worker immigration. The PPI has long supported efforts to ensure that companies in the United States can gain access to the skilled workers they need both through immigration and through improvements in our nation's education and training system. While both the H1B and L1 visa programs provide skilled workers, both programs are subject to abuse. For example, some companies, particularly Indian-based IT companies that have established "job shop" operations in the United States, may be abusing this system by hiring predominately immigrants and not paying them prevailing wages that other U.S. IT companies pay.[35] For example, under the L1 program (for intra-company transferees) workers are required to have "specialized knowledge," but this requirement can be easily circumvented. Moreover, unlike in the H1B program, L1 workers are not required to be paid the prevailing wage and there is no restriction on companies hiring L1 workers to displace U.S. workers. Some foreign companies bring in L1 workers who are then placed as subcontractors in other companies in the United States. Congress should address the problems with these programs, and devote more resources to the U.S. Department of Labor to better enforce existing provisions of the law.

II. Getting Tough on Distortions to Free Trade

In the textbook version of free trade, we import products and services from countries and they import roughly the same value of goods and services from us. If that were occurring, public concern over offshoring would be less pronounced. Low-wage nations would sell us back-office services or electronic goods, but we would sell them software, telecommunications equipment, airplanes, and financial services—creating jobs in all of those industries. Yet, as reflected by our record trade deficit of nearly $500 billion in 2003, it is not working this way.[36] Other nations are selling us large quantities of goods and services, yet buying far fewer goods and services from us. America's large and persistent trade deficit mainly reflects today's flawed macroeconomic policies, particularly the huge federal debt. But trade distortions and barriers—including currency manipulation, tariff and non-tariff barriers, and piracy of products and services—also play a role. If other countries want the benefits of global trade, they should play by the rules, and the U.S. administration and the global trading regime should ensure that they do. Unfortunately, the Bush administration has been lax in pressing the U.S. case to open up foreign markets, and press countries to end current manipulation, and reduce intellectual property theft.

If the textbook benefits of trade are to be realized for all parties, there needs to be as little distortion to markets as possible. There are a number of steps we need to take to reduce these distortions:

Aggressively Work to Stop Currency Manipulation

Just as prices reflect changes in supply and demand of goods, changes in currency valuations should reflect changes in economic activity between nations. If the market is working, nations that import much more than they export will see the value of their currency fall, which will in turn make their exports cheaper and imports more expensive. For this to work effectively, however, currency valuations should be set by the underlying market forces, not government intervention.

Many governments, however, consistently intervene in currency markets, either explicitly, for competitive purposes, or implicitly, as the United States is doing now by running up large budget deficits, to keep the value of the dollar higher than it would be otherwise. Such steps distort market forces, leading to a misallocation of resources and lower productivity growth. For example, China has pegged the yuan to the dollar at a rate some experts consider to be undervalued by as much as 40 percent. This gives producers an incentive to locate production in China even though, if Chinese currency was more closely aligned with its true value, it might actually be more efficient to locate in the United States. Similarly, the Japanese government spending $360 billion this year to prop up the yen is conceptually no different than if the government simply handed cash to Japanese exporters, a violation of WTO rules.[37]

Under rules established by the International Monetary Fund (IMF), each member country has agreed not to engage in "protracted, large-scale intervention in one direction in the exchange market."[38] Unfortunately, the IMF has done next to nothing during the last two decades to enforce currency manipulation rules. As a long-term response, **the U.S. government should work with the WTO to make certain types of currency manipulation violations of trade rules.** Specifically, it should be a trade violation for governments to purchase currencies over a sustained period with the intent of lowering currency values to gain trade advantages (rather than as emergency actions during financial crises). More immediately, **the administration should work with the G8 members and other Asian nations to establish a Plaza Accord II as mutual commitment to abide by market-determined exchange rates.**

As we ask other nations to stop manipulating their currencies, we must also get our fiscal house in order. Economists have long argued that large federal budget deficits keep the dollar higher than it otherwise would be. Clearly, **deficit reduction will be an important tool for bringing about dollar adjustment.** But deficit reduction is important for another reason: The Bush administration has showed inaction in the face of foreign currency manipulation in part because it has become dependent on foreigners buying the T-bills needed to finance our huge budget deficit.

Vigorously Work to Enforce Global Trade Rules Against Product and Service Piracy

If countries want to engage in global trade, they need to crack down on piracy of intellectual property.[39] While the comparative advantage of a country like India may be in low-skill information processing jobs, one of America's comparative advantages is its ability to produce knowledge-rich products and services. Worldwide, copyright industry sources estimate that in 2002 costs from lost revenues due to overseas piracy amounted to over $1.5 billion for movies, $2.2 billion for music, $4.4 billion for business software, $1.5 billion for entertainment software, and $500 million for books. That year, an estimated 70 percent of business software in India was pirated.[40] The rate in China was even higher—an astounding 92 percent. If China paid for its business software, U.S. companies would have received an additional $1.6 billion in revenue, and China's trade surplus might have been lower as well.[41] If American companies received even one-half of their due, the U.S. economy could create an additional 75,000 jobs. But piracy is by no means limited to information-based products. Chinese companies illegally pirate and "knock off" a wide range of goods with serious consequences for the U.S. economy. For example, one manufacturing company recently had to close a U.S. plant because a Chinese company had illegally copied their patented product and exported it more cheaply to the United States. Likewise, a Chinese car company in a joint venture with GM has started producing almost exact replicas of the GM Spark vehicle. While China agreed to an action plan that includes "significantly" reducing infringement of intellectual property rights and increasing penalties for violations, it is not clear how effectively the plan will be implemented. In contrast to the Clinton administration, which filed 13 intellectual property rights cases with the WTO, the Bush administration has filed none. **We need to step up both formal enforcement actions and informal pressure on other nations to curb intellectual property theft.**

Open Up Foreign Markets to U.S. Goods and Services

Some of the very countries that are benefiting from the offshoring of U.S. jobs and large trade surpluses with the United States (such as China and India), also have substantial restrictions on access to their domestic markets. For example, while the Indian government has made some progress in opening up its domestic consumer markets to imports, tariffs are still relatively high. There is also a considerable number of ways they could expand their markets to service imports. Likewise, the Chinese government manipulates its tax code and standards process to give its domestic manufacturers an unfair advantage. China provides domestic semiconductor makers with illegal export subsidies by exempting exports from value-added taxes (VAT). China has developed its own standard for communications devices that is different from the established standard used in the rest of the world to keep out foreign competitors in the wireless market, including the United States.[42] They are also preparing procurement rules that would require government to buy software made domestically. China and other governments also require companies to establish joint ventures and share proprietary technology if they are to sell to the Chinese market. As a result, we should:

- **Double funding for trade enforcement.** Trade enforcement has not only been a low political priority for the Bush administration, it has also been starved of funds. We should double the current funding to the U.S. Trade Representative for enforcement of trade agreements, intellectual property standards, and other priorities.

Stop Subsidizing American Companies' Overseas Investments

It makes perfect sense for the U.S. government to encourage domestic companies to establish facilities overseas to access foreign markets. But Washington has no business encouraging U.S. companies to move production facilities overseas that end up selling products in the United States. Here is what we should do:

- **Eliminate tax loopholes that encourage countries to reincorporate in offshore tax havens**.[43] A number of countries, including the United States, tax the income of companies operating on their shores no matter where that income is obtained.[44] United States companies are allowed to take a credit against taxes they pay in foreign countries, but must pay the remainder of their taxes to the United States. In reality, companies avoid paying billions of dollars in taxes in part by keeping money overseas indefinitely, and in part by repatriating the profits in years when they have losses at home. Congress should stop such practices. It should embrace Sen. John Kerry's proposal to require U.S. companies to pay taxes on foreign income in the same year that it is produced. But, as Kerry proposed, this provision should apply only on foreign income that is generated from products and services sold in the U.S. market. Such a measure should be revenue neutral in the federal budget, with the tax dollars supporting an expanded R&D tax credit and a new capital investment tax credit.

  Some have argued that requiring companies to pay taxes on foreign revenue derived from sales in the U.S. market encourages offshoring by raising the taxes U.S. companies pay. In fact, the opposite is true. If companies could sell products and services in the U.S. market tax free by moving offshore, they would do it much more often. And in fact, at the margin, the current tax code contributes to this practice. Some also argue that requiring companies to pay taxes on foreign revenues derived from sales in the U.S. market distorts global investment flows. But the truth is, allowing that income to be tax free tilts the economic playing field to provide companies with an incentive to locate outside the United States, even if that is not the most economically efficient place to be located. Finally, some have opposed requiring companies to pay taxes on the income derived from selling products and services in the U.S. market on the grounds that it is too cumbersome and unworkable. While it is true that such a requirement would be more complicated than the current law, the new approach should at least be tried to see if it is workable.

- **Congress should engage in oversight of the Overseas Private Investment Corporation.** The Overseas Private Investment Corporation (OPIC) is a governmental corporation whose mission is to help American companies invest overseas. When Congress created OPIC in 1971 to get American companies to invest in developing countries, it was a different world.[45] We were not only fighting a global battle with communism, but we were also running a significant trade surplus and were the world's economic leader. In today's competitive global economy, OPIC's mission is an anachronism, yet it continues to encourage U.S. companies to move to other nations, including India. For example, OPIC's website, which is targeted to American business, includes links to organizations such as the Indian Investment Center—a government agency that seeks to induce American companies to move jobs to India—and the Federation of Indian Chambers of Commerce and Industry. This is akin to the state of New York's department of economic development advertising Alabama's industrial recruitment incentives. The OPIC also guarantees investments in overseas venture capital funds, many of which invest in high-tech ventures that potentially compete with U.S. companies. For example, the OPIC India Private Equity Fund, administered by the Oppenheimer investment bank, made investments in Indian companies in the banking, computer, and other industries.[46] It is one thing to help companies make investments overseas that help struggling domestic economies with things like water and electricity supply or energy extraction, but it is quite another thing to subsidize investment in foreign companies that are direct competitors to U.S. companies.

- **End other government efforts to encourage companies to move overseas.** For example, the U.S. Department of Commerce has hosted conferences for U.S. companies designed to help them invest in foreign nations like China, even if these companies are closing their U.S. plants and opening up plants in China to sell into the U.S. market.[47] Businesses signing up for one such conference could list one of their interests as opening "up an office, warehouse/ distribution center, [or] manufacturing facilities."[48] They could find information on "How to Select Locations for your Businesses and who to Partner with in China" and learn about "China's Taxation for Foreign Companies and Joint Ventures post WTO."

III. Establish a New Bargain With American Workers

There is no question that trade can be disruptive. Even the conservatives' patron saint of laissez faire economics, Adam Smith, admitted as much.[49] It would be a mistake to offer false hope to American workers that we can somehow insulate them from the dynamism of the new, global, technology-based economy. We can, however, offer workers a new bargain: if the workforce accepts a rapidly changing and highly competitive economy, government will ensure they have portable employee benefits, fair unemployment insurance benefits, a state-of-the-art system of rapid re-employment, access to continuous and affordable life-long education, and expanded opportunities for capital ownership.

The Bush administration, unfortunately, is doing little to help, and in many cases is actually making matters worse.[50] For example, in contrast to the policy of the Clinton administration, the Bush administration has refused to provide Trade Adjustment Assistance (TAA) for laid-off software workers, claiming that the law is aimed only at helping manufacturing workers.[51] The administration has also consistently opposed temporarily extending unemployment insurance (UI) benefits for workers who have exhausted benefits, and has even proposed radically reducing the federal government's role in UI. And the administration has cut federal funding for dislocated workers by almost one-half.[52]

Why is the Bush administration throwing a double whammy at workers at a time when unemployment is already too high? The answer is ideological. The administration is guided by an every-man-for-himself philosophy. Former Bush administration economic advisor Glen Hubbard summed that up when he argued that because adjustment *is* a market phenomenon, a reliance on individuals is the best adjustment policy. The president's advisors believe government only makes things worse. They believe that extending UI benefits when unemployment is high creates more unemployment.

Besides imposing real hardship on the very workers who are already struggling, the Bush approach also reduces support for the kind of dynamic economy that trade and technological change bring. In the new knowledge economy, embracing economic progress requires taking proactive steps to ensure that we can rapidly adapt to inevitable changes that threaten people in a wide range of occupations. Empowering workers does more than simply help those individuals cope with change, it allows the whole economy to weather disruptions and grow more efficiently. If workers see themselves adrift in a turbulent economy without support while corporate CEOs get golden parachutes, they will be less willing to embrace change.

Since fluctuations are regular market phenomena, Progressive Policy Institute believes adjustment policy should empower individuals with effective tools to adapt to change. We need to do two major things: 1) help workers who lose their jobs specifically because of offshoring; and 2) improve general programs focused on displaced workers.

There are several actions government can take to make this happen:

- **Require companies to provide at least three months advance notice to workers losing their jobs due to offshoring.** The most important factor in determining the re-employment prospects of workers is the amount of notice they have.[53] The Worker Adjustment and Retraining Notification (WARN) Act currently covers employers with 100 or more employees, applies to layoffs of more than 50 workers, and requires notice of 60 calendar days. The benefits for workers whose jobs are intentionally moved offshore should be more generous. The "Jobs for America Act of 2004," introduced by Sen. Tom Daschle (D-S.D.), would require that any company with more than 50 employees, offshoring more than 15 jobs, should provide three months notice to workers scheduled to be laid off. That is a good proposal.

  Companies may complain that such requirements impose an unfair burden on business. While this could be true in cases where companies lay off workers due to foreign competition, it is not true when they offshore the work. In this case, companies know ahead of time what they are going to do and it is only fair to provide more notice to workers who will lose their job. Companies may also argue that such notice gives disgruntled workers the opportunity to sabotage work or engage in other undesirable activities. The evidence, however, suggests that this is not the case.[54] In fact, by treating employees with respect, companies can minimize the resentment of their remaining workers.

- **Require Trade Adjustment Assistance Act benefits to apply to workers in any industry or occupation who are laid off due to trade-related causes.** When Congress created the TAA program in 1962, it focused on displacement in manufacturing. Policymakers at the time could not conceive of today's technology allowing service functions to be conducted halfway around the world at the speed of light. It is time to modernize the anachronistic manufacturing-only provision and extend TAA benefits to all workers who lose their jobs due to trade. When Democrats tried to get rid of the discriminatory treatment of service workers during the TAA Act reauthorization debate in 2002, congressional Republicans blocked the effort. Now, Rep. Adam Smith (D-Wash.) and Sens. Richard Durbin (D- Ill.) and Max Baucus (D-Mont.) have introduced legislation that would change the law itself to provide equal help for services workers. Their proposals (H.R. 3881, S. 2143, and S. 2157, respectively) deserve broad support.

- **Provide wage insurance for offshored workers, and pay for it through unemployment insurance surcharges.** On average, workers who lose their jobs due to trade and are re-employed in new jobs make only 87 percent of their former salaries.[55] For many workers, the loss in income is even more significant. Still others are unable to find jobs at close to comparable wages and remain unemployed for long periods of time. One solution to this negative trend is to extend wage insurance to workers who lose their jobs due to offshoring. The recent Trade Promotion Authority legislation created a wage insurance program for workers older than 50 and earning less than $50,000 at their previous job. It allowed them to receive one-half of the difference between their old and new wages for as long as two years. This program, funded in part by employer contributions, should be applied to all workers whose jobs are offshored, and the wage ceiling should be lifted to $75,000.

Given the budget deficit, finding the funds for such a program will be difficult. The Progressive Policy Institute proposes that wage insurance payments be paid for from the unemployment insurance fund, but the fund be built on payments from companies that employ workers overseas. These payments would be included when calculating a company's new UI tax rate based on their "experience rating."[56] The logic for this is as follows: When companies lay workers off to shift the work to a low-wage nation, they may cut costs and create new value at lower prices for consumers in the moderate term, but in the short-run they impose costs on society. American economic output declines at least until the workers are reemployed—and in some cases the workers, especially older workers, are never reemployed. Laid-off workers can experience a range of problems, including alcoholism, family abuse, and failing health. While companies pay the costs of workers' unemployment insurance, additional benefits workers might receive, including those under the TAA, are paid for by the public. So, if companies choose to lay off American workers in order to have the work done overseas, they should be asked to pay not only for the unemployment insurance costs incurred, but also for the wage insurance costs for workers who take insurance payments. McKinsey and Company estimates that such a program need not be expensive, amounting to as little as 4 percent to 5 percent of the savings companies would accrue by offshoring.[57] Moreover, such a system would give companies an added incentive to help their workers find new good, new jobs quickly.

- **Reform and expand programs to help all laid off workers.** We can and should take steps to help all dislocated workers adjust and gain good jobs in other sectors. The Progressive Policy Institute has proposed a comprehensive set of initiatives to help "expand the winners' circle" for American workers. These include expanding and modernizing the unemployment insurance system,[58] consolidating federal training programs into a National Skills Corporation,[59] transferring funds for dislocated worker programs into a New Economy Scholarship Program for dislocated workers to use for training or outplacement services,[60] and expanding health insurance tax credits for laid-off workers.[61]

- **Reinstate income averaging in the federal tax code.** Before it was removed in the 1986 Tax Reform act, workers could average their income over three years. Workers whose income fluctuated from one year to the next—either because they lost jobs, or took risks to start new companies—could thus receive tax refunds if their previous payments were significantly higher than the taxes due on their current earnings. Today's tax code penalizes risk takers and workers who lose their jobs, because people with fluctuating incomes end up paying taxes on a higher percentage of their earnings than people whose incomes are steady. We should reinstate income averaging both to encourage the risk takers who often play a big role in helping the economy grow, to help people navigate turbulent economic conditions.

- **Consolidate federal community and regional development programs into a National Community and Regional Development Corporation.** While the negative impacts of offshoring, and trade in general, are usually on workers, in some cases they are large enough to impact whole communities. As a result, we need to do more than simply help workers; we must also do a better job of helping communities adjust to trade impacts. Unfortunately, federal programs to help distressed communities have grown up piecemeal, with different goals, target areas, and rules. Moreover, over the years, the federal government's commitment to distressed regions has declined. We should transfer the funding for federal community and regional economic development programs, including the U.S. Department of Housing and Urban Development's Community Development Block Grant program, the U.S. Department of Commerce's Economic Development Administration, and the U.S. Department of Agriculture's Rural Development programs, to a new National Community and Regional Development Corporation. One of the Corporation's jobs would be to work with states to identify and, in turn, work with communities at risk from dislocation from trade to help them put proactive economic development strategies in place.

- **Provide $50 million in matching grants to communities to create 10 "Onshore Communities."** While some foreign locations provide companies with production cost savings that cannot be met anywhere in the United States, in some cases low-cost locations—here at home usually rural—can provide cost-effective alternatives. This is especially true when the full costs of offshoring are taken into account (including possible customer relations problems). The cost of living in rural America is often lower than in metropolitan and suburban regions, and therefore, wages can also be lower. For example, the average salary in Washington, D.C., is 60 percent higher than in Tattnall County, Ga.[62]

In many cases, however, rural areas have neither the infrastructure—such as fiber optic telecommunications and office parks—nor the trained workforce needed to be viable locations for finding labor. The Economic Development Administration could provide competitive grants to communities focused on attracting companies doing outsourced business-process work (call centers, software development, and back-office information processing). Communities could use the funds to partner with telecommunications companies to provide modern, high-speed telecommunications capabilities, office parks, training programs at local community colleges, and marketing to attract companies.

Conclusion

Some might argue that the changes brought about by offshoring present too great a challenge to the U.S. economy and American workers, and we should take steps to slow down change and minimize dislocation. The Progressive Policy Institute believes that, in the same way a champion athlete uses the challenge of a big game as motivation to train harder, the nation should use the challenge of offshoring as motivation to enact policies that will make our economy a leader in the 21st century. That includes giving American workers tools to better cope with economic change, and taking steps to minimize the costs individuals face in a more-risky economy.

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Endnotes

[1] *http://www.whitehouse.gov/news/releases/2004/03/20040311-8.html.*

[2] Weisman, Jonathan, "Bush, Adviser Assailed for Stance on 'Offshoring' Jobs," *The Washington Post*, February 11, 2004.

[3] Kull, Steven, *Americans on Globalization, Trade, and Farm Subsidies*, The Program on International Policy Attitudes, January 22, 2004.

[4] The National Foundation for American Policy, *http://www.nfap.net/researchactivities/globalsourcing*.

[5] In spite of the common wisdom that Democrats are protectionists and Republicans are free traders, this provision was inserted by Republican Sens. George Voinovich (Ohio) and Craig Thomas (Wyo.).

[6] These state laws are somewhat disingenuous. For over a generation, lawmakers, particularly in Southern states, dangled large incentives, including cash and the promise of keeping labor unions out, in order to get companies to relocate their facilites to their states. Now that the same thing is happening to them, they cry foul. Moreover, because so many of these states relied on a low-cost recruitment strategy for so long, they are ill-prepared to compete in the new global economy.

[7] The debate over outsourcing and offshoring has been characterized by a confusion of terms. We define "outsourcing" as the process by which a company contracts with another to conduct specific business tasks (e.g., payroll, customer relations). Companies can outsource work to companies located in the United States or in other nations. When people complain about outsourcing, what they really mean is "offshoring," which occurs when U.S. companies move a branch of their company overseas. For purposes of this paper, offshoring will refer to any process whereby work is moved outside this nation.

[8] See Gov. Ed Rendell's Strategic Sourcing Initiative "Savings Thermometer": *http://www.governor.state.pa.us/governor/cwp/view.asp?a=3&q=437328*. Also see: *Idea of the Week: State Procurement Reform*, Democratic Leadership Council, May 14, 2004, *http://www.ndol.org*.

[9] Legislation restricting offshoring of government services often uses the purported risk of privacy as a rationale. For example, supporters of Utah legislation restricting offshoring of call center services for government services cited concerns over identity theft.

[10] Legislation can be found online: *http://www.leginfo.ca.gov/pub/bill/asm/ab_0651-0700/ab_664_bill_20040218_amended_sen.html*. California is also considering similar legislation that would apply to medical data. California Democratic State Sen. Liz Figueroa plans to hold a hearing next month to discuss legislation that would prohibit California hospitals from outsourcing clerical work abroad. Arizona also considered legislation that would have banned medical transcription from being done outside the United States.

[11] Atkinson, Robert, "Understanding the Offshoring Challenge," Progressive Policy Institute, May 2004, *http://www.ppionline.org*.

[12] Consider the following two statements from State of the State addresses given by governors this year. The first is from Republican Governor of Kentucky, Ernie Fletcher, and the second from Democratic Governor of Arizona, Janet Napolitano.

"... [T]he global economy is changing rapidly. To prosper we will change with it and we will seize the opportunities of the Knowledge Economy. To do this, we will recognize our universities and our community colleges as essential economic engines. They transfer technology from the laboratory to the work place. They are the incubators of human capital. And for our colleges and universities to fulfill this role, we must invest in their training, technology transfer and research. That's why our budget makes the wise investment of expanding research space in both of our major universities ..."

"I plan to implement this [high tech] strategy, which includes a package of legislation to establish early stage and venture capital investments in [our state's] … growing innovative industry sectors. We must invest in these high-tech sectors and in our rural economies, to ensure growth in the number of high-paying jobs …"

[13] One key reason states have been able to implement these policies: By and large, they do not rely on economists for advice, for when they have done so, economists, relying on textbook theory, not on the ground experience, usually tell states that the best thing they can do is nothing. Not only is this bad economic advice, it is terrible political advice.

[14] Fiorina, Carly, "Be Creative, Not Protectionist," *Wall Street Journal*, February 13, 2004.

[15] "Focused Learning @ibm," IBM Corporation, Powerpoint Presentation, 2004.

[16] *http://www.newbalance.com/aboutus/misc/tour.html*.

[17] Jarboe, Kenan Patrick, and Robert D. Atkinson, "The Case for Technology in the Knowledge Economy," Progressive Policy Institute, June 1998, *http://www.ppionline.org*.

[18] *http://www.nsf.gov/od/lpa/nsf50/nsfoutreach/htm/home.htm.*

[19] For details see Atkinson, Robert, "The Innovation Economy: A New Vision for Economic Growth in the 21st Century," Progressive Policy Institute, October 20, 2003, *http://www.ppionline.org*.

[20] For a more detailed agenda to boost manufacturing competitiveness, see: Atkinson, Robert D., "The Bush Manufacturing Crisis," Progressive Policy Institute, October 2003, *http://www.ppionline.org*.

[21] For an example of a description of tax loophole closing proposals, see: Weinstein, Paul, "A Return to Fiscal Responsibility," Progressive Polcy Institute, February 2004, *http://www.ppionline.org*.

[22] Expanding the tax credit is important given the fierce global competition for attracting corporate R&D jobs and facilities, and the significant incentives other countries offer.

[23] For a discussion of these ideas see Atkinson, Robert, "Boosting Technological Innovation Through the Research and Experimentation Tax Credit," Progressive Policy Institute, May 1, 1999, *http://www.ppionline.org*.
[24] The Senate passed legislation that was less of a grab bag of giveaways, but it also focused on rate cuts, as opposed to incentives for things like more R&D and investment in equipment. H.R. 2896 and S. 1637.
[25] For more detail, see Atkinson, Robert, "The Failure of Cyber-Libertarianism: The Case for a National E-Commerce Strategy," Progressive Policy Institute, June 8, 2001, *http://www.ppionline.org*.
[26] More specifically, the program works by the Small Business Association issuing guaranteed debentures that certified private sector venture capital companies can draw down if they provide $1 for every $2 in federal loans.
[27] *http://www.workforcealliance.org/news/press/TWAon05Budget2-3-04.pdf.*
[28] It is important to not get too carried away with pure numbers of researchers. Russia has almost as many as Japan (505,000 vs. 648,000) but is nowhere near as innovative. China has the second highest number (743,000) in the world, well behind the United States (1.3 million).
[29] The number of U.S. citizens getting science and engineering doctorates has declined from approximately 13,000 in 1995 to less than 10,000 today.
[30] National Science Board, "An Emerging and Critical Problem of the Science and Engineering Labor Force," National Science Foundation, January 2004, *http://www.nsf.gov/sbe/srs/nsb0407/start.htm*.
[31] In 2000, the General Accounting Office reported that, even after the passage of the Workforce Investment Act, there were more than 40 separate training programs in seven federal agencies.
[32] Atkinson, Robert, "Creating a National Skills Corporation," Progressive Policy Institute, June 14, 2002, *http://www.ppionline.org*.
[33] *Ibid*.
[34] Currently, there only a handful of high schools specializing in math and science nationwide. With this program, Congress could fund matching grants for states and school districts to set up math and science charter or magnet high schools. To be eligible, the schools would have to enter into a partnership with technology-focused companies.
[34] A number of offshore outsourcing firms have stretched the guest worker visa regulations (H1B and L1) to gain competitive advantage in the U.S. market. This process of exploiting the lax visa regulations has actually accelerated the process of offshoring and offshore outsourcing. Many of the offshore outsourcing and offshoring business models rely very heavily on H1Bs and L1s. "For example, Electronic Data Systems proposed, in its FY 2001 Labor Condition Applications, to pay its 452 H1B's a median salary of $71,251, Wipro and Tata (Indian companies with operations in the United States) proposed salaries of $50,648 for 3,120 H1B's and Tata $36,502 for 11,982 H1Bs respectively." (Source: Hira, Ron, "Shifting IT Resources Offshore: A Panacea or Pandora's Box?," Remarks given to International Committee, Northern Virginia Technology Council, December 18, 2003.)
[36] Foreign Trade Division, U.S. Census Bureau.
[37] Japan ran a $66 billion trade surplus with the United States in 2003 and has run a surplus for almost three decades, yet it persists in manipulating its currency to keep down the yen's value and keep up their trade surplus.
[38] Goldstein, Morris, "Currency Manipulation," *JoongAhn Daily*, December 11, 2003.
[39] In many foreign countries, there is widespread piracy of products and, in some, companies illegally knock-off designs and trademarks of U.S. companies.
[40] "Eighth Annual BSA Global Software Piracy Study," Business Software Alliance, June 2003.
[41] "Special 301 Report: India," International Intellectual Property Alliance, 2004, *http://www.iipa.com/rbc/2004/2004SPEC301INDIA.pdf*.
[42] While there was recent progress between the United States and China on this issue, it is not clear whether China will take serious steps to stop using standards for protectionist purposes.
[43] President Bush claims that we should close the Bermuda corporate loophole, but has opposed legislation to do so.
[44] Other countries that tax foreign income include Japan, the United Kingdom, and Italy.
[45] The OPIC's mission is "to mobilize and facilitate the participation of United States private capital and skills in the economic and social development of less developed countries and areas, and countries in transition from non-market to market economies." The OPIC Finance Department, *http://www.opic.gov/Finance/.*
[46] The OPIC Investment Funds Department, *http://www.opic.gov/investmentfunds/.*
[47] *http://www.iht.com/articles/121030.html.*
[48] *http://216.239.39.104/search?q=cache:k6rGCTlhaxMJ:www.williambmay.com/documents/Registration_Survey_Form.pdf+%22economic+and+trade+conference%22&hl=en&lr=lang_en&ie=UTF-8.*
[49] Smith stated in reference to what would happen if trade were to suddenly accelerate due to removal of tariffs, "Humanity may in this case require that the freedom of trade should be restored only by slow gradations, and with a good deal of reserve and circumspection. Were those high duties and prohibitions taken away all at once, cheaper foreign goods of the same kind might be poured so fast into the home market as to deprive all at once many thousands of our people of their ordinary employment and means of subsistence. The disorder which this would occasion might no doubt be very considerable." Book Four, Chapter 2.
[50] Atkinson, Rob, "Bush's Double Whammy on Jobs," *Blueprint*, July 27, 2003, *http://www.ndol.org*.
[51] Laid off programmers filed a class-action suit against the Department of Labor (DOL) claiming that the agency has illegally denied 10,000 of them benefits under TAA. During the Bush administration, DOL has ruled that many software workers are ineligible because software and IT services do not qualify as products or "articles" under TAA guidelines.

[52] Federal funding for dislocated workers has fallen from about $300 dollars per worker in the last year of the Clinton administration to just $161 now.
[53] U.S. Congress, Office of Technology Assessment, "After the Cold War: Living with Lower Defense Spending," U.S. Government Printing Office, February 1992.
[54] *Ibid.*
[55] Kletzer, Lori, "Imports, Exports, and American Jobs: Understanding the Links and What They Mean for U.S. Workers," W.E. Upjohn Institute for Employment Research, December 2002.
[56] The UI tax rate companies pay is based in part on the extent to which their employees have used the system and drawn down benefits in prior years. Companies that lay off few workers pay a lower rate than companies that lay off many workers.
[57] Agarwal, Vivek and Diana Farrell, "Who Wins in Offshoring," *The McKinsey Quarterly*, No. 4, 2003.
[58] Atkinson, Robert, "Modernizing Unemployment Insurance for the New Economy and the New Social Policy," Progressive Policy Institute, February 19, 2002, *http://www.ppionline.org*.
[59] Atkinson, Robert, "Creating a National Skills Corporation," Progressive Policy Institute, June 14, 2002, *http://www.ppionline.org*.
[60] Weinstein Jr., Paul, "New Economy Work (NEW) Scholarships: Universal Access to Training for Displaced Workers," Progressive Policy Institute, June 14, 2002, *http://www.ppionline.org*.
[61] Lemieux, Jeff, et al., "From Transitional to Universal Health Coverage," Progressive Policy Institute, September 30, 2003, *http://www.ppionline.org*.
[62] Atkinson, Robert, "Reversing Rural America's Economic Decline: The Case for a National Balanced Growth Strategy," Progressive Policy Institute, February 2004, *http://www.ppionline.org*.