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In advance of the 24th Labor & Employment Law Section Annual Meeting in Silicon Valley on **October 27-28**, this issue of the Review focuses on new developments in the creative and high-tech workplace.

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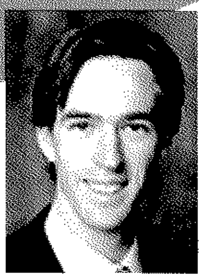
MCLE Self-Study

"So This Guy Walks Into a Bar . . . .": Dirty Jokes and Vulgar Language in the Workplace After the California Supreme Court's "Friends" Decision

By Adam Levin and Taylor Ball



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The California Supreme Court recently wrote the epilogue of the hit "Friends" television series. Plaintiff Amaani Lyle, hired as a writers' assistant on the show, alleged that the use of sexual jokes, stories, comments and expressive gestures by the show's writers constituted sexual harassment. In a unanimous decision, the seven justice of the Supreme Court rejected Lyle's claim against Warner Bros. Television Production, and writers and producers of "Friends," ruling that because the alleged conduct was not directed at or about the plaintiff, the conduct did not violate California law.[1] It is not the use of sexual speech that is prohibited by state and federal employment laws, the Court explained, but speech and conduct that is directed at an employee or group of employees *because of* their gender.[2] With its ruling, the Supreme Court brought California law into line with decisions interpreting Title VII of the Civil Rights Act of 1964.[3]

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— Inside the Review —

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The Economics of Outsourcing

Benjamin Powell, Ph.D., and Matt Ryan

The outsourcing, or "offshoring," of American technology and service jobs has become a hotly debated topic over the past five years. California's large concentration of technology jobs makes the issue particularly relevant here. Is outsourcing good or bad for California?

This article begins by reviewing why the outsourcing of service jobs has emerged in recent years. The economic consequences of outsourcing are then explained. The final section concludes that outsourcing is beneficial to our economy.

WHY OUTSOURCING NOW?

Many hail the globalization of the world economy as the beginning of a new era. However, the United States was nearly as integrated into the world economy over 100 years ago. Merchandise exports were eight percent of our economy in the year 2000, while they were approximately seven percent of our economy during the late 19th century.[1] We are not in a new era of globalization; what has changed is the composition of what is traded internationally. Merchandise imports and exports still account for most of the United State's international trade, but the service industry trade has increased substantially. In 1970, service exports accounted for less than one percent of our economy; by 2000, they accounted for over three percent of it.[2] Even this number understates our true level of international trade in services since companies oftentimes make direct investments abroad (and foreign companies here) and provide services on sight. United States' direct investment abroad increased from six percent of our economy in 1960 to 20 percent by 1996, while foreign investment in the U.S. increased to 16 percent of our economy, up from one percent.[3] Changes in technology, capital mobility, and the external environment are the three main factors that account for the increasing role services play in international trade.

Many services have traditionally required face-to-face interaction. Changes in technology have helped lessen the need for physical proximity in services trade. The wide spread use of computers, increased broadband data capacity, and lower international calling rates have all made it easier to perform services from abroad. It is no longer necessary for the person who reads and diagnoses your x-ray to be at the same location. Today, the same x-ray can be sent to a technician halfway around the world instantaneously, and a diagnosis can be returned just as fast. Technical support for products and other call-in centers are now operated from abroad due to low international calling rates. Computers and high-speed networks have allowed more marketing, product design, and software development to be done abroad and sent back to the U.S.

Technology alone doesn't account for the rise of outsourcing. Capital must be free to move between countries so that investments can be made to establish supporting infrastructure, such as software development facilities and call-in centers. Under the Bretton Woods system of fixed exchange rates, which emerged shortly after World War II and lasted until the early 1970s, many countries put restraints on capital mobility. Since the end of Bretton Woods, capital has flowed more freely, allowing more investments to be undertaken which support the outsourcing of service and technology jobs.

Finally, improvements in the external environment have played a major role in promoting outsourcing from the United States. Companies generally do not make the investments that promote outsourcing in countries that lack secure property rights and the enforcement of contracts, or in countries with high rates of taxation, inflation, and excessive business regulation. All of these conditions generally can be thought of as decreasing economic freedom. The *Economic Freedom of the World Annual Report* ranks countries based on how they perform on these measures. From 1980 through 2003 they find that the overall level of economic freedom around the world has increased by 25 percent.[4] This improvement in policies around the world has increased the attractiveness of starting business ventures in other countries.

Although manufacturing outsourcing can occur in many countries around the world where there are low-cost and low-skilled workers, the outsourcing of technology and service jobs generally requires a better educated workforce and often the ability to speak English. Ireland and India, two well-educated and English speaking countries, have been extremely successful in attracting U.S. outsourcing of technology and services. It is no coincidence that this pair has also made dramatic improvements in their respective economic policies.

After achieving independence, India's economic policies were heavily influenced by socialist planning ideology. Some reforms were initiated in the 1980s but the majority of India's reforms stemmed from a financial crisis the country faced in 1991. Fortunately for India, its reforms coincided with the rise of technology that made the outsourcing of service and technology jobs to India possible. India increased its economic freedom score by over 30 percent between 1990 and 2003. Far from the top of the list, it currently ranks as the 65th freest country in the world. However, the freedom to trade internationally has been one of the biggest areas of improvement in India. Telecommunications have benefited from decreased regulation, while the software industry emerged after, and independent of, the industrial licensing system in India. Thus, the sectors in India that benefit most from U.S. outsourcing can be traced to India's greatest advances in economic freedom over the last decade and a half.[5]

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Outsourcing

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Ireland was in the economic backwater of Europe for much of the 20th century and, like India, experienced a fiscal crisis that initiated a wave of economic reforms. The reforms slashed government spending, eliminated fiscal deficits, controlled inflation and cut taxes. As a result, Ireland increased its economic freedom score by 30 percent from 1985 to 1995 and became the 5th freest economy in the world. The result was dramatic economic growth for much of the 1990s and large scale investment by many U.S. firms who located financial, technology, and back office processing jobs in Ireland. By 1994, America already had $10 billion ($3,000 per Irish citizen) invested in Ireland.[6]

It is no accident that outsourcing of U.S. service and technology jobs expanded throughout the 1990s and into this century. The rise of outsourcing was caused by improvements in technology, freer capital mobility, and improvements in economic policies in other countries. These forces combined to create the outsourcing observable in the Bay Area's technology sector. The next section analyzes outsourcing's effect on the well-being of the American population.

ECONOMIC IMPACT OF OUTSOURCING

When jobs that were performed in the United States move abroad, American workers get laid off and businesses close. These easily visible costs of outsourcing lead many Americans to believe that outsourcing is bad for our economy. The benefits we get from outsourcing are less direct and often go unseen. While some individual workers are made worse off when their jobs are outsourced, once the benefits are accounted for, the U.S. economy, on net, gains from the outsourcing of jobs.

The first crucial point to recognize is that there is not a fixed number or distribution of jobs in our economy. Jobs are constantly created and destroyed. When figures of job creation are released to the general public, the number of "jobs created" is the amount of jobs created *on net.* Creating 10,000 new jobs can involve the generation of 100,000 new positions and the removal of 90,000 existing positions. Overall, total civilian employment and the size of the U.S. labor force have tracked each other fairly closely over the last 60 years.[7] When we have extra workers, we create more jobs to help satisfy consumers' demand for goods and services. The massive entry of women into the work force in the post-World War II years did not create any long-term increases in unemployment. Instead, more jobs were created. The same is true when workers become available because their jobs were outsourced—other jobs are created for them. Outsourcing does not change the total quantity of jobs in the U.S. It changes the composition of those jobs.

Is the change in the mix of jobs desirable? Jobs are outsourced when foreign workers can complete a given job more cost effectively than U.S. workers. It's obvious that companies outsource the jobs to increase their profits. To understand the economic significance of what it means when a foreign worker can more cost effectively complete a job, one must understand how wages are determined.

In a competitive labor market, the maximum that any worker can earn is the marginal productivity of their labor. In other words, the upper limit of a worker's wage is the amount they contribute to their employer's profits. Employers, of course, want to pay as little as possible for labor. The lowest wage a worker will accept is what he could earn in his next best alternative employment. Therefore, the actual wage a worker receives will be in between these two limits.

Thus, when a service or technology job is outsourced to a foreign worker for a lower wage it reflects one of two things, or both: their marginal productivity of labor is lower, and thus can not command as high of a wage, and/or their next best alternative employment is less appealing than the alternative to for the U.S. worker. The gains to society from outsourcing stem from differences in the next best alternative employment of workers. The work that could be done in this alternative employment is the cost to society of having a worker perform a particular job. Assume that the alternative to working at a call-in center in India is the relatively unproductive job of hand weaving; the alternative to working in a call-in center in the U.S. is being a receptionist at another company and that the cost adjusted value each call center provides are equal. If the call-in center is located in the U.S., Americans get call-in center services and can trade for a few hand woven garments. If the call-in center is located in India, U.S. society gets call-in center services and the services of the receptionist. Either way, the call-in center services are provided. The crucial question—the one of economic efficiency—is which is more valuable: the hand woven garments or the services of a receptionist? The market answers this question through competitive labor markets. In this example, since the Indian worker would not earn much in hand weaving, the lower bound of their wage would be much lower than what the U.S. worker could earn as a receptionist. Therefore, because the company could get the call-in center job performed at a lower wage in India, the firm would be led by the market's invisible hand to outsource the call-in center position to India. Society would benefit from the creation of a larger total economic pie by having both call-in center services and a receptionist, because these services are more valuable than call-in center services and hand woven garments.

Though a simple example, it illustrates a powerful economic concept—the law of comparative advantage. When countries specialize and produce what they are relatively more efficient at producing (i.e., have a comparative advantage in), *both* countries gain by having a larger total amount of goods and services. The economics of the outsourcing of services and technology jobs is not different than the economics of outsourcing manufacturing jobs. Since Adam Smith wrote the *Wealth of Nations* over 200 years ago, there has been widespread consensus among economists that countries are better off by specializing and freely trading with other nations. In a recent survey of members of the American Economics Association, economists were more strongly opposed to the imposition of tariffs to protect American industries than any of the other 17 policy questions surveyed.[8]

Unfortunately, the benefits of foreign trade are often harder to observe than the costs of it—namely, the workers who become temporarily unemployed because of it. It is hard to identify exactly which jobs were created because international trade freed up U.S. labor and which jobs were created in our economy for any of a multitude of other reasons. Sorting out exactly which jobs stem from our outsourcing of other jobs is not possible. That these jobs are difficult to observe should not diminish the fact that they are no less real than any other job created in our economy.

Although not all domestic jobs created by our own outsourcing are identifiable, some are. Jobs that are "insourced" to the United States from foreign countries and jobs in companies that export products overseas are a direct result of our own outsourcing. One of the first lessons taught in international economics is that "exports are the price you pay for imports." When we export some jobs overseas through outsourcing, other jobs are created in the United States because foreign workers use their earnings to buy American-made products and services, or to make investments back into the U.S. economy. California, and the San Francisco Bay Area in particular, benefit from this process. Bay Area manufacturers derive almost 60 percent of their revenue from foreign sales. Due to the Bay's Area's high technology, California leads the nation in "insourced" jobs—over 700,000 employees in the state work for subsidiaries of foreign corporations. According to a study by the Bay Area Economic Forum, the San Francisco Bay Area has more foreign-owned research and development facilities than other region or even State in the U.S. The Bay Area's share of employment devoted to R&D positions, at 6%, is two and a half times that of the United States as a whole.[9] If some of our technical support services and back office processing jobs were not outsourced overseas a smaller share of our labor force would be available to focus in R&D. America's outsourcing of jobs and importing of products enables foreigners to demand our products and make investments within the United States. Policies attempting to limit outsourcing would have the detrimental effect of limiting "insourcing" as well.

CONCLUSION

The outsourcing of U.S. service and technology jobs is not something to fear. The economics of outsourcing is not different than the economics of international trade in traditional manufacturing sectors. In services and technology, as well as manufacturing, the U.S. benefits when it is open to international trade. Our total number of jobs is unaffected, and our mix of jobs changes to better reflect what we more efficiently produce. In the process, the standard of living in the United States improves.

ENDNOTES

1. Irwin, Douglas A., FREE TRADE UNDER FIRE, at 6 (Princeton University Press, 2002).
2. *Id.* at 12.
3. *Id.*
4. Gwartney, James, and Robert Lawson, ECONOMIC FREEDOM OF THE WORLD 2005 ANNUALL REPORT (Fraser Institute 2005).
5. For a discussion of India's economic growth see Benjamin Powell, *The Environment of Productive Entrepreneurship: Evidence from Asia and the Pacific'Rim*, INDIAN J. OF ECON. & BUS (forthcoming).
6. For a discussion of Ireland's economic reforms and growth see Benjamin Powell, *Economic Freedom and Growth: The Case of the Celtic Tiger*, 22 CATO J 431 (Winter 2003).
7. *See* Irwin, *supra* note 1, at 72.
8. See Daniel Klein and Charlotta Stern, *Is There a Free Market Economist in the House?* AM. J. OF ECON. & SOC. (forthcoming).
9. Kearny, A.T., THE FUTURE OF BAY AREA JOBS: THE IMPACT OF OFFSHORING AND OTHER KEY TRENDS (Bay Area Economic Forum, 2004).