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REVIEW & OUTLOOK

The 'Insourcing' Problem

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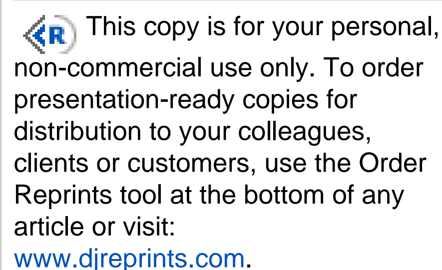

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Now that the election is over, all the wailing about "outsourcing" seems to have vanished, as it certainly should. So maybe we can all begin to pay attention to the more important economic subject known as "insourcing," where some of the recent data really are worrisome.

Insourcing is what happens when foreign-headquartered multinationals operate subsidiaries in the U.S. These companies contribute both to U.S. economic growth and living standards, but a precise measure of these gains is hard to come by. That's why the Bureau of Economic Analysis's recent data about insourcing through 2002 is worth noting. As is the study of this data by Matthew Slaughter, an economist at Dartmouth's Tuck School of Business.

Mr. Slaughter finds that insourcing companies boost the U.S. economy in two ways: through their own operations and their interactions with domestic firms. Insourcing provided jobs for more than 5.4 million U.S. workers in 2002, or nearly 5% of total private-sector employment. These are good-paying jobs, too. Payroll came to more than $307 billion -- or 6% of all private-sector compensation. The average annual compensation at such companies was a tad over $56,000, or some 31% more than the average annual private U.S. compensation.

The internal operations of insourcing companies also contribute to research and development and to capital investment. Their share of private-sector R&D expenditures came to 14% (or $28 billion) and their share of capital investment topped 10% (or $112 billion). Just as eye-popping, insourcing companies accounted for 20% of U.S. goods exports.

Insourcing companies also purchase a high and rising share of their intermediate inputs from domestic suppliers -- in 2002, nearly 80 cents of every dollar, or $1.3 trillion. Just as important, these companies share technology and other knowledge with these U.S. suppliers to improve quality and reliability.

As Mr. Slaughter points out, the vitality of U.S. insourcing has depended upon several strengths -- talented workers across many occupations, deep capital markets and a culture that supports innovation and risk-

taking.

However, and here's the worry, the past is not necessarily prologue. There's no guarantee that the world's best companies will continue to invest as much in the U.S. They now have plenty of other choices. China and India are the world's two most populous countries, have been growing rapidly, and have liberalized their trade and investment policies. Ditto for some of the newer members of the European Union.

And that's what makes some other data, through year-end 2003, a bit disturbing. Total flows of Foreign Direct Investment capital into the U.S. have collapsed since 2000 -- from a peak of $314 billion in 2000 to $29.8 billion in 2003. That's down 90%. No doubt some of that decline is a cyclical response to the giant surge in the late 1990s. But some of the falloff might be structural. In 2003, for the first time, China attracted more FDI than the U.S. ($53 billion). This comes as the U.S. share of world FDI inflows fell to only 5.3% in 2003, from 22.6% in 2000.

It's too early to say whether the attractiveness of the U.S. for business and capital is diminishing. But it's not too early to do what is necessary to maintain our status. That means pressing for more accountability in public schools, and trying to broaden the appeal of science and math. The U.S. remains heavily reliant on foreign-born scientists and engineers -- a virtue of immigration. But they are increasingly difficult to retain in America when opportunities for innovative R&D beckon in their homelands.

As Mr. Slaughter says: "Insourcing companies have contributed a lot to the U.S. economy, but the country is facing rising competition to attract and retain them." He's right.

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