

Outsourcing and Offshoring: Pushing the European Model Over the Hill, Rather Than Off the Cliff!

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Once again a specter is haunting Europe—not in the shape that Marx saw it but in the form of outsourcing and offshoring, which allegedly will empty Europe of the highly skilled high-paying jobs of the future. This working paper argues that the specter needs to be dispelled. Today, Europe faces challenges in the form of low productivity growth and low labor utilization/high unemployment.¹ Outsourcing and offshoring, far from being a blight, are powerful tools to help solve the productivity growth problem and may also—provided the right structural reforms are implemented—assist in solving Europe’s low employment problem.

European governments must realize that offshoring and outsourcing are not simply “a trade issue” but require policy responses on far broader fronts, such as labor markets, education, and regional policies. Auspiciously, EU members² already have many of the required solutions at hand in the Lisbon Agenda to generate both higher productivity growth and higher employment from outsourcing and offshoring—what matters is that they are implemented.

Managing the impact of outsourcing and offshoring presents an opportunity to solve Europe’s most pressing problems of low productivity growth and low employment. Outsourcing and offshoring, however, also connote a very important additional imperative for structural reforms in Europe. European economies cannot simply opt out of either outsourcing or offshoring, and the two will substantially increase the costs to Europe of not quickly implementing relevant parts of the Lisbon Agenda and other reforms. Today Europe, through offshoring and outsourcing, is feeling the “gaiatsu” of an outside world that has raised its game in terms of competitiveness and human talent to new heights. This rapid development of the world around them must make European decision makers realize that the status quo is now even less sustainable. If Europe stands still now, it will be run over.

This working paper starts off with a brief discussion of the definition of outsourcing and offshoring and in section II attempts to grasp from available sources the extent of outsourcing and offshoring in Europe. Section III identifies the winners and losers from the phenomenon in the EU-15. Section IV details which of Europe’s policy areas currently pose obstacles to the continent benefiting from offshoring and outsourcing, and section V provides prescriptions to remedy these impediments and indicates what Europe should do to utilize outsourcing and offshoring to solve her underlying structural problems of low productivity growth and low employment. Concluding remarks round up the paper.

¹ For an extensive discussion of Europe’s structural problems, see Baily and Kirkegaard (2004).

² For the purposes of this working paper, Europe is synonymous with the EU-15.

I. DEFINING OUTSOURCING AND OFFSHORING

While in the United States the current debate on outsourcing and offshoring seems almost entirely focused on the loss to India of US software programming jobs, in Europe the discussions of offshoring, outsourcing, *delocalization*, the “bazaar-economy,”³ and deindustrialization are significantly wider in scope and effectively concern the entire economy. In some respects, this broader current European debate probably reflects a “rolling into one debate” of several debates that have raged in the United States in the last couple of decades about the merits of free trade in the North American Free Trade Agreement (NAFTA), about global production platforms for reexports of goods and services back into the United States, and about foreign trade (deficits) in general. This working paper therefore initially adopts a broad definition, which warrants a brief discussion.⁴

Outsourcing refers to the purchasing of intermediate inputs by companies (or governments) at arm’s length. Raw material inputs are excluded. For instance, purchases of raw steel by Volkswagen would not be outsourcing, but if Volkswagen decided to purchase the doors for its cars from a supplier, rather than manufacture them itself, it would have “outsourced its production of car doors.” Similarly, if Credit Lyonnais decided to hire a cleaning company to clean its offices, rather than have cleaners on its own payroll, it would have “outsourced its cleaning services.” It is important to realize that this phenomenon is not new and has been going on since at least the industrial revolution. It is effectively synonymous with the distribution of labor and with companies remaining competitive and cost-conscious while specializing in what they do best. What is new, however, is that information and communication technology (ICT) in recent years has made outsourcing of whole new types of services possible. IT and cheap communication today facilitate companies to outsource most things that can be reproduced/conducted in digital form, such as IT support, back office (payroll administration and accounting), call-centers, software programming, and some R&D functions. Similarly, ICT has enabled additional outsourcing in goods manufacturing, as intermediate inputs can now be seamlessly sourced from multiple suppliers. Just-in-time production techniques, which Toyota invented in the pre-IT period, today rely heavily on ICT.

Offshoring refers to the acquisition of intermediate inputs by companies (or governments) from locations outside the consuming country. It is the crossing of international borders that distinguishes it from outsourcing in general.⁵ Offshoring may take the form of a transfer of

³ A “bazaar economy” is a national economy that sells goods originating in a variety of international locations and only a few goods produced on national territory. See DIW (2004).

⁴ For narrower definitions of both offshoring and outsourcing, see Kirkegaard (2004), Mann (2003), Cronin, Catchpole, and Hall (2004), van Welsum (2004), and Amiti and Wei (2004).

⁵ Alternatively, offshore is “at a significant physical distance from the location of the consumer;” see Forrester (2004a). EFILWC (2004) quotes an EU-wide survey showing that in 2000 only 5.3 percent of establishments

particular tasks within an organization to a foreign location—for instance, Lufthansa opening a new accounting department in Poland for company use is offshoring but not outsourcing. An important distinction must be made between offshoring and foreign direct investment (FDI). Not all FDI is offshoring. If ST Microelectronics decides to build a factory in China to serve the Chinese market, then it is FDI in China but not necessarily offshoring. The distinction is blurred if a company moves an entire domestic production facility abroad and then imports the produced goods (or services) back into its home country—for instance, Benetton moves its Italian shirt production to China and imports Chinese-made Benetton shirts back to Italy.⁶ The distinction between FDI, global sourcing, and offshoring might seem to hinge on the very difficult demarcation of what is an intermediate input, what is a final good or service, and where this good or service is sold. Yet, nonetheless the distinction is for the purposes of this working paper sensible, as many of the underlying issues that drive FDI and global sourcing affect outsourcing and offshoring to a much smaller degree. Focusing on intermediate inputs helps isolate the issues that propel outsourcing and offshoring, rather than affect the related, but distinct area of FDI. In particular, subject areas such as host-nation corporate tax rates and accounting rules for transfer pricing are well known to play a large role in locational FDI decisions of multinational companies but are of limited importance for companies' decisions on what to outsource.⁷

Offshoring may also occur as purchases of intermediate inputs at arm's length from foreign suppliers, in which case one may describe it as offshore outsourcing. When AXA uses the Indian company Wipro for IT application maintenance, or BMW switches to buying car parts from a Czech supplier for use in Bavaria, it is offshore outsourcing.

Again, it must be stressed that this is not an entirely new phenomenon but that the rapid development in ICT and the accompanying drop in the cost of communication have enabled many new inputs of particularly services to be traded across borders—if it can be outsourced, then it can generally also be offshored. Today such tasks as technical drawing in architecture,⁸ radiologist readings of X-rays,⁹ or certain legal services¹⁰ may be sent overseas. Hence, the development of ICT has expanded international trade by lowering transaction costs and making entirely new things

surveyed had outsourced tasks to locations outside their home country, compared with 34.5 percent that had outsourced tasks to their local area.

⁶ Such a strategy would however best be classified as “global sourcing,” rather than offshoring.

⁷ For an excellent overview of literature on the importance of corporate taxation rates on corporate FDI decisions, see Hines (1996).

⁸ “Designs for Western Living from the East,” *Financial Times*, September 2, 2003, 9.

⁹ “The Future of Work Survey,” *Financial Times*, September 27, 2004, 6.

¹⁰ “Caseload Grows for Advocates in Absentia,” *Financial Times*, October 4, 2004, 8.

tradeable.¹¹ This is not unlike the impact of the international container system in the 1950s, which also caused international trade to soar.¹²

The focus of this working paper is on offshoring and offshore outsourcing and not purely on domestic outsourcing, although the fact that the European Union consists of 25 countries does muddy the waters, in the sense that offshore outsourcing between two EU member states for the purposes of EU-level regulation might be considered domestic in character. This highlights the fact that the EU-25 contains both consumers and suppliers of offshored and offshore outsourced goods and services, which adds an additional layer of complexity to the required “European response to offshoring and offshore outsourcing,” which will be discussed below.

II. EXTENT OF OFFSHORING AND OFFSHORE OUTSOURCING IN EUROPE

Numerous pitfalls lie in the way of trying to validly quantify a phenomenon that has no commonly agreed-upon definition (offshoring and offshore outsourcing), whose “perpetrators” have clear incentives to remain unnoticed (companies laying off workers because of offshoring and offshore outsourcing), and whose coverage by official statistical data collection is in its infancy (services sectors and multinational companies), but nonetheless is high on the media and politicians’ agendas.¹³ No authoritative official statistical number exists on the extent of offshoring and offshore outsourcing in Europe, and no coordinated official attempt, national or EU-level, to gauge it has been made.¹⁴ It is important to grasp that the very dearth of such solid statistical quantification of offshoring and offshore outsourcing in Europe will inevitably fuel the widespread public anxiety about the issue. *BusinessWeek*’s February 3, 2003, cover story “Is Your Job Next?” amply captures the public mood.¹⁵ But without solid statistics, we simply do not know if your European job is next.

In the absence of solid data, one must search for proxies to get a sense of how widespread offshoring and offshore outsourcing is in Europe. Several industry experts and consultants have put forward estimates and predictions, generally based on interview surveys with European company executives. Forrester Research, whose November 2002 projection of 3.3 million jobs lost in the

¹¹ See, among others, Van Welsum (2004), Amiti and Wei (2004), Bardhan and Jaffee (2004), Whichard (2003), Mann (2004a), and Mann (forthcoming) for examples of increases in international trade in intermediate inputs and services.

¹² For data on the growth in postwar maritime trade, see UNCTAD, Review of Maritime Transports, annual reports at www.unctad.org.

¹³ Amiti and Wei (2004) found 2,634 reports in US newspapers and 380 reports in British newspapers linking offshoring and offshore outsourcing to job losses between January 2004 and May 2004.

¹⁴ Similarly in the United States, where a recent report from the GAO had the telling title “Current Government Data Provide Limited Insight into Offshoring of Services,” GAO (2004).

¹⁵ “Deutschland: Export Weltmeister (von Arbeitsplätzen)” (“Germany: World Exports Champion (of Jobs)”), *Der Spiegel*, October 25, 2004, is a recent similar European headline.

United States by 2015 can almost be seen as having framed the entire subsequent US debate on the issue,¹⁶ estimated in August 2004 that 81,000 IT and other services sector jobs had been sent outside Europe and that the number would rise to 1.16 million by 2015.¹⁷ With 56.7 million people employed in the EU-15 in services¹⁸ in 2003, this would indicate that 0.14 percent of the EU-15 services sector jobs had been shifted offshore in mid-2004 and that assuming zero employment growth in the EU-15 until 2015, roughly 2 percent of EU-15 service-sector employment is at risk. Hence it is important to emphasize that—like in the United States—only a very small fraction of all services jobs are likely affected in the EU-15. According to Forrester, Britain will account for the largest share (two-thirds) of the services jobs at risk. Language and cultural barriers to a degree insulate most European countries against much competition from India, for instance—cold comfort perhaps for British workers. But, other major European languages, such as German, French, and Spanish, may see increased low-wage language-based competition from Eastern Europe (German), North Africa (French), and Latin America (Spanish), respectively. Nonetheless, Eurostat (2004) reports that from 2000 to 2003, employment in knowledge-intensive services in the EU-15 grew at a rate twice as fast as that in less knowledge-intensive services.

Likewise, software-programming languages are “spoken globally,” so in strictly IT/software programming jobs, non-English speaking countries in Europe will not be linguistically sheltered. Forrester (2004) estimates that 31,000 jobs in IT-related occupations only had been moved outside the EU-15 and Switzerland by mid-2004, and that this will rise to 150,000 by 2015. The European Commission (2004) provides detailed estimates for the “computer and related services sector”¹⁹ in the EU-15 and EU-25, which shows that between 2002 and 2003, 23,500 jobs were created in the EU-15 and that average annual job creation in the sector was 175,000 from 1995 to 2002 in the EU-15. It thus does seem as if job growth in the EU-15 IT sector has slowed since 2002 but nonetheless is still present. It would, however, be erroneous to simply conclude that the growth slowdown is due to offshoring and offshore outsourcing alone, as the “computer and related services sector” is also

¹⁶ See Kirkegaard (2004) for an in-depth analysis of this number.

¹⁷ See Forrester (2004). In this report, offshoring is defined as the use of services delivered by a provider based in a country at least 500 miles away from the country where the buyer is located and where the country of delivery has a cost base at least 50 percent lower than the buyer company’s country. Forrester calculates numbers for the EU-15, plus Switzerland, but for the purposes of these calculations, Switzerland has been subtracted.

¹⁸ Defined as NACE categories G (Wholesale and retail trade; repair of motor vehicles, motorcycles, and personal and household goods), H (Hotels and restaurants), I (Transport, storage, and communication), J (Financial intermediation) and K (Real estate, renting, and business activities). Data sourced from Eurostat NewCronos database; data are for 2003Q2.

¹⁹ NACE 2D-72, which includes hardware consultancy, software consultancy and supply, data processing, database activities, maintenance and repair of office, accounting and computer machinery, and other computer related services. Note that these data are classified by sector of the economy, rather than the Forrester data, which are classified by occupational type, i.e., across the entire economy.

subject to the broader business cycle, which in Europe has been decisively weak since 2002, likely depressing sectoral employment growth.

For the European manufacturing sector, no widely circulated explicit job loss number exists, and the distinction between FDI serving a foreign market and offshoring and offshore outsourcing must again be emphasized. Similarly, the new EU member states have recently benefited from much manufacturing offshoring and offshore outsourcing from the EU-15, particularly in the car industry, so the impact on the EU-25 is complex to describe.²⁰ Based on a survey of large EU-15 manufacturers, KPMG (2004) describes how the share of manufacturing carried out within the EU-15 is expected to decline by 6 percentage points from mid-2004 to 42 percent in mid-2007, with China and Eastern Europe the main beneficiaries of new investment. On the other hand, the EU-15 today enjoys a large trade surplus with the rest of the world in manufactured goods. Table 1, which is based on the 13 EU member states for which data were immediately available, shows that the extra-EU-13 trade surplus rose rapidly by €41 billion from 2000 to 2003, when it stood at €33 billion—an accomplishment (especially seen from the United States) considering that the euro rose by a trade-weighted 16 percent from 2000 to 2003.²¹ Using data from the UN ComTrade database from which individual EU member state extra-EU manufactured goods trade deficits can be calculated for the period, it becomes clear that very large differences exist among the EU-13. Overall, the improvement in the extra-EU-13 trade balance did not occur due to a collapse in imports, although this was the driving reason in Finland, France, Ireland, the Netherlands, and Sweden. The striking feature of table 1 is that it illustrates that the vast majority of the improvement in EU-13 manufactured goods trade can be attributed to German export success. Yet, it is at the same time highly probable that income effects from the rise in the euro cut the other way and contributed to the stagnation in EU-13 imports of manufactured goods.

Table 1 points to continued competitive strength of the EU-13 in manufactured goods,²² so while some manufacturing capacity will flow out of the EU-15 in coming years, talks of imminent total deindustrialization, especially in Germany, must be dismissed. Indeed, the German Ministry of Industry and Work (BMWA 2004) shows value-added from German exports rising as a share of total German value-added, despite a rising share of intermediate imports in German exports. This indicates two things: first that rising intermediate imports seem to have helped German export

²⁰ Eurostat (2004) reports that EU-15 manufacturing employment declined by 1.4 percent a year from 2000 to 2003, thus mirroring the decline seen in the United States. At 18.6 percent of total employment, this sector, though, remains larger than in the United States.

²¹ Manufactured goods defined as SITC categories 6 “Manufactured Goods,” 7 “Machinery and transportation equipment,” and 8 “Miscellaneous Manufactured Articles.” Data are from UN ComTrade database. Exchange rate data are from the ECB’s daily nominal effective exchange rate, available at www.ecb.int/stats/exchange/effective/html/index.en.html#data (accessed October 27, 2004).

²² See also KPMG (2004).

performance, and second that Germany as a whole is benefiting from these rising exports. In short, from its increased use of imported intermediate goods, Germany is already reaping some of the benefits from offshoring, offshore outsourcing, and globalization in general, through improved competitiveness, rising exports, and creation of higher domestic value-added.

A different approach to determining the true extent of offshoring and offshore outsourcing in Europe in the absence of valid official statistical data is to rely on surveys of media reporting of the phenomenon. While this approach obviously depends crucially on the questionable assumption of complete press coverage, it does have the advantage that it relies on broadly verifiable public sources. This stands in contrast to the reports of industry experts and consultants, which rely almost exclusively on unpublished interviews with corporate executives and frequently employ rather opaque methodologies. Two slightly different methods can be identified: scanning news media either for reports of all types of corporate restructuring, regardless of its type and cause, or only for reports on offshoring and offshore outsourcing related to corporate restructuring. The former method has the advantage of allowing comparisons of the relative importance of different causes of corporate restructuring—i.e., seeing if, for instance, people are being laid off due to corporate bankruptcies rather than offshoring and offshore outsourcing.²³ On the other hand, it is clearly very resource-demanding to cover all types of corporate restructuring, and therefore the threshold for inclusion into the “sample of restructurings” will frequently be put so high, say at 50 or 100 layoffs, that much valuable information of smaller restructurings is lost.²⁴ This means that the hard number for lay-offs caused by, for instance, offshoring and offshore outsourcing from this broad type of media survey will likely be an underestimate.

The European Monitor Center on Change runs the European Restructuring Monitor (ERM), which carries out this sort of wide-ranging media surveillance in order to gauge the intensity and nature of corporate restructuring in Europe.²⁵ Its findings from the start of 2002 until February 12, 2005, are presented in table 2.²⁶

²³ If corporate bankruptcies and aggregate demand were the major problems, clearly the policy response to the rising unemployment would include other measures than if it were mostly related to offshoring and offshore outsourcing.

²⁴ Such thresholds may also dangerously bias the sample towards “big events,” such as bankruptcies or plant closures (internal restructurings), which will tend to pass a high threshold in terms of lay-offs, whereas smaller-scale events, say the offshoring of part of the 50-employee company back-office, may not.

²⁵ Available at www.erm.emcc.eurofound.eu.int/erm/index.php?template=home. See Kirkegaard (2004) and European Commission (2004) for examples of use of ERM data in discussions of offshoring and offshore outsourcing in Europe.

²⁶ ERM defines outsourcing as “a type of restructuring where the key activity is subcontracted to another company, which may or may not be located within the European Union.” This definition does not separate outsourcing and offshoring and may therefore cover more cases than are the focus of this working paper. ERM defines relocation as “where the activity is relocated to another country of the European Union or beyond its borders.” All such relocations are thus included in the focus of this working paper.

Table 2 suggests that as a reason for corporate restructuring in Europe, “outsourcing” and “relocation abroad” are of relatively limited importance—at about 7 percent of total jobs lost.²⁷ The ERM covers the daily and business press in the EU-15 and records European corporate restructuring that affects at least one EU-15 country, entails the announced or actual destruction of at least 100 jobs, or involves at least 10 percent of the workforce at sites employing more than 250 people—in other words, the threshold for inclusion is relatively high. Hence, the ERM will likely underestimate the true number of jobs lost and may also skew the relative importance of outsourcing/relocation vs. generally “larger lay-off events” arising from bankruptcies or restructurings downward.

Another recent media survey of European economies, which covers offshoring and offshore outsourcing, is found in Bronfenbrenner and Luce (2004). The authors track cases of “production shifts” globally from January 1 to March 31, 2004, using a variety of news databases—i.e., their study is of the second, more focused type, which tracks only one particular type of restructuring and therefore will probably be more comprehensive. Their study focuses on the United States and the role of China but contains valuable information about European countries, too. The findings for production shifts out of Europe are summarized in table 3: The difference between Bronfenbrenner and Luce (2004) and the ERM data for the same period is striking. Table 4 presents ERM statistics for January 1–April 1, 2004.

Bronfenbrenner and Luce surveyed English-language news media for shifts to Asia and Latin America and note that they therefore will likely have underreported production shifts from non-English speaking European countries and particularly production shifts from Western to Eastern Europe. On the other hand, they, unlike ERM, did not have any lower threshold for the size of job losses to be included in their sample. Both media surveys cover all sectors of the economy, but Bronfenbrenner and Luce (2004) also include Eastern European countries, Norway, and Switzerland in their definition of Europe. Nonetheless, Bronfenbrenner and Luce detect 119 more instances of “production shifts” than does ERM of “outsourcing” and “relocation abroad” in the first quarter of 2004, with more than 12 times the reported jobs lost! Yet, based on average sizes, the vast majority of Bronfenbrenner and Luce’s detected cases of “production shifts” should pass the “100 jobs lost threshold” for inclusion in the ERM database. Annualizing their first quarter data, Bronfenbrenner and Luce’s number of total jobs lost to offshoring and offshore outsourcing (production shifts) for the entire year of 2004 in Europe would approximate 160,000 jobs, thus ignoring their self-professed

²⁷ This corresponds relatively closely with the US Department of Labor’s Mass Layoff Statistics, which tracks sustained US lay-offs of more than 50 people. Here, overseas relocations and import competition are responsible for only about 2 to 4 percent of jobs lost. See BLS news releases “Extended Mass Layoffs Associated with Domestic and Overseas Relocations” at www.bls.gov/news.release/reloc.toc.htm, and Baily and Lawrence (2004) on trade in general as a minor cause for job losses in US manufacturing.

likely underreporting. This equals 0.14 percent of the 116 million privately employed people in the EU-15 in 2003.²⁸

Taking the Bronfenbrenner and Luce study as “objective truth” is obviously untenable. For instance, their inclusion of Eastern European countries in “Europe” may skew their numbers upwards, as production shifts from here to, say, China. Yet in their study they have used an extensive number of professional news and media databases, such as Lexis-Nexis, Factiva, Dun and Bradstreet, Business Source Premier, ISI Emerging Markets, and ABI-Inform. Access to these databases is very expensive, but on the other hand they provide very broad media coverage. Evidently, there is a risk of double counting when searching multiple databases, but the authors’ methodology also utilizes company-specific data and thus registers only entry per company production shift. According to ERM’s Web site,²⁹ their data are instead collected by a network of economists, sociologists, or journalists specialized in industrial relations, relying on major national newspapers and company and trade union Web sites. This indicates that Bronfenbrenner and Luce had access to more resources than does ERM and that the big difference in detected cases suggests that the ERM very significantly underestimates the scope in Europe of outsourcing and relocations abroad. This further indicates that for the ERM database, which is funded by the European Commission, to reflect the true scope of offshoring and offshore outsourcing in Europe and hence be of value to policymakers in the debate on the subject, it needs a substantial increase in the resources available to it.

The result one ends up with when attempting to gauge the present extent of offshoring and offshore outsourcing in Europe is that any sense of imminent doom for Europe’s labor markets because of offshoring and offshore outsourcing is unwarranted, even if one relies on the highest job loss estimates available. Similar to the case in the United States, the shares of jobs are very small, particularly compared with the 14.3 million total unemployed in the EU-15 in 2003. About 81,000 IT and services jobs out of a total of 56.7 million so far, rising to (conservative estimate) 160,000 out of 116 million for the total private economy in 2004 alone have migrated outside the European Union. The important question, however, is not whether this migration will continue—it will—but who will benefit and who will lose, and as an extension thereof how Europe should respond.

²⁸ 116 million equals total employment with NACE categories “L” (Public administration and defense; compulsory social security), “M” (Education), “N” (Health and social work), “O” (Other community, social, personal service activities), “P” (Activities of households), and “Q” (Extra-territorial organizations and bodies subtracted). All these are generally sectors of the economy that are publicly managed in the EU-15. Britain is a partial exception in education. Data are for Q2 2003 from Eurostat NewCronos database.

²⁹ ERM sourcing available at www.erm.emcc.eurofound.eu.int/erm/index.php?template=help2.

III. WHO GAINS AND WHO LOSES?

Today, offshoring and offshore outsourcing generates more trade, frequently in new types of inputs and in new sectors. We know from theory and empirical studies that trade generates wealth, but we also know that trade generates both winners and losers. The question is who they will be in Europe. Before considering that, however, it is important to note that offshoring and offshore outsourcing will clearly increase world welfare, even if it imposes some costs on particular segments of the European economy.

Starting with the assumption/assertion that the decision to offshore or offshore outsource a task by a company (or government) is implemented in a successful way, both winners and losers may be identified a priori. It is, however, crucial to emphasize that legally and technically possible offshoring and offshore outsourcing does not mean it will be profitable. There may be many reasons why such a decision is not profitable in all instances. Customers may not like to be served by call-centers overseas, companies may not receive the intermediate goods in the required quality at the specified time, cultural misunderstandings may occur between companies and clients or across international borders, or proprietary information may be leaked to competitors.

The particular benefits from offshore outsourcing and offshoring will vary from company to company and will frequently only be realized after a number of “trials and errors.”³⁰ For instance, the most recent PWC Management Barometer Survey (PWC 2004) indicates that less than half of the European companies that have outsourced their financial functions have so far actually realized large savings, yet two-thirds of the same companies see offshored and offshore outsourced functions as very important to their profitable growth in the next two years. That so many companies see offshoring and offshore outsourcing as important for future profits, despite their initially disappointing savings, indicates that companies foresee a steep learning curve and expect to eventually realize the potential savings.

Keeping the assertion of potential profitability in mind, there are three certain European winners, namely companies engaging in outsourcing and offshoring, countries that supply offshored

³⁰ See, for instance, *Financial Times*, “How to tap the opportunities for outsourcing,” August 25, 2004, p. 7; “Fresh set of management skills is needed,” September 27, 2004; Special Report: Risk Management, “Move to reduce costs can also lose customers”, June 2, 2004, on what individual managers should consider in order to achieve cost-effective offshore outsourcing. The example of Dell Computers, which in late 2003 following complaints from customers shifted technical support for two of its computer models back to the United States after an initial offshoring to India is a highly publicized case of possible, but ultimately not profitable, offshoring. See CNET News.com, “Dell drops some tech calls to India” November 24, 2003, available at http://news.com.com/Dell+drops+some+tech+calls+to+India/2100-7342_3-5110933.html?tag=nl (accessed November 24, 2004).

and offshore outsourced production and services, and consumers of such products and services. Two assured European losers are workers who lose their jobs and companies that are unable to adopt best-industry practices through offshoring or offshore outsourcing. And then there is the big unknown—namely whether European countries whose companies carry out offshoring and offshore outsourcing and whose residents consume offshored and offshore outsourced goods and services (but also may lose their jobs) will be better or worse off. This, it will be argued below, depends crucially on the structural policies in European countries.

Winners

European companies engaging in offshoring and offshore outsourcing. These get access to potentially very large cost savings, mostly arising from lower labor costs.³¹ Savings will vary from industry to industry and country to country, but most industry expert estimates range between 30 and 60 percent.³² In the longer term, these companies will also gain access to new pools of highly skilled labor, both directly through their own offshored facilities and indirectly through offshore outsourcing from local suppliers. Furthermore, for companies located in European countries with very inflexible labor markets, offshore locations generally will allow a more flexible management of their workforce levels.³³ As offshoring and offshore outsourcing entails the application of modern management techniques and a large capital stock in a low-wage labor setting, the traditional close relationship between wages and productivity is loosened in the short and medium terms. Hence, companies that engage in offshoring and offshore outsourcing in total stand to gain significant productivity improvements.³⁴

It is, however, worth emphasizing that companies that view offshoring and offshore outsourcing as merely a one-off cost-cutting measure and do not attempt to utilize new inputs to create wholly new products and services are unlikely to reap the longer-term benefits available from offshoring and offshore outsourcing. Development of new markets may also very well start with the

³¹ Lower capital investment requirements are another potential cost saver for companies choosing to locate a new facility offshore, rather than expand in their home market. Such “balance-sheet savings” will be one-off but may be substantial in term of the total return on invested capital.

³² See McKinsey (2003, 2004), BCG (2004), Deloitte Research (2004), and PWC (2004). Most of these estimates relate to savings for US companies, and McKinsey (2004) suggests that European companies may realize slightly lower savings, as they face bigger hurdles in laying off workers and restructuring their domestic businesses than do US firms. Hence, while European firms may have generally higher labor costs than US firms and thus ought to be able to realize higher savings, structural impediments in the European labor market prevent this from happening.

³³ See comments by Dieter Mankowski, head of the German Chamber of Commerce, in “Czech Wages are Strong Draw,” *Financial Times*, July 23, 2004, p. 11.

³⁴ There is a large literature on the superior productivity of multinational companies, relative to purely domestic companies; see excellent overview in Lewis and Richardson (2001).

location of an offshore facility there. Such local production facilities can allow European companies to hit the local “price-point”—i.e., produce goods and services at prices that make sales in low-wage countries possible.³⁵

European countries that supply offshored and offshore outsourced production and services.³⁶

With the accession of the 10 new member states in May 2004, the European Union now contains several large suppliers of offshored and offshore outsourced products and services. However, some EU-15 countries, especially Ireland, have also benefited as “offshore production locations.”³⁷ Supplying countries’ benefits are straightforward: In the short term benefits are in terms of the jobs generated and the investment attracted, and those in the longer term are in terms of the technology and skill transfers to local populations that accompany offshore and offshore outsourcing decisions by companies.

Consumers of offshored and offshore outsourced production and services.

Ultimate consumers (i.e., individuals, not just companies) of offshored goods and services will benefit from lower prices of the items they consume. Mann (2003), for instance, estimates that between 10 and 30 percent of the price decline in semiconductors and memory chips during the 1990s occurred because of the globalization of the IT hardware industry. Consumers may also benefit from expanded business hours in many services industries—i.e., the opportunity to call a company call-center in Bangalore after 5pm GMT/CET. Price declines will, depending on the extent of offshoring and offshore outsourcing relative to the total, drive inflation lower and thereby lead to higher real wages. This serves furthermore as a “redistributive tool” between company profits and consumer benefits of the total “welfare gain” from offshoring and offshore outsourcing.

Losers

European workers who lose their jobs because of offshoring and offshore outsourcing.

Workers who lose their jobs as a consequence of offshoring and offshore outsourcing are the obvious and immediate losers. It is important to appreciate that similar to other types of international trade, those who lose their jobs are a small and concentrated group hit hard,

³⁵ For the case of the US IT hardware industry hitting the “local price point,” see Mann (forthcoming).

³⁶ This refers only to European countries but clearly is equally true for supplying countries outside Europe.

³⁷ Ireland’s position as an offshore location for both goods and services production by US technology companies is well known, but Roland Berger/UNCTAD (2004) indicates that 29 percent of offshoring and offshore outsourcing projects by European companies remains within the EU-15 (+ EEA), also benefiting countries like Britain, Spain, and Portugal.

relative to the much more numerous and diverse group of winners from offshoring and offshore outsourcing, who (with the possible exception of companies) will all benefit only relatively little individually. This asymmetry between winners and losers makes the political economy of offshoring and outsourcing identical to most other discussions of free trade and import competition (Lewis and Richardson 2001).

European companies unable to adopt “best practices” through offshoring and offshore outsourcing. This frequently overlooked group of European losers from offshoring and offshore outsourcing is nonetheless very important because one of the fundamental problems plaguing Europe today is low productivity growth. As globalization accelerates, for more and more industries offshoring and offshore outsourcing strategies are no longer merely an option; they are already a competitive imperative for companies.³⁸ This means that European companies unable to restructure their operations with the use of offshoring and offshore outsourcing of particular intermediate inputs or tasks will be at a competitive disadvantage against both their non-EU competitors and EU competitors able to do so. As the circumstances of individual companies are highly disparate, and experiences thus rarely directly transferable between companies, this holds true, even if offshoring companies are faced with a “learning curve” and first movers don’t always get it immediately right. European companies will face slower growth and may ultimately either be driven completely from the marketplace through bankruptcy or voluntary market withdrawal or choose to relocate their entire production (or as much as possible) outside their countries of origin—in both cases likely with larger job losses occurring than if offshoring and offshore outsourcing had been possible at an earlier stage.

Winners or Losers

European countries, whose companies engage in offshoring and offshore outsourcing and whose residents consume offshore and offshore outsourced goods and services. Obviously, whether European countries emerge as winners or losers from offshoring and offshore outsourcing depends on whether they can create more winners than losers and whether they can turn losers into winners. The answer to this question is still uncertain and will be the focus of the remainder of this working paper.

³⁸ See BCG (2004). Roland Berger/UNCTAD (2004) cites a representative survey of Europe’s top 500 companies in which 47 percent of companies are guided by competitors’ best-practice examples when deciding upon a destination for service-sector offshoring and offshore outsourcing.

IV. WHAT MIGHT PREVENT EUROPE FROM BENEFITING FROM OFFSHORING AND OFFSHORE OUTSOURCING AND SOLVING ITS LOW PRODUCTIVITY GROWTH AND EMPLOYMENT PROBLEMS?

Offshoring and offshore outsourcing are an integral part of competitive business in the 21st century, and a Europe focused on economic growth, social sustainability, and competitiveness cannot avoid its consequences. Therefore, Europe needs to direct its policies toward managing the consequences of the phenomenon rather than attempting to block it. Europe needs to create winners rather than losers, and turn losers into winners. Unfortunately, studies show that this may not be happening at the moment.

Laid-off workers

Two studies of service-sector offshoring and offshore outsourcing by the McKinsey Global Institute (MGI) on the benefits to the United States and Germany, respectively, reach starkly different conclusions. MGI (2003) estimates that the US economy benefits by a net \$1.14 for every \$1 of services production offshored or offshore outsourced to India—i.e., it is a net winner. More than 40 percent of the total gain to the US economy comes from reemployment of laid-off US workers in the United States. In contrast, MGI (2004) estimates that the German economy on aggregate loses €0.20 for every €1 of services offshored or offshore outsourced, with a gain of only €0.29 per euro from reemployed labor. The two studies³⁹ clearly point to the single most crucial issue that will prevent European economies from benefiting from offshoring and outsourcing—Europe’s very low reemployment rate for laid-off workers. In order for Europe to achieve a net gain from offshoring and offshore outsourcing, European governments must take on the important task of ameliorating the losses of laid-off workers—the group most adversely affected by offshoring and offshore outsourcing—and productively reemploying them in the economy.

Institute Senior Fellow Lori Kletzer estimated that 65 percent of displaced (laid-off) US manufacturing workers and 69 percent of nonmanufacturing workers find employment again shortly after being laid off (Kletzer 2001, 31).⁴⁰ More recent data from the Bureau of Labor Statistics show

³⁹ A direct comparison between the two studies is made complicated by the fact that the US study refers to only production offshored or offshore outsourced to India (i.e., a bilateral relationship), whereas the German study refers to German services offshored or offshore outsourced both to India and Eastern Europe, where savings are lower.

⁴⁰ Kletzer’s data source, the US Bureau of Labor Statistics’ “Displaced Worker Survey” reports time of reemployment only as at the time of surveying, so cannot be immediately used to gauge the duration of the unemployment spell. Lori Kletzer’s data are used by the MGI for their study of the United States.

that the share of permanent job losers in the United States who found new employment within 14 weeks of becoming unemployed in 2002–03 was 59.4 percent, while the share of permanent job losers without employment after more than six months was only 21.3 percent.⁴¹ Estimates for European reemployment rates for displaced workers are not immediately comparable with US data,⁴² but empirical studies have pointed to the apparent trade-off in Europe between smaller wage losses than in the United States and higher risk of long-term unemployment. Burda and Mertens (2001) find that in Germany, up to 20 percent of displaced workers are unemployed even after four years of being initially laid off.⁴³

Based on a comparison (figure 1) of the average duration of US and European unemployment spells, it becomes clear that laid-off European workers on average face significantly longer spells of unemployment than do workers in the United States. For some Europeans, this is, however, undoubtedly voluntary, because of the higher levels of unemployment benefits. OECD (2002, table 3.10) estimates that on average, net replacement rates for unemployment benefits across family types and earnings levels long unemployment spells (60 months) in the EU-15 at 60 percent are twice the level of 32 percent in the United States.

Not only do the majority of European countries have much higher unemployment than does the United States but also unemployed Europeans remain unemployed far longer than do Americans. Palpably, if European labor markets create long-term unemployed out of workers who lose their jobs due to offshoring and offshore outsourcing, then this will prevent such countries from benefiting from offshoring and offshore outsourcing, as workers are not productively reemployed in the economy.

In many of Europe's large industrial restructurings,⁴⁴ early retirement has been used as a tool to provide a social cushion for workers. This leads to permanent inactivity, which from the perspective of the worker may be advantageous, but clearly for European countries already suffering from low labor utilization (especially among older workers) and mounting fiscal deficits is the worst possible outcome. Early retirement granted to people without appropriate health problems but principally to combat unemployment is of particular concern in relation to offshoring and offshore outsourcing. Offshoring and offshore outsourcing frequently may result in closure of entire production facilities in Europe. This puts not just recent hires but also other peripheral groups on the

⁴¹ Historical data for table A-33 from the BLS CPS survey available at www.bls.gov/cps/home.htm#data (accessed November 2, 2004).

⁴² This is due to the differences in methodologies in the statistical data material available. Surveys differ in such areas as sectoral coverage, occupational coverage, and time dimensions.

⁴³ See also Ljungqvist and Sargent (1998).

⁴⁴ For instance, the restructuring of Renault in the 1990s, which included the closing of the Vilvorde plant near Brussels, saw workers down to the age of 48 receiving early retirement pensions. See Baily and Kirkegaard (2004).

labor market, such as women, young people, and older workers—where, as can be seen in table 5, Europe’s low employment problem is concentrated—at risk. Also, many prime age male (25 to 54 years) traditional “insiders” in the labor market may be affected. If this group, which as can be seen in table 5 also enjoys very high employment rates of around 85 percent in Europe and which possesses a larger political voice than do the more marginal groups, were to increasingly receive early retirement following job losses related to offshoring and offshore outsourcing, it would certainly ruin Europe’s attempts at raising its overall labor input, as well as preventing it from becoming a net beneficiary of offshore and offshore outsourcing.

Regional Unemployment

An additional frequently overlooked aspect of Europe’s high unemployment is that it is highly unevenly distributed. In 2003, unemployment among EU-15 countries ranged between 3.7 percent in Luxembourg to 11.3 percent in Spain. Given the different product- and labor-market regulations, languages, and historical experiences across Europe, it is not surprising that large differences exist between EU-15 countries.⁴⁵

However, much more damaging are the even bigger differences in unemployment rates within individual European countries. It is somewhat ironic that a lot of discussion has taken place with respect to the optimality of the eurozone as a currency area, when indeed the case can be made that the regional differences within individual eurozone member states—the currency areas being replaced by the eurozone—with respect to labor mobility are larger than between them. Eurostat collects data for three European subnational regions in the so-called NUTS system.⁴⁶ NUTS level 1 covers regions of an average size between 3 million and 7 million inhabitants, NUTS level 2 from 800,000 to 3 million inhabitants, and NUTS level 3 from 150,000 to 800,000 inhabitants.

As can be seen in figure 2, which is ranked by OECD standardized unemployment averages, unemployment rates vary much more within EU-15 countries than between them. In Italy, for instance, the domestic range is more than 20 percentage points. Several other things are also illuminated in figure 2. All six EU-15 countries that in 2003 had a lower unemployment rate than the United States also had a low standard deviation in the regional percentage differences in unemployment rates (2 or less). What this indicates is that the countries in Europe with low overall unemployment do not have very large differences in unemployment rates between regions. On the other hand, the very high standard deviations of regional differences of unemployment rates in high-

⁴⁵ See Baily and Kirkegaard (2004) for an elaboration of the crucial national differences between EU-15 states.

⁴⁶ The French acronym for Nomenclature of Statistical Territorial Units. See Eurostat (2003) for more information.

unemployment EU-15 countries indicate large regional differences. That is to say France, Germany, and Italy do not have 8 to 10 percent unemployment in every region: Unemployment in some regions in these countries is very high, while in others it is low. Indeed, all European countries except France and Greece had regions with lower unemployment in 2003 than the US average. It is the archipelago of very high unemployment regions in Europe that gives the continent its overall unemployment problem.

It furthermore seems that even very high unemployment rates is a very poor predictor of internal migration in Europe. Figures 3 and 4 plot recent multiyear net changes in the labor force (15 years and above, employed or unemployed) in those European regions with more than 15 percent unemployment and a 50 percent share of long-term unemployment, respectively. Contrary to what economic logic would predict, there is no uniform large-scale emigration from these depressed areas. Europeans apparently do not consider high unemployment locally as a sufficient incentive to move to another region within their country.

In fact, as can be seen in figures 3 and 4, in regions with either very high unemployment or high long-term unemployment, labor force growth is slightly positively correlated with the degree of unemployment. It goes without saying that a system sustaining such an archipelago of very high unemployment regions, without apparently providing appropriate incentives for the unemployed to move to more dynamic regions, is very ill suited to provide people being laid off due to offshoring or offshore outsourcing with better reemployment opportunities.

And the number of Europeans affected is far from negligible. In 2003, a labor force of more than 19 million people, or 11 percent of the total labor force in the EU-15, lived in regions (NUTS level 2 or 3) with more than 15 percent unemployment. This is compared with the less than 1 million Americans in total, or 0.34 percent of the total US population, who in 2003 lived in counties with 15 percent or more unemployment.⁴⁷

Companies Unable to Restructure

Due to geopolitical events and new promarket policies, the period since the late 1980s has been characterized by the increasing integration of close to 2.5 billion people from China, India, and the former Soviet Union into the world economy,⁴⁸ many millions of whom are highly skilled professionals. Combined with the rapid technological development described above, this “one-off”

⁴⁷ Bureau of Labor Statistics data available at www.bls.gov/lau/home.htm (accessed November 25, 2004). Statistics for the US labor force at the county level were not immediately available.

⁴⁸ United Nations, Population and Vital Statistics Report, 2004, available at <http://unstats.un.org/unsd/demographic/sconcerns/popsizesize2.htm> (accessed November 6, 2004).

has changed the competitive landscape facing European and other companies to a degree arguably unlike any in postwar history. Hence, the premium available for flexible European companies with the ability to restructure is higher today than earlier. This makes the need to facilitate flexibility for companies correspondingly more urgent than in earlier periods.

From the perspective of companies, offshoring and offshore outsourcing are akin to an organizational change, a restructuring of their businesses to improve competitiveness. Restructurings are accompanied by both the creation and destruction of jobs, and it is crucial for companies to continuously restructure to remain competitive and adopt new technologies. Figure 5 indicates the rate of job turnover (job creations from expansions plus job destructions from contractions, firm births and deaths excluded) in existing companies in European countries during different periods in the 1990s. As can be seen, there are differences between countries, but when compared with the total job turnover rate in the United States, which from 1993 to 2001 was an average 12.6 percent *per quarter*, it is evident that the rate of restructuring (creative destruction) in European firms is lower than in the United States.⁴⁹

Inability to restructure European businesses may arise from many different reasons,⁵⁰ but the biggest obstacle by far is the inflexibility of many of Europe's labor markets, where many layers of employment protection legislation and likely court interferences prevent lay-offs and thus ultimately new hiring of workers. As presented in table 6, employment protection legislation in most, especially large continental, European countries is very tight, and as table 7 lays out, companies in many European countries face numerous and frequently lengthy court battles to lay off workers following a restructuring.⁵¹

⁴⁹ US data for expansions and contractions in the total private economy are from the BLS Business Employment Dynamics Database at www.bls.gov/bdm/home.htm. A firm word of caution on a too direct comparison of the US and European data sources: The European data are firm-level, while the US data are establishment-level. Firm-level job flows understate the actual magnitude of gross job flows among plants (Gomez-Salvador, Messina, and Vallanti 2004, 473), thus the European data are relatively biased downward. Secondly, the European data have a threshold for inclusion biased against small firms, whereas the US data include all sizes of firms. As employment in small (and young) firms and establishments will fluctuate more than that in larger (and older) firms (Khan 2002), this too relatively biases the European data downward. The exclusion of both newly started and closing companies somewhat mitigates this effect. Finally, it is important to realize that annual job turnover rates are not simply equal to four times the quarterly rate. Issues of establishment splits and consolidations and ownership changes make such simple "annual sums of quarterly rates" misleading. See OECD (1994) for elaboration. However, several studies of US annual flows point toward annual job turnover rates of close to 20 percent. Davis, Haltiwanger, and Schuh (1996) calculate 19.4 percent annually from 1973 to 1988 in US manufacturing with a sample excluding companies with less than five employees. Pinkston and Spletzer (2001) calculate 19.7 percent for expansions and contractions in California from 1999 to 2000, and Spletzer (2000) calculates 16.7 percent for West Virginia's expansions and contractions from 1990 to 1994.

⁵⁰ See Baily and Kirkegaard (2004) for elaboration.

⁵¹ For the importance of judicial interference in employment protection in France, see also Blanchard and Tirole (2003).

Uncertainty, more than the economic costs themselves, is the most detrimental aspect of large-scale legal institution involvement in labor-market issues. The risk of having a labor court suddenly overturn announced lay-offs makes financial planning of potential business expansions much more difficult, as maximum potential costs cannot be gauged in advance. This inevitably dampens business risk appetite for expansions and adversely affects job creation.

V. EUROPE'S NECESSARY POLICY RESPONSE

As laid out in Baily and Kirkegaard (2004), Europe today faces a number of interrelated economic challenges. Fortunately, rising to the particular challenge of offshoring and offshore outsourcing not only addresses a topic of increasing political importance but also holds part of the solution to Europe's two overarching problems of low productivity growth and low labor input. It is essential that European public anxiety regarding offshoring and offshore outsourcing and accompanying potential political action be utilized to push for the right structural reforms in Europe—not to promote further restrictions on trade and businesses.⁵²

So, what are the right structural reforms to deal with this issue? In section III, we saw how offshoring and offshore outsourcing create winners in the form of European companies that achieve lower costs and higher productivity and European consumers who get lower prices and higher real wages. At the same time, European workers who lose their jobs and European companies that cannot realize the benefits of offshoring and offshore outsourcing lose out. From section IV it is clear that Europe's overwhelming lack of labor-market flexibility creates such losers—laid-off workers are less likely to find new employment and companies less likely to restructure. To benefit from offshoring and offshore outsourcing, Europe therefore first and foremost needs to increase the flexibility of its labor markets.

Auspiciously, such reforms are already part of the Lisbon Agenda. The 2003 EU Employment Guidelines adopted by the European Council states that member states shall implement the following policies:

⁵² High labor costs in Europe have in recent decades led to highly capital-intensive production, especially in manufacturing. Thus the issue of labor-to-capital substitution is less of a concern in Europe than in the United States, for instance. Yet, it is important to realize that the true counterfactual to a job kept in Europe, due to constraints on companies' ability to restructure, is not a job kept in Europe perpetually. Instead, especially in the services sectors, it is probably a job lost to automation—the cheapest labor of all. US estimates of the costs of call-centers indicate that the cost to a company of a fully automated call handled by a computer is as low as \$.50, as opposed to \$7 to talk to a real person. The magnitude of the cost difference should cause most companies to move toward computer-handled call-centers. However, surveys indicate that customer satisfaction with services provided by a computer is much lower than phone calls handled by a person. See *USA Today*, "An Automated Call Costs Less Than 50 Cents vs. \$7 to Talk to a Real Person", September 26, 2003, p. 1a.

“...review, and where appropriate, reform overly restrictive elements in employment legislation that affect labour market dynamics...”⁵³

Similarly, the Report of the Employment Task Force, chaired by Wim Kok (2003), reads on page 28:

“...Member States should assess and where necessary alter the level of flexibility provided in standard [unlimited duration] contracts, in areas such as periods of notice, costs and procedures for individual or collective dismissal, or the definition of unfair dismissal.”

In other words, the need for increased labor-market flexibility is not exactly news to European decision makers. It is, however, critical to emphasize that offshoring and offshore outsourcing add further to the urgency and “appropriateness” of this particular type of reforms. The approach to labor-market reforms taken so far by several European governments of introducing new flexibility simply on the periphery of European labor markets—by conceiving new types of employment contracts while still protecting the core standard contracts—will no longer suffice.⁵⁴ Handling offshoring and offshore outsourcing requires increased flexibility throughout the labor market.

European policymakers should take comfort in IMF estimates by Amity and Wei (2004) on service-sector job growth in Britain and the United States, the two countries most affected by offshoring and offshore outsourcing in the services sectors. Both countries have very flexible labor markets (table 6) and can in this respect be said to have already implemented the required parts of the EU Lisbon Agenda on labor-market flexibility. Amity and Wei (2004, 18) conclude that their

“...results suggest that service outsourcing not only would not induce a fall in aggregate employment, but also have the potential to make firms/sectors sufficiently more efficient, leading to enough job creation in the same sectors to offset the lost jobs due to outsourcing.”

Efforts such as the German Agenda 2010, which reduced the level and duration of available unemployment benefits, is a step in the right direction for Germany as it serves to increase the

⁵³ Official Journal of the European Union L197/13, Council Decision of 22 July, 2003, on guidelines for the employment policies of the member states.

⁵⁴ This is the essence of recent years’ employment reforms in Italy (Biagi laws), France (the various contract forms of Contrats de Qualification [CDQ], Contrats Initiative Emploi [CIE], Emplois Jeune Contracts [EJC], Contrats Emplois-Consolidés [CEC], or Contrats Employ-Solidarité [CES]), Germany (Ich-AGs, Mini-jobs), and Spain (fixed term contracts introduced in the mid-1980s and new permanent contracts with lower firing costs for youth and older workers and the long-term unemployed in the mid-1990s).

incentives for seeking work and thus will raise labor supply. However, with offshoring and offshore outsourcing growing, flexibility is what spurs labor demand and creates new jobs. Thus, legal barriers to hiring and firing all types of workers must be brought down substantially, not just in Germany but also in almost every European country, in order for labor-market reforms to appropriately prepare Europe for the future of offshoring and offshore outsourcing.

Some might argue that increased labor-market flexibility flies in the face of the notions of “social Europe” and inevitably comes at the expense of workers and their health. However, as presented in sections III and IV, such arguments are rooted in misperceptions of the present situation in Europe. No society should claim to be truly socially cohesive, if—as is the case in, for instance, France, Italy, Spain, Belgium, or Greece today—less than a third of young people under the age of 24 are attached to the labor market, only about half of all women are employed, and the majority of people above 55 are outside the labor market. Such a state is manifestly not socially cohesive and neither fair to future generations nor fiscally sustainable even in the short term—indeed it is the opposite. Similarly, as laid out above, many jobs are lost in Europe even today. The current system is thus trapping European workers between two stools. Faced with offshoring and offshore outsourcing and despite the best efforts of labor-market regulations in many countries, European workers neither have individual “job security” nor do they enjoy “the employment security” available in more liberal labor markets able to generate a large number of new jobs. In truth, it is thus the efforts to promote labor-market liberalization and boost productivity growth and job creation that should be labeled “social” in nature.

A further key to a genuinely flexible labor market is a labor force equipped with the appropriate skills demanded, and providing workers with the opportunities to continuously upgrade their skills is fundamental to assisting laid-off workers in finding new jobs. Increased restructuring accompanying offshoring and offshore outsourcing in Europe puts renewed emphasis on the need for worker retraining, as also previously protected workers can expect to change jobs more frequently than in the past. As presented in figure 6, there are large differences between European countries in this area, with governments and businesses in the Netherlands and Denmark spending large sums of money on the subject while Southern European governments and businesses are spending less.

Noticeably, Britain and the United States, with very flexible labor markets, are not heavy spenders in this area, and both countries would clearly benefit even more from offshoring and offshore outsourcing were they to channel more resources into it. Europe, though, is generally well positioned with respect to worker retraining and the “Education and Training” part of the Lisbon Agenda, in which the European Council among other things gives priority to

“...providing opportunities to acquire and/or upgrade basic skills, including the new basic skills, such as IT skills, foreign languages, technological culture, entrepreneurship and social skills...”⁵⁵

This type of skill-upgrading provides an appropriate path of future improvement of the European labor force. The need to closely involve businesses in training efforts must be emphasized. The Austrian system of tax deductions to companies of up to 120 percent of training costs⁵⁶ seems an excellent way of overcoming the risk of market failure, with companies unwilling to fund their employees’ training only to find them lured away by competitors. A similarly effective idea is the “Human Capital Investment Tax Credit,” proposed by Institute Senior Fellow Catherine Mann, where companies get tax deductions for investments in human capital, just as they currently do in the United States for investments in capital goods and research.

Finally, as also laid out in section IV, the governments of several EU-15 countries—Belgium, Finland, Italy, Germany, Greece, France, and Spain—need to urgently address their regional differences: European populations need to be incentivized to move geographically to more dynamic regions more willingly. Here, clearly a fundamental rethink of regional policies is called for. Considering the enormous transfers to the former Germany or the southern part of Italy over the years,⁵⁷ which obviously have had very limited effects on unemployment or economic growth, it is evident that even unsustainably large public investments in certain regions cannot lift these out of stagnation. Palpably, jobs cannot simply be moved to where people live, so people must move to where the jobs are. At least two alternatives must be pursued.

Less developed regions should be freed from national and EU-level labor-market legislation (of course it would be better if these were liberalized at the national level) on such areas as working time, minimum wages as well as hiring and firing restrictions. Local zoning regulations could also be covered by blanket exemptions. Such freedom would make local businesses in depressed regions more competitive, not unlike the very successful special economic zones in China, for instance. This will allow the reward ratio between work and inactivity to be set based on the local situation, rather than on national averages, which may not be appropriate for a particular region. This is of particular importance in eastern Germany, which is struggling under a system fine-tuned to West German conditions, as well as in southern Italy, where the national Italian labor market system is dictated by the conditions and requirements of the successful northern part of the country.

Another way to refocus regional policy is to no longer target the land but the people living on the land. Instead of pouring money into public investments and job creation in declining regions,

⁵⁵ European Council Resolution OJ C163/2002, June 27, 2002.

⁵⁶ Report of the Employment Taskforce chaired by Wim Kok (2003, 51).

⁵⁷ Transfers to eastern Germany alone accounts for more than €500 billion in the 1990s, and €156 billion more is scheduled until 2019, Baily and Kirkegaard (2004).

the money should be spent on assisting people in moving out of these regions. All European countries have dynamic regions with very low unemployment, so if people need to move there to find a job, governments should help them make this move, rather than continuously subsidizing their dwelling in areas with very low chances of finding employment. This means that such things as subsidized housing, traditionally available to unemployed families, should be made more conditional on willingness to move. Similarly, the requirement for the unemployed to move to a new location, in order to take up a vacant position there, must be tightened and rigorously enforced.⁵⁸ Finally, the costs of moving—i.e., principally buying and selling real estate—must be brought down, as such costs might otherwise prohibit mobility.

Many of the same changes should be made to the EU regional aid system. In the summer of 2004, the European Commission adopted its new proposals for EU regional policy reform from 2007 to 2013.⁵⁹ A total of €336 billion has been allocated for the period. Unfortunately almost 80 percent of the budget continues to be earmarked to the underdeveloped and outermost regions,⁶⁰ with priority projects including infrastructure, transport networks, sustainable transport, renewable energy, and administrative capacity. No doubt the continuation of this policy of funding physical capital in stagnating and outlying regions will continue to be very politically expedient for both the EU Commission (which gets to hand out the money) and the EU Council (which gets some bargaining chips to distribute during political negotiations and common EU money to spend at home). Regrettably, however, what Europe needs most to deal with offshoring and offshore outsourcing is flexible, mobile human capital. The European Commission ought to focus a much bigger share of its regional aid than at present to generating human capital among the inhabitants of depressed and outlying regions and then facilitate its use in more dynamic regions of Europe.

The required regional efforts ought not involve transfers of massive financial resources but be concentrated in legislation and regulation aimed at scaling back legal barriers to economic growth. Money should indeed be spent but on retraining and skill-upgrading of people, rather than on regions with the lowest GDP. The goal of an EU “cohesion policy” should be to provide everybody with the skills to be employed and the opportunity to move to where the jobs are, rather than fund roads, bridges, and tunnels between locations that may no longer possess a future. Enlightened regional

⁵⁸ See Baily and Kirkegaard (2004) for positive results in lowering the levels of structural unemployment with such policies of under the threat of losing unemployment benefits of “requiring the unemployed to move to take up a new job” in Denmark.

⁵⁹ Cohesion Policy: The 2007 Watershed. Available at http://europa.eu.int/comm/regional_policy/sources/docgener/informat/reg2007_en.pdf (accessed November 27, 2004).

⁶⁰ Regions with either per capita GDP of <75 percent of the EU-25 average, <75 percent of EU-15, and >75 percent of EU-25 or per capita GNI of <90 percent of the European Community average, depending on the particular program.

policy should not aim to simply keep regions on life support—it occasionally should aid their euthanasia.

V. CONCLUDING REMARKS

Offshoring and offshore outsourcing is not a choice for Europe—it is a fact. Yet, it is an opportunity, rather than a threat. As this working paper has presented, it will generate both winners and losers among Europeans, but it is up to individual governments to ensure countries realize a net gain. Perhaps up to 2 percent of Europe’s service-sector employment and a similar minor share of manufacturing employment may be affected in the coming decade, so most ominous European employment predictions must be rejected. Only few reliable data are available to quantify the true extent of the trend, so increased official statistical efforts to gather relevant data must be advocated. For instance, efforts such as the European Commission–funded European Restructuring Monitor will assist policymaking and help inform the public.

Fortunately, no new grand schemes or costly programs are required for European countries to become net beneficiaries from offshoring and offshore outsourcing, in terms of both productivity and employment. Instead, worries over the phenomenon should add new thrust to the implementation of the two parts of the existing Lisbon Agenda that deal with liberalization of Europe’s labor markets and opportunities for worker retraining and skill upgrading. Particular efforts must be made to lower the restrictions on hiring and firing workers and restrict the influence of the judicial branch in routine labor-market disputes. Finally, Europe needs to put its people over its land and focus on providing skills to people in stagnating regions, rather than build superfluous new infrastructure there. All Europe’s countries contain dynamic regions of low unemployment, and Europeans need to be encouraged to move there and search for jobs, rather than languish in perpetual unemployment in regions no longer economically viable and generating no employment opportunities.

Europe thus already has much of the right medication to gain from offshoring and offshore outsourcing—it simply needs to swallow hard.

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Table 1 EU-13 member state change in extra-EU manufactured goods trade balance, 2000–03 (billions of euros)

Country	Rise in exports	Rise in imports	Change in trade balance
Austria	5.10	.94	4.15
Belgium	- 2.50	- 1.84	- .66
Denmark	.79	.57	.23
Finland	- .35	- .62	.27
France	- 6.48	- 10.28	3.81
Germany	3.71	1.51	30.22
Greece	.32	2.47	- 2.15
Ireland	- 2.23	- 3.77	1.54
Italy	2.76	2.37	.40
Netherlands	- 4.77	- 5.75	.97
Spain	1.71	4.90	- 3.20
Sweden	.14	- 1.66	1.81
United Kingdom	16.57	12.87	3.71
Total EU-13	42.77	1.71	41.06

Notes: No data are available for Portugal and Luxembourg, and Luxembourg is treated as a non-EU member. Manufactured goods are defined as SITC categories 6, 7 and 8. UN ComTrade data are denominated in current US dollars but have been converted to euros using the annual period average exchange rates from the IMF *International Financial Statistics* (IFS). Non-euro members Denmark and Sweden are assumed to track the euro versus the US dollar, while the UK dollar-denominated data are first converted into pounds and then into euros, again utilizing IFS annual averages.

Table 2 Planned EU-15 job reductions by type of restructuring, January 2002–February 2005

Type of restructuring	Number of planned reductions	Planned job reductions (percent)
Internal restructuring	888,850	78.18
Bankruptcy/closure	135,021	11.94
Relocation (abroad)	54,307	4.80
Merger/acquisition	32,511	2.88
Outsourcing	23,960	2.12

Source: ERM online database.

Table 3 Announced or reported production shifts out of Europe, January–March 2004^a

Destination country	Number of production shifts	Average Number of jobs lost per shift	Total reported number of jobs lost
China	55	280	12,589
India	25	243 ^b	6,075 ^d
Other Asia	17	399 ^b	6,783 ^d
Latin America	8	162 ^c	1,296 ^d
Eastern Europe	24	560	13,440 ^d
Other countries	4	n.a.	n.a.
Total	133	n.a.	40,183

n.a. = not available

- a. Europe includes EU-25, as well as Norway and Switzerland.
- b. Average number for all shifts of production, regardless of place of origin.
- c. Average number for Latin America, excluding Mexico.
- d. Number of shifts multiplied by average.

Source: Bronfenbrenner and Luce (2004).

Table 4 Planned EU-15 job reductions by type of restructuring, January 1–April 1, 2004

Type of restructuring	Number of planned reductions	Planned job reductions (percent)	Number of cases
Internal restructuring	17,097	61.28	56
Bankruptcy/closure	5,913	21.19	25
Relocation	2,333	8.36	11
Merger/acquisition	18,000	6.45	3
Outsourcing	757	2.71	3

Source: ERM online database.

Table 5 EU-15 employment rates, by sex and age group, 2003 (percent)

Country	Total age, 15–64	Age 15–24		Age 25–54		Age 55–64	
		Men	Women	Men	Women	Men	Women
Denmark	75	62	58	88	79	67	53
Netherlands	74	69	67	90	74	57	32
Sweden	73	40	42	85	82	71	66
Britain	72	57	54	88	74	65	46
Austria	69	55	47	91	79	40	22
Finland	68	40	39	83	79	51	48
Portugal	67	43	34	88	74	62	42
Ireland	65	51	45	87	65	65	33
Germany	65	45	43	84	72	48	31
EU-15 average	64	43	37	87	68	52	32
France	63	33	26	87	72	41	33
Luxembourg ^a	63	27	26	92	65	39	21
Spain	60	39	28	86	57	59	23
Belgium	60	30	25	85	68	38	19
Greece	58	31	20	90	57	59	26
Italy	56	30	21	87	55	43	19

a. Data are for 2003Q2.

Source: European Commission (2004), Eurostat NewCronos Database.

Table 6 Structural labor and product market indicators, 2003

Country	Employment protection legislation indicator ^a			Product market regulation indicator ^b	Tax wedge ^c	
	Regular employment	Temporary employment	Collective dismissals		Single persons without children	Two-earner family with two children
France	2.5	3.6	2.1	2.1	48.3	40.1
Germany	2.7	1.8	3.8	1.4	52.0	43.9
Italy	1.8	2.1	4.9	2.3	45.3	40.9
Spain	2.6	3.5	3.1	1.6	37.6	34.1
Britain	1.1	0.3	2.9	0.5	31.1	23.9
Australia	1.5	0.9	2.9	0.9	28.3	24.4
Canada	1.3	0.3	2.9	1.5	32.4	29.1
United States	0.2	0.2	2.9	1.0	29.4	23.2

a. 0-6 Summary Index: 0 = most flexible, 6 = least flexible.

Source: OECD (2004)

b. 0-6 Summary Index: 0 = most flexible, 6 = least flexible. Data are for 1998. Most recent data are available but due to privatizations since 1998 the indicator may be overstating the degree of inflexibility in 2003.

Source: Nicoletti, Scarpetta, and Boylaud (2000).

c. The tax wedge reflects income tax, employee contributions less cash benefits, and employer social security contributions as a percent of total labor cost. Income level at 100 percent of average production worker for single and primary earner and 67 percent for secondary earner in two-earner family.

Source: OECD (2003).

Table 7 Labor relations court cases in select countries, 2003

Country	Competent body	Percentage of lay-offs brought before competent bodies	Percentage of cases won by workers	Length of procedure
Australia	Australian Industrial Relations Commission	1.1	2.7	6–7 months
France	Labor court	25.3	75	Approximately 1 year ^a
Germany	Labor court	22.6	n.a.	3–4 months ^b
Italy	Provincial Labor Office (attempted conciliation), then labor court	1.6	55	Approximately 2 years
Britain	Advisory Conciliation and Arbitration Service (ACAS) and employment tribunals (ET)	7.1 (ACAS); 0.8 (ET)	n.a. (ACAS); 44 (ET)	Approximately 4 weeks
United States	EEOC, FMCS, NLRB, and federal courts	0.03 (NLRB) and 0 (a total of 217 cases) filed by EEOC before federal courts	19.45 (NLRB) and 83 for federal courts	Approximately 3 years for NLRB

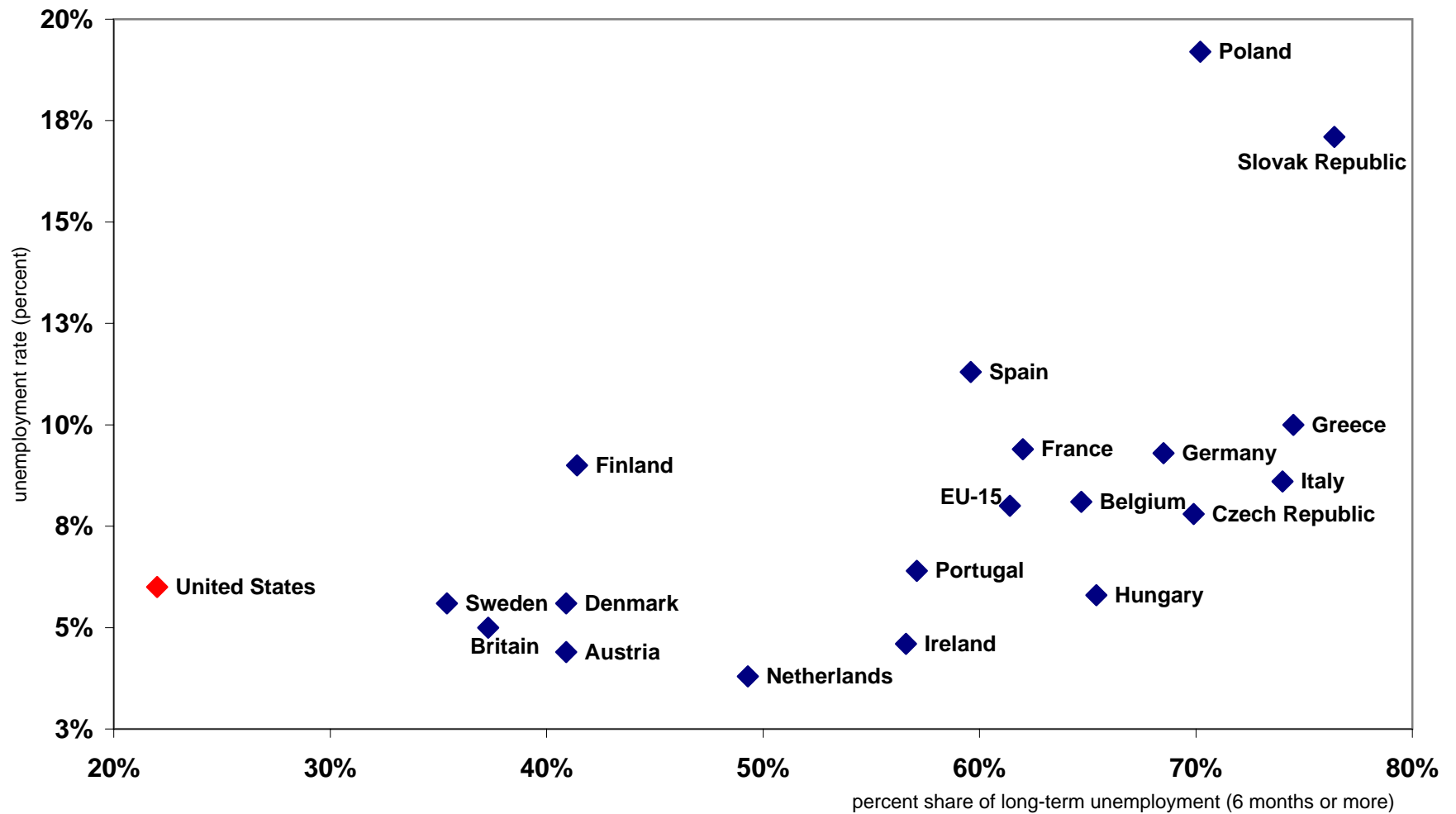
n.a. = not available

a. EIRO (2004a) shows that 57 percent of judgments were appealed against in 2000.

b. EIRO (2004b) shows that employees, trade unions, and works councils initiated 97 percent of cases in 2002.

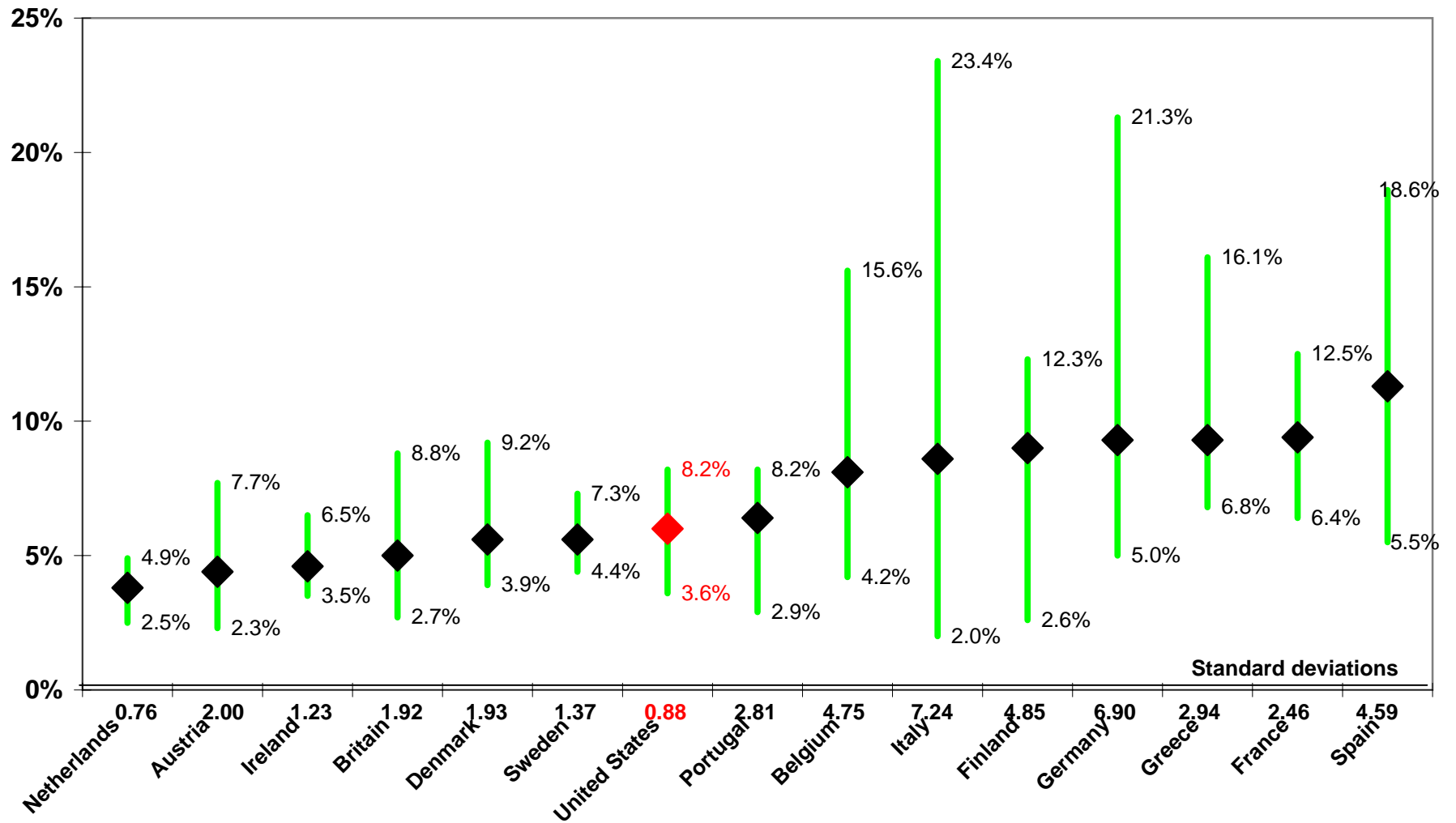
Source: OECD (2004), table 2.1.

Figure 1 US and European unemployment rate and long-term unemployment rate, 2003



Source: OECD Labor Force Indicators.

Figure 2 EU-15 regional unemployment extremes, 2003



Note: Regional data are NUTS level 2 (European regions of 800,000 to 3 million inhabitants), except Denmark and Ireland, for which data are NUTS level 3 (150,000 to 800,000 inhabitants). Luxembourg is excluded due to small geographical size. US data are on state-level.
 Source: OECD, Eurostat Regional Labor Force Data, and the US Bureau of Labor Statistics.

Figure 3 Changes in the labor force in European regions with more than 15 percent unemployment

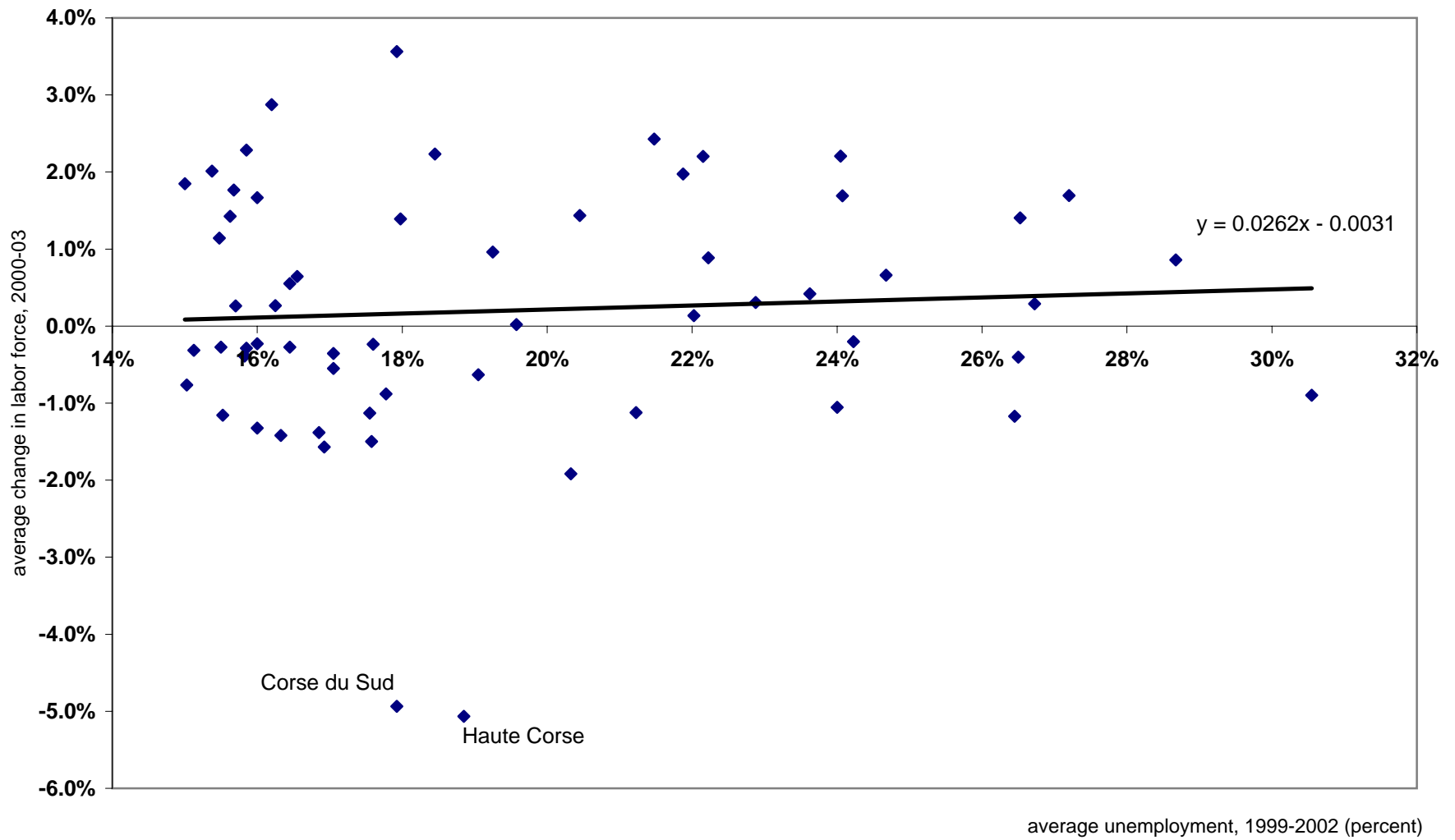


Figure 4 Changes in the labor force in European regions with more than 50 percent share of long-term unemployment

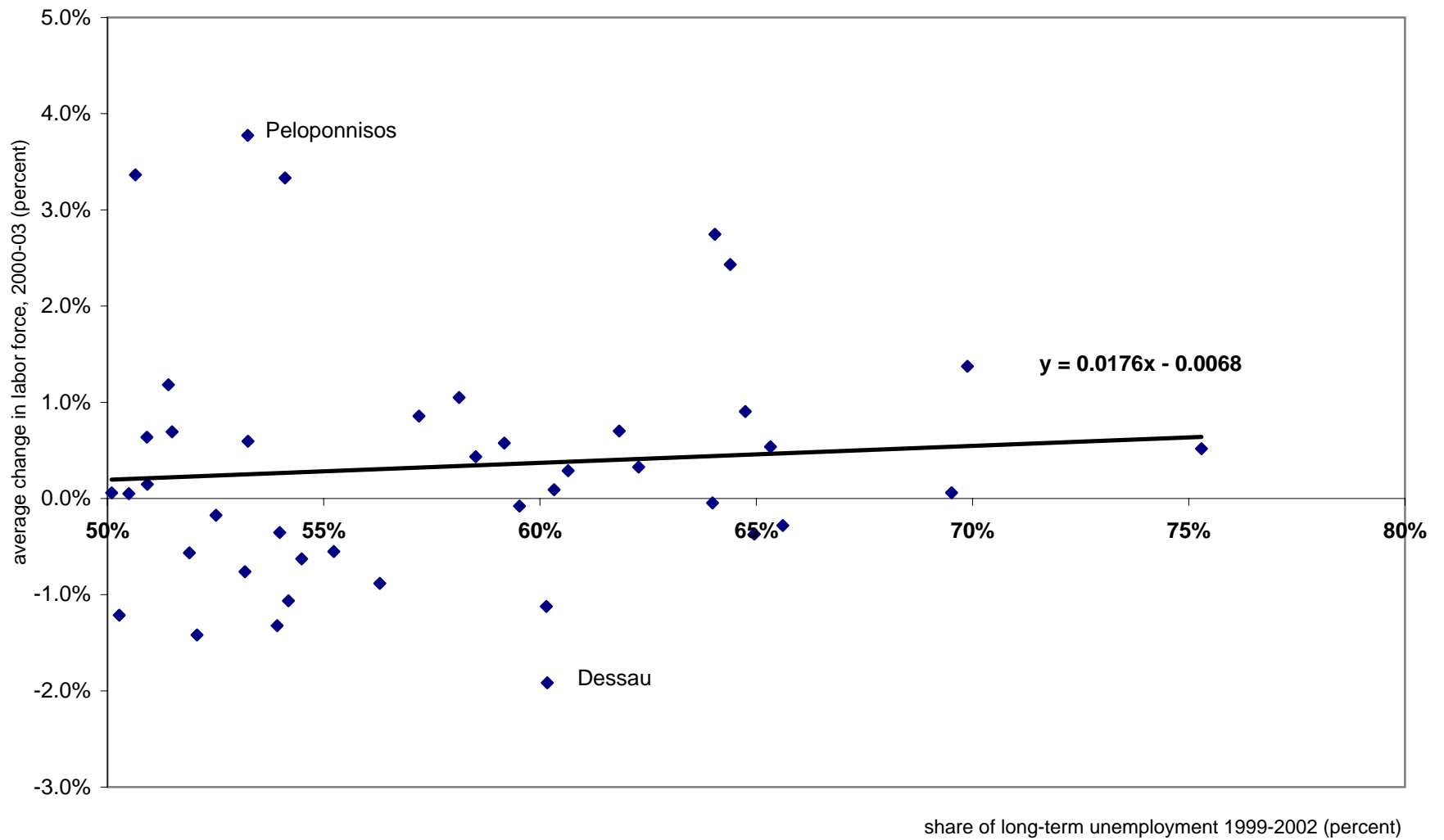
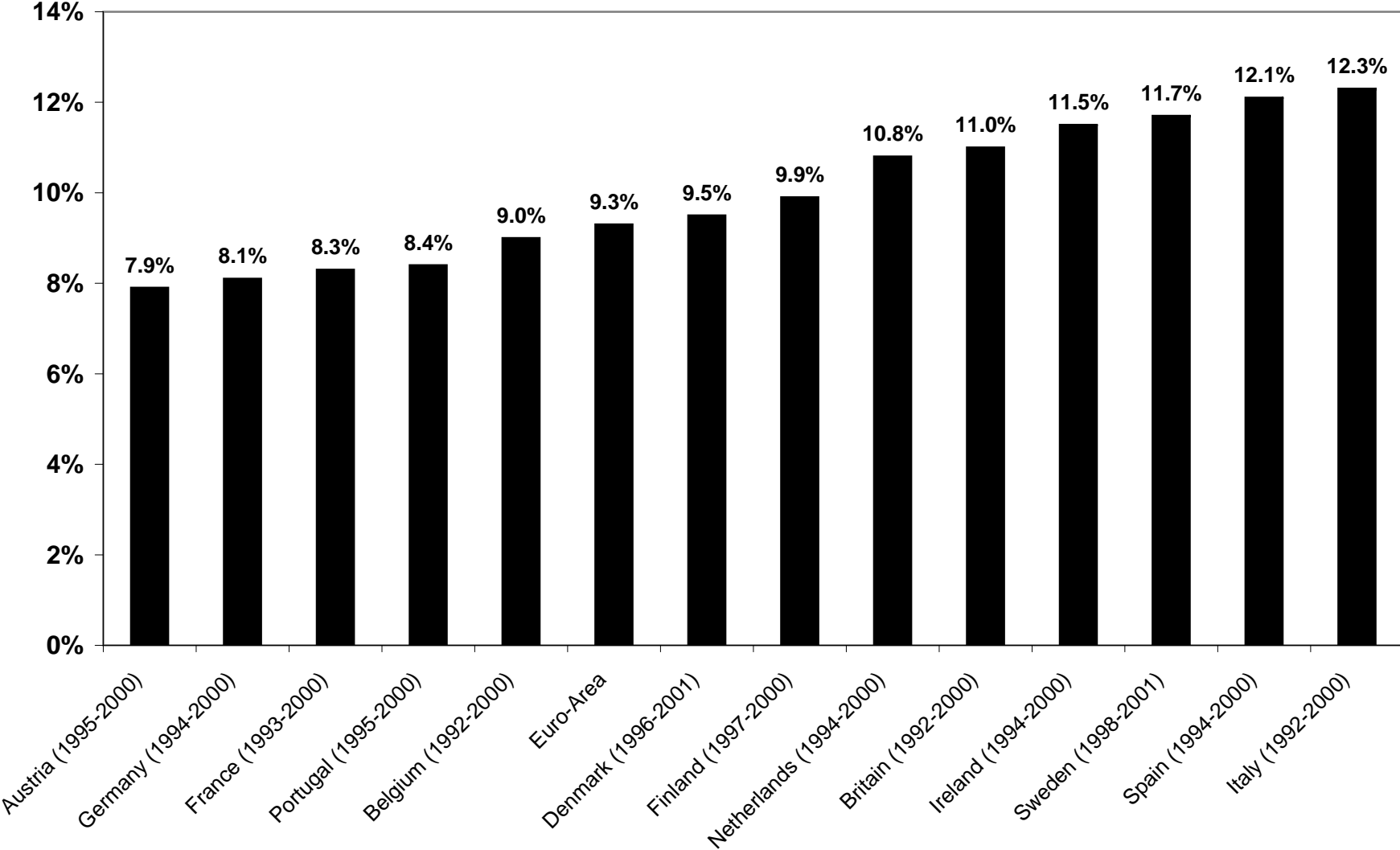
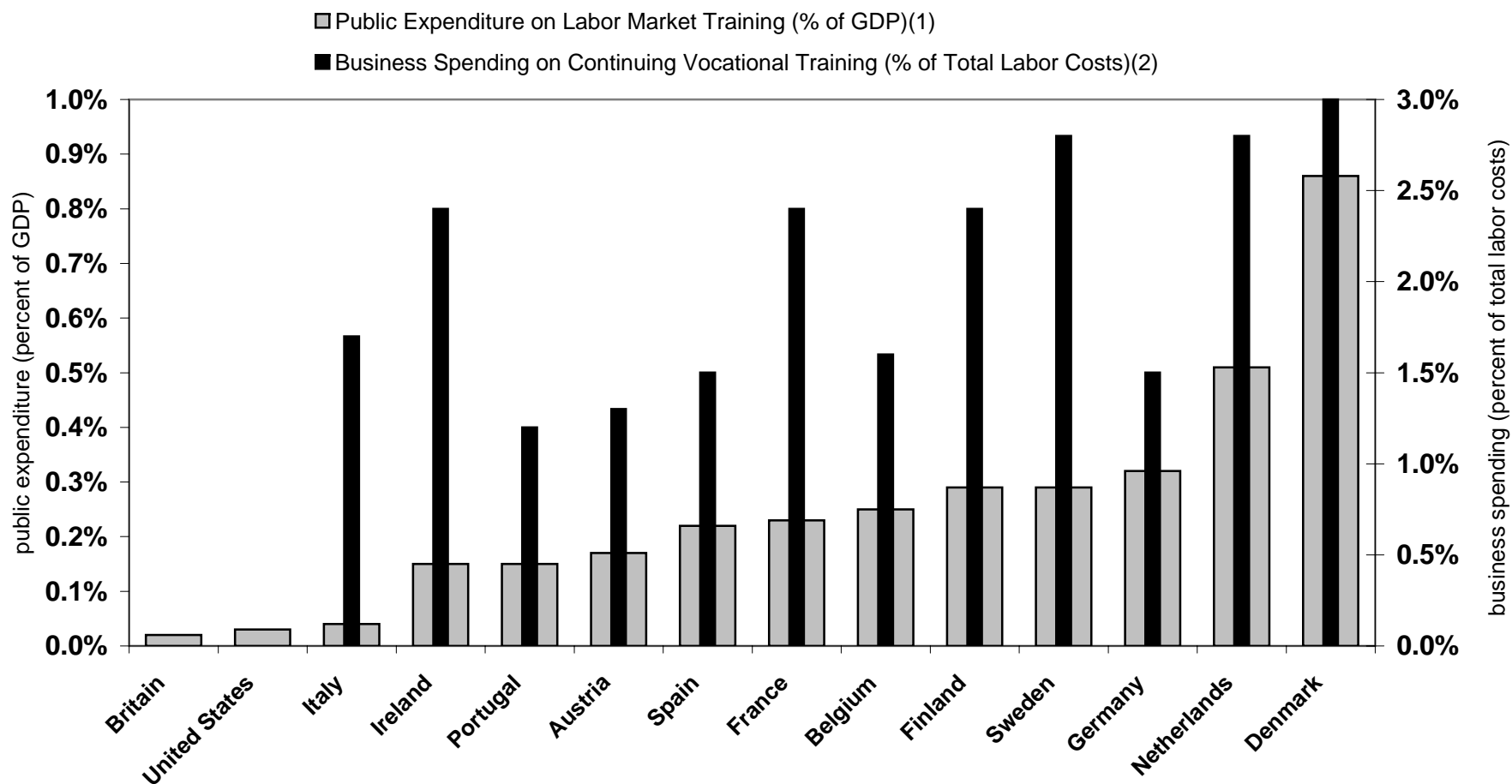


Figure 5 Average annual job turnover rates in existing companies



Source: Gomez-Salvador, Messina, and Vallanti (2004).

Figure 6 EU-15 expenditure on training and skill provision



(1) Data for public expenditure are for most recent year between 2000 and 2002. Includes training for the unemployed, people at risk of unemployment, and the employed. *Source:* OECD Labor Force Indicators.

(2) Data for business spending are 1999. No data are available for Poland, Slovak Republic, Czech Republic, Britain, United States, and Hungary. *Source:* Eurostat (2003).