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Bailing outsourcing

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ABSTRACT

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In a model of organizational choice, this paper shows that in face of an increasingly expected bailout from the government, outsourcing input production to an offshore location is more likely an optimal choice for a firm. Such a response is consistent with the three trends in the US manufacturing sector after the crisis: (a) employment keeps declining; (b) massive layoffs have not stopped; and (c) imported intermediate inputs have been gaining importance. *Journal of Comparative Economics* **xxx** (xx) (2014) xxx–xxx. The Chinese University of Hong Kong, Hong Kong.

1. Introduction

This paper presents a model of organizational choice when a firm expects the government to be more likely to bail it out in face of financial distress. Relative to domestic production, outsourcing the production of inputs to an offshore location lowers a firm's production cost at the expense of more unpredictable product quality. This is due to the difficulty of controlling quality across border: it hinges on the effectiveness of contract enforcement in the offshore location (Lu et al., 2012). Bailouts distort this trade-off by making unpredictable product quality less costly, resulting in a stronger-than-optimal incentive for the firm to outsource to an offshore location.

If this mechanism has been what is going on, bailouts would have weakened rather than strengthened domestic job creation. The following 3 trends in the US manufacturing sector seems to support such a possibility: (a) employment growth has been weak; (b) massive layoffs in the manufacturing sector did not stop; and (c) imported intermediate inputs have been gaining importance.

In October 2008, the US senate passed a vote on using the Troubled Assets Relief Program (TARP) money for non-financial institutions, officially beginning the unusually controversial auto industry bailouts. The expectation of bailouts has never been higher. Acharya et al. (2013) use the difference between what the large US banks paid their creditors and government debt yield as an estimate.[1] They show that the expectation of bailouts in the US has been steadily rising from 2004–2006. It

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[1] More precisely, their estimate is the difference between what the banks paid creditors for borrowing money and what investors earned from owning US government debt. The authors subtracted that number from the same measurement for smaller banks and, factoring in the differences in risk unrelated to bank size, determined the value of the implicit government subsidy, an estimate of the expectation of bailouts. Such an estimate peaks at 2009.20 basis points between 2002 and 2006, peaking up to over 120 basis points.

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then shifts gear and rises more rapidly in 2007. The expectation dramatically increases in 2008, and peaks at 2009, and continues to be high in 2010. How would such a dramatic increase in the expectation of bailouts affect the private sector?[2]

While most recent papers about bailouts focus on financial institutions, this paper focuses on the manufacturing sector instead. A major reason is that the politicians do talk a lot about domestic jobs, even more so when they are talking about bailouts.[3] Given the weak employment figures in manufacturing, is it possible that bailouts actually have threatened rather than strengthen domestic job creation? If so, how would the underlying mechanism look like?

The true cost of bailouts have just started to be better understood. The literature has been trying to estimate the true cost, including the moral hazard related to financial institutions taking exceedingly more risk. The manufacturing sector is unlikely to be immunized. But exactly how the sector's moral hazard would pan out remains an open question, because they are unlikely to deal as much with financial derivatives as financial institutions do. Obscure financial transactions and off-the-balance-sheet tricks are also less common among manufacturing firms.

I will first talk about the politics that motivate my inquiry of the relation between bailouts and jobs. I then discuss several trends that suggest a possible perverse effects of bailouts on manufacturing firms is to outsource more to offshore locations and thus threatening rather than strengthening domestic job creation.

1.1. The bailout politics

In recent politics, both the auto industry bailout and outsourcing are widely discussed. At a Colorado pep rally, President Obama praised his GM bailout as an example for American industry to follow.

"The American automobile industry has come roaring back. . .So now I want to say what we did with the auto industry, we can do it in manufacturing across America. Let's make sure advanced, high-tech manufacturing jobs take root here, not in China. And that means supporting investment here. Governor Romney. . .invested in companies that were called 'pioneers' of outsourcing. I don't want to outsource. I want to insource."[4]

The auto industry bailout, widely touted during the 2012 Democratic National Convention, costs billions.[5] The above speech by President Obama has raised concerns about whether the government would bail out even more distressed firms.[6] Such an impression is consistent with the Congressional Oversight Panel's take. In its 2009 report on using the TARP money on the auto industry, the Panel recommends that "Treasury provide its legal analysis justifying the use of TARP funds for this purpose. This analysis will inform policymakers' and taxpayers' understanding of the potential for Treasury to use its authority to assist other struggling industries." (The Congressional Oversight Panel, 2009)

While a major focus of the auto industry bailout is on estimating the direct economic cost of taxpayers, an unintended consequence that attracts little attention is the changed expectation among other firms that would change firms' strategies.[7]

The media has been reporting links between bailouts and outsourcing. Wells Fargo, the fourth-largest US bank by assets, received $25 billion under the TARP program, was reported to be looking to move some jobs outside the US, sending work in its retirement division, technology areas and other business lines to India and the Philippines.[8] A source reported that the Bank of America, the second largest US bank which received $45 billion bailout funds, announced in the fall of 2011 to lay off 30,000 US workers but has plans to hire more in overseas.[9] There are reports that other bailed-out companies had fired some of their US workers while shipping their jobs overseas.[10]

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[2] Anginer and Warburton (2013) specifically investigate the effects of Chrysler's bailout on senior bond performance of industrial firms but not financial firms. Chrysler's bailout undermined the US bankruptcy law by allowing the United Auto Workers Trust, an unsecured creditor of Chrysler, to cut in the line and subordinate the secured creditors of Chrysler during the process. Such undermining means unionized firms' senior bond should perform badly. Anginer and Warburton (2013), however, found that there was actually no negative effects when they compare senior bonds across unionized and non-unionized industrial firms, suggesting that the expectation of being bailed out by the government for unionized firms more than compensated the negative effects brought by the disrupted bankruptcy process.

[3] A good example is the statement from President Barack Obama released by the White House immediately after the government has sold its remaining stake in General Motors on December 9, 2013. http://www.whitehouse.gov/the-press-office/2013/12/09/statement-president.

[4] Obama,. 2012. "Remarks by the President at Campaign Event – Colorado Springs, CO." *The White House Office of the Press Secretary*, August 9. http://www.whitehouse.gov/the-press-office/2012/08/09/remarks-president-campaign-event-colorado-springs-co.

[5] The precise figure has been a mystery. See Ramseyer and Rasmusen (2011) for the difficulty of coming up with an accurate estimation due to special tax treatments that allow the new GM to pay substantially less corporate tax a few years down the road by carrying the accumulated losses of the old GM across the future tax years. Special tax treatments were available for Chrysler too.

[6] President Obama continues on his remarks on the differential treatment between companies that do and do not invest overseas, "Let's reform our tax code and let's make it simpler. And let's make sure that we're providing tax breaks to companies that are investing here in Colorado Springs, here in Colorado – not overseas. (Applause.) They're the ones who need tax breaks. Let's give tax breaks to companies that are investing here. It's the right thing to do." Reforming tax code is not bailout, but reforming it with differential treatment on companies of different oversea strategies can be viewed as part of the integrated bailout packages to selected companies.

[7] See Table 1 of Reinhart (2011) for a comprehensive time-line of the major events surrounding the financial crisis in 2008.

[8] Rothacker. 2012. "Wells Fargo looking to move some jobs to India, Philippines." *Reuters*, June 20. http://www.reuters.com/article/2012/06/21/us-wellsfargo-offshoring-idUSBRE85K05A20120621. and Campbell, 2012. "Wells Fargo May Send Some Jobs To India, Philippines." *Bloomberg*, June 21. http://www.bloomberg.com/news/2012-06-20/wells-fargo-may-send-some-jobs-to-india-philippines.html.

[9] Harkinson, Josh. 2012. "3 Years After Taxpayer Bailout, Bank of America Ships Jobs Overseas." *Mother Jones*, May 29. http://www.motherjones.com/politics/2012/05/bank-of-america-outsourcing-call-center-philippines.

[10] According to a news source, GM actually outsources quite a lot. GM outsources almost two thirds of its jobs overseas. Less than one in five GM vehicles are manufactured in the United States. After the bailout, GM's 2011 annual report shows General Motors of North America accounting for 98,000 of the 207,000 GM jobs worldwide. But 12,000 of these jobs are in Canada and 11,500 are in Mexico. Accordingly, GM has 74,500 jobs in the United States and 122,500 abroad. Almost two thirds of GM's jobs are in other countries. Source: Gregory, 2012. "Outsourcer-In-Chief: Obama Of General Motors." *Forbes*, August 12.

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