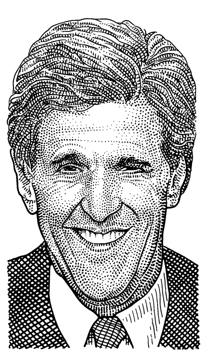
REVIEW & OUTLOOK

Outsourcing Is Good for India, and America

Greg Mankiw, chairman of the U.S. President's Council of Economic Advisers, is getting a tiny taste of the inanities of the political season. Mr. Mankiw, a noted economist and author of a best-selling text on macroeconomics, ventured to repeat what all economists and businesspeople know: Trade is good.

Specifically, Mr. Mankiw dared to point out the potential economic benefits of relocating the production of goods or services to lower-wage countries. "Outsourcing is a growing phenomenon," he said this week, "but it's something that we should realize is probably a plus for the economy in the long run."

Wham! Bam! Faster than you can say Bangalore, Sen. John Kerry was all over him. The front-runner for the Democratic Presidential nomination is smart enough to understand the law of comparative advantage, but chose to ignore it by declaring that "My economic policy is not to export American jobs. . . . Unlike the Bush Administration, I want to repeal every tax break and loophole that rewards any Benedict Arnold CEO or corporation for shipping American jobs overseas." For those not steeped in the intricacies of U.S. history, Benedict Arnold was a traitorous general during the American Revolution.



John Kerry

Comparative advantage means that if country X does or makes something with relatively less cost than country Y, then country X should do it. Country Y is thus released to earn higher returns on something else. The magic is that both countries are better off through this arrangement. In the current trade debate, country X stands for India and country Y is the U.S. By moving some data entry, customer service and software engineering activities to India, the economies of both countries gain.

The impetus for this trade in services has come from cheaper and higher quality telecommunications and a well-educated but cheaper labor force overseas. The combination has made it more cost effective for U.S. companies to shift the production of some services abroad. Even better, the difference in time zones makes it possible for companies to work round-the-clock, adding to the efficiencies.

> **Keeping your company competitive is now treasonous.**

The immediate, short-term impact of outsourcing is some lost American jobs. Mr. Mankiw acknowledges this, observing that an open trading system is good but "can create painful dislocations for some workers." The key word here is short-term. As Mr. Mankiw went on to say, "I know there will be jobs in the future because I know this is a vibrant economy, a dynamic economy." The political problem—which Mr. Kerry is trying to exploit—is that the lost jobs are felt immediately while the jobs of the future are by definition still unknown.

By reducing costs, outsourcing gives companies more money to invest. More investment means more jobs, especially jobs with higher value added. It's also good for shareholders. This is pretty much what happened in U.S. manufacturing when companies started to move plants overseas. As important, lower costs means lower prices. This is a boon for consumers who then enjoy increased purchasing power.

Even discounting for the excesses of politics, it's hard to see how all of this adds up to treason. The opposite is closer to the truth. CEOs who don't do whatever they must to stay competitive are the real traitors to their workers because eventually their companies will go out of business.

Mr. Kerry understands this, which is why until this campaign year he was known as a free trader. But if by some chance he is elected, we suspect he'd quickly drop all the Benedict Arnold blather and begin inviting those same CEOs to the White House. His own political prosperity would then depend on their success, outsourcing included.

Decent Exposure

Viacom President Mel Karmazin traveled to the U.S. Congress on Wednesday to face the music for his company's CBS and MTV Super Bowl fiasco, and we can only hope he learned that even champions of capitalism think that CEOs have to show some respect for public mores in their pursuit of a buck.

This being Congress, the members were in high moral dudgeon for the cameras. "They knew that this was beneath the standards, including CBS running some lewd and crude commercials during the Super Bowl," said House Majority Leader Tom DeLay. "Everybody has got egg on their face." And that was one of the milder complaints. The members have clearly heard from their constituents, who didn't like Janet Jackson's unbundling and are also tired of the sneering condescension with which companies such as Viacom treat them.

We know how they feel. After we ran a Super Bowl editorial last week, MTV Networks CEO Tom Freston wrote our U.S. edition a letter suggesting that we didn't understand the "youth culture" while his fellow MTV hipsters did because they have so many viewers. U.S. readers roasted him a couple of days later, and believe us when we say we could have filled an entire page or more with the letters. Our own reaction is that it's hardly a sign of marketing genius to induce teenagers, or poorly supervised preteens, to watch naked bodies and sexual innuendo on screen. Have hormones, will travel.

It's up to grownups, if that's the right word for the folks at MTV, to set proper limits. The men and women who run Viacom haven't been doing so, which is obvious from even a casual click through MTV's lineup. The network admitted as much this week when it moved some of its more suggestive videos to later night viewing. It would be nice, however, if corporate executives would do this when they aren't facing public and political pressure.

Mr. Karmazin and other big media moguls were surprised last year when Congress overruled their request to purchase stations in more parts of the United States. We supported them on free-market grounds, but these CEOs don't buy themselves any political goodwill when their content executives exhibit such obvious contempt for the viewing public.

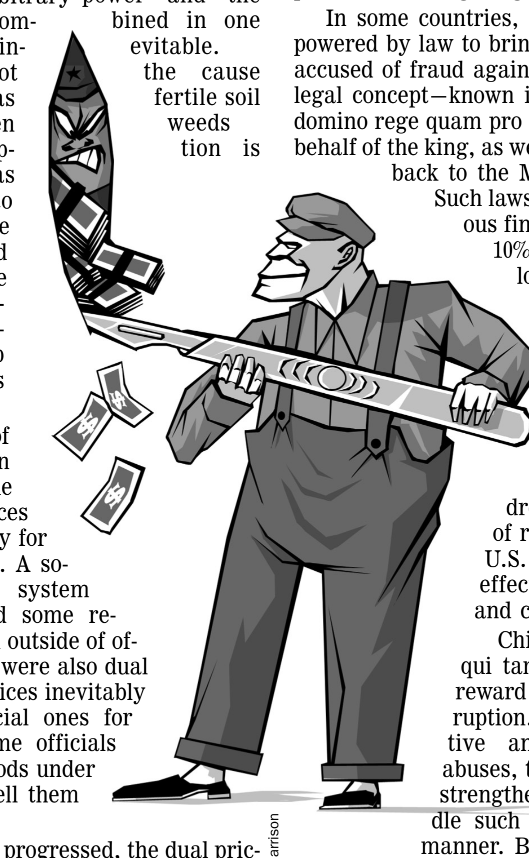
How to Fight Corruption in China

By Weijian Shan

The cancer of corruption, while not as malignant as it was a few years ago, remains a serious threat to China's body politic. The top leaders in Beijing are acutely aware that the public's frustration with crooked officials undermines the government's legitimacy. In response, they repeatedly vow to catch the perpetrators, and every year execute more corrupt criminals than the rest of the world combined.

Yet despite all the crackdowns and campaigns, corruption remains a systemic problem. It seems that severe punishment, although necessary and popular with the common people, is unlikely to resolve corruption once and for all. Why is this problem so intractable, and how can it be addressed?

Since the advent of reforms in 1979, China has become a hybrid of command and market economies. When arbitrary power and the profit motive are combined in one system, corruption is inevitable. The market itself is not the cause for corruption, just as fertile soil is not to blame when weeds grow. In fact corruption is likely to fade away as China continues to move toward a more mature market-based economy. But in the meantime, some creative measures to allow the public to help root out offenders may be necessary.



Harry Harrison

In the early years of reform, corruption sprang up because the advent of market prices created the opportunity for illegal price arbitrage. A so-called "dual-track" system emerged that allowed some resources to be allocated outside of official channels. There were also dual prices, with market prices inevitably higher than the official ones for scarce resources. Some officials were able to divert goods under their control and re-sell them for personal gain.

As China's reforms progressed, the dual pricing system disappeared and so did the price-arbitrage corruption. However, the country remains a hybrid economy and other forms of rent-seeking have sprung up. The government retains far-reaching control over societal resources, and officials still have too much discretionary power over businesses, state-owned or private.

For example, all land in China is owned by the state. Until recently, officials retained power over the sale of land-use rights. The banking system is basically a state monopoly. Government officials can grant or deny licensing rights for practically all businesses. One cadre in the right position can make or break a business. The state-owned sector still dominates many major industries. Even as China privatizes its state-owned firms, the power over the disposal of state-owned assets often resides in the hands of bureaucrats or state-appointed managers.

All these powers make corruption possible, indeed unavoidable. Just by reading the official media, one can see that most prominent corruption cases in China involve the misuse of resources such as bank loans, land-use rights, business licenses and permits.

This is not to argue that the government should not play a significant role in economic policy and regulatory matters. Indeed, China's leadership has been largely responsible for the successful market-reform policies of the past two decades, and it needs to play a more active regulatory role. Rather it is the discretionary power over resources, firms and individuals which must be taken out of the hands of individual government officials.

Although corruption is rampant in China, there is no need to despair. The good news is that market reforms have already taken on a life of their own. In comparison with 10 years ago, the Chinese government is a lot smaller, as many industry-specific ministries have been abolished and the state-owned sector has significantly shrunk in its relative importance to the economy.

The ongoing privatization of state-owned enterprises will ultimately remove official power over many more resources. In the process of privatization, corruption may temporarily get worse, as the disposal of state-owned assets offers enormous profiteering opportunities for those with decision-making powers. But as state control over these assets decreases, the rent-seeking behavior should abate.

Depending on the pace of market reforms and the privatization of state-owned enterprises, it may take a long time for China to get there. Before then, China should learn from some foreign countries or even take a page out of its own history books to take advantage of "people power" in the fight against corruption.

In some countries, private citizens are empowered by law to bring lawsuits against those accused of fraud against the government. This legal concept—known in Latin as Qui tam pro domino rege quam pro se ipso, or "Who sues on behalf of the king, as well as for himself"—dates back to the Middle Ages in England. Such laws typically provide generous financial rewards, between 10% to 30% of the recovered losses as in the United States, to "whistle blowers" who prosecute claims against those who defraud the government, whether they be corrupt officials or businessmen. Judging by the hundreds of millions of dollars of rewards each year in the U.S. alone, the law is quite effective in fighting fraud and corruption.

China should enact similar qui tam laws to empower and reward its citizens to fight corruption. Of course, to be effective and to avoid potential abuses, the judiciary needs to be strengthened so that it can handle such cases in a transparent manner. But with so many highly motivated watchful eyes, it would become harder for corrupt officials to escape detection and prosecution.

There is a precedent in Chinese history for such an idea. The founding emperor of the Ming dynasty, Zhu Yuanzhang (1328-1398 A.D.), was known for sparing no effort in the fight against official corruption. Rising from poverty, he harbored strong hatred for corrupt officials. He dealt with them in two ways, first by meting out unusually cruel punishment, and second by empowering people to fight corruption. Under Zhu's reign, convicted magistrates were skinned alive and stuffed with straw. Their bodies were hung up like trophies in their own courtrooms as warnings to their successors. In some well-known cases of corruption during his rein, the emperor executed so many officials, as many as more than 15,000 at one time, that he created a severe shortage of civil servants.

In a Chinese version of qui tam, Emperor Zhu Yuanzhang decreed that commoners led by the elderly had the right to tie up corrupt officials and send them to the capital for trial. Any obstruction by other government officials was punishable by the perpetrator being hung by his spine on a tree by a sharp steel hook. As a result, thousands of corrupt officials were thus brought to the capital for trial, and Zhu's rein was one of the cleanest in Chinese history.

Of course the real cure for corruption is a free market with minimal discretionary power for government officials. To that end, Beijing needs to resolutely continue with market reforms and privatization of its economy. But in the short term, a dose of people power may help China control the symptoms of the corruption cancer.

Mr. Shan is a partner of Newbridge Capital, a private equity firm.

Outsourcing Is An Old Story With New Critics

By Ila Patnaik

The most important fact about the present outsourcing debate is that it is not new. The world economy has been through the same phenomenon before, and when U.S. politicians attack White House chief economist Gregory Mankiw for pointing out the potential economic benefits of relocating some jobs to lower-wage countries, they betray a lack of knowledge of American history.

Many decades ago, technological improvements dramatically drove down the cost of cargo transported by ship and air. Suddenly, the electronics assembly work that was done in Maryland could be done cheaper in Malaysia. That led to massive growth in trade in goods.

Production chains broke up, with specialized manufacturing taking place across the globe, exploiting opportunities for the lowest costs. Companies that did this benefited—they were able to cut costs and reduce prices. Consumers benefited from cheaper goods. The manufacturing work which went to poor countries helped ignite economic development, particularly in Mexico, China and the four Asian tiger economies—Hong Kong, Singapore, Taiwan and South Korea.

That process was obviously unkind to the blue-collar workers in the West who lost their jobs. And it is equally unkind to the many middle-class workers who are now losing their jobs due to outsourcing. The difference is that these middle-class workers are closer to the political elites in their country, so they are in a position to make a louder fuss about it.

But what those who complain forget is that, throughout this earlier transition, world gross domestic product grew. Output and productivity—in both rich and poor countries—rose. The workers who were formally in manufacturing got absorbed into other parts of the economy.

Throughout this episode, populist politicians periodically complained about job losses, and fitfully tried to do something about it. But the basic logic was loud and clear. The essence of capitalism is a ceaseless quest for cost reductions. The companies that manufactured at the lowest cost venues were the ones that prospered.

This identical story is now being repeated afresh, through a different technological impetus. The driver here is the incredible progress in telecom, where high bandwidth is now available virtually across the globe at extremely low prices. Suddenly, it became possible to think of "global production chains" for services as well.

Once again, we are seeing production being sliced up into pieces, and each piece is placed at the best production venue available globally. And once again populist politicians are exploiting the understandable concern about job losses in an attempt to score cheap political points. That has been demonstrated in Washington over the past few days, as those who should know better rushed to condemn Mr. Mankiw's observation, at a news conference Monday, that sending U.S. service jobs abroad "is probably a plus for the economy in the long run." Prominent among the critics was Democratic presidential front-runner Sen. John Kerry.

Their short-sighted criticisms ignore the fact that the companies, such as General Electric, that have taken advantage of the incredible progress in telecommunications to relocate jobs have benefited by being able to cut costs and prices. Consumers in Western countries have benefited too—from cheaper goods and services, to more responsive help lines they can call. The services work that goes to countries like India is helping to ignite economic development. Thanks to this, World GDP is growing.

The benefits of outsourcing are not limited to companies. Governments and public-sector entities in the West are also finding that sending work to India is a way of making ends meet. When health-care work gets done in India, all consumers in the West benefit from cheaper health care.

The deepest consequence of this new outsourcing is perhaps found in research and development. The cost of doing R&D in India is roughly half that of doing it in the West. Startups in Silicon Valley are now routinely structured as a marketing operation in the U.S., and the entire engineering work is done in India. When research is cheaper, the CEO can place more bets. More avenues are explored, and more risks are taken. This can lead to an acceleration of technological progress, which could have a profound impact upon world GDP growth in coming decades.

What is perhaps different here is that when blue-collar workers were losing jobs, they were far removed from the political elites of advanced countries. In contrast, job loss in services strikes closer to home with respect to middle class, high-skill families. This is a novel feeling of insecurity for many prosperous people.

It is perhaps unsurprising that populist politicians will try to harness the insecurity in the minds of many workers. But the basic logic is clear: Companies that will exploit global production chains will out-compete companies that don't. Corporations and citizens alike have a direct interest in blocking the new protectionism. Perhaps Sen. Kerry should remember that before he abandons his former free-trade credentials to attack a trend that can only benefit America—and the world—in the long run.

Ms. Patnaik is senior economist at the National Council of Applied Economic Research in New Delhi.

Afghan Dispatch

By Barnett R. Rubin

In his State of the Union address, U.S. President George W. Bush proclaimed that Afghanistan "has a new constitution, guaranteeing free elections and full participation by women." At the meeting of G7 finance ministers last weekend, Afghanistan's minister provided a sober analysis of what it will take to make the constitution's words a reality: $28 billion over seven years, with about $6 billion supplied directly to the government's budget.

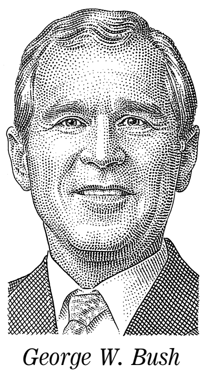
Without the resources needed to revive Afghanistan's legal economy, no one will be able to establish a stable government or implement the constitution. But Kabul is running out of money, and the amount offered falls far short of the need. Afghans cannot build a constitutional order on a criminalized base. The IMF says at least 40% of the economy is illicit: the drug trade, trafficking in emeralds and timber, smuggling of artifacts, land grabs by warlords and trafficking of women. Income from illicit exports finances most of the imports and provides much of the demand for the remaining parts of the economy—trade and construction. This illicit economy is the tax base for insecurity. Those who profit from it command resources to resist the rule of law. And they're not alone: 25 years of war have ravaged the agriculture and herding from which Afghans formerly made a hard but self-sufficient life. Opium cultivation, or employment in opium harvesting or trafficking, provide indispensable income.

Afghans demand that the government curb the gun-wielders. But the government cannot raise taxes to pay or equip its police. The head of the U.N. Office of Drugs and Crime saw the reality first-hand on his visit to an opium producing province in the northeast. Local traffickers zipped around in 4x4 vehicles, wielding satellite phones, with guards carrying automatic weapons. The police plodded on foot or bicycle.

The people demand security, but not at the cost of their livelihood. An Afghan security official told me that he could not attack drug traffickers, who included colleagues in government. He is under pressure to eradicate the crop, not interdict the trade. But without an economy to provide legal income, eradicating the only livelihood further undermines efforts to establish the rule of law. Whichever way you look at the goals—creating a tax base for the government, providing livelihoods to its constituents—there is no way to turn Afghanistan into a stable state where terror finds no refuge without a legal economy that will outgrow the illegal one—fast.

Two years ago, at the Tokyo donor conference, international organizations estimated it might take up to $12.2 billion over five years, and up to $18.1 billion over 10 to "rebuild" Afghanistan. The $5 billion pledged then is nearly exhausted. The Afghan government is not only falling short of the Tokyo donors' assessments, it also believes they underestimated the cost. With the World Bank, the Afghan government has now "recosted" reconstruction, based on two years' experience with real Afghan conditions. The result is a study showing that laying the foundations of a state and economy that can outgrow the criminal sectors will require $28 billion over the next seven years.

Kabul will present these results to a donor conference in March. But preparatory consultations have encountered resistance. While the U.S. has doubled its contribution to Afghanistan, adding another $1.2 billion, it allocated $22 billion last year alone to Iraq—a country of about the same size whose standard of living is decades ahead of Afghanistan's. Europeans may squeeze a bit out of existing aid budgets, but they resist doing more, protesting what they see as U.S. plans to turn the multilateral effort in Afghanistan into a more unilateral one. Japan seems eager to do more, but has not yet said how much.



George W. Bush

Meanwhile, the Taliban are regrouping; and opium production, which has soared since their overthrow, each year sets a new record. It doesn't matter if every country has met its Tokyo pledges. It matters only that we accomplish the goal we share with our partners in Afghanistan: turning that country toward stability, legality and security. The Afghan government has in effect presented us with the bill for our own security. If we don't pay it, the newly passed constitution and the triumphal words of Mr. Bush's State of the Union address will take their place in the long history of betrayed hopes.

Mr. Rubin, the author of "The Fragmentation of Afghanistan" (Yale, 2002), is director of studies at NYU's Center on International Cooperation.

The Washington Post/ *By George F. Will*

The Sour Taste of Sugar Quotas

WASHINGTON—Saturday, Valentine's Day, sweets will be showered on sweethearts—a bonanza for candy makers. But the very next day, all 242 Fannie May and Fanny Farmer chocolate candy stores will be closed.

They and many jobs are, in part, casualties of that outdated facility, bad business decisions and high U.S. labor and other costs. But jobs in America's candy industry also are jeopardized by protectionism, which is always advertised as job-protection. In this case, the protectionism is an agriculture subsidy—sugar import quotas.

Chicago remains America's candy capital, home of Tootsie Rolls and many other treats. But in 1970, employment by the city's candy manufacturers was 15,000. Today it is under 8,000, and falling.

But the end of 2003 brought the end of Brach's production of hard candy on the city's West Side. A decade ago, Brach's employed about 2,300. Until recently, many of the remaining Teamster jobs paid $19 an hour. Most of the jobs have gone to Mexico. Labor is cheaper there, but so is 92% of the raw material for hard candy—sugar. By moving outside the United States, Brach's can pay the world market price of sugar, which is one-half to one-third of the U.S. price as propped up by import quotas.

Life Savers, which for 90 years were made in America, are now made in Canada, where labor costs are comparable to those in the U.S. but the yearly cost of sugar is $10 million less.

Dueling economic studies, few of them disinterested, purport to demonstrate that more American jobs are saved or—much more plausibly—lost because protectionist quotas raise the price of sugar for 280 million Americans. In the life of this Republic, in which rent-seeking—bending public power for private advantage—is pandemic, sugar quotas are symptomatic.

It was to a North Dakota radio station that Robert Zoellick, U.S. trade representative, vowed that he would stand like Horatius at the bridge to block Australian sugar. The quotas can be considered among the bearable transaction costs of democracy, keeping North Dakota's, Minnesota's and other states' growers of sugar beets and Florida's, Louisiana's and other states' growers of sugar cane from starving.

Or seceding. Or—heaven forfend—being forced to grow something else. But protectionism is unconservative, unseemly and unhealthy—indeed, lethal.

Unconservative? Protectionism is a variant of what conservatives disparage as "industrial policy" when nonconservatives do it. It is government supplanting the market as the picker of economic winners. Another name for industrial policy is lemon socialism—survival of the unfit.

Unseemly? America has no better friend than Australia. Yet such is the power of American sugar interests, the Bush administration has forced Australia to acquiesce in continuing quotas on its sugar exports to America. That was a price for achieving the not-exactly "free trade" agreement signed last weekend. But look on the bright side: Restrictions on beef imports will be phased out *over 18 years*.

Is protectionism lethal? Promoted by Democrats hawking their compassion, protectionism could flatten somewhat the trajectory of America's rising prosperity. But protectionism could kill millions in developing nations by slowing world growth, thereby impeding those nations from achieving prosperity sufficient to pay for potable water, inoculations, etc. Developed nations spend $1 billion *a day* on agriculture subsidies that prevent poor nations' farmers from competing in the world market.

Sugar quotas, although a bipartisan addiction, are worst when defended by Republicans who actually know better, and who lose their ability to make a principled argument against the Democrats' protectionist temptation. Fortunately, splendid trouble may be on the horizon.

Last September's collapse of the World Trade Organization's ministerial meeting in Cancun meant that the pernicious "peace clause" was not renewed. For nine years it has prevented the WTO from treating agricultural subsides as what they obviously are—market distortions incompatible with free trade. For Americans, a fight over that is worth having, and losing.

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