THE FREEMAN
IDEAS ON LIBERTY

The Benefits of Outsourcing

by Brian Boland and Walter Block

Imagine yourself an entrepreneur planning a new firm. After extensive market research, you decide to manufacture pencils. You begin selling them for five cents each. Your accountants have determined that it costs you two cents to produce each eraser—40 percent of your selling price. Another firm can produce erasers for you for only one cent each (a 50 percent savings on erasers). Do you continue to make them yourself or do you farm out this operation?

Common sense dictates the latter course. This demonstrates the principle of outsourcing—purchasing parts or hiring labor from an outside source in order to cut manufacturing costs.

Traditional economic theory holds that firms are created to keep the cost of transactions down. By reducing the costs and inefficiencies associated with searching for and training the proper personnel, businesses can better maximize profits. For example, if a CEO had to place an ad in the paper for a secretary every time he needed a report typed, time and money would be wasted. By maintaining a staff sufficient to cover the firm's needs, such inconveniences are avoided.

Occasionally the enterprise must look outside its own personnel to fill its needs. Subcontractors may be called in when they can be expected to do a job better or more efficiently than those presently employed. The profit-maximizing firm will be expected to do that which is in the best interest of its bottom line. Contrary to union rhetoric, often the best way to get the job done is to have someone else do it.

For instance, the superintendent of a building typically has a working knowledge of electricity, plumbing, and heating; he will perform many repairs or adjustments that arise. While he may be very capable, he may not be the best person for each and every task. There may be times when a heating specialist should be called in because he has the expertise to do a job better or more efficiently. When it snows, the super may hire local kids to shovel the sidewalk, leaving him free to attend to other tasks. It all comes down to the most efficient allocation of resources.

A successful manager recognizes that there are occasions when it is best to hire a specialist. This is because there are opportunity costs involved. The superintendent in this example delegates responsibility so that every task is completed efficiently. His time is worth more installing light fixtures than shoveling snow, so he assigns someone else to clear the sidewalks. He doesn't hire a full-time snow shoveler for his staff since this sort of work is seasonal. Nor can he afford to retain a heating specialist on a 24-hour basis. Such help is called upon only when needed.

A Sensible Choice

Outsourcing makes good sense. Profits increase as resources are allocated more efficiently. But not everyone agrees.

Some critics argue that outsourcing causes unemployment. Consider again our example of the pencil factory. Many would condemn outsourcing eraser production to another firm

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because such action means unemployment for workers on the in-house eraser assembly line. The "exploitative" capitalist has maximized his own profits at the expense of the workforce.

On the surface, the criticism seems to have some validity. Purchasing services from others does weaken dependency on the current staff. If output remains constant, the need for staff employment will decrease. If the trend continues, the classic workforce will be slowly rendered obsolete; the logical implication is a world where everyone is self-employed—working for firms on a temporary or catch-as-catch-can basis.

Moral and Religious Criticisms

Pope John Paul II has condemned outsourcing because he thinks it contributes to "the scourge of unemployment" and denies the worker "a just wage and the personal security of the worker and his or her family."[1]

The Pope went on to say, "Every effort must be made to ensure that in this kind of system . . . the human person can preserve his awareness of working for himself. If it is not done, incalculable damage is inevitably done throughout the economic process, not only economic damage but first and foremost damage to the man."[2]

The U.S. Catholic bishops have supported the priority of labor and condemned profit maximization. They believe that the market improperly places profits before people. Entrepreneurs are only concerned with their own self-interest and will act without regard for their fellow humans in seeking profits.[3]

The bishops are missing the point. Profits are an indication that needs are being met and customers are being satisfied. If someone attempts to provide a service for which there is no demand, it will be a losing endeavor. Under capitalism, as Adam Smith pointed out, one's best interest is to provide a service that is also in someone else's best interest. If it is not, there will be no sale at all, let alone a profit. A profitable business venture does not exploit workers; rather, it serves customers, employees, investors, and suppliers by providing opportunities they consider beneficial.

Pope John Paul II recognizes the inherent good in profit. In his 1991 encyclical, *Centesimus Annus*, he said "The Church acknowledges the legitimate role of profit as an indication that a business is functioning well. When a firm makes a profit, this means that productive factors have been properly employed and corresponding human needs have been duly satisfied."

But what constitutes a productive factor's proper employment? Henry Ford developed a method of producing cars that made them more affordable and hence accessible to the average consumer. When this happened, the horse-and-buggy industry was all but destroyed. Should the owners of buggy factories be forced to remain open if there is no demand for their product? Should the government step in and provide subsidies for horse breakers, carriage makers, or whip and bridle manufacturers? Of course not. To do so would be to render more difficult and costly the production of cars and trucks. Given the new technology, this would be highly inefficient—and unsatisfactory.

Manipulating the Market

Some people are able to manipulate the market so they can thrive in conditions that would otherwise drive them out of business. Government intervention—including subsidies, bailouts, and special privileges—allows them to compete in a market that would not sustain them otherwise. The Chrysler bailout of the early 1980s and the strike at General Motors in the spring of 1996 are two examples of such behavior.

GM had been entertaining the notion of outsourcing brake production and shutting down two of its brake plants in Dayton, Ohio. The threatened workers went on strike. Unfortunately for GM, the company had recently adopted a just-in-time theory of inventory management and had very few surplus parts on hand. Keeping inventory to a minimum, while more efficient, creates a stronger dependence on suppliers, and gives them greater bargaining power. Without brakes, GM could not build new cars. Production ceased in 26 of its 29 assembly plants in North

America. The 3,000 workers in Dayton were able to make GM capitulate and thus saved their jobs. Union leaders heralded the event as a tremendous victory. But all they really did was to perpetuate inefficiency.

If the brake plants had been profitable, would GM have considered closing them down? Not at all. But the plants were not performing adequately. The workers in essence have forced GM to provide them with work although they are not producing at levels that would enable them to be paid their salaries. GM tried to avoid a waste of resources, but was not allowed to do so.

GM line workers cost the company $45 an hour in wages and benefits—double the labor costs of some outside contractors.[4] The company saw considerable savings in producing parts elsewhere. Some might argue that GM's decision would have rendered 3,000 workers unemployed. But what about the people who would have been employed at non-GM plants? The Dayton workers are more "guilty" of self-interest than any of the capitalists who wanted to close the plants.

The strength of this strike was due to a welter of U.S. labor laws—Norris-La Guardia, the Wagner Act, and Taft-Hartley—which give unfair advantage to unionized workers vis-à-vis capitalists and competing nonunion labor. In an attempt to preserve their own "right to work"—that is, the "right" to prevent the owner from hiring whom he wished—the Dayton workers forced thousands of other GM employees into idleness. It is impossible to ignore the fact that these 3,000 workers consciously decided to force the temporary unemployment of thousands of others, without regard for their right to work.

It is easy for intellectuals critical of capitalism to condemn outsourcing as a cause of unemployment without considering why the company might choose to look elsewhere or what the long-term effects might be. No one can deny that outsourcing causes unemployment, at least initially. But the same can be said every time an entrepreneur declines to use a specific factor of production in favor of a more efficient alternative.

In effect, the GM workers are attempting to promulgate the spread-the-work schemes criticized by Henry Hazlitt in *Economics in One Lesson*. The Dayton employees used their protected legal position to ensure that more labor is employed than is truly necessary. GM would be better off if it had been able to close the plant, or at least to engage in outsourcing. Both options were thwarted by labor legislation; the firm could have been accused of "unfair labor practices" had it chosen either alternative.

By outsourcing, companies can achieve improved levels of efficiency. Even an extremely conservative estimate places the savings by outsourcing at a healthy 9 percent.[5] Lower production costs lead to a decreased price for the consumer in a competitive market. That frees up more of the consumer's income to purchase other goods and services.

Had the market been allowed to function properly, those 3,000 workers in Ohio would be looking for new jobs, where they could now produce items hitherto unavailable to the public. In addition, thousands of other workers would be employed elsewhere and the general public would have enjoyed more affordable automobiles. Here is just one more example of the shortsightedness our society so often rewards.

Let nothing said above be interpreted as a blanket advocacy of outsourcing. Subcontracting is but one tool management can use. Sometimes it can be profitable; at other times it can reduce profits, as in the case where the workers already hired can do the same job more cheaply than outsiders. What can be said, however, is that if the entrepreneur is allowed to pick and choose, the profit-and-loss system will allocate resources efficiently. But this is all that the system of free enterprise can promise in any case. □

1. *Laborem Exercens* (Washington, D.C.: Catholic News Service, 1995), p. 19.
2. *Ibid.*, p. 35.
3. Pastoral Letter on Catholic Social Teaching and the U.S. Economy: *Origins*, NC Documentary Service, November 15, 1984, Vol. 14, No. 22/23; "Second Draft of the U.S. Bishops' Pastoral Letter on Catholic Teaching and the U.S. Economy," *Origins*, October 10, 1985.
4. Bill Vlasic, "Bracing for the Big One," *Business Week*, April 1, 1996, pp. 34–35.
5. *Ibid.*

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Marcus Tullius Cicero, Who Gave Natural Law to the Modern World

by Jim Powell

Marcus Tullius Cicero expressed principles that became the bedrock of liberty in the modern world.

He insisted on the primacy of moral standards over government laws. These standards became known as natural law. Above all, Cicero declared, government is morally obliged to protect human life and private property. When government runs amok, people have a right to rebel—Cicero honored daring individuals who helped overthrow tyrants.

Intellectual historian Murray N. Rothbard praised Cicero as "the great transmitter of Stoic ideas from Greece to Rome. . . . Stoic natural law doctrines heavily influenced the Roman jurists of the second and third centuries A.D., and thus helped shape the great structures of Roman law which became pervasive in Western civilization."

For centuries, people read Cicero because of his beautiful Latin prose. He transformed Latin from a utilitarian language, which served generals, merchants, and lawyers, into a poetic language. The first century A.D. Roman author Quintilian remarked that Cicero was "the name not of a man, but of eloquence itself." As a writer, Thomas Jefferson called Cicero "the first master of the world." Historian Edward Gibbon, who elegantly chronicled Rome's decline, recalled that when reading Cicero "I tasted the beauties of language, I breathed the spirit of freedom, and I imbibed from his precepts and examples the public and private sense of a man."

As Rome's most famous orator, Cicero prosecuted crooked politicians and defended citizens against rapacious officials. On one occasion when Cicero spoke, mighty Julius Caesar reportedly trembled so much that he dropped papers he was holding. Scholar H. Grose Hodge observed that Cicero at his best offered "a sustained interest, a constant variety, a consummate blend of humour and pathos, of narrative and argument, of description and declamation; while every part is subordinated to the purpose of the whole, and combines, despite its intricacy of detail, to form a dramatic and coherent unit."

Amidst a violent age, Cicero was a man of peace. He refused to build a personal army like other leading Roman politicians, and he spoke out against violence. "A war which is launched without provocation," he wrote, "cannot possibly be just." He warned: "violence is more ruinous than anything else."

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