Study: Outsourcing hurts consumers by softening competition among firms

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Firms that outsource aspects of their business to a foreign country may profit by saving money, but the practice tends to soften the competition among industry rivals, exacting a hidden cost on consumers, says new research co-written by a University of Illinois business administration professor.

Yunchuan "Frank" Liu says outsourcing hurts society in two ways – it results in lost jobs for workers, and in consumers paying higher prices than they should for goods.

"Outsourcing is a topic that affects just about everyone, and the general consensus is that it's bad because American workers will lose jobs because of it," he said. "Most people only focus on the job-displacement angle, but very few people have questioned how it affects consumers and competition in the marketplace."

The study, which will appear in the journal *Management Science*, is the first to examine the effects of outsourcing on competition as well as consumers and society, said Liu, who co-wrote the study with Rajeev Tyagi, an economist at the University of California at Irvine.

Liu says that if firms are unwilling to pass along the savings they've reaped from outsourcing production and labor to a cheaper country, all consumers suffer because of softer competition.

"If a firm outsources production to a low-cost country, there's a cost-

saving effect, but there's also a weakening among on the competition," Liu said.

"If the competition is softened and the production costs become lower, businesses don't have an incentive to pass those savings along to consumers," Liu said. "In some cases, consumers pay higher prices."

Before outsourcing became a popular strategy for businesses looking to cut costs, competition among firms was more intense.

"Before firms started outsourcing, firms competed head-to-head, and the result of this competition is that businesses were more consumer-centric," Liu said.

But when firms outsource aspects of their business, they cease competing head-to-head, as the actual competition grows to include more players, Liu said.

"Once more businesses are involved, even if firms become more customer-focused, if their suppliers don't cooperate, they can't lower prices," he said. "So firms lose the incentive to become consumer-centric and competitive. And the reason why that happens is that outsourcing softens the competition among rival firms."

Liu says that businesses aren't simply pocketing the money they're saving from outsourcing; in some cases, the cost saving from outsourcing is not that significant.

"Some U.S. businesses may outsource to Canada, where the cost-savings are insignificant. Why do firms want to do that? One potential reason is to soften the competition among competing firms, which has the effect of keeping prices artificially higher than they should be."

Liu says that lawmakers need to consider policies that would facilitate open competition between firms and incentivize satisfying consumers tastes. Otherwise, firms are better off while consumers suffer.

"For public policymakers, it's just another negative effect of outsourcing ," he said. "They need to consider not only the Americans who are losing their jobs because of it, but also the consumers who are being gouged."

Provided by University of Illinois at Urbana-Champaign

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