VENABLE LLP

LEGISLATIVE ALERT

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Outsourcing of Services and the Legislative Outlook

Summary

In recent weeks, the issue of **outsourcing of services abroad by American companies** rapidly has been gaining steam on Capitol Hill and is likely to intensify as a political factor as this election year unfolds. Outsourcing (also called offshoring) is also gaining momentum at the state level, with bills being introduced or under discussion in as many as two dozen state legislatures. Fueling the potency of outsourcing as a election-year issue is the fact that it has been largely partisan, with the party out of power seeing an opportunity for political gain against the party in power during a election that may hinge on jobs and the economy. Federal measures introduced to date have been mainly "sense of the Congress"-type measures with no legal effect and notice and reporting requirements, designed to gain visibility for the anti-outsourcing position. But given what appears to be growing support for such measures, introduction of substantive legislation – including tax disincentives – should be expected.

With the increased efficiency and reduced cost of communications, especially via the Internet, virtually any function a company has that involves information or intellectual assets can be outsourced to a remote location. In an increasingly competitive global economy, a growing number of firms are responding to market pressure to procure information-related services from less expensive providers outside the United States. Thus, companies in almost any industry sector with information-based assets – which, in effect, is all of them – are actual or potential outsourcers and could be impacted by legislation to limit it. Among the sectors increasing their use of outsourcing, and therefore possibly needing to be actively involved in the legislative process, are:

- software design and IT
- telecommunications
- research and development
- scientific and technical
- accounting (including tax preparation)
- telemarketing
- financial services
- voice and data processing (including insurance claims)
- transcription of records (including medical)
- analysis (including market analysis)
- design and engineering
- customer services

and potentially many others.

The Outsourcing Issue

As a political issue, the current outsourcing[1] (or offshoring) debate can be seen as the latest installment of the continuing tension between existing American jobs and industries facing foreign competition, and the growth of a global economy transcending national borders. Previous political installments reflecting that tension include trade agreements (NAFTA, GATT, WTO), visas for foreign workers[2] (notably H-1B specialized workers and L-1 intra-company transfers, especially in high-tech industries like IT), corporate "inversions" (American corporations that open shell subsidiaries or pro-forma foreign headquarters offices for tax and other advantages), and plant closings by U.S. firms transferring operations abroad.

The newest debate differs less in the overall issues involved (pitting existing domestic capacities against future competitiveness in the global marketplace) than in the specific sectors and interests affected. Whereas outsourcing, in a general sense, denotes any shift to foreign providers of work previously done in the United States, the narrower meaning for purposes of the current debate refers to the use of workers in foreign countries to **provide information-based services to customers in the United States via telephone and Internet**. Unlike earlier issues, which involve people or goods physically crossing national borders, the current outsourcing issue means primarily, or even exclusively, **transfer of information**, control of which is virtually impossible. In addition, it means that whereas sectors impacted earlier were largely in manufacturing, those now affected are in information-based services. It also means the American workers directly affected are now in white-collar service industries rather than in blue-collar manufacturing jobs.

Politics of Outsourcing

This current round of the political debate on outsourcing was touched off by the observation on February 9 by Gregory Mankiw, Chairman of President Bush's Council of Economic Advisors, that outsourcing of services to remote locations via advanced communications was "just a new way of doing international trade." He also observed: "More things are tradeable than were tradeable in the past, and that's a good thing. That doesn't mean there's not dislocations; trade always means there's dislocations. And we need to help workers find jobs and make sure to create jobs here." Mr. Mankiw's remarks instantly became the occasion of sharp attacks from Democrats. Republican responses were mixed, with some distancing themselves from what sounded like insensitivity to American job loss. These included House Speaker Denny Hastert (R-IL), who said Mr. Mankiw's observation "fails a basic test of real economics." Others suggested that Mr. Mankiw was being targeted for stating an obvious fact of economic life by Democrats perceiving an election-year opportunity.

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[1] The current outsourcing issue is related to, but distinct from, "outsourcing" of services in the general sense of companies and agencies increasingly having work formerly done by employees in-house done by outside contractors. Such generic outsourcing may or may not involve outsourcing of services to providers outside the United States, which is the exclusive focus of this survey.

[2] While outsourcing of services to remote locations outside the United States is distinct from the visa issue, there are points of overlap. Critics of outsourcing have noted that entry of workers to the United States under the H-1B and L-1 visa programs can expedite transfer of manufacturing and service functions to lower-cost overseas locations by affording the non-U.S. professionals connections, language skills, and familiarity with offshore business partners, as well as an acquired knowledge of the U.S. market and business practices and exposure to U.S. technology and its applications.

Status of Legislation To Date

Among the states where measures to prohibit state agencies from outsourcing services to foreign providers have been introduced in state legislatures are Connecticut, Colorado, Florida, Hawaii, Indiana, Maryland, Mississippi, New Jersey, New York, North Carolina, South Carolina, Washington, Kansas, and Missouri. Bills are also expected to be introduced in California, Georgia, and other states. No bill has yet been passed by both legislative houses in any state. Federal constitutional and legal questions have been raised about the validity of such state laws, should any be enacted.

Federal legislative efforts to date include the following:

1. The **Fiscal Year 2004 Consolidated Appropriations** bill (H.R. 2673, P.L. 108-199, signed into law 1/23/04) includes in the title funding the Department of Transportation (Division F) a provision (Section 647(e)) as follows: "An activity or function of an executive agency that is converted to contractor performance under Office of Management and Budget Circular A-76[3] may not be performed by the contractor at a location outside the United States except to the extent that such activity or function was previously performed by Federal Government employees outside the United States." This provision, which is limited to the agencies funded in Division F, will expire at the end of the fiscal year unless renewed.

2. The **Jobs for America Act** (S. 2090). Introduced on February 12, 2004, S. 2090 primarily is a notice and reporting mandate. According to the chief sponsor, Senate Minority Leader Tom Daschle (D-SD), the bill "would require companies that lay off 15 or more workers and send their jobs overseas to provide at least three months notice. The legislation would also require notification to the Department of Labor, state agencies responsible for helping laid-off employees, and local government officials. Such notification would inform policymakers about where job loss is most acute and help them further address the problem." The bill has 19 cosponsors, all Democrats, including presidential candidates John Kerry (D-MA) and John Edwards (D-NC). The bill has been referred to the Senate Committee on Health, Education, Labor, and Pensions.

2. The **Call Center Consumer's Right to Know Act** (S. 1873/H.R. 3816). Introduced on November 17, 2003, and referred to the Senate Committee on Commerce, Science, and Transportation, S. 1873 would require employees at a call center who either initiate or receive telephone calls to disclose their physical location. An identical House bill (H.R. 3816) was introduced on February 11, 2004, and referred to the House Committee on Energy and Commerce. "Physical location" is not defined in the bill.

4. **Amendment 2311** to S. 1072 (an unrelated highway bill) is a **Sense of the Senate** resolution to the effect that "that the Senate should (1) oppose any efforts to encourage the outsourcing of American jobs overseas; and (2) adopt legislation providing for a manufacturing tax incentive to encourage job creation in the United States and oppose efforts to make it cheaper to send jobs

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[3] OMB Circular A-76, issued August 4, 1983, and revised in 1999, establishes Federal policy regarding the performance of commercial activities and implements the statutory requirements of the Federal Activities Inventory Reform Act of 1998, Public Law 105-270. The Supplement to this Circular sets forth the procedures for determining whether commercial activities should be performed under contract with commercial sources or in-house using Government facilities and personnel. Found at: http://www.whitehouse.gov/omb/circulars/a076/a076.html .

overseas." The chair ruled the amendment, sponsored by Senator Hillary Clinton (D-NY), with 10 Democratic cosponsors, non-germane to the underlying bill.

5. The **American Manufacturing Retention Act** (H.R. 3134). Introduced on September 17, 2003, H.R. 3134 requires that federal contractors have at least 50 percent of their workforce located in the United States. Sponsored by Rep. James Walsh (R-NY), the bill has 17 cosponsors (13 of them Republicans), and has been referred to the Committee on Government Reform and to the Committee on Armed Services.

6. **The United States Workers Protection Act** (H.R. 3820/S. 2094). These bills would codify the restrictions on government outsourcing in the Consolidated Appropriations bill (Item 1, *above*) and apply them as a statutory limitation on all federal government agencies. In addition, the bills would bar federal assistance to states unless the state government has certified "that none of such funds will be expended for goods or services performed outside the United States under contracts for the procurement of goods or services entered into by such State." The Senate bill was introduced on February 12, 2004, and the House bill on February 24; they have been referred, respectively, to the Senate Committee on Government Affairs and the House Committee on Government Reform.

Possible Future Legislation

While the items seen so far are largely efforts to gain the political high ground for the anti-outsourcing position, the speed with which the issue is gaining political "legs" indicates a likely shift soon to real disincentives for outsourcing. These are likely to fall into two categories: (1) a broadening of restrictions on outsourcing by federal government agencies and on government contracts with firms that outsource (such as items 1, 5, and 6, *above*); and (2) measures to impact private industry.

With respect to government agencies and government contracts, additional restrictive measures are likely to be introduced following the soon-expected issuance of reports from the General Accounting Office on worker displacement due to outsourcing, and from the Central Intelligence Agency on the national security impact of outsourcing. Other initiatives will certainly appear during the Fiscal Year 2005 appropriations cycle, now getting underway.

With respect to direct impact on private industry, among the most effective would be tax measures to make it more costly for firms to outsource services outside the United States. This could be accomplished, for example:

- By providing incentives to encourage domestic employment (via a reduced tax rate on domestic manufacturing or a wage credit for U.S.-sourced wages), or

- Perhaps more likely, by providing disincentives that would apply to domestic companies with overseas operations (such as rules that further restrict a domestic subsidiary's ability to deduct interest payments to a related foreign entity or more stringent requirements regarding the transfer of intellectual property to foreign operations).

Venable's Legislative Practice Group is closely monitoring the developing outsourcing issue. Representatives of firms that may be impacted and are interested in participating in legislative efforts to protect their interests are encouraged to contact us. For more information call or e-mail James George Jatras at 202-344-8308 or jgjatras@venable.com.