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SPECIAL REPORT -- WHERE ARE THE JOBS?

By Paul Craig Roberts

Guest Commentary: The Harsh Truth About Outsourcing
It's not a mutually beneficial trade practice -- it's outright labor arbitrage

Economists are blind to the loss of American industries and occupations because they believe these results reflect the beneficial workings of free trade. Whatever is being lost, they think, is being replaced by something as good or better. This thinking is rooted in the doctrine of comparative advantage put forth by economist David Ricardo in 1817.

It states that, even if a country is a high-cost producer of most things, it can still enjoy an advantage, since it will produce some goods at lower relative cost than its trading partners.

Today's economists can't identify what the new industries and occupations might be that will replace those that are lost, but they're certain that those jobs and sectors are out there somewhere. What does not occur to them is that the same incentive that causes the loss of one tradable good or service -- cheap, skilled foreign labor -- applies to all tradable goods and services. There is no reason that the "replacement" industry or job, if it exists, won't follow its predecessor offshore.

For comparative advantage to work, a country's labor, capital, and technology must not move offshore. This international immobility is necessary to prevent a business from seeking an absolute advantage by going abroad. The internal cost ratios that determine comparative advantage reflect the quantity and quality of the country's technology and capital. If these factors move abroad to where cheap labor makes them more productive, absolute advantage takes over from comparative advantage.

This is what is wrong with today's debate about outsourcing and offshore production. It's not really about trade but about labor arbitrage. Companies producing for U.S. markets are substituting cheap labor for expensive U.S. labor. The U.S. loses jobs and also the capital and technology that move offshore to employ the cheaper foreign labor. Economists argue that this loss of capital does not result in unemployment but rather a reduction in wages. The remaining capital is spread more thinly among workers, while the foreign workers whose country gains the money become more productive and are better paid.

Economists call this wrenching adjustment "short-run friction." But when the loss of jobs leaves people with less income but the same mortgages and debts, upward mobility collapses. Income distribution becomes more polarized, the tax base is lost, and the ability to maintain infrastructure, entitlements, and public commitments is reduced. Nor is this adjustment just short-run. The huge excess supplies of labor in India and China mean that American wages will fall a lot faster than Asian wages will rise for a long time.

Until recently, First World countries retained their capital, labor, and technology. Foreign investment occurred, but it worked differently from outsourcing. Foreign investment was

confined mainly to the First World. Its purpose was to avoid shipping costs, tariffs, and quotas, and thus sell more cheaply in the foreign market. The purpose of foreign investment was not offshore production with cheap foreign labor for the home market.

When Ricardo developed the doctrine of comparative advantage, climate and geography were important variables in the economy. The assumption that factors of production were immobile internationally was realistic. Since there were inherent differences in climate and geography, the assumption that different countries would have different relative costs of producing tradable goods was also realistic.

Today, acquired knowledge is the basis for most tradable goods and services, making the Ricardian assumptions unrealistic. Indeed, it is not clear where there is a basis for comparative advantage when production rests on acquired knowledge. Modern production functions operate the same way regardless of their locations. There is no necessary reason for the relative costs of producing manufactured goods to vary from one country to another. Yet without different internal cost ratios, there is no basis for comparative advantage.

Outsourcing is driven by absolute advantage. Asia has an absolute advantage because of its vast excess supply of skilled and educated labor. With First World capital, technology, and business knowhow, this labor can be just as productive as First World labor, but workers can be hired for much less money. Thus, the capitalist incentive to seek the lowest cost and most profit will seek to substitute cheap labor for expensive labor. India and China are gaining, and the First World is losing.

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