Senate Democratic Policy Committee Hearing

"Shipping American Jobs Overseas: A Hearing on the Bush Administration's Claim That Outsourcing is Good for the U.S. Economy"

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"Is Off-shoring Really Just Good Old Free Trade?"

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Summary

Many academic economists argue that off-shoring is simply the next chapter in "free trade" theory – a "good thing." However, some politicians of both parties are beginning to question whether off-shoring represents a fundamental break from the past.

To them it appears that off-shoring is not free trade, as most think of it, but the systematic substitution in the production process of higher cost U.S. workers by lower priced foreign workers, due to an increasingly integrated global economy. The result is rising corporate profits, but falling U.S. jobs, stagnating wages, and enormous pressure on the country's middle class.

The authors contend that what is happening in today's globally integrated economy is not the classical operation of "free trade," and, they point out, that argument can be found in the original writings on which free trade theory is based.

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George Bernard Shaw once observed that if you took all the economists in the world and lined them up head to toe you would still not reach a conclusion. Yet most economists have reached a definitive conclusion about the off-shoring[1] of U.S. white and blue collar jobs. As President Bush's chief economic adviser, Gregory Manikiw, recently and now famously made clear, off-shoring is "a good thing."

This conviction comes despite a surprising lack of hard data. The Federal Government does not collect figures on the extent of off-shoring by U.S. companies. The evidence of off-shoring's impact comes primarily from announcements by major companies about their intentions to send jobs and work to India and China and the personal anecdotes of those whose jobs have been off-shored.

However, some private sector economists have attempted to estimate the extent of the off-shoring phenomenon. Mark Zandi, chief economist of Economy.com, estimates that off-shoring may be responsible for more than one-quarter, or between 700,000 and 1 million, lost jobs since early 2001. In addition, as Mr. Zandi observes, "Moreover, there is little reason to believe that the magnitude of the job losses due to off-shoring will abate anytime soon."[2] Likewise, Stephen Roach, chief economist of Morgan Stanley, has characterized off-shoring as a powerful and disruptive new phenomenon which he labels, "global labor arbitrage"[3] – multinational companies trading higher priced domestic labor for lower priced skilled foreign labor in as many job functions as profitable.

The conviction that off-shoring is a good thing also stands in contrast to the current jobs data. Despite historically low interest rates, large tax cuts, record spending and record deficits, the highly stimulated U.S. economy is simply is not creating many jobs. The January jobs figure of 112,000 new jobs was 40,000 to 90,000 jobs short of where the consensus forecast it would be.

This anemic level of job creation is completely out of sync with past economic cycles. Of the many recession/recovery cycles since the end of the Great Depression, this is the only one that has failed to produce significant new jobs this far into a recovery.[4] In fact, since the onset of what has been officially marked a "recovery" over two years ago, the U.S. economy has shown not a net gain, but a net loss, of 782,000 private sector jobs. This figure is net of more than 1.3 million lost manufacturing jobs. Something new appears to be weighing on the economy's ability to create jobs.

Unfortunately, the U.S. jobs problem is not just one of quantity; it is also one of quality. Job losses have been concentrated in our export and import-competitive sectors. The few new jobs that have been created are concentrated in lower paying areas of the service sector and are not those traditionally associated with ladders of upward mobility that gave America the stability of a large middle class.[5] These jobs do not have the potential to produce exports to close the more than $500 billion gap in our balance of trade.

If the benefits of off-shoring do not show up in the data, what gives economists such confidence? Their conviction arises from the belief that off-shoring is simply the

latest chapter in the benevolent story of "free trade." As Gregory Manikiw, among others, believes, off-shoring simply signals that services have become "tradeable." Therefore, the thinking goes, since off-shoring is free trade, and free trade is good, then off-shoring must be good too.

There is one small problem with this argument: off-shoring is not free trade. The fact that it is not free trade can be found in the very writings of the man credited with originating free trade theory, the British economist, David Ricardo.

A Brief Review of Free Trade Theory and Comparative Advantage

Two centuries ago, David Ricardo demonstrated the mutual benefits from free trade through his theory of "comparative advantage." Many academics consider this the "deepest and most beautiful result in all of economics." Paul Krugman once wrote, "If there were an Economist's Creed it would surely contain the affirmations, 'I believe in the Principle of Comparative Advantage,' and 'I believe in free trade.'" Likewise, John Maynard Keynes wrote, "I was brought up, like most Englishmen, to respect free trade not only as an economic doctrine which a rational and instructed person could not doubt but almost as a part of the moral law." Clearly, free trade theory has become something of a religion.

According to the principle of comparative advantage, a country will be better off if it specializes in what it is most efficient at producing, relative to other goods or services it could produce, and then trades with other nations for other needs. Ricardo showed that trade was still beneficial even if a country was not the lowest cost producer worldwide, or, in economic terms, even if it did not have an "absolute advantage" in production of that good or service. The country simply needed to specialize in whichever activity its internal resources were most efficient at producing. Ricardo illustrated that, contrary to intuition and the thinking of his time, a country that was the most productive in all goods and services would still be better off specializing and trading with other nations.

Ricardo's theory is often simplified by stating it in terms of individuals. A favorite example is the lawyer and her secretary. The lawyer happens to be a champion speed typist. She therefore has an absolute advantage over the secretary both in typing and of course in practicing law. But the lawyer nevertheless finds it advantageous to hire the secretary to do the typing, and they both specialize according to each person's comparative advantage. Although the lawyer is a slightly better typist than the secretary, she is a much better lawyer, and she is not so foolish as to spend her time typing when she could be billing clients at $500 per hour!

Ricardo used the now famous example of trade between England and Portugal in cloth and wine. Even though Portugal was a more efficient producer of both wine and cloth, Ricardo showed it would be better off focusing its capital and labor in the production of the good that was relatively cheaper for it to produce, and trading with England for the other. England would also be better off.

Within the world of its assumptions, Ricardo's argument is unassailable. However, there is an often-overlooked premise that is of great relevance to today's off-shoring debate.

<u>The Importance of the Factors of Production Staying Put</u>

Comparative advantage assumes that the "factors of production" – the key resources required to make something – will not move between trading partners. It is impossible for the productive energy and capacity of the secretary – her factors of production – to be transferred to the absolutely more efficient person of the lawyer. The lawyer is not a vampire that can suck the lifeblood and energy out of the hapless secretary in order to employ them more efficiently. Since the factors of production are immobile, the theory of comparative advantage holds true.

However, the analogy with the lawyer and secretary is misleading when applied to Portugal and England unless their factors of production – labor and capital – stay at home. Only then will they be reallocated domestically to their best use according to the principle of comparative advantage.

Ricardo was quite explicit about his assumption of immobile factors of production between countries, and the likely results if that assumption did not hold, as is now the case with off-shoring. As he wrote:

> "It would undoubtedly be advantageous to the capitalists of England, and to the consumers in both countries, that under such circumstances [Portugal's absolute advantage in both goods], the wine and the cloth should both be made in Portugal, and therefore that the capital and labour of England employed in making cloth, should be removed to Portugal for that purpose."[6]

In other words, Ricardo is stating that if the factors of production can move they will seek their highest return. Capital may not stay in the home country, and therefore some countries will lose jobs and income while others gain. In his example, the labor and capital move from England to Portugal.

However, Ricardo did not believe that would happen because, in his experience, capitalists were patriots who preferred to invest at home.[7] As he wrote:

> "Experience, however, shews, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and intrust himself with all his habits fixed, to a strange government and new laws, checks the emigration of capital. These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a

more advantageous employment for their wealth in foreign nations."[8]

The immobility of the factors of production was critical to Ricardo's theory of comparative advantage. Labor and capital could move within a country, but they could not – and would not in his experience – leave the country. He confirms this view in another passage:

> "The difference in this respect between a single country and many, is easily accounted for by considering the difficulty with which capital moves from one country to another, to seek a more profitable employment and activity in which it invariably passes from one province to another in the same country."[9]

Everything that differentiates domestic from international trade depends for Ricardo on the immobility of the factors of production.

To put it another way, in order to produce anything a country needs its resources. If all of its resources can leave the country, then the country may not be able to produce anything. Of course, some resources are more mobile than others. It is easy for capital to leave, but difficult for labor and natural resources to leave. Human beings get tied to their communities, friends and families.

The Factors of Production in the Modern World

Ricardo's view seems quaint today. It is clear that he was considering a world in which businesses were first and foremost good Englishmen, Frenchmen, etc. who would keep their capital close to home, not a world of cosmopolitan money managers and transnational corporations.

In our new era, capital, technology, and ideas – the modern factors of production – are deployed instantaneously in the pursuit of the lowest cost labor around the world and the highest profit. Production and service jobs are sent offshore, along with U.S. capital, to produce commodities mainly for import back to the U.S. As evidence of this trend, Stephen Roach has estimated that 65% of China's exports in 2002, the key to its economic growth, can be traceable back to multinationals' production facilities in China.

While off-shoring may lead to an increase in world production and lower costs for the world's consumers, it is no longer achieving a better outcome for each nation – the classic argument for free trade. This is a critical point. Global economic efficiency may be a valuable end in and of itself, but it has never been the justification for free trade policies.

Trade, and the social dislocations and upheaval's in citizens lives that come with it, have always been justified on the grounds that the nation, which we all have a communal interest in, would itself be better off. While there would be winners and losers under free

trade policies within the national economy, the fact that we all live under the same roof justifies some pain in the national interest. It also allows the many citizens and businesses that gain from free trade to compensate the few who do not. However, we do not all live under one global government, and so the implications of having winners and losers between national economies is much different, and not the outcome those engaged in multilateral free trade agreements have signed onto.

Ricardo and Others

If Ricardo were alive today it is likely he would not be preaching that today's off-shore production of goods and services is free trade. He was, like his contemporaries, a realist who paid close attention to actual conditions. Unfortunately, many of today's economists are idealists who have become so enamored of the "beauty" of the free trade argument that they do not stop to consider the conditions on which it rests.

However, a few economists have done so, and Ricardo's writings are not the only source for a review of free trade theory in a world of off-shoring.

John Maynard Keynes reconsidered his early support for free trade given the increasing mobility of capital in an essay in 1933.[10] More recently, Ralph Gomory and William Baumol, two highly respected scholars, have written a book that illustrates how free trade in a modern economy based on massive economies of scale can create national conflict. As they write in *Global Trade and Conflicting National Interests*, "However, as modified by us, the theory [classic trade models] shows that there are in fact inherent conflicts in international trade. That means that it is often true that improvement in once country's productive capabilities is attainable only at the expense of another country's general welfare."[11] In other words, under certain conditions, very similar to the ones now existing between the U.S., China and India, free trade will create winners and losers between nations, and not mutual gains.

The politicians and workers who are concerned about off-shoring are not the misguided, "economic illiterates" some have labeled them.

Conclusion

History is often the story of nations and leaders unable to account for what is new and different as a result of ideology or old thinking. To mistakenly characterize off-shoring as free trade undermines support for genuine free trade policies. It also discourages the hard work and commitment that will be required to design a national strategy for a new era based on enhancing our educational systems, investing in robust worker retraining programs, and encouraging innovation in this country. It is time for a realistic review of the impact of off-shoring based on hard facts, not economic ideology.

Summary End Notes

[1] "Off-shoring" refers to the replacement of U.S. workers by lower cost foreign workers stationed offshore in the production process of goods and services
[2] Mark Zandi, "The Off-shoring Threat," Economy.com, October 24, 2003
[3] Stephen Roach, "The Global Labor Arbitrage," Morgan Stanley, October 24, 2003
[4] For more information see "Job Watch" published by the Economic Policy Institute, www.jobwatch.org
[5] For more information see www.mbginfosvcs.com for data on jobs lost by category during the past three years
[6] David Ricardo, Sraffa (Ed.) 1951, p. 136-137
[7] Adam Smith shared Ricardo's view of the capitalist as patriot, as he writes in this famous passage: "By preferring the support of domestic to that of foreign industry he intends only his own security; and by directing that industry in such manner as its own produce may be of the greatest, he intends only his own gain, and he is in this as in many other cases, led by an invisible hand to promote an end which as no part of his intention." (1776, p. 423)
[8] David Ricardo, Sraffa (Ed.), 1951, p. 136-137
[9] David Ricardo, Sraffa (Ed.), 1951, p. 136
[10] John Maynard Keynes, "National Self Sufficiency", The Yale Review, Summer 1933
[11] Ralph E. Gomory and William J. Baumol, Global Trade and Conflicting National Interests, The MIT Press, 2000, p. 4

Note: Statement prepared with James Socas