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REVIEW & OUTLOOK

# Outsourcing 101

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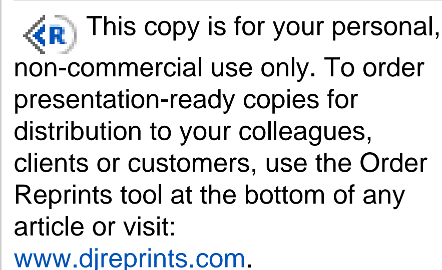

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Dig below the politics of the great outsourcing debate and there's one serious economic question: Has David Ricardo's law of comparative advantage become irrelevant in this age of digitized information and cheap telecommunications?

The argument goes something like this: Comparative advantage works only if factors of production -- land, labor and capital -- are immobile. Since these factors can now locate to countries with the greatest absolute advantage, job losses in the U.S. are permanent. Ergo, free trade is no longer in the American national interest. Few serious economists believe this, mind you. But Lou Dobbs and New York Senator Chuck Schumer have been peddling it to some effect, so we'll try to take it on.

For starters, they confuse "comparative" and "absolute" advantage. An absolute advantage means that a country can produce something with fewer inputs (labor and capital) than another country. To use Mr. Ricardo's favorite example: Although Portugal had the absolute advantage in producing both wine and cloth, Portugal was still better off producing to its comparative advantage in wine and then trading with England for cloth.

So even if China becomes the country with all the absolute advantages on the planet, China still benefits from specializing in, say, running shoes and then trading with the U.S. to buy computers. Economic models have improved since Ricardo first described comparative advantage in 1817. The new models assume that labor and capital are internationally mobile, and they still demonstrate that there are overall gains from trade.

Consider the recent work of Matthew J. Slaughter, an economist at Dartmouth's Tuck School of Business, who points out the fallacy of thinking only of the "substitution" impact of overseas job expansion -- that is, where one Indian worker substitutes for one American worker. The result is that outsourcing is thought to be a zero-sum game. Mr. Slaughter points out that this ignores three crucial concepts.

First, complementarity. When U.S. firms hire lower-cost labor overseas they have to hire other inputs to complement the expanded amount of foreign labor. For example, if a firm is producing different parts of its

widgets in different locations it might need more labor in the U.S. to combine with the increased widget-part production. Or say a firm builds a new factory in a foreign country to service demand where the firm has not been selling at all -- that, too, generates more demand for inputs in the U.S.

Complementarity works itself out in two ways: scale and scope. Firms that expand overseas for lower-cost labor, or to get access to new markets, will increase the scale of their operations; they will use more scientists and engineers to refine products to appeal to those foreign markets, more marketing people, more logistics and financial people, and more support staff. Overseas expansion can also cause firms to change their scope -- the mix of activities undertaken in the U.S. That change is toward higher value-added activities here.

Simply put, focusing on substitution to India results in counting the number of jobs lost but ignoring the greater number of jobs created. The cost-savings and gains in foreign-market access spur growth in company-wide activities -- both abroad and in the U.S. Higher sales in foreign affiliates appear to raise, not lower, domestic employment in the parent company.

This theory is sound, sure, but it is also supported by the facts. Mr. Slaughter looked at Bureau of Economic Analysis data, reported yearly between 1991 and 2001, for 2,500 multinational companies. This is an excellent decade to observe outsourcing's impact because it captures the increasing global engagement of both China and India.

Mr. Slaughter found that while employment in foreign affiliates rose by 2.8 million jobs, employment in U. S. parent firms rose even more smartly -- by some 5.5 million jobs. For every one job outsourced abroad, multinationals created nearly two jobs in the U.S. Moreover, when Mr. Slaughter compares that growth with total job growth, it is clear that multinationals logged faster job creation.

Critics of outsourcing miss that the world economy is a dynamic enterprise. Jobs created overseas generate jobs at home. Not just more jobs for Americans, but higher-skilled and better paying ones. At the same time, trade offers consumers a greater quantity and variety of goods and services for lower prices. David Ricardo lives.

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