Paul Craig Roberts
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Offshore outsourcing is misunderstood by economists and policymakers. The phenomenon is misperceived as an extension of the mutual benefits of comparative advantage-based trade.

Comparative advantage has two necessary conditions, neither of which is met today. One condition is that capital is immobile internationally relative to traded goods. The other is that the trading countries have different opportunity costs of producing the traded goods. (The economic concept of opportunity cost is an in-kind measure; for example, the quantity of wine that is not produced in order to make a yard of cloth.)

The condition of capital immobility is required to insure that a country’s capital seeks comparative advantage at home instead of absolute advantage abroad. Different internal cost ratios of producing one good in terms of another are necessary if low- and high-cost countries are to experience mutual gains from specializing and trading.

David Ricardo discovered comparative advantage when he investigated the question of why a country that could most cheaply produce all tradable goods would trade with a higher cost country.

Ricardo’s answer is that the opportunity cost of producing one good in terms of the other was different in the two countries. He was able to show that total output would increase if each country specialized in the product in which it had relative advantage. He then showed that the increased output would be shared by the terms on which the countries would trade one product for the other.

In Ricardo’s example, the different opportunity cost ratios of producing wine and cloth in the two countries are due to inherent differences in geography, climate and soil.

Modern production functions, however, are based on acquired knowledge. They operate the same in all countries. These production functions do not reflect country-specific inherent differences that result in different opportunity cost ratios on which comparative advantage depends.

When I point out that the conditions on which the case for free trade is based are no longer met in today’s world, economists either evade the issue or drag red herrings across the path. They talk about shifts in the terms of trade, about productivity gains abroad, and about the pervasiveness of factor mobility even in Ricardo’s time. They equate the rise of the high speed Internet and collapse of world socialism, which made vast quantities of cheap labor available to first world capital, with innovations such as lower transport costs that turned previously non-traded goods into traded goods.

None of these arguments engages the issue. Ricardo imposed the condition of relative capital immobility internationally in order that specialization according to comparative advantage could occur. Otherwise, a country's capital would flow to absolute advantage abroad. When US firms substitute foreign labor for domestic labor in their production for domestic markets, capital is flowing to absolute advantage.

Factor mobility from Ricardo's time to the recent advent of offshore outsourcing was qualitatively different. Foreign investment was a way to evade tariffs, quotas, and high transport costs. Foreign investment was not geared toward offshore production for home markets. Ford and GM produced cars in Europe to sell to Europeans, not to export to America.

Economists assume that offshore production for home markets is trade because the goods count as imports when they enter the US. But what is being traded when a US firm closes its American factory, lays off its American work force, moves its capital and technology offshore and uses foreign labor to produce the identical product for the same US markets? This is not trade in the traditional sense with one country specializing in cloth, the other in wine, and sharing the gains.

The old free trade argument that US labor has nothing to fear from cheap foreign labor, because US labor works with more capital and better technology no longer holds when US firms provide the same capital and technology to foreign labor. The international mobility of capital and technology and the advent of production functions that operate the same regardless of location mean first world labor will be displaced in tradable goods and services until there is a global equalization of wages and living standards.

Indeed, one reason the facts of offshore outsourcing are evaded by so many economists is that they look with favor on the international redistribution of income and wealth that is occurring.

As the BLS payroll jobs statistics make clear, the US has ceased to create jobs in tradable goods and services. The higher productivity, higher value-added jobs that provide upward mobility are missing from the data. Our most prestigious engineering schools report a marked decline in enrollments in computer and electrical engineering. Business Week magazine reports that US firms are now outsourcing R&D, design and innovation.

As I report each month following the BLS release, so far in the 21st century the US economy has been able to create jobs only in domestic nontradable services. Independent studies by economists at Northeastern University (reported in The Boston Globe by Charles Stein, Feb. 20, 2005) and by Edwin S. Rubenstein conclude that most of the new jobs in domestic services have gone to new legal and illegal immigrants. If these studies are correct, employment growth of native-born Americans has ceased in the 21st century.

In the 21st century, the US labor force has been acquiring the complexion of a third world country, with new jobs available only in domestic services. In contrast, China and

India are acquiring high tech manufacturing and professional service jobs, the mark of first world countries.

How does the US gain from inability to create jobs in export and import-competitive goods and services?

How do Americans gain from the loss of the jobs, careers, and incomes associated with the production of the goods and services that they consume?

How do US firms gain, beyond the short-run advantage of CEO bonuses and share prices based on quarterly performance, from becoming brand names with a sales force marketing foreign made goods?

How does America as a whole gain when the US pays for the cheap foreign labor contained in the offshored goods and services (a major component of the rising trade deficit) a second time by handing over to foreigners more of its existing stock of assets? The "cheap Wal-Mart goods" are not cheap when properly measured.

How do US universities gain when there are no payoffs to a university degree? The BLS estimates that the vast majority of the new jobs that the economy is expected to create during the next ten years require no university education.

Where is patriotism when politicians turn a blind eye to the decimation of opportunity for native-born citizens.

What is the state of economic education in the US when economists cannot comprehend the reality that confronts them?

Economists are not even aware of the latest and most important work in international trade. In 2000 M.I.T. Press published *Global Trade and Conflicting National Interest*s by Ralph E. Gomory and William J. Baumol. This important work, which does not directly address the offshore outsourcing issue, shows that the comparative advantage case for free trade is too unsophisticated to be correct even if its required conditions are met.

It will take economists a decade or longer to absorb this work. In the meantime, they are operating with a defective trade model that leads them to incorrect conclusions and disastrous policy advice.