Outsourcing Common Sense

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CAMBRIDGE, Mass. - The theory of comparative advantage claims that a country should specialize in the goods that it can produce more easily than other countries. For example, if your country is relatively better at making computer motherboards and mine is relatively better at manufacturing television sets, yours should specialize in the former and let mine do the latter. With each country playing to its relative strengths, all would gain from trade, the theory says.

But if every country has a comparative advantage in something, why are there persistent complaints about jobs moving to Mexico, China or India?

The theory of comparative advantage was the brainchild of 19th century economist David Ricardo, who used it to explain how Portugal and England might mutually benefit from the differences in their natural resources. Hot, sunny Portugal ought to specialize in wine, advised Ricardo. Temperate, rainy England should stick to woolen cloth.
But the theory doesn't apply well to the contemporary world, and outsourcing shows why.

Suppose there's an all-purpose widget that high-tech Americans can produce at several times the speed of low-tech Indians. It might seem that with all-purpose widgets, there is nothing to trade. Not so, says the economist: Even in a world of all-purpose widgets, there is a second commodity, leisure. Ricardo would say that Americans have the comparative edge in widgets and Indians enjoy the advantage in leisure, which is to say, not producing the widgets with their inferior technology. Instead, India would sell its leisure to America.

In other words, U.S. producers should substitute Indian labor for their own. Both Americans and Indians gain from trade. We get more leisure without reducing the quantity of available widgets here because we can supplement our reduced domestic production by importing widgets made with our technology in low-wage India. In India, it's more widgets for the same amount of work, even taking account of what is shipped overseas, because a superior technology replaces an inferior one.

Where does it go wrong?

First, we don't live in Ricardo's world, where trade is determined by fixed natural resources. In his world, technology and capital are immobile: You can't move Portuguese vineyards to England, nor can England's lush sheep pastures survive in Portugal's climate. Today, technology and capital move almost as easily across international borders as within a country.

Second, the theory imagines a world of generic Englishmen and Portuguese who are both worker and consumer, both worker and owner. The Englishman raises sheep and manufactures cloth, consuming part of his production and trading the rest for Portuguese wine. A Portuguese grower-vintner produces wine for his table and ships his surplus to English tables. Today, few of us consume a significant part of what we produce. Consumption is separate from production. Even more important, few of us own the machines, tools and equipment needed to produce goods and services. Instead, we work for wages. The distinction between worker and owner is basic to capitalism.

The comparative advantage theory might still be useful if widget workers had a significant ownership stake in their factories, and if labor markets functioned like model competitive markets, in which workers were free to work as much or as little as they desired at the going wage. In such a world, there is, by definition, no unemployment beyond the leisure the individual chooses. Outsourcing might lower wages in this country and raise them in India, but U.S. workers would profit from the dividends and capital gains they received as shareholders, and the lower prices they paid as consumers. And these gains, according to the comparative advantage theory, would be greater than what workers lost in wages.

But American workers don't, in general, own much stock, and U.S. labor markets fall far short of the ideal in which the worker gets to choose how much to work. In today's world, we can't understand international trade in terms of abstractions like "Americans" and "Indians" because the consequences of outsourcing are dramatically different for different groups. American owners can gain while American workers lose. Consumers can gain while workers lose.

Shareholders prosper from the cost reductions associated with substituting Indian labor for American labor. Some workers lose big-time because the added leisure that comes from shifting production abroad is not widely shared. An unfortunate minority lose their jobs altogether - their "leisure" is involuntary. For these folks, the added profits generated by outsourcing are cold comfort. U.S. consumers who don't lose their jobs benefit from lower prices, again cold comfort for folks whose old jobs are now overseas.

Economists may talk about winners compensating losers, but I've never heard a convincing story about how a 50-year-old mother of two is to be compensated after her manufacturing job is outsourced. She may, if lucky, find a comparable job somewhere, but only at the price of uprooting the family. Her husband may find another job in their new place of residence. Staying put, her only alternative may be a low-paying job.

The only clear winner would seem to be the Indian worker, who enjoys an increase in income and consumption without any corresponding increase in work time or effort. But even here the standard explanation oversimplifies: The Indians are unambiguously better off only if we don't count the costs of the disruption to their communities and other "externalities" such as the substitution of rapid Westernization for a more gradual evolution of Indian culture colliding with globalization.

Economists trumpet the virtues of free trade as if the differences between textbook theory and the world were of little importance. No wonder economics is hard to translate into a language that addresses the concerns of ordinary folks.

The great 20th century economist John Maynard Keynes began "General Theory of Employment, Interest and Money" by observing that before we can construct relevant theories for the present, we have to unlearn the useless theories of the past. In Keynes' view, shedding the old was more difficult than building the new. He concluded with the observation that "practical men" who chart national policies are more often than not the slaves of useless theories.

The practical men and women who are responsible for trade policy today are equally the slaves of outmoded dogma. The first step to a better trade policy is to clear our minds of the cobwebs of comparative advantage, the refuge of those who find it easier to justify the havoc wrought by outsourcing than to re-examine received ideas. We need trade and we need trade policy. We don't need free-market mantras.