

Tariffs and the Question of Outsourcing

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Introduction

President Trump has begun to implement one of the measures which he promised, during his election campaign, to implement as president; namely, the imposition of tariffs on goods produced in other countries which enter the United States. The tariffs are supposed to benefit the US economy in two primary ways: First, by eliminating the margin of cost-savings which US companies procure by locating their goods production in other countries (or, "outsourcing"), it is reasoned that the impetus for companies to outsource productive jobs will be eliminated, or, at least, reduced. Thus, tariffs are supposed to increase the amount of productive jobs in the US by eliminating the outsourcing of current and future productive jobs to "cheaper labor markets". Second, by charging tariffs on foreign imports to the US, the price of the goods imported will increase. Ideally, this increase in price will be to an extent such that the final price of the imported goods will nearly equal the final price of identical domestically produced goods. It is reasoned that, because it will be seen that the price of domestically produced goods equals the price of goods produced abroad, domestic firms will see a profit opportunity in the production of those goods, and an increase of domestic industry will take place, involving, of course, an increase in productive jobs within the US.

The report below is the first in a series which will take up an examination of the issues which are most pertinent to a sound consideration of the possible effects of policy changes in the realm of international economics. Below is a discussion on the effects of "outsourcing" jobs from one economy to a "cheaper labor market". Later reports will include discussions of things such as how internal economic waste can nullify the potential benefits of a "protectionist" economic policy, the economic vulnerabilities created by widespread liberalization (or "globalization"), and the cultural effects of globalization.

Outsourcing

One of the first questions to be addressed in this investigation is: Is the process of "outsourcing" beneficial to the outsourcing economy or not? The answer to that question will have a direct, even if preliminary bearing, on the question of whether the imposition of tariffs (which are supposed to reduce the amount of outsourcing) will be of any economic benefit to the nation which implements them. That question is taken up below.

Let us examine the theoretically discernable results of the outsourcing process.

Let us examine the hypothetical case in which a single production firm in the economy, which produces a certain kind of good, denoted as G, outsources some of the jobs required for the production of that good to a cheaper labor market.

Denote the total labor-cost of production of G before outsourcing as X.

Denote the total cost of producing the goods after outsourcing to be Y.

The difference between the two values (X-Y) can be denoted by D.

Of course, in instances in which jobs are outsourced to cheaper labor markets, D is positive.

There is another expense for which we must account: The increase of the shipping cost deriving from the greater distance from the domestic economy for which the goods are produced. This will be denoted by S.

D must be greater than S in order for any company to engage in outsourcing for the purpose of increasing profit. Assume, then, that D is greater than S.

There will be a value $D-S=N$ which would be the net reduction of production costs to the firm.

Assuming that this firm is the only firm in the economy which performed this outsourcing, and that all other factors remained equal, N would represent the total increase in profit of the firm resulting from the outsourcing operation.

On the basis of the fact that outsourcing can lead to an increase in the profit of the individual firms which engage in it, an argument is sometimes made that the process of outsourcing must be of systemic benefit to the entirety of the outsourcing economy. However, we can demonstrate that the process of outsourcing cannot lead to any net benefit to the outsourcing economy considered as an entirety.

Let us examine the effect of outsourcing in terms of the changes in the monetary incomes of the parties involved in outsourcing. This is a useful way to analyze the effect which outsourcing has upon resource distribution, since the monetary income of an individual limits, to a large extent, the quantity and quality of the resources which that individual can consume.

First, because the workers in the domestic economy who lost their productive jobs (hereafter referred to as "Outsourcing Losers", or OL) will no longer be paid the amount X in wages for

their work, X must be registered as a reduction of the total income of the individuals in the outsourcing economy.

Second, because Y must be paid to the workers outside of the outsourcing economy who received the outsourced jobs (we will hereafter refer to these workers as "Outsourcing Recipients" or OR), Y must be registered as an increase in the total income of the individuals outside the outsourcing economy.

Third, because N is the increase in profit of the firm which performs outsourcing, N must be registered as an increase in the total income of the individuals in the outsourcing economy.

Fourth, the additional cost of shipping, S, must be paid as wages to workers at the shipping company. Although it is likely that, in the case of the US, for example, a large portion of the shipping companies which are involved in the transportation of goods produced by OR back to the US are not themselves American companies, we will assume the "best case scenario" in which all of the shipping companies are owned by individuals in the domestic economy. That is, we will assume that the entire added cost of S which results from outsourcing will be paid to individuals in the outsourcing economy. Thus, S must be registered as an increase in the total income of the individuals in the outsourcing economy.

Thus, if we are to answer the question as to what the net effect of outsourcing by a single firm upon the total income of the outsourcing economy, all we need to do is tally up the relevant values just identified.

$(-X) + (N) + (S) = \text{Total Change in Income of Individuals in Domestic Economy (or T)}$

But, obviously, $(N+S)$ could never equal X, unless Y were 0. That is, $N+S$ could never equal X unless the OR would be willing to work for free. Therefore, the total aggregate income of the individuals within the outsourcing economy must decrease. This represents a reduction in the claims to resources (real wealth). Therefore, outsourcing must lead to a reduction of the claims to resources (wealth) of the nation which engages in outsourcing.

Further, even if the OR were willing to work for free (something which would be physically impossible), the total change in T would only be 0. That is, outsourcing could never produce an increase in the aggregate total incomes of the individuals in the outsourcing economy. In the best case scenario (which is impossible), it could only result in no net change. In any case, the outsourcing process would necessarily reduce the equitability of the distribution of income. That is, those which had the immediate claims to the profit of production firms (which is usually a

small minority within the society) would see an increase in income at the expense of the loss of income of OL. The "wealth gap" would necessarily become larger.

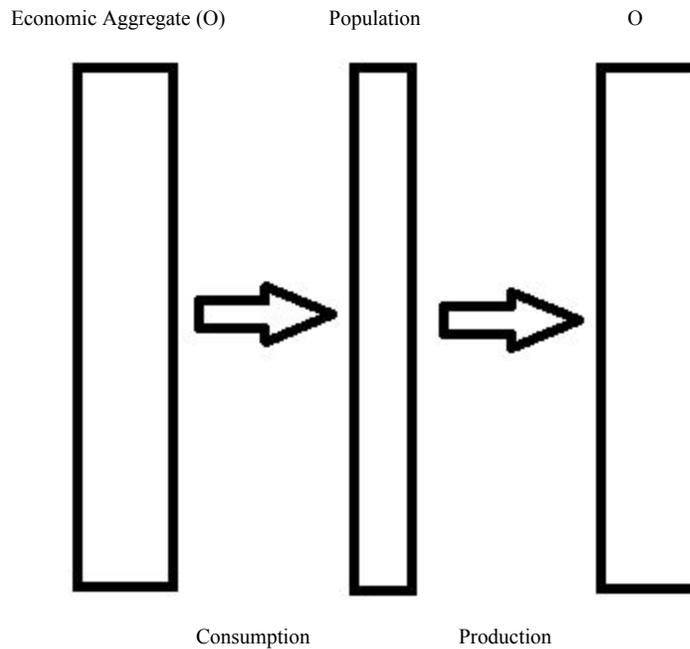
Before proceeding, it should be mentioned that in the case examined above, we assumed that only one firm engaged in outsourcing. In real life, if only one firm in an economy were to outsource, it is probably the case that the reduction of the total income of OL resulting from that outsourcing (X) would not be enough to have an effect upon the total demand G within the outsourcing economy. This allows us to assume that the total sales of the outsourcing firm would not decrease as a result of the overall reduction of the total income of individuals in the outsourcing economy. However, if we assume that widespread outsourcing in the economy were to take place, this would oblige us to consider the way in which the sales of the firms could remain constant, given the significant reduction of the total income of the individuals in the domestic economy.

Thus, we can note here that, while the result arrived at above is based on the assumption that the effect of income reduction from the outsourcing performed by one firm is not enough to reduce the total demand for G, (and, thus, not enough to reduce the sales volume of the firm producing G), the result derived above is also a theoretical result implied by the assumption of widespread outsourcing- given the adoption of another assumption. That assumption is, that OR engages in the purchase of part of the economic aggregate which OR assists in producing.

To clarify, consider how it is that OR does not necessarily need to spend the money with which they are paid (Y) in the form of purchases of articles out of the same batch of resources which the individuals in the outsourcing economy consume. For example, OR could use that money to purchase goods from other economies which are not in any way connected with the outsourcing economy. US dollars, for instance, are accepted as payment for goods and services all over the world. Therefore, whether or not we adopt this assumption will have some bearing in our judgements of the effect of outsourcing upon the US economy. Let's look at the case of widespread outsourcing with the aid of a bar diagram model of economic reproduction to illustrate the difference between the theoretical results necessitated by the admission or non-admission of that assumption- that is, the assumption that OR purchases (consumes) part of the economic aggregate which is also consumed by the outsourcing economy.

Assume a completely self sufficient economy in a state of reproductive "equilibrium". That is, assume that all factors, such as population level, productivity level, output level, labor quantity, wage level etc., are all constant over successive cycles of social reproduction. We have the following visual representation of such a situation:

[Figure 1]



The aggregate productive output, O , is distributed to (and consumed by) the various population sectors, such as producers, administrators, the elderly, the young etc. The distribution pattern of this aggregate to the population sectors will (largely) depend upon the monetary income which those sectors of the population procure. The consumption of the economic aggregate over time is facilitated by purchases of the aggregate by the individuals in the economy- and the amount of purchases which they can make is largely fixed by their income level. Assume, then, that there is a total income, denoted I , which is procured by the population and utilized to consume O over successive cycles of production. As shown above, if this economy were to outsource productive jobs to cheaper labor markets, the total income of the individuals in the economy would decrease by Y .

Because the income of the individuals in the economy would be reduced in this way, the firms would no longer have the ability to sell the entire aggregate at the same price for which those goods were sold before the outsourcing took place to the individuals in that outsourcing economy. Therefore, what could allow the firms to sell O at the same price as before outsourcing? There are a number of ways in which this can be theoretically addressed:

First, we will mention the extreme options which are contingent upon the actions of OR.

A: The first option is the possible assumption mentioned above: OR uses the all of the money with which OR was paid to purchase a portion of O. In other words, the money paid to OR immediately returns to the outsourcing economy in exchange for a portion of O.

B: The second assumption is that OR uses none of the money with which OR is paid to purchase any portion of O, and, that none of the money paid to OR ever returns to the outsourcing economy in the form of purchases of portions of O. That is, money paid to OR never returns to the outsourcing economy.

In addition to both of these options, there are two additional extreme options which exist.

C: That the purchasing power of the outsourcing economy is increased via the creation of money or credit, such that O can be purchased by the members of the outsourcing economy at the same price as before outsourcing.

D: There is no creation of credit or money which compensates for the reduction of income resulting from the outsourcing process.

Obviously, it is not likely that any of these extreme options will prevail in the real world. However, by examining the results implied by assuming that these extreme conditions do prevail in a hypothetical situation, we are able to discern the effects which will theory tells us will necessarily be present to greater or lesser degrees in real life situations which correspond, in some degree, to the extreme conditions.

Let us examine the combinations of the above listed options, namely, the combinations of AC, AD, BC, and BD.

Combination AC: Because OR uses all of the money with which OR was paid to purchase part of O, any increase of purchasing power within the domestic economy will lead to inflation. For, O is fixed and the money purchasing O is increased to a magnitude larger than I. The net wealth position of the outsourcing economy will necessarily be below what it had been before the outsourcing. The degree to which this reduction of the power of the individuals in the outsourcing economy to purchase O occurs is determined by the amount of money and/or credit created for the purpose of increasing their purchasing power.

Both money and credit creation will have inflationary effects.¹

¹ The creation of credit presents an additional liability however. For, if the economy had been in equilibrium before, it is assumed that all of the credit arrangements were such that all debts would be repaid after each successive cycle of production. This, in conjunction with the assumption that O is constant, obliges the following conclusion: Any additional debt created within such a system could only be repaid by the extraction of wealth from some part of the system at some time after the debt had been

Combination AD: Because OR uses all of the money with which OR was paid to purchase a portion of O, and there is no increase of money used to purchase O anywhere else, the total amount of money used to purchase O is the same as it was before outsourcing (I), and thus, no inflation would result. Prices would remain stable, but the share of O which the individuals in the outsourcing economy would be able to purchase would be reduced by the amount by which the portion of O consumed by OR increased.

Combination BC: Because the money paid to OR never returns to the outsourcing economy, and never is used to purchase any of O, the total amount of O available for consumption by the individuals in the outsourcing economy remains equal. Deflation would need to occur in order to allow O to be purchased with a smaller amount of money (smaller because of the reduction of income created by outsourcing). If new money is created in the required amount, prices could be maintained at the same level.

Combination BD: Because the money paid to OR never returns to the outsourcing economy, and never is used to purchase any of O, the total amount of O available for consumption by the individuals in the outsourcing economy remains equal. Deflation would need to occur in order to allow O to be purchased with a smaller amount of money (smaller because of the reduction of income created by outsourcing). A problem is created in that, on account of the reduction of prices, the same payment of Y to OR would represent a larger portion of the real claims to wealth by the firms. Thus, there would be a tendency to try to reduce the amount of payment made to OR. But, since the money supply is not increasing, any further payments to OR would reduce the money supply of the outsourcing economy further. Thus, the cycle would repeat itself.

made. Theoretically, a debt can be rolled over indefinitely, but assuming that the additional debt added to the system would need to be paid back eventually, that repayment would represent a reduction of the purchasing power of someone, somewhere. Thus, debt increases in such a situation would only represent a deferment of the full reduction of the amount of wealth capable of being claimed by the individuals in the outsourcing economy. If there were an increase in O of a magnitude proportional to the increase in debt, then the increased debt would represent no problem, as it could simply be rolled over indefinitely on the basis of actual production and sale of O (granted those contracting the debt were the ones with ownership of the new goods being produced to the effect of increasing O). This would only be the "ignition" of a self-sustaining income stream for whomever contracted the debt in the first place. However, we are assuming that the magnitude of O does not change, and that, therefore, increasing the debt can only be a temporary, one time deferment of the drop in consumption which outsourcing must produce. To maintain such a level of consumption by the outsourcing economy would require new additions of debt with each cycle of production- and that in an amount twice the size as the original increase in debt (to cover the repayment of the previously incurred debt). Theoretically, this could continue indefinitely, unless we admit interest payments- a factor which limits the theoretical possibility of sustaining consumption by continually increasing debt in this way (if we were to admit that interest payment could not be made with newly created debt).

Deflation would continue indefinitely if OR would be willing to accept indefinitely smaller and smaller payment for the labor which they perform. Assuming that there would be a point after which OR would not accept a lower wage, that is the point at which the payments to OR would start increasing in real terms, while the real wealth of the individuals in the domestic economy would start to fall in real terms. Since the money supply would be fixed, the payments to OR of the same nominal wage would continually increase until all of the profit resulting from the outsourcing had been eaten up, and even until all of the income of the real income of those in the outsourcing economy had been eliminated.

As we can see from the four possible combinations of extremes, widely different results could be arrived at under different conditions. It is difficult, or probably impossible, to gauge the degree to which the effects resulting from outsourcing within the context of a set of prevailing conditions are attributable to one condition or another. It is very easy to know what is happening in a hypothetical situation (since we create them in our minds), but very difficult to know what is happening in real life, especially in a complicated process like the social reproduction of the human species.

However, it seems to be irrefragable that under all conditions, the real claims to wealth of the outsourcing economy would be reduced, except for the extreme situation (which is impossible) in which OR does not purchase any of the goods out of the aggregate O which had formerly been available to the outsourcing economy, and the money supply of the outsourcing economy is increased to compensate for the drain of money associated with the payment to OR. So, one thing is certain: outsourcing reduced the real claims to wealth of the individuals within the outsourcing economy.