Outsourcing and Wage Inequality in a Dynamic Product Cycle Model*

by

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Abstract

This paper constructs a dynamic North-South model of trade with outsourcing and endogenous innovation. In the model, production of high quality goods is first carried out in the North (Northern phase), then split between the North and the South (Outsourcing phase), and finally shifted to the South (Southern phase). This cycle is reignited every time a higher quality product is discovered in the North.

Using the model we investigate the impact of increased outsourcing by Northern quality leaders on wage inequality trends in both the North and the South. We find that an increase in the extent of outsourcing raises the Northern skill premium unambiguously, while raising the Southern skill premium if and only if the skill intensity of production outsourced to the South is higher than that of local Southern production. Numerical simulations show that the larger the skill-intensity gap the larger the response of skill premia in both regions. We also report the level and growth effects of increased outsourcing on real wages of skilled and unskilled labor in both regions.

Keywords: FDI, wage inequality, outsourcing, endogenous growth
JEL Classification: F21, F43, J30

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