

Dynamic Effects of Outsourcing on Wage Inequality and Skill Formation^{*}

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Abstract

This paper investigates the effects of multinational firm activity on wage inequality in both the host and source economy. We develop a North-South product cycle model of endogenous growth without scale effects, where the rates of innovation, outsourcing and skill acquisition are endogenously determined. We consider two sets of exogenous events that increase the extent of Foreign Direct Investment (FDI). The first refers to technological improvements in outsourcing, which increase the feasibility of shifting production to the South or reduce the resource requirement to explore the Southern market. The second refers to policy changes through taxes and subsidies, which alter the investment decisions of multinationals. When increased FDI is driven by technological change, the impact on the wage differential between skilled and unskilled labor in the North and the South is ambiguous. Whereas if FDI is driven by policy changes such as production subsidies by the South or production taxes by the North, the wage gap in both economies widens. The rise in wage inequality, in turn, induces a higher fraction of the population to upgrade their skills.

Keywords: FDI, wage inequality, outsourcing, endogenous growth

JEL Classification: F21, F43, J30

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