

# Problem Set 3

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**Due:** Thu, December 1, 2011  
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## 1 Offshoring as a Rybczynski Effect

There are two industries 1 and 2 and two factors of production: non-offshorable labor  $N$  and offshorable labor  $L$ . Non-offshorable labor earns a wage  $s$  and offshorable labor earns a wage  $w$ . Each industry  $i$ 's production function  $Q_i = AF_i(N_i, L_i)$  is homogeneous of degree one. The foreign country's production functions are identical up to a Hicks-neutral productivity parameter:  $Q_i = A^*F_i(N_i, L_i)$ . Suppose  $A^* < A$ . Throughout this question, assume that factor-price equalization occurs:  $w/w^* = s/s^* = A/A^*$  and that  $A$  and  $A^*$  are constant.

Introduce one additional type of trade: firms can have  $L$ -tasks performed offshore. Onshore and offshore tasks are not perfect substitutes. They are combined through a Cobb-Douglas production function

$$L_i = (L_i^{\text{on}})^{1-\gamma}(L_i^{\text{off}})^{\gamma},$$

where  $L_i^{\text{off}}$  denotes offshored labor and  $\gamma \in (0, 1)$  captures the intensity of onshore labor. When offshored, a foreign unit of labor costs  $\beta w^*$  for the home economy to contract foreign labor at a distance.

To standardize the analysis, consider industry 1 to be relatively intensive in offshorable  $L$ -labor and industry 2 intensive in non-offshorable  $N$ -labor. Only the offshoring cost parameter  $\beta$  in the model is free to change.

1. Derive the elasticity of substitution between  $L_i^{\text{on}}$  and  $L_i^{\text{off}}$ :  $-\text{d} \ln L_i^{\text{on}} / \text{d} \ln L_i^{\text{off}}$  for given  $L_i$ . [Hint: Derive optimal inputs  $L_i^{\text{on}}$  and  $L_i^{\text{off}}$  as functions of  $p_i \partial Q_i / \partial L_i$  and each other, and express  $L_i^{\text{on}}$  as a function of  $L_i^{\text{off}}$ .]
2. Under these functional forms, is there offshoring for  $\beta w^* > w$ ? In other words, is  $A^* < A$  a necessary condition for offshoring? Is there two-way offshoring (home contracting from abroad and abroad contracting from home)? Show that your answers hold for any function  $L_i = G(L_i^{\text{off}}, L_i^{\text{on}})$  that satisfies the Inada conditions  $\lim_{L_i^{\text{off}} \rightarrow 0} \partial G(L_i^{\text{off}}, L_i^{\text{on}}) / \partial L_i^{\text{off}} = \infty$  and  $\lim_{L_i^{\text{off}} \rightarrow \infty} \partial G(L_i^{\text{off}}, L_i^{\text{on}}) / \partial L_i^{\text{off}} = 0$ .

3. Use the first-order conditions for optimal inputs to show that

$$\hat{L}_i^{\text{off}} = \hat{L}_i^{\text{on}} - \hat{\beta} = \frac{1}{1+\gamma} \hat{L}_i - \frac{1-\gamma}{1+\gamma} \hat{\beta},$$

where hats over a variable  $x$  denote relative changes  $\hat{x} \equiv d \ln x$ .

4. Show that, in equilibrium, total offshorable labor supply to the home economy is

$$L = L_1 + L_2 = (L^{\text{on}})^{1-\gamma} (L^{\text{off}})^\gamma.$$

[Hint: Use the fact that  $L_i^{\text{on}}/L_i^{\text{off}}$  is a constant across both industries for given  $\beta$ .]

5. Factor market clearing is equivalent to

$$\begin{aligned} a_{L1}Q_1 + a_{L2}Q_2 &= (L^{\text{on}})^{1-\gamma} (L^{\text{off}})^\gamma \\ a_{N1}Q_1 + a_{N2}Q_2 &= N \end{aligned}$$

for the unit labor requirements  $a_{Lj} = L_j/Q_j = [(L_i^{\text{on}})^{1-\gamma} (L_i^{\text{off}})^\gamma]/Q_j$  and  $a_{Nj} = N_j/Q_j$ . Show that

$$\begin{aligned} \alpha_{L1} \hat{Q}_1 + (1-\alpha_{L1}) \hat{Q}_2 &= (1-\gamma) \hat{L}^{\text{on}} + \gamma \hat{L}^{\text{off}} \\ \alpha_{N1} \hat{Q}_1 + (1-\alpha_{N1}) \hat{Q}_2 &= \hat{N} \end{aligned}$$

for adequately defined  $\alpha_{L1}$  and  $\alpha_{N1}$ . State  $\alpha_{L1}$  and  $\alpha_{N1}$ .

6. What does inelastic labor supply and the absence of cross-border migration imply for  $\hat{L}^{\text{on}}$  and  $\hat{N}$ ?
7. Use inelastic labor supply and the result from 3 to show that

$$\begin{pmatrix} \hat{Q}_1 \\ \hat{Q}_2 \end{pmatrix} = -\frac{\gamma}{\alpha_{LX} - \alpha_{NX}} \begin{pmatrix} 1 - \alpha_{NX} \\ -\alpha_{NX} \end{pmatrix} \cdot \hat{\beta}.$$

Under the assumptions made in the beginning, what are the signs of  $\hat{Q}_1$  and  $\hat{Q}_2$ ?

8. Much of the empirical literature on wage inequality and trade uses wage-bill shares in estimation. Define the onshore wage-bill share of non-offshorable labor in industry  $i$  as

$$\theta_{Ni}^{\text{on}} = \frac{sN_i}{wL_i^{\text{on}} + sN_i}.$$

Show that the relative change in the wage-bill share of non-offshorable labor is

$$\hat{\theta}_{Ni}^{\text{on}} = (1 - \theta_{Ni}^{\text{on}})(\hat{s} - \hat{w} + \hat{N}_i - \hat{L}_i^{\text{on}}).$$

9. Suppose factor-price equalization holds. Use the above results to derive  $\hat{\theta}_{N1}^{\text{on}}$  and  $\hat{\theta}_{N2}^{\text{on}}$  as functions of  $\theta_{Ni}^{\text{on}}$ , parameters and  $\hat{\beta}$ . How do the  $\hat{\theta}_{Ni}^{\text{on}}$  responses to  $\hat{\beta}$  differ in sign? How do their responses to  $\hat{\beta}$  differ in magnitude?

## 2 Helpman, Melitz & Yeaple (AER 2004) and Horizontal FDI

There are two countries, and there is a continuum of firms in each country. In each country lives a measure of  $L_d$  consumers, who inelastically supply one unit of labor and own the shares of domestic firms. The  $L_d$  representative consumers have identical CES preferences over a continuum of varieties

$$U_d = \left[ \sum_{s=1}^2 \int_{\omega \in \Omega_{sd}} q_{sd}(\omega)^{\frac{\sigma-1}{\sigma}} d\omega \right]^{\frac{\sigma}{\sigma-1}} \quad \text{with } \sigma > 1,$$

where  $s$  denotes the source country and  $d$  the destination country of a variety shipment.

Each firm produces one variety  $\omega$ . A firm's production technology is constant returns to scale given the firm's productivity  $\phi$ . Firms draw  $\phi$  from a Pareto distribution  $F(\phi) = 1 - (b_s/\phi)^\theta$ . It will be convenient to call all firms  $\omega$  with a given productivity level the firms  $\phi$ .

Firms choose to enter their respective home market and any foreign destination. There are two modes of entry into the foreign destination: exports from the respective home market, or horizontal foreign direct investment. There are iceberg transportation costs  $\tau_{sd}$  between countries for exporting. There is a fixed cost  $F_D$  to enter the domestic market, a fixed cost  $F_X$  for exporting to the foreign market, and a fixed cost  $F_I$  to enter the foreign market through horizontal FDI.

1. Show that demand for a variety  $q_{sd}(\omega)$  is

$$q_{sd}(\omega) = \frac{(p_{sd})^{-\sigma}}{(P_d)^{1-\sigma}} y_d L_d \quad \text{with} \quad P_d \equiv \left( \int_{\omega \in \Omega_{sd}} p_{sd}^{1-\sigma} d\omega \right)^{\frac{1}{1-\sigma}}.$$

2. Show that profit maximization of firm with productivity  $\phi$  implies:

$$p_{sd}(\phi) = \tilde{\sigma} \frac{\tau_{sd} w_s}{\phi} \quad \text{with} \quad \tilde{\sigma} = \frac{\sigma}{\sigma - 1}.$$

3. Show that a firm's gross operational profits from producing in source country  $s$  and shipping to destination market  $d$  are

$$\Pi(\tau_{sd} w_s) \equiv \left( \frac{P_d \phi}{\tilde{\sigma} \tau_{sd} w_s} \right)^{\sigma-1} \frac{y_d L_d}{\sigma}.$$

4. Show that net profits are  $\Pi(\tau_{ss} w_s, F_D)$  for national non-exporters,  $\Pi(\tau_{sd} w_s, F_X)$  for exporters, and  $\Pi(\tau_{dd} w_d, F_I)$  for horizontal multinationals, where

$$\begin{aligned}\Pi(\tau_{ss} w_s, F_D) &= \left( \frac{P_s \phi}{\tilde{\sigma} w_s} \right)^{\sigma-1} \frac{y_s L_s}{\sigma} - F_D \\ \Pi(\tau_{sd} w_s, F_X) &= \left( \frac{P_d \phi}{\tilde{\sigma} \tau_{sd} w_s} \right)^{\sigma-1} \frac{y_d L_d}{\sigma} - F_X \\ \Pi(\tau_{dd} w_d, F_I) &= \left( \frac{P_d \phi}{\tilde{\sigma} w_d} \right)^{\sigma-1} \frac{y_d L_d}{\sigma} - F_I.\end{aligned}$$

5. Derive the following break-even points for a firm as productivity thresholds:  $\phi_D$  (break-even between shutdown and national non-exporting),  $\phi_X$  (break-even between national non-exporting status and exporting), and  $\phi_I$  (break-even between exporting status and horizontal multinational status). What chain of inequalities do  $(w_d/w_s)$  and the fixed costs need to satisfy so that  $\phi_D < \phi_X < \phi_I$ ?
6. Is it possible to find conditions so that  $\phi_D < \phi_I < \phi_X$ ? Is it possible to find conditions so that  $\phi_X < \phi_D < \phi_I$ ?

### 3 Translog Cost Functions

Burgess (REStat 1974) has extended Christensen, Jorgenson & Lau's (REStat 1973) single-product translog (transcendental logarithmic) cost function to the case of multiple products (such as products shipped to  $N$  different destination markets or made in  $N$  different source countries):

$$\begin{aligned}\ln C_j &= \alpha + \sum_{k=1}^N \alpha_k \ln Q_j^k + \sum_{\ell=1}^N \tau_\ell \ln w_\ell + \sum_{k=1}^N \sum_{\ell=1}^N \chi_{k\ell} \ln Q_j^k \ln w_\ell \\ &\quad + \frac{1}{2} \sum_{k=1}^N \sum_{\ell=1}^N \lambda_{k\ell} \ln Q_j^k \ln Q_j^\ell + \frac{1}{2} \sum_{k=1}^N \sum_{\ell=1}^N \delta_{k\ell} \ln w_k \ln w_\ell,\end{aligned}\tag{1}$$

where the subscript  $j$  denotes a firm or an industry, depending on application,  $Q_j^\ell$  is output at or for location  $\ell$ , and  $w_\ell$  is a factor price at or for location  $\ell$ . There are  $N$  locations that differentiate the product.

1. Is the cost function (1) separable in individual products for product-level cost functions  $c_j^\ell(\cdot)$  so that  $C_j(\mathbf{Q}_j; \mathbf{w}) = \sum_\ell c_j^\ell(Q_j^\ell; \mathbf{w})$ ?

2. For (1) to be homogeneous of degree one in factor prices for any given output vector  $Q_j$ , parameters must satisfy certain conditions. What condition does  $\sum_{\ell=1}^N \tau_\ell$  have to satisfy? What does  $\sum_{\ell=1}^N \chi_{k\ell}$  have to satisfy for all  $k$ ? What condition do the sums  $\sum_{k=1}^N \delta_{k\ell}$ ,  $\sum_{\ell=1}^N \delta_{k\ell}$  and  $\sum_{k=1}^N \sum_{\ell=1}^N \delta_{k\ell}$  have to satisfy? By symmetry, we must have  $\delta_{k\ell} = \delta_{\ell k}$ . How many symmetry restrictions are there for  $N$  locations?

Now consider capital  $K^\ell$  a quasi-fixed factor in the short run. Following Brown & Christensen (equation 10.21 of chapter 10 in Berndt & Field 1981: *Modeling and measuring natural resource substitution*), one can augment (1) to a short-run translog multiproduct cost function

$$\begin{aligned}
\ln C_j^V &= \alpha + \sum_{k=1}^N \alpha_k \ln Q_j^k + \sum_{\ell=1}^N \tau_\ell \ln w_\ell + \sum_{k=1}^N \sum_{\ell=1}^N \chi_{k\ell} \ln Q_j^k \ln w_\ell \\
&+ \frac{1}{2} \sum_{k=1}^N \sum_{\ell=1}^N \lambda_{k\ell} \ln Q_j^k \ln Q_j^\ell + \frac{1}{2} \sum_{k=1}^N \sum_{\ell=1}^N \delta_{k\ell} \ln w_k \ln w_\ell \\
&+ \sum_{k=1}^N \kappa_k \ln K_j^k + \sum_{k=1}^N \sum_{\ell=1}^N \mu_{k\ell} \ln K_j^k \ln Q_j^\ell \\
&+ \sum_{k=1}^N \sum_{\ell=1}^N \zeta_{k\ell} \ln K_j^k \ln w_\ell + \frac{1}{2} \sum_{k=1}^N \sum_{\ell=1}^N \psi_{k\ell} \ln K_j^k \ln K_j^\ell.
\end{aligned} \tag{2}$$

1. What additional condition on  $\sum_{\ell=1}^N \zeta_{k\ell}$  is now needed for linear homogeneity of (2) in factor prices?
2. Use Shepard's Lemma to derive firm or industry  $j$ 's demand for factor  $\ell$  from (2).
3. Show that the cost share of factor  $\ell$  in  $j$ 's total costs  $C_j^V$  is

$$\theta_j^\ell = \tau_\ell + \sum_{k=1}^N \chi_{k\ell} \ln Q_j^k + \sum_{k=1}^N \zeta_{k\ell} \ln K_j^k + \sum_{k=1}^N \delta_{k\ell} \ln w_k.$$

4. The constant-output *cross-price elasticity of substitution* between factors  $\ell$  and  $k$  is defined as

$$\varepsilon_{\ell k} \equiv \frac{\partial \ln X_j^\ell}{\partial \ln w_k} = w_k \cdot \frac{\partial^2 C_j}{\partial w_\ell \partial w_k} \bigg/ \left( \frac{\partial C_j}{\partial w_\ell} \right),$$

where  $X_j^\ell$  is factor demand. Show that the second equality follows from Shepard's Lemma. Derive the cross-price elasticity of substitution ( $\ell \neq k$  off diagonal) and the own-price elasticity ( $\ell = k$  on diagonal) for the translog cost function  $C_j^V$ .

5. The partial *Allen-Uzawa elasticity of substitution* between two factors of production  $\ell$  and  $k$  is defined as

$$\sigma_{\ell k}^{AU} \equiv C_j \cdot \frac{\partial^2 C_j}{\partial w_\ell \partial w_k} \bigg/ \left( \frac{\partial C_j}{\partial w_\ell} \frac{\partial C_j}{\partial w_k} \right) = \frac{\varepsilon_{\ell k}}{\theta_j^k},$$

where  $\varepsilon_{\ell k}$  is the (constant-output) cross-price elasticity of factor demand and  $\theta_j^k$  is the share of the  $k$ th input in total cost. Show that the second equality follows from Shepard's Lemma. Derive the Allen-Uzawa elasticity on and off the diagonal for the translog cost function  $C_j^V$ .

6. *Morishima* elasticities are superior to Allen-Uzawa elasticities. Blackorby & Russel (AER 1989) show that, among other benefits, Morishima elasticities preserve Hicks's notion that the elasticity of substitution between two factors of production should completely characterize the curvature of an isoquant. Allen-Uzawa elasticities fail in this regard when there are more than two inputs. The *Morishima elasticity of substitution* can be derived as a natural generalization of Hicks's two-factor elasticity and is defined as

$$\sigma_{\ell k}^M \equiv w_\ell \cdot \frac{\partial^2 C_j}{\partial w_\ell \partial w_k} \bigg/ \left( \frac{\partial C_j}{\partial w_k} \right) - w_\ell \cdot \frac{\partial^2 C_j}{(\partial w_\ell)^2} \bigg/ \left( \frac{\partial C_j}{\partial w_\ell} \right) = \varepsilon_{k\ell} - \varepsilon_{\ell\ell},$$

where  $\varepsilon_{k\ell}$  is the (constant-output) cross-price elasticity of factor demand. Show that the second equality follows from Shepard's Lemma. Derive the Morishima elasticity on and off the diagonal for the translog cost function  $C_j^V$ . [Note: Morishima elasticities are inherently asymmetric because Hicks's definition requires that only the price  $w_\ell$  in the ratio  $w_\ell/w_k$  vary.]