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Offshoring and Unemployment in a Credit-Constrained Economy

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Abstract

This paper develops a two-sector small open economy model of offshoring where product markets are perfectly competitive, but capital and labor markets exhibit frictions. Individuals differ with respect to their managerial ability, and choose to become entrepreneurs or workers depending on profit opportunities and labor market conditions. The model generates three groups: low-income workers facing the prospect of unemployment, middle-income entrepreneurs producing domestically, and high-income entrepreneurs offshoring some tasks abroad. Lowering financial frictions induces more individuals to become entrepreneurs, increases the masses of offshoring firms and tasks, and improves personal income and welfare distribution. It reduces unemployment when tasks are less substitutable and labor share in production is high. The paper also investigates the impact of reducing offshoring costs and labor market frictions on the mass of entrepreneurs, decision to offshore, income distribution, and unemployment.

JEL Classification: F1, J2, J3, J6, L1

Keywords: Credit Constraints, Inequality, Occupational Choice, Offshoring, Directed Search, Unemployment

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