

Learning on the quick and cheap: Gains from trade through imported expertise

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Abstract

Gains from knowledge transmission arising from the presence of foreign firms has received a good deal of empirical attention, but micro-foundations for this mechanism are weak. Here we focus on production by foreign experts who may train domestic unskilled workers who work with them. Gains from training can in turn be decomposed into two types: (a) obtaining knowledge and skills at a *lower cost* than if they are self-taught at home, (b) producing domestic skilled workers *earlier in time* than if the domestic economy had to rediscover the relevant knowledge through “reinventing the wheel”. We develop a three-period model in which the economy initially has no skilled workers. Workers can withdraw from the labor force for two periods of self study and then produce as skilled workers in the third period. Alternatively, foreign experts can be hired in period 1 and domestic unskilled labor working with the experts become skilled in the second period. We analyze how production, training, and welfare depend on two important parameters: the cost of foreign experts and the learning (or “absorptive”) capacity of the domestic economy.

“I once asked a plumber who came to fix my water heater, and who did it in three minutes, how he dared to charge me eighty thousand lire for turning a little knob. He told me it had taken him twenty years to learn which knob to turn.”

from “Wilful Behavior” , a novel by Donna Leon

“I wanted to work for a foreign company so I could learn from experts. My life would be much harder if I didn’t have this job. Now we can think about the future. If I can afford it, I want to send my son to study overseas - maybe Australia or the United States.”

Dang Thi Hai Yen, production manager at a Vietnamese factory sub-contracted by Nike, Inc.

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1. Introduction

Trade regimes across countries are often more liberal than investment regimes which are in turn generally more liberal than restrictions on temporary migration. This is interesting in the context of the literature on the transmission of technical/managerial knowledge and productivity “spillovers” between countries and whether trade or investment is a more important channel of transmission (Keller, 1998, 2002a,b, Gong and Keller 2003).

In the latter vein of literature, several different ideas for the micro-foundations of the transmission mechanism have been proposed or modeled. Theoretical models have looked at linkages as a source of productivity spillover, so that upstream and/or downstream firms benefit from the arrival of multinationals (Markusen and Venables, 1999). This has generally been in the form of variety effects from supporting an increased number of intermediate or final goods. A second stream of theoretical analysis looks at workers or local firms learning from watching or working for foreign firms with a resulting increase in their productivity (Fosfuri, Motta, and Rønde 2001, Glass and Saggi 2002, Ethier and Markusen 1996, Markusen 2001). Empirical work in search of spillovers to local firms include Blomström and Kokko (1998), Blomström and Sjöholm (1999), Aiken and Harrison and Lipsey (1996), Smarzynska (2004), and Smarzynska and Spatareanu (2003). Other empirical literature has documented that local firms and their managers often get their start as employees of multinational firms (Katz 1987, Hobday 1995, Hall and Khan 2003).

Very little in this literature is directed at modeling the precise micro-mechanism of how foreign skilled workers impart those skills to domestic workers. That then is the purpose of this paper. We focus on direct imports of the services of foreign experts as a method of both

providing an important good or service and for training domestic workers faster and/or cheaper than they can learn on their own. We depart from the tradition of comparative steady-state analysis used in new growth theory, since we want to explicitly consider timing issues rather than merely steady-state levels and growth rates. For this reason, we use a very simple competitive constant-returns model with no spillovers, externalities, or other bells-and-whistles.

The economy lasts three periods and initially has no skilled workers who are needed to produce a non-traded good X. Unskilled workers can withdraw from production (of good Y) for two periods and learn to be skilled workers through a self-learning process (“reinventing the wheel) and become skilled workers in period three.

Instead of relying on learning by studying (LBS), the economy may import foreign experts who have accumulated expertise from previous activities. Foreign experts can produce good X working alone in any period. Alternatively, foreign experts can produce X in the first/second period and domestic unskilled labor working with them become skilled in the second/third period. We refer to this as learning by watching (LBW). In the latter event, in the second period these newly skilled domestic workers can produce X and can train additional domestic workers for period 3. As in the case of foreign experts, domestic skilled workers may also produce alone without training additional workers.

We solve for a perfect-foresight, competitive equilibrium, initially with the economy allowed to borrow subject to three-period trade balance constraint. A period-by-period trade-balance constraint is considered in an appendix. There are nine possible training/production activities, and the set of activities operating in equilibrium is referred to as the regime.

An important parameter in the model is the cost of foreign experts in terms of the

composite other good Y produced by the economy. When this cost is very high, domestic workers engage in LBS and no skilled workers and no X are available until period 3. At a somewhat lower cost, foreign experts are used in period one only and then more domestic skilled workers are trained in period 2 by the domestic workers trained by foreign experts in period 1. At a yet lower cost, all training is by foreign experts. Finally, at a very low cost, it doesn't pay to train any one, and all production in all periods is done by the foreigners working alone.

Gains from trade are a combination of: more X, getting X earlier, cheaper training of domestic workers, and getting domestic skilled workers earlier. X is available in period 1, and domestic skilled workers are available in period 2 instead of both of these things occurring first in period 3 when experts are very costly.

A second important parameter is the learning or "absorptive" capacity of the unskilled workers. When this capacity is very low (and experts are moderately priced), experts do all the X production and no domestic workers engage in LBS or LBW. As this capacity grows, foreign experts are used for fewer periods and switch from production only to production plus training. At high levels of learning capacity, the economy also engages in LBS and no foreign experts are used past the first period.

The model and these results may be interesting in several empirical and policy contexts. From an empirical point of view, it may help interpret a number of findings including the fact that managers of local firms in developing countries often get their start working for multinationals. From a policy point of view, it suggests that foreigners are not substitutes for local skilled labor unless the former are very cheap and/or the latter rather stupid, and that barriers to foreign firms and workers (e.g., visa, residence restrictions) may be costly.

2. The three-period model

- (a) There are three time periods, $t = 1, 2, 3$
- (b) There are two goods, X and Y; both sectors competitive, constant returns to scale
- (c) There are three factors of production, R, L, and S
- (d) Y is produced from a sector-specific factor R, and unskilled labor L.
- (e) X is produced from skilled labor S and is non-traded.
- (f) The stock of R and the initial stock of L are fixed. Initially there are no S.

Skilled workers are produced from unskilled workers L. The stock of unskilled workers going forward to $t+1$ is reduced by the number beginning training at t . There are two ways skilled workers can be produced. First, an unskilled worker can go off and study for two period on his/her own and become skilled. Thus unskilled workers who withdraw from the labor force at $t = 1$, are skilled at $t = 3$. The second is to work with existing skilled workers. An unskilled worker who works alongside a skilled worker in producing X becomes skilled in one time period rather than two. LBW is more efficient than LBS.

When permitted, foreign skilled workers, called foreign experts (or just experts), can also be hired from abroad and paid for at a fixed rental price in terms of Y. When the economy is open, foreign experts can be hired at $t = 1, 2, 3$. They can produce X working alone (as can domestic skilled workers) or a domestic unskilled worker can work along side the expert (or domestic skilled worker) and become skilled in one period. Thus trade offers both X consumption earlier at $t = 1$ and allows domestic skilled workers to be produced more cheaply and earlier at $t = 2$. Both are only available at $t = 3$ in autarky.

There are nine activities relating to X and/or training over the three period (several

activities may be active at the same time). Codes to denote X production and/or training activity are given by a three-digit code: IJT.

I = D, F D denotes a domestic activity using no foreign experts

F is an activity involving foreign experts

J = S, N S denotes an activity involving training skilled workers

N denotes an activity without no training

T = 1,2,3 Time period

All activities involve production of X *except* DT1, where domestic workers begin self-study for two periods, and produce no X until T = 3.

At t = 1:

(A) domestic unskilled workers study alone, *no production* DS1

(B) foreign experts working with unskilled
domestics who become skilled at t = 2. FS1

(C) foreign experts working alone FN1

At t = 2:

(D) domestic skilled workers working with unskilled
domestics who become skilled at t = 3. DS2

(C) domestic skilled workers working alone¹ DN2

(B) foreign experts working with unskilled
domestics who become skilled at t = 3. FS2

(D) foreign experts working alone FN2

At t = 3.

(A) domestic skilled workers working alone DN3

(B) foreign experts working alone FN3

There is no discounting. When hiring foreigners is permitted, Y produced in any period

¹Note that DS2 and DN2 can only be positive if FS1 is positive.

can be exchanged for consultants in any period at a fixed price. This gives an intertemporal budget constrained with borrowing in early periods. Alternatively, the economy must pay for the consultants with Y produced in the period in which the consultants are used.

Notation is as follows:

Y_i, p_{yi}	quantity and price of good Y at time $t = i$
R_i, p_{ri}	quantity and price of Y -sector-specific factor R at time $t = i$
L_i, p_{li}	quantity and asset price (not rental price) of unskilled labor L at time $t = i^2$
U_i, p_{ui}	quantity and (rental) price of unskilled labor U at time $t = i$
S_i, p_{si}	quantity and (rental) price of skilled labor S at time $t = i$
F_i, p_{fi}	quantity and price of foreign experts F at time $t = i$
E_i, p_{ei}	quantity and price of “foreign exchange” at time $t = i$
X_i, p_{xi}	quantity and price of good X at time $t = i$

Factors R_i and L_i are fixed quantities. L_2 and L_3 are variables, since labor available for unskilled work is reduced by the number of workers entering training. E is an artificial good: Y can be exchanged (exported) for E and E can then be exchanged for imported foreign experts F . With borrowing and lending allowed, E carries no subscript and thus exports of Y in any period can be exchanged for foreign experts in any period (zero interest rate). With no borrowing or lending, Y_i is exchanged for E_i which is exchanged for F_i .

A key parameter in the model is *cost*, which is the number of units of Y that must be exchanged for one for expert. A second parameter is *ac* (“absorptive capacity”), which give the efficiency units of skilled labor resulting from the training of one unskilled worker. Higher

²Analogous to the price of a unit of capital, p_{li} is the present value at $t = i$ of a unit of unskilled labor. p_{ui} , following line, is the single period rental price of unskilled labor at $t = i$.

levels of *cost* are bad, higher levels of *ac* are good. The parameter *cost* will impact primarily on the substitution between LBS and LBW, while the parameter *ac* will impact primarily on the substitution between using experts solely for production and using them (and the LBS activity) for training as well.³

Convexity in the model comes from the fixed factor R in the Y sector, which is assumed Cobb-Douglas in the simulations: labor is drawn into training and X production at increasing cost in terms of Y, with $c_{yi}(p_{ui}, p_{ri})$ denoting the unit cost function for Y_i . In the X sector, units are chosen such that one domestic or foreign skilled worker produces one unit of X and, when training is involved, one unskilled worker works with one skilled worker (fixed coefficients) and that unskilled worker becomes one skilled worker for all future time periods (no skills depreciation).

Utility or welfare is treated as a produced good. The flow of utility in period i and the price of obtaining a unit of utility is

W_i, p_{wi} quantity and price of welfare at $t = i$

W, p_w quantity and price of intertemporal utility

The price of utility in period i and overall are given by standard cost or unit expenditure functions, denoted $c_{wi}(p_{yi}, p_{xi})$ and $c_w(p_{w1}, p_{w2}, p_{w3})$ respectively. An elasticity of substitution greater than one is assumed in these functions to ensure a solution with $X_1 = X_2 = 0$ in autarky (a value of 3 is used in the simulations).

One final assumption before presenting the equations of the model. The model has an

³*cost* and *ac* are exogenous to the economy. *ac* is reflecting an inherent ability to learn. Some of the empirical articles referenced above essentially suggested that absorptive capacity is endogenous and depends on existing skills and education. Endogenizing *ac* is beyond the scope of this paper, but we can certainly think of it as being inherited from past choices in, for example, educational infrastructure.

implicit contracting assumption in training/production activities, but it is incorrect to say that foreign experts capture rents. In competitive equilibrium, foreign experts earn their opportunity cost which is the constant, exogenous value of working at home. Workers going into self learning or training earn their opportunity cost which is being an unskilled worker for three periods. “Rents” (gains from trade) from lower foreign experts’ *cost* accrue to the domestic representative consumer.

When foreign experts are expensive, for example, a worker going into training activity FS1 earns the 3-period unskilled wage, and the second and third period skilled wage accrues to “the firm” (the contracting assumption).⁴ But if there is a surplus on this in equilibrium, this surplus is exactly equal to the excess of the expert’s wage over the value of X that is produced by activity FS1 (i.e., activity FN1 is unprofitable). To interpret it slightly differently, the unskilled worker makes a payment for training that leaves him with his opportunity costs, and this payment (when positive) allows an otherwise unprofitable production activity (X production only, no training) to operate. The zero-profit inequality condition for FS1 is cost greater-than-or-equal to revenue:

$$(1) \quad p_{f1} + \sum p_{ui} = p_{f1} + p_{l1} \geq p_{s2} + p_{s3} + p_{x1}$$

The general-equilibrium model is a non-linear complementarity problem in mathematical programming language: a set of inequalities each with an associated non-negative variable. If an inequality holds as an equation the complementary variable is generally positive, and the

⁴Economic historian Ann Carlos tells us that the consensus in the apprenticeship literature is that the apprentices were a losing proposition in early years but that the apprenticeship period ran about two years after the master broke even, during which time he recouped his loss. Often families paid masters to take their sons, and legal institutions were developed to enforce the contract and return runaways to their masters.

complementary variable is zero if the associated inequality holds as a strict inequality in equilibrium.

There are three classes of inequalities in the model. First, there is a zero-profit inequality for each activity: unit cost must be greater than or equal to the price of the complementary good or factor. Activities include production/training activities, labor supply activities, and trading activities. Second, there is a set of market clearing conditions for each good/factor, with prices as complementary variables. Third, there is an income balance or trade balance condition for the economy. For completeness, we present the entire list of inequalities and complementary variables in the next section. This can probably be skipped by readers interested in going to the simulation results in sections 4 and 5.

3. The full model: inequalities and unknowns (may be skipped)

<u>Zero-profit Inequality</u>	<u>Complementary variable</u>	<u>Description</u>
$c_{yi}(p_{ui}, p_{ri}) \geq p_{yi}$	Y_i	Production activity Y_i
$p_{li} \geq p_{li+1} + p_{ui}$	U_i	Unskilled labor supply to Y_i ⁵
$p_{l1} \geq p_{s3} * ac$	$DS1$	S_3 produced from activity $DS1$
$p_{l1} + p_{f1} \geq p_{s2} * ac + p_{s3} * ac + p_{x1}$	$FS1$	$X_1 = S_2 = S_3$ from activity $FS1$
$p_{f1} \geq p_{x1}$	$FN1$	X_1 from activity $FN1$
$p_{l2} + p_{f2} \geq p_{s3} * ac + p_{x2}$	$FS2$	$X_2 = S_3$ from activity $FS2$
$p_{f2} \geq p_{x2}$	$FN2$	X_2 from activity $FN2$
$p_{s2} + p_{l2} \geq p_{s3} * ac + p_{x2}$	$DS2$	$X_2 = S_3$ from activity $DS2$
$p_{s2} \geq p_{x2}$	$DN2$	X_2 from activity $DN2$
$p_{f3} \geq p_{x3}$	$FN3$	X_3 from activity $FN3$
$p_{s3} \geq p_{x3}$	$DN3$	X_3 from activity $DN3$
$p_e * cost \geq p_{fi}$	F_i	Imports of experts at $t = i$
$p_{yi} \geq p_e$	EY_i	Exports of Y at $t = i$
$c_{wi}(p_{yi}, p_{xi}) \geq p_{wi}$	W_i	Sub-welfare at $t = i$
$c_w(p_{w1}, p_{w2}, p_{w3}) \geq p_w$	W	Total (present value) of welfare

The next set of inequalities are market clearing conditions for each of the goods, factors, and trade activities. The complementary variables are prices of these quantity variables. Inequalities are written as supply greater than or equal to demand, where a strictly greater-than relationship

⁵Activities U_i account for change in the unskilled labor stock as workers move into training and production. Activity U_1 has L_1 as the input and U_1 (used in Y_1) and L_2 as outputs. Activity U_2 has L_2 as the input and U_2 (used in Y_2) and L_3 as outputs.

implies that the price is zero (a free good) in equilibrium. Demands for goods/factors exploit Shephard's lemma in activities Y_i and W_i where there is variable substitution among inputs.

<u>Market-clearing inequality</u>	<u>Complementary variable</u>	<u>Description</u>
$Y_i > \frac{\partial c_{ui}}{\partial p_{yi}} W_i$	p_{yi}	Supply - demand for Y_i
$U_i > \frac{\partial c_{yi}}{\partial p_{ui}} Y_i$	p_{ui}	Supply - demand for U_i
$R_i > \frac{\partial c_{yi}}{\partial p_{ri}} Y_i$	p_{ri}	Supply - demand for R_i
$L_1 \geq U_1 + FS1 + DS1$	p_{l1}	Supply - demand for L_1
$U_1 \geq U_2 + FS2 + DS2$	p_{l2}	Supply - demand for L_2
$U_3 \geq U_2$	p_{l3}	Supply - demand for L_3
$FS1 \geq DS2 + DN2$	p_{s2}	Supply - demand for S_2
$DS1 + FS1 + DS2 + FS2 \geq DN3$	p_{s3}	Supply - demand for S_3
$F_1 \geq FS1 + FN1$	p_{f1}	Supply - demand for F_1
$F_2 \geq FS2 + FN2$	p_{f2}	Supply - demand for F_2
$F_3 \geq FN3$	p_{f3}	Supply - demand for F_3
$FS1 + FN1 \geq \frac{\partial c_{w1}}{\partial p_{x1}} W_1$	p_{x1}	Supply - demand fo X_1
$FS2 + FN2 + DS2 + DN2 \geq \frac{\partial c_{w2}}{\partial p_{x2}} W_2$	p_{x2}	Supply - demand for X_2
$FN3 + DN3 \geq \frac{\partial c_{w3}}{\partial p_{w3}} W_3$	p_{x3}	Supply - demand for X_3

$W_i \geq \frac{\partial c_{wi}}{\partial p_{wi}} W$	p_{wi}	Supply - demand for W_i
$W \geq I/p_w$	p_w	Supply - demand for W
$\sum EY_i \geq \sum cost_i F_i$	p_e	Supply - demand for foreign exch

<u>Income balance equation</u>	<u>Complementary Variable</u>	<u>Description</u>
$I = p_{ll}L_1 + \sum p_{ri}R_i$	I	Income balance

In all, the model then consists of 51 inequalities in 51 unknowns. One equation is redundant by Walras' Law, so the price of "foreign exchange", p_e is used as numeraire and the corresponding equation is dropped from the model. The model is coded in Rutherford's MPS/GE, a subsystem of GAMS and solve using the non-linear complementarity solver in GAMS.

4. Results 1: varying the cost of foreign experts

Figures 1-4 consider different levels of *cost*, solving the general-equilibrium model for each level. On the left of the horizontal axis, the cost is prohibitively high, while on the right-hand edge foreign experts are cheap. Thus moving left to right corresponds to moving from economies facing very high cost of experts toward economies facing a low-cost situation (*cost* is a trade cost variable, not a tariff, so there is no income effect of tariff revenue, and its value is exogenous to the government).

Figure 1 lists the nine possible training/X production activities on the vertical axis. The top panel of Figure 1 groups these by domestic (no foreign experts used) versus activities that use foreign experts. The bottom panel presents the same information but groups the activities by time period.

There are seven different equilibrium regimes, sets of activities active in equilibrium, in this simulation. For an economy facing a very high *cost* on the left, no foreigners are used and the economy is autarkic. Some domestic workers withdraw from production in period 1 to self train/study (DS1) and then produce X output in period 3 (DN3). Moving to lower *cost* economies, the first regime shift moving to the right is that foreign experts are employed to produce and train in period 1 only (FS1). The workers that they train then produce X and train additional domestic workers in period 2 (DS2). No foreigners are used after the initial period.

The second regime shift as foreign experts become cheaper is that the self-training activity DS1 becomes unprofitable and ceases. All initial training is done by foreign experts but still in period 1 only (FS1), and additional domestic workers are training by the foreign trained workers in period 2 (DS2).

The third regime shift (fourth regime) is that some foreign-training workers from period 1 produce in period 2 without training additional workers (DN2 becomes active) while some additional training also occurs (DS2 remains active).

The fourth regime shift (fifth regime) is that training of additional workers in period 2 ceases (DS2 becomes inactive). Training of workers in the first period is preferred since that investment can be recouped over two periods instead of just one. But when foreign experts are very expensive, it is just too costly to do all training in period 1 using foreigners, so some training is postponed until period 2 when it can be done by newly foreign-trained domestic workers. As the cost of foreign experts falls, it eventually becomes profitable to use them to do all training in period 1.

The fifth shift (regime 6) is that foreign experts are now sufficiently cheap that they are employed to produce only and not train anyone (FN2 and FN3 become active). Equation (1) continues to hold, so both FS1 and FN1 are used simultaneously.⁶ Finally, at a sufficiently low price, training of domestic workers ceases entirely and all X production is undertaken by foreign experts (FN1, FN2, and FN3 are the only activities active). We thus move from the extreme of LBS in autarky to LBW and finally to no one learning anything when experts are really cheap.

Figure 2 shows the number of domestic workers who are skilled by period 3, dividing them into self trained, trained by foreign experts in period 1 (FS1) and those trained by foreign-trained domestic workers in period 2 (DS2). As the cost of foreign experts falls, we see that self training falls to zero. Over regimes 2 and 3 (vertical dotted lines separate regimes), $FS1 = DS2$

⁶This reflects general-equilibrium effects. Recall that pulling unskilled workers into training (FT1) drives up the wage. Thus there exists a regime where activities FT1 and FN1 can coexist, something that would generally not be true in partial equilibrium.

since every domestic worker foreign trained at $t = 1$ trains another domestic worker at $t = 2$. But in regime 4, not all workers foreign-trained at $t = 1$ train an addition worker and instead an increasing number produce without training (DN2). In regime 5, training of additional workers at $t = 2$ ceases entirely. In regime 6, training by experts declines toward zero.

This last regime shift, in which all training ceases, can be thought of in terms of equation (1) above. Skilled wages are driven down relative to the unskilled wage in periods 2 and 3 sufficiently that the zero-profit condition for FS1 becomes slack and that for FN1 holds with equality.

$$(2) \quad p_{ll} + p_{fl} > p_{s2} + p_{s3} + p_{x1} \quad p_{fl} = p_{x1} \Rightarrow \sum p_{ui} = p_{ll} > p_{s2} + p_{s3}$$

Up to regime 6, the number of skilled workers trained and the number working are the same, since skilled workers at $t = 3$ are all domestic trained in activities DS1, FS1 and/or DS2. But again, once foreign experts are sufficiently cheap, training declines toward zero as foreigners are used for production only, training becoming unprofitable. Taken together, these results imply that, over a substantial range, the use of foreign experts and the training of domestic skilled workers are *complements*, but that they become *substitutes* as foreign experts become very cheap.

Figure 3 graphs the total number of domestic workers who are trained by $t = 3$, and the cumulative number of domestic skilled-worker years. This illustrates that the advantages offered by increasingly cheaper foreigners are taken in the form of getting skilled workers *earlier*, rather than having *more* skilled workers at $t = 3$, until the foreign experts are truly cheap.

In spite of the complicated regime shifting as foreign experts become cheaper, our intuition would suggest that two things ought to rise monotonically with lower cost of experts.

First, cumulative X production ought to rise continuously and so should intertemporal welfare.

Both suspicions are correct. Cumulative X production which does indeed rise monotonically.

Figure 4 shows welfare and X production/consumption in each time period as a function of the cost of experts. Welfare rises steadily as *cost* fall as intuition would suggest. However, it is interesting to note that the gains from trade are taken over a large range of costs in the form of *earlier* consumption of X; indeed, there is a range over which X_3 *declines*. Perfect smoothing is achieved after the shift to regime 5, where additional training of workers at $t = 2$ ceases (DS2 becomes inactive). At this point and over all of regime 5, there is an equal number of skilled workers in all time periods (n experts at $t = 1$ produce n domestic skilled workers for periods 2 and 3 using FT1), and so an equal X output in all time periods.

The appendix to the paper illustrates the effects of imposing a period-by-period trade-balance constraint.

5. Results 2: varying learning capacity

Now consider a different experiment. Suppose that foreign experts are available at a constant moderate cost, but we vary the parameter ac (absorptive capacity) which gives the number of efficiency units of skilled labor produced when an unskilled laborer is trained. We begin with this value very low, so that initially all production is done by foreign experts and no training is done whether by LBS or LBW. An economy with low capacity is stagnant, consuming the same amount every period.⁷

Regimes are shown in Figure 5, using the same format as Figure 1. Capacity or capability rise as we move to the right on the horizontal axis. Initially, all production is done by foreign experts and there is no training as just noted. For economies with a higher capacity, we see that activity FS1 becomes active, and some domestic workers are trained for periods 2 and 3, but non-training production activities by foreigners FN2 and FN3 continue to be used in regimes 2 and 3. In regime 4, production-only activities FN2 and DN2 cease and DS2 becomes active: some workers trained by foreigners in period 1 train additional domestic workers in period 2. In regime 5, FN3 becomes inactive, so from this point on foreign experts are only used in activities with training. In regime 6, DS1 becomes active, as it now pays some workers to begin LBS in period 1.⁸ Finally, use of foreign experts after $t = 1$ ceases in regime 7. Foreign experts are only used to train some workers at $t = 1$, who then train additional workers at $t = 2$, the latter joining LBS workers as skilled workers in period 3.

⁷This simulation uses a value of $cost = 8$. ac was set at 1 in Figure 1-4; here we concentrate on lower values to illustrate the region of interesting action.

⁸With reference to the previous footnote, DS1 (LBS) would never be active at lower values of $cost$, one reason we chose a moderately high value in this simulation.

Figure 6 presents the same information as Figure 2. In the present case, there is no training/learning initially. All production is by foreign experts working alone. Then we have a region in which all training is done by foreign experts. Then some of those trained undertake additional training in period 2 (DS2). The “experts” and “domestic” curves come together when additional training by experts at $t = 2$ ceases ($FS2 = 0$) and each domestic worker train by a foreign expert at $t = 1$, trains an additional worker at $t = 2$ ($FS1 = DS2$). Then the self-training activity becomes active ($DS1 > 0$). Thus as capacity improves, an increasingly large share of domestic skilled workers are self or domestic trained.

Figure 7 shows the use of foreign experts by period. While the total number of foreign experts continues to rise for economies of successively higher capacities, it is clear that the use of foreigners moves earlier in time. Their role is to help “jump start” the process, allowing X to be consumed in period 1 and domestic skilled workers to be produced for period 2.

Figure 8 presents this information another way, showing the number of foreigners used in production-only activities versus training activities. The number of domestic workers in self-study and being trained by other skilled domestic workers is also shown. Economies with low capacity rely on foreigners to produce X in all periods, but production-only activities are replaced by those with training at higher capacities. Eventually, the use of foreigners for training is overtaken by self-study and training by skilled domestic workers.

Taken together, Figures 6-8 show that economies with successively higher capacities (a) rely proportionately less on foreigner experts, (b) use foreign experts for a shorter period of time, (c) decrease and then eliminate the use of foreigners in production-only activities. For low capacity economies, foreign experts *substitute* for domestic skilled workers. But for higher

capacity economies, foreign experts become *complements* to domestic skilled workers in that the former cease production-only activities and engage in production-training activities. But for very high-capacity economies, the LBS activity DS1 increasingly *substitutes* for foreign production-training at $t = 2$ (FS2) and the use of foreigners is confined to period 1.⁹

Finally, Figure 9 shows welfare and X production in the three periods. Here we have a situation quite different from the *cost* results of the previous section. There we started with an uneven consumption pattern and achieved consumption smoothing as things improved. Here the low-capacity economies are stagnant and characterized by smooth (and low) consumption. Uneven consumption and growth occurs for high-capacity economies.¹⁰

⁹Activity FS1 continues to increase with even higher values of ac ; it never goes to zero since it is vital to getting X output at $t = 2$ and $t = 3$, and for producing skilled workers for $t = 2$.

¹⁰ X_1 is higher than X_2 and X_3 over the middle range because X_1 is important for generating skilled workers for $t = 2$. That is, activity FS1 is run at a high level because of the valuable joint outputs of S_2 and S_3 .

6. Summary

We can now summarize the results of our three-period model.

(1) Importing foreign experts allows the economy to produce skilled workers earlier and at a lower cost than through learning from scratch: reinventing the wheel. This in turn allows earlier and large consumption of the good produced using skilled labor.

(2) As the cost of foreign experts falls from an initially prohibitive level, they are used sparingly for one period only, with the newly-skilled domestic workers training additional domestic workers in period 2. As foreign experts become cheaper, all training is done by foreigners, and when they are very cheap it does not pay to train anyone, and all production of X is done by the foreigners.

(3) As the cost of foreign experts falls from an initially prohibitive level, gains from trade are initially taken in the form of having skilled workers *earlier* rather than in having *more* skilled workers by $t = 3$, and in having X consumption *earlier* rather than (significantly) *more* X over three periods.

(4) Taken together, (2) and (3) imply that foreign experts and domestic skilled workers are *complements* up to the point where the former are very cheap. They are complements in the sense that a fall in the price of foreign experts induces the creation of domestic skilled workers earlier, and a large cumulative number of domestic skilled-worker years, although not necessarily a larger total of domestic skilled workers at $t = 3$. When foreigners are very cheap, foreign experts and domestic skilled workers are *substitutes* in the sense that further falls in the cost of experts reduces and eventually eliminates domestic training.

(5) Our second experiment involved changing the economy's learning or "absorptive"

capacity: the efficiency with which unskilled workers are transformed into skilled workers in both LBS and LBW activities. Results show that economies with successively higher capacities (a) rely proportionately less on foreign experts, (b) use foreign experts for a shorter period of time, (c) decrease and then eliminate the use of foreigners in production-only activities.

(6) For low capacity economies, foreign experts *substitute* for domestic skilled workers. But for higher capacity economies, foreign experts become *complements* to domestic skilled workers in that the former cease production-only activities and engage in production-training activities. But for very high-capacity economies, the LBS activity DS1 increasingly *substitutes* for foreign production-training at $t = 2$ (FS2) and the use of foreigners is confined to period 1.

(7) We also did an experiment constraining international borrowing to pay for experts in early years by imposing a period-by-period balance-of-trade constraint. Results here are generally intuitive in comparison to the case with borrowing permitted, so they are reported in an appendix for the *cost* experiment. Self-study persists at lower values of experts' costs than with borrowing. The use of foreign experts to train domestic workers is both reduced and spread out over time relative to the case with borrowing. There is less consumption smoothing, and consumption of X in period 1 in particular lags behind what is achieved in the case with borrowing.

(8) Borrowing supports more total domestic workers trained and more cumulative skilled-worker years than without, and in that sense we can say that access to foreign experts and to foreign borrowing are *complements*.

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Appendix: No international borrowing

The assumption in the model that foreign borrowing is allowed to pay for foreign experts in early years may not be realistic for many developing economies. Thus in this section we briefly consider the extreme opposite assumption that there is no international borrowing allowed. Obviously, this makes no difference in autarky. In addition, we have calibrated the model so that at a price for foreign experts of one (right-hand end of our figures), there is perfect consumption smoothing and so again the ability to borrow or not makes no difference. The ability to borrow thus matters between autarky and the price of one.

The model is now modified to have three foreign-exchange “goods” instead of one. Experts can only be imported in period 1 in exchange for Y_1 and similarly for experts in periods 2 and 3. Thus trade balances within each period.

Figure A1 shows the regimes in the same manner as Figure 1 for decreasing costs of consultants moving left to right. Results are rather intuitive, and so let us just list them in comparison to the case of Figure 1 with borrowing allowed.

(1) The self-study/training activity DS1 continues to be active at lower experts’ cost than with borrowing.

(2) The activity DS2, in which domestic skilled workers trained by foreign experts in period 1 train more domestic workers in period 2 continues to be active at lower experts’ cost than with borrowing.

(3) Activity FS2, in which foreign experts are employed to train a second-generation of domestic workers in period 2 is now active for an intermediate range of costs. This activity is never active with borrowing allowed.

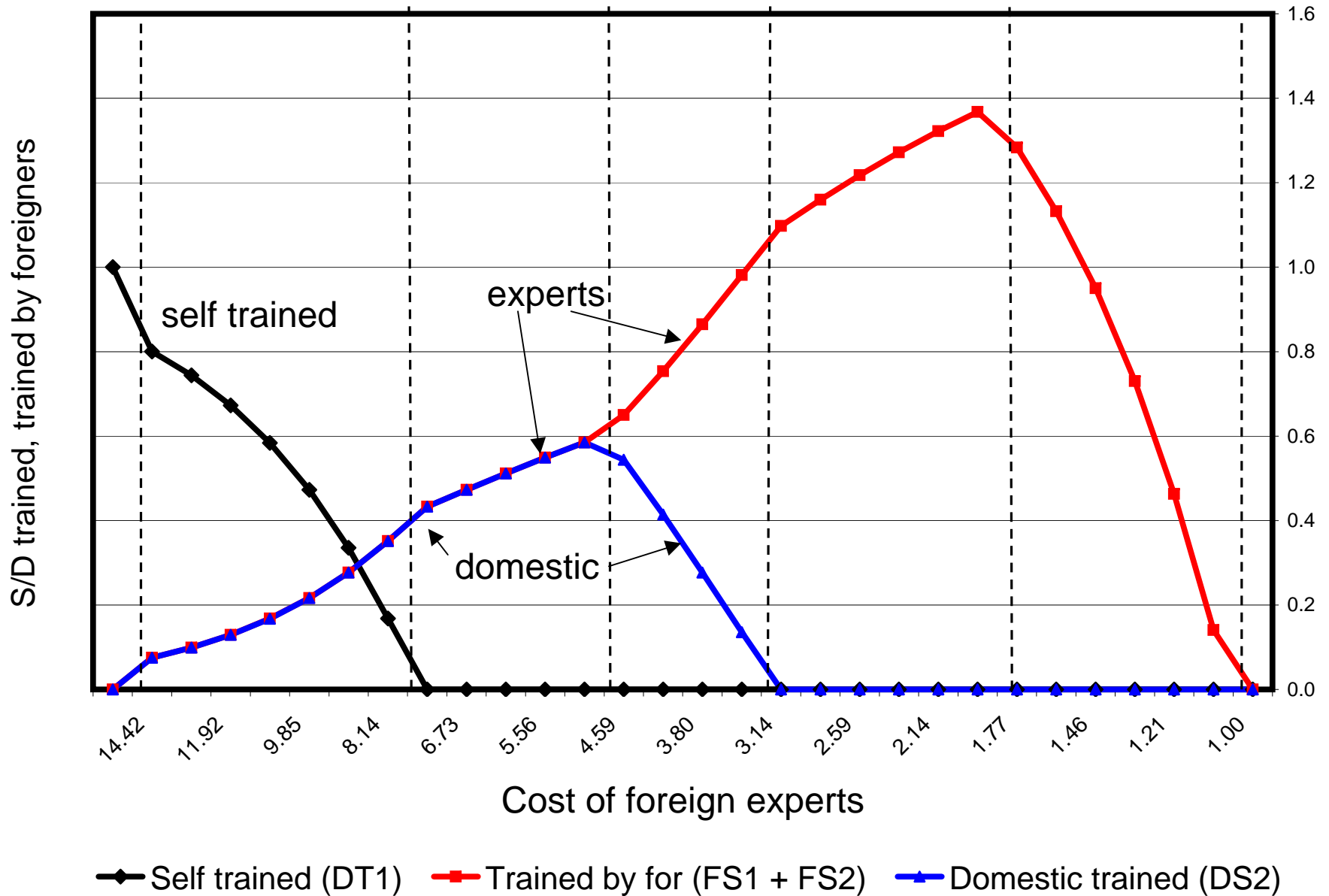
(4) The use of foreign experts to simply produce and not train (FN1, FN2, FN3) now occurs at higher costs than with borrowing allowed.

Thus the international borrowing constraint implies that self-study/training persists at lower experts’ costs, but conversely experts are used to produce without training any domestic workers at higher experts’ costs. Somewhat loosely, we could say that the use of foreign experts for training is both reduced and is shifted later in time (or spread out over time).

Figure A2 shows the equivalent of Figure 2, and differs from the latter by the fact that the activity FS2 (foreigners training more domestics at $t = 2$) is now used at intermediate experts’ cost. Figure 9 shows that there is more reliance on self-study (DS1) and training by domestic skilled workers (DS2) at moderate costs and, when all training is done by experts when costs are low, fewer domestic workers are trained. For all levels of experts’ cost except the two endpoints, fewer domestic workers are trained and the total cumulative skilled-worker years is less when borrowing is not allowed (results not shown).

Lastly, Figure A3 reveals again that the welfare benefits of access to foreign experts are taken in the form of earlier X consumption up to the point where experts’ cost are moderate. There is less consumption smoothing, and complete smoothing is not achieved until the price of experts falls to one. Between autarky and a price of one, welfare is somewhat lower (but not dramatically so) with borrowing constrained.

Figures 2: Total self/domestic trained and trained by foreign experts by $t = 3$



Figures 3: Total trained, total skilled-worker years

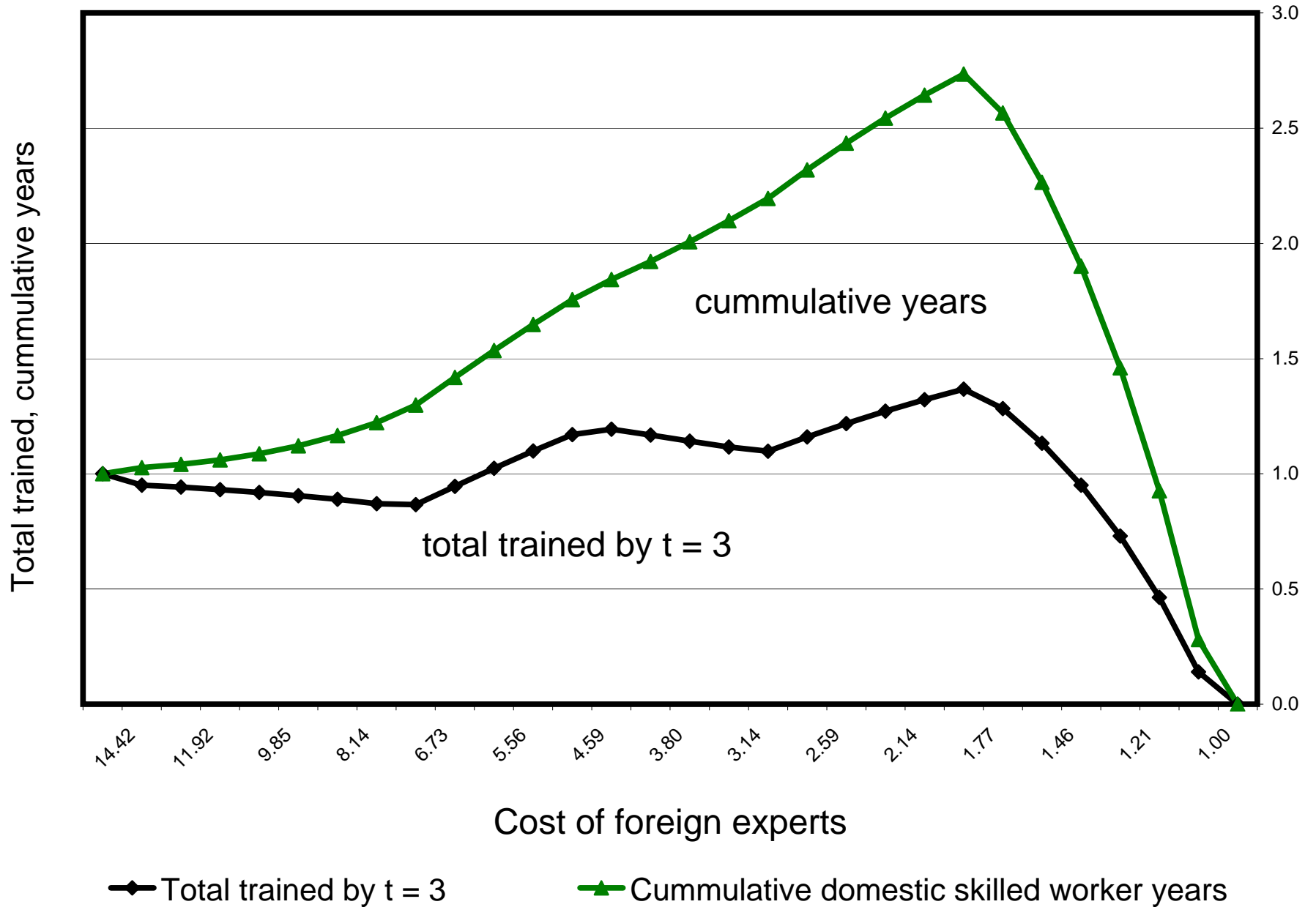


Figure 4: X production by period, welfare

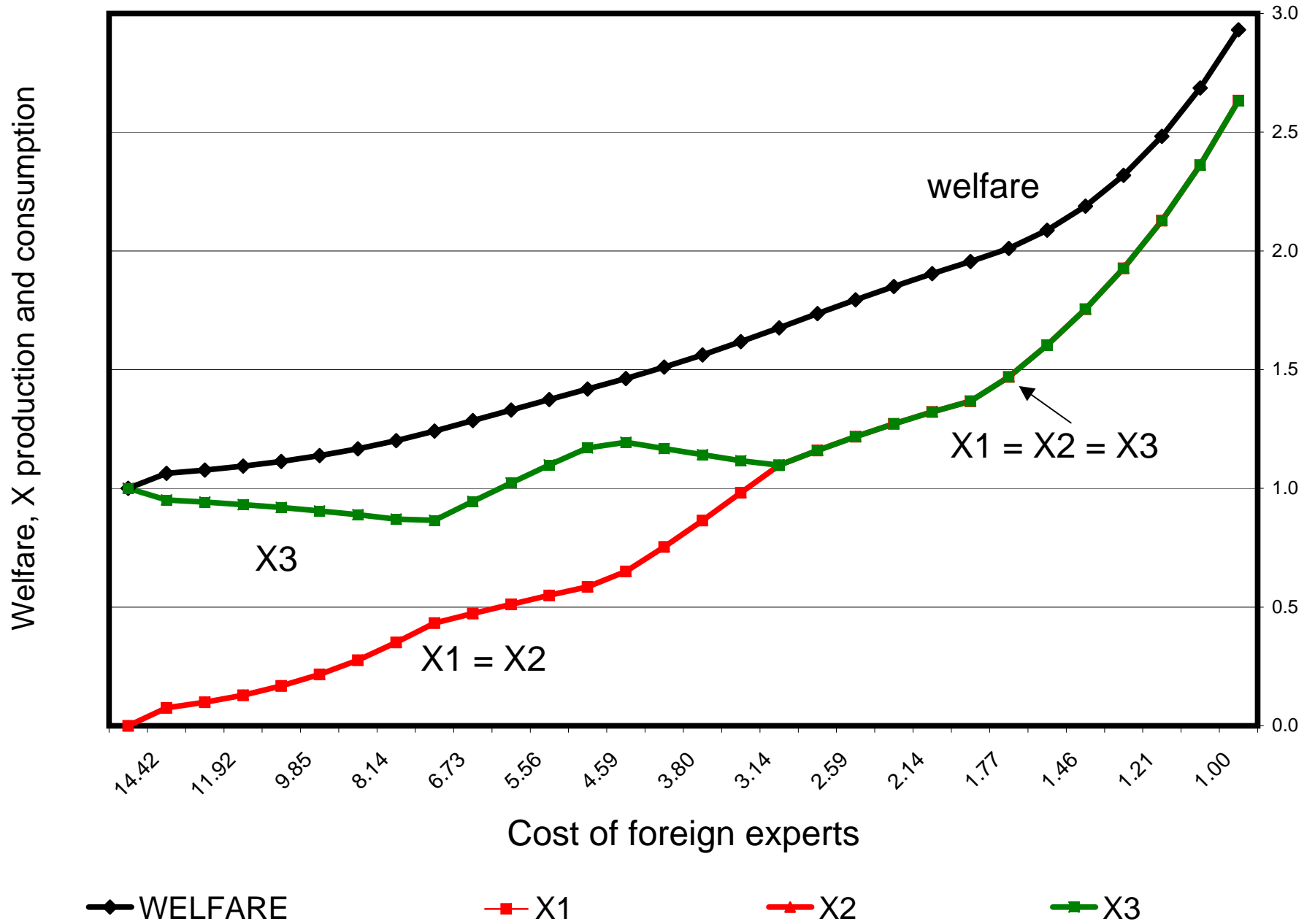
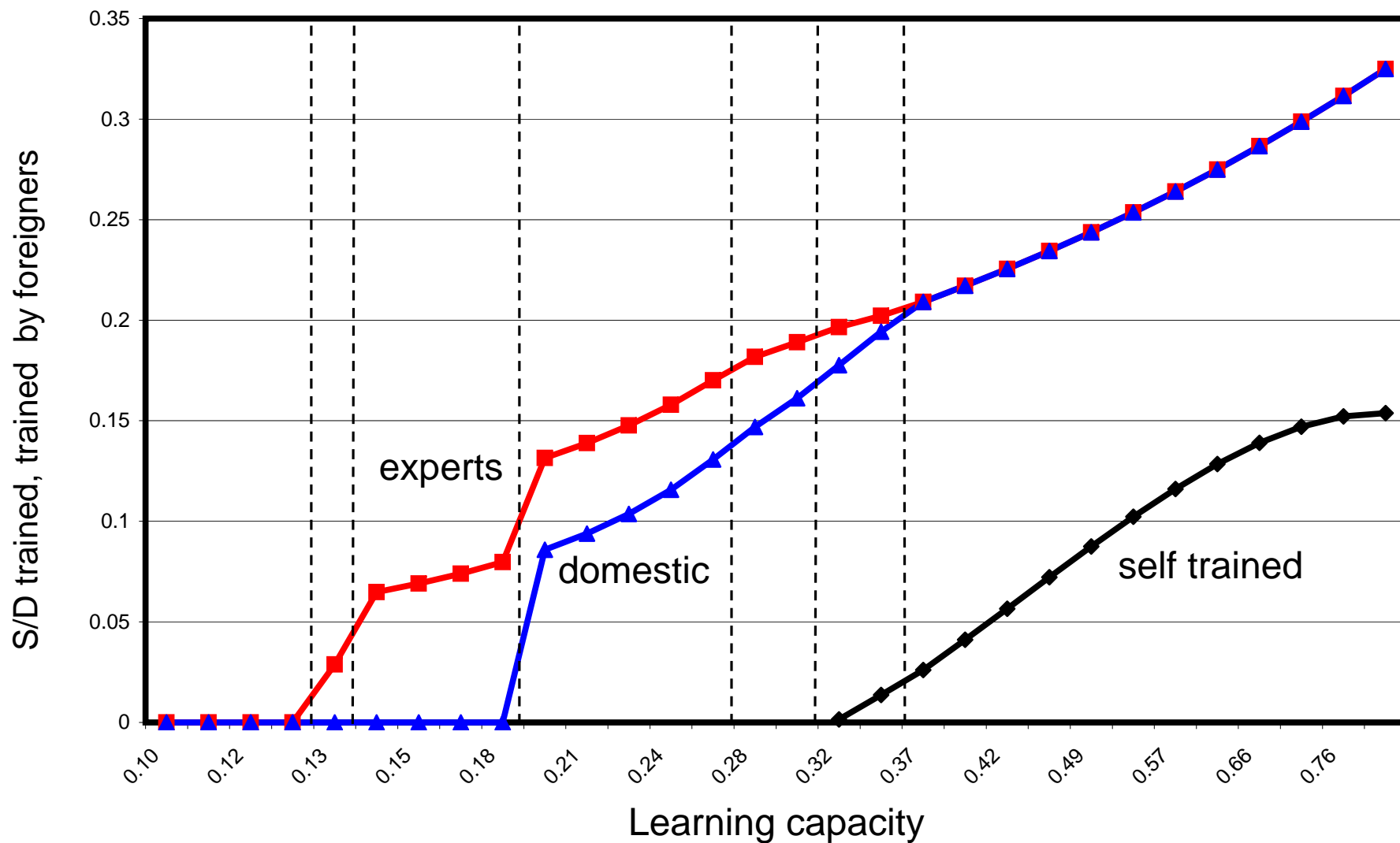


Figure 6: Total self/domestic trained and trained by foreign experts by $t = 3$



Self trained (DS1)
 Trained by for (FS1+FS2)
 Domestic trained (DS2)

Figure 7: Use of foreign experts by period

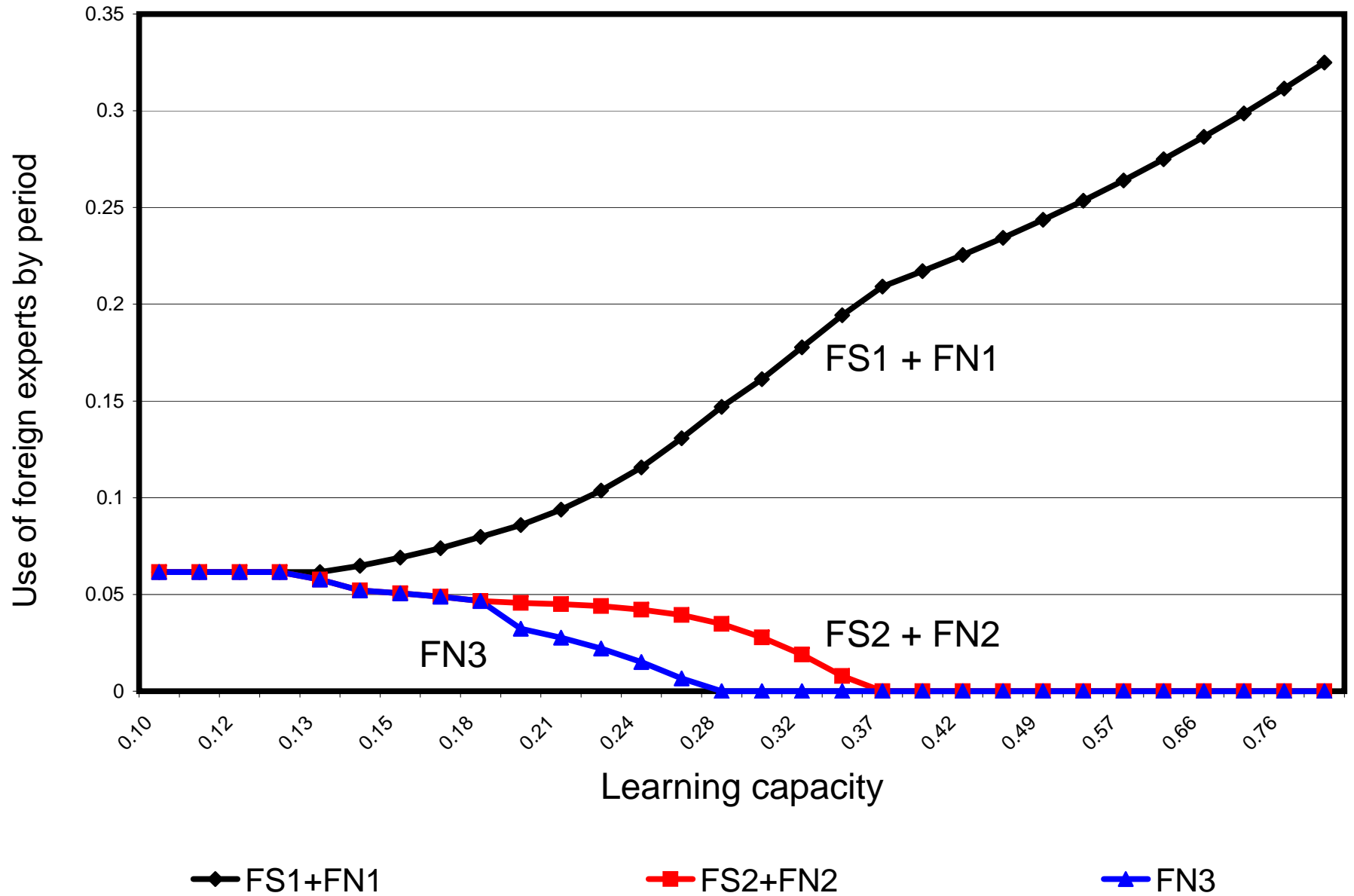


Figure 8: Use of foreign experts for training versus production only over three periods

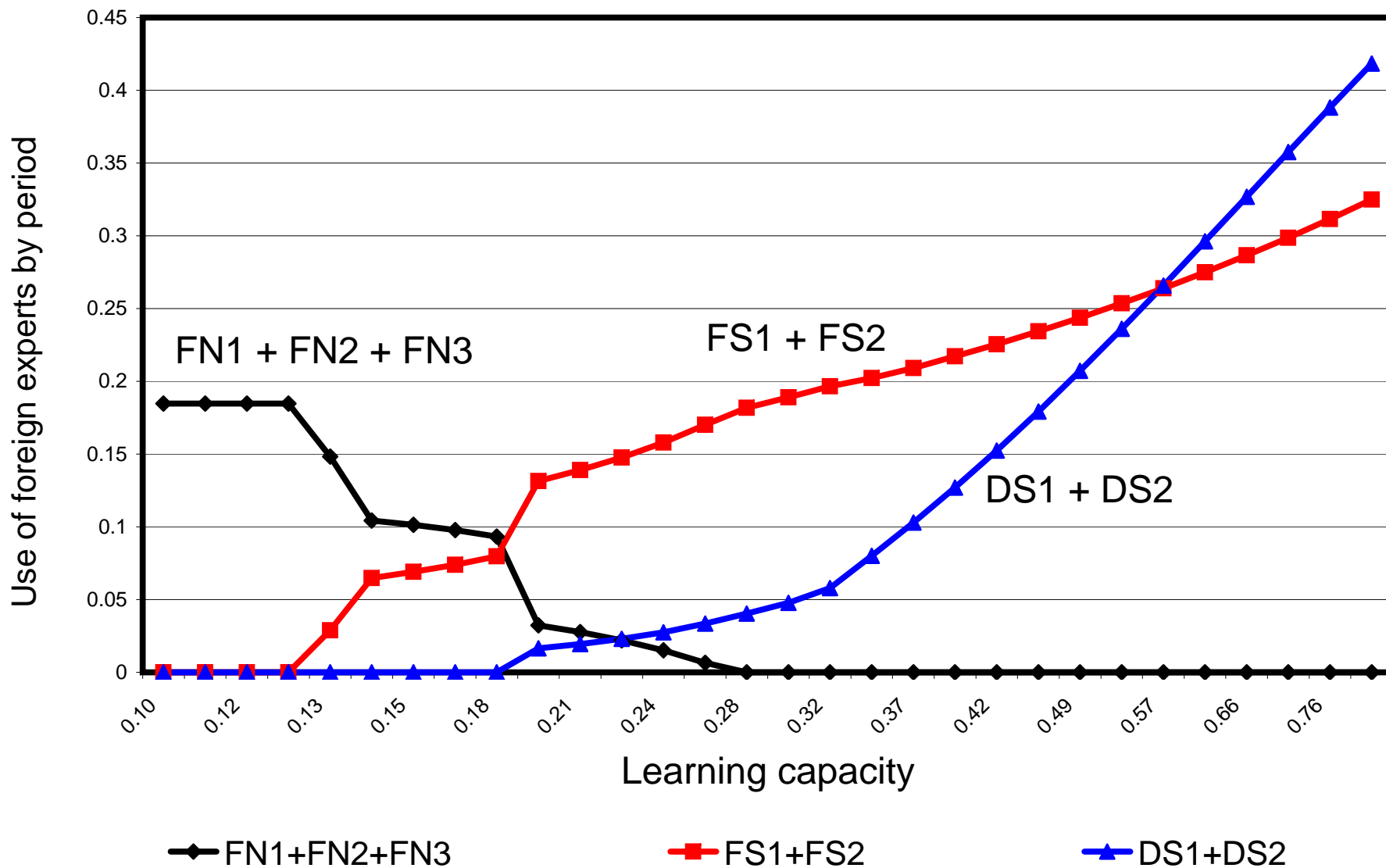


Figure 9: X production by period, welfare

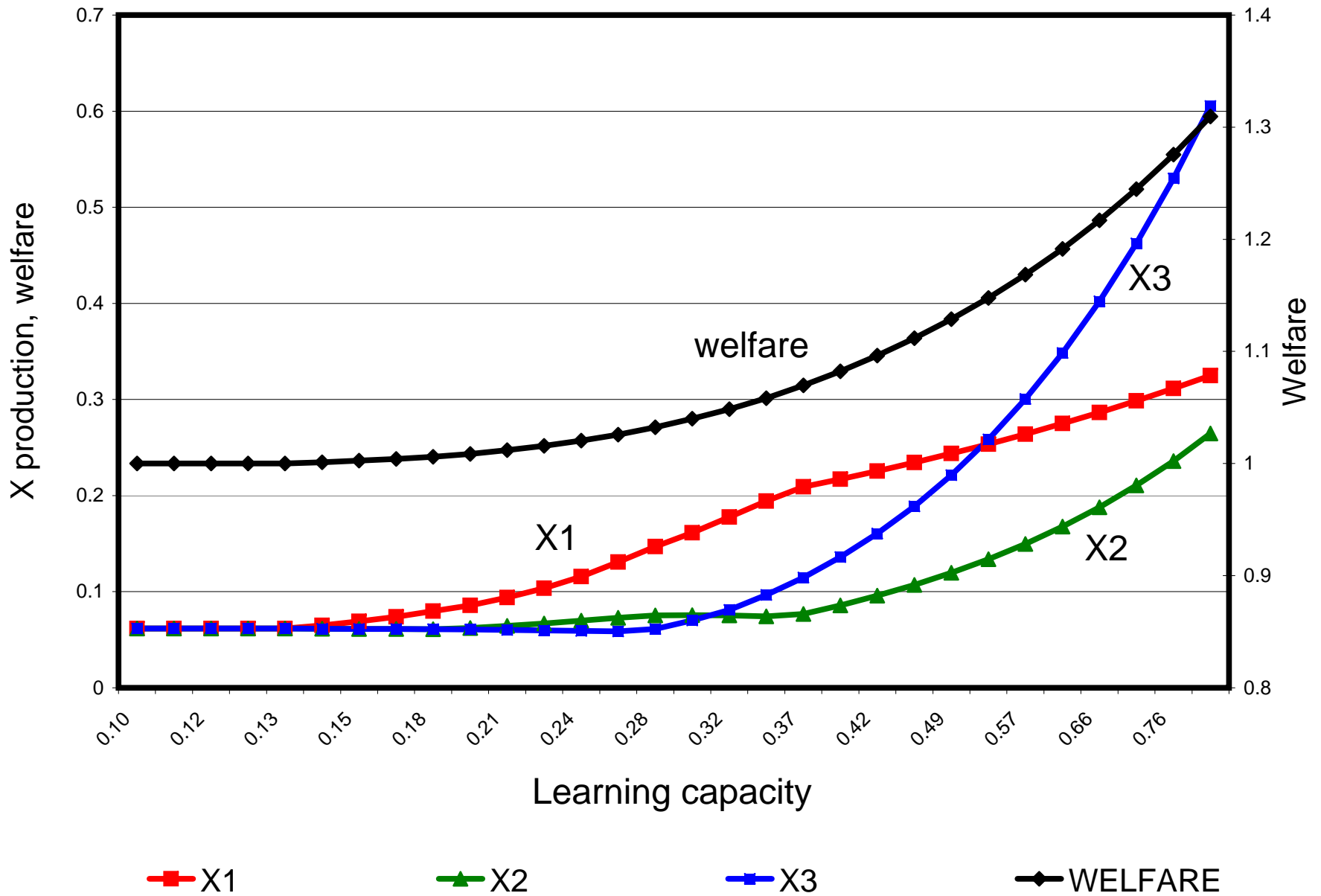


Figure A1: Production and training regimes with no international borrowing allowed - cost of foreign experts

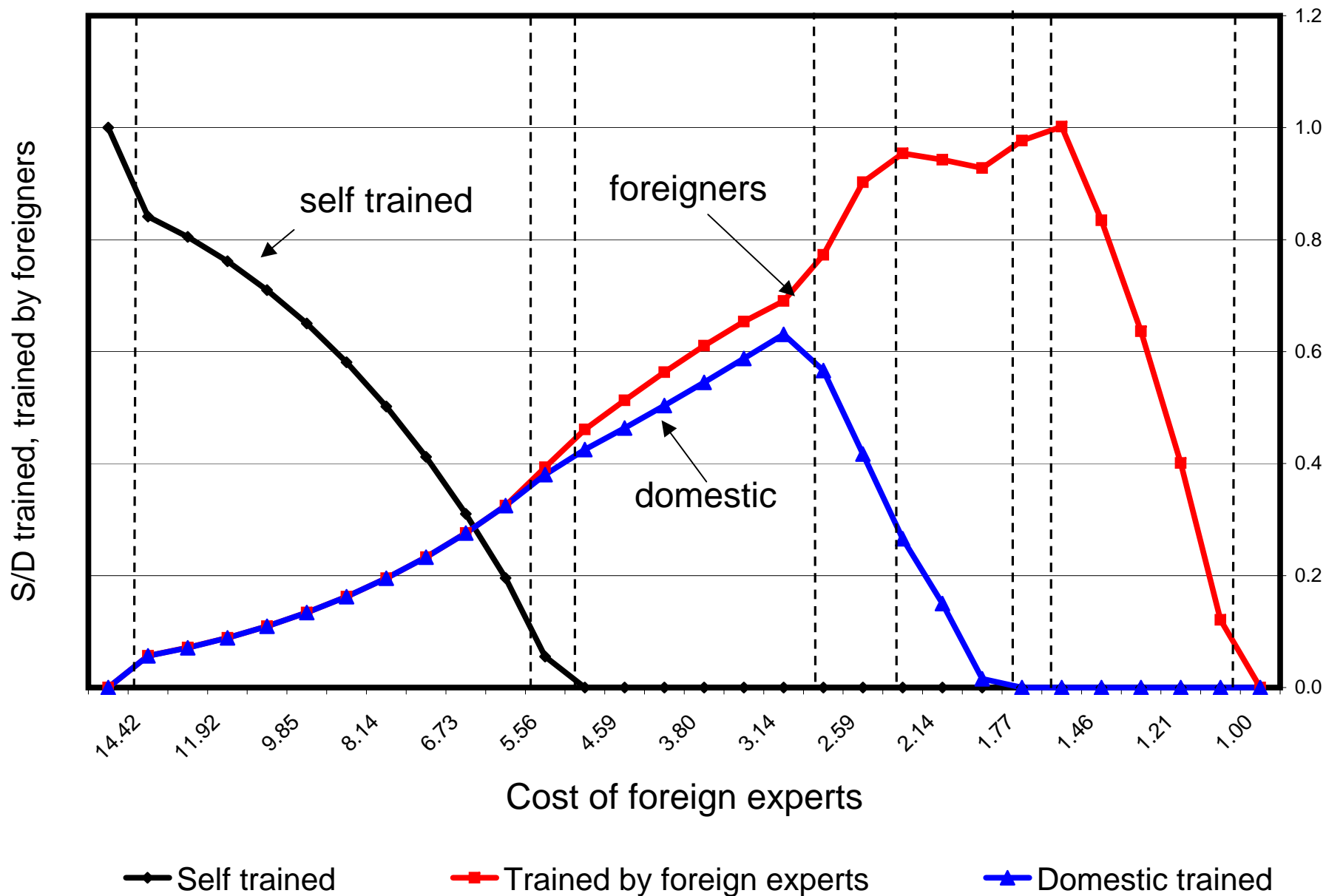
Panel A: grouped by domestic/foreign

DS1	*	*	*	*	*	*	*	*	*	*	*	*																		
DS2		*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*													
DN2														*	*	*	*	*	*	*	*									
DN3	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*						
FS1		*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*												
FN1																		*	*	*	*	*	*							
FS2													*	*	*	*	*	*	*											
FN2														*	*	*	*	*	*	*	*	*	*	*	*					
FN3																		*	*	*	*	*	*							
COST	1000	14.42	13.11	11.92	10.83	9.85	8.95	8.14	7.40	6.73	6.12	5.56	5.05	4.59	4.18	3.80	3.45	3.14	2.85	2.59	2.36	2.14	1.95	1.77	1.61	1.46	1.33	1.21	1.10	1.00

Panel B: grouped by time period

DS1	*	*	*	*	*	*	*	*	*	*	*	*																			
FS1		*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*													
FN1																			*	*	*	*	*	*					*		
DS2		*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*													
DN2														*	*	*	*	*	*	*	*	*	*	*	*						
FS2													*	*	*	*	*	*	*												
FN2																		*	*	*	*	*	*	*	*	*	*	*	*		
DN3	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
FN3																		*	*	*	*	*	*	*	*	*	*	*	*		
COST	1000	14.42	13.11	11.92	10.83	9.85	8.95	8.14	7.40	6.73	6.12	5.56	5.05	4.59	4.18	3.80	3.45	3.14	2.85	2.59	2.36	2.14	1.95	1.77	1.61	1.46	1.33	1.21	1.10	1.00	

Figures A2: Total self/domestic trained and trained by foreign experts by $t = 3$ (no international borrowing)



Figures A3: Welfare, X consumption (no international borrowing)

