

COMPARATIVE ADVANTAGE THEORY

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INTRODUCTION

Comparative advantage is an economic theory developed by a British economist David Ricardo in his book *Principles of Political Economy and Taxation (1817)*. It states that a country engages in production of goods and services that has a lower opportunity cost. It is ability to produce goods and services at a lower opportunity cost. Ricardo's comparative advantage theory argues in favour of a free trade model and it is a notion implied to defend trade liberalization. Protection is seen as interference in the free play of market forces. Comparative advantage theory does not compare between the costs of production in money terms, as generally understood, in domestic and foreign markets, rather between real costs (in terms of labour time and other resources) of different commodities at home. Unlike the neoclassical economists, David Ricardo based his arguments on the labour theory of value. Free trade has been a powerful policy for international organisations such as the IMF, the World Bank and WTO (World Bank, 2002; WTO, 2015). Ricardo used two country static models, where Portugal was assumed to be a more efficient producer of cloth than England, but the country is also more efficient in wine production. According to him, Portugal and England would gain by a division of labour in which each country produced and specialised in the goods in which it had greater comparative advantage. Even though England was relatively less efficient than Portugal in both goods, following free trade would mean that Portugal would focus on the production of wine and England on cloth production. This theory implies that a country that has comparative advantage in the production of certain goods and services gains efficiency and profitability.

Mainstream economists and international organisations claim that trade liberalisation and de-regulation have produced benefits (WTO, 2015). According to Indeed Editorial Team (2021) David Ricardo claimed that a country gains the most economic growth by focusing on the industries in which it had the greatest comparative advantage. He developed the theory to argue against trade restrictions on imported wheat in England. He argued that England shouldn't place restrictions on low-cost and high-quality wheat from other countries and that it would, instead, gain greater value by exporting products that required machinery and skilled labour. Opportunity cost is key to comparative advantage. Opportunity cost is the benefit that someone loses by choosing one option over another. In the case of comparative advantage, the benefit that has been given up for producing a product is lower for one country than it is for another. Though Ricardo's model assumes that all resources are fully employed, but neoclassical economists argued that this is far from reality, especially in developing countries where massive unemployment exists and the potential surplus and resources are under employed. It also assumes that with the adoption of free trade policies, exports will pay for imports so that exports of those commodities in which the country has a comparative advantage will increase. Contrary to this claim, neoclassical economists also argued that the value of exports from developing countries largely depends on world market demands and the prices of other rival suppliers. Kalim S (2012)

COMPARATIVE ADVANTAGE

Comparative advantage states that a country engages in production of goods and services that has a lower opportunity cost. Comparative advantage occurs when a country can produce a good or service at a lower opportunity cost than another country.

David Ricardo used the theory of comparative advantage to argue against Great Britain's protectionist Corn Laws, which restricted the import of wheat from 1815 to 1846. In arguing

for free trade, the political economist stated that countries were better off specializing in what they enjoy a comparative advantage in and importing the goods in which they lack a comparative advantage.

WHAT IS AN OPPORTUNITY COST?

To understand the theory behind a comparative advantage, it is crucial to understand the idea of an opportunity cost. An opportunity cost is the foregone benefits from choosing one alternative over others.

For example, a labourer can use one hour of work to produce either 1 cloth or 3 wines. We can think of opportunity cost as follows: What is the forgone benefit from choosing to produce one cloth or one wine?

Therefore:

By producing one cloth, the opportunity cost is 3 wines.

By producing one wine, the opportunity cost is $\frac{1}{3}$ cloth.

Example: Comparative Advantage

Consider two countries (France and the United States) that use labour as an input to produce two goods: wine and cloth.

In France, one hour of a worker’s labour can produce either 5 cloths or 10 wines.

In the US, one hour of a worker’s labour can produce either 20 cloths or 20 wines.

The information provided is illustrated as follows:

	Cloth	Wine
Europe	5	10
The United States	20	20

It is important to note that the United States enjoys an absolute advantage in the production of cloth and wine. With one labour hour, a worker can produce either 20 cloths or 20 wines in the United States compared to France’s 5 cloths or 10 wines.

The United States enjoys an absolute advantage in the production of cloth and wine.

To determine the comparative advantages of France and the United States, we must first determine the opportunity cost for each output:

France:

Opportunity cost of 1 cloth = 2 wine

Opportunity cost of 1 wine = $\frac{1}{2}$ cloth

The United States:

Opportunity cost of 1 cloth = 1 wine

Opportunity cost of 1 wine = 1 cloth

When comparing the opportunity cost of 1 cloth for both France and the United States, we can see that the opportunity cost of cloth is lower in the United States. Therefore, the United States enjoys a comparative advantage in the production of cloth.

Additionally, when comparing the opportunity cost of 1 wine for France and the United States, we can see that the opportunity cost of wine is lower in France. Therefore, France enjoys a comparative advantage in the production of wine.

ASSUMPTIONS OF COMPARATIVE ADVANTAGE

The Ricardian model is based on several assumptions:

1. Fixed endowment of (identical) resources
2. Factors of production are completely mobile between alternative uses within a country
3. Factors of production are completely immobile externally
4. A labour theory of value is employed in the model

5. The level of technology is fixed for both countries
6. Unit costs of production are constant
7. There is full employment
8. Perfect competition
9. No government-imposed obstacles to economic activity
10. Internal and external transportation costs are zero
11. For simple analysis: a 2-country, 2-commodity "world" (Appleyard and Field, 2001)

ADVANTAGES OF COMPARATIVE ADVANTAGE

There are some advantages of comparative advantage, which are:

Lower opportunity costs and higher profit margins

Countries that have a comparative advantage can focus their labour, capital and resources on production that requires a lower opportunity cost and therefore achieve higher profit margins.

Specialization

Countries specialize in the production of goods and services they have lower opportunity cost.

Increased efficiency

Countries choose to specialize their production on goods or services that they can make more efficiently and then purchase what they cannot efficiently create from trading partners.

Comparative advantage advocates for Free trade

Countries enjoy international trade without tariff or restrictions with free trade policy.

DISADVANTAGES OF COMPARATIVE ADVANTAGE

There are some arguments against comparative advantage.

Change in government policy

If a country removes itself from an international trade agreement or a government imposes tariffs, it could create complications for the companies that were relying on those countries for resources.

Transport cost may outweigh the comparative advantage

While the cost of materials and labour overseas may be cheaper than manufacturing them in the same country, the savings may not be enough to outweigh the cost of transport. In some cases, transportation costs may outweigh any comparative advantage.

Increased specialization may result to difficulty to engage other skills

If your products and services require specialized skills, it may be difficult to employ other workers with other skills.

CONCLUSION

The theory of comparative advantage states that a country should engage in the production of goods and services it has lower opportunity cost. The theory advocates for free trade among countries. Those in favour of comparative advantage agreed that it results to efficiency and profitability while argument against it is that specialization in a particular production can result to over dependency on other countries for other products, also, employment of other skills may be difficult. It does not encourage transfer of technology, and does not consider cost of transport which may outweigh the benefit of opportunity cost.

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