

The Theory of Comparative Advantage

A critical feature of globalization rhetoric is what is often termed "Neo-Liberalism," or what might also be called the ideology of "free market fundamentalism." On this view, the global integration of markets is inescapable, but since markets are "efficient" only when they are "free," standing in the way of "liberalizing" them is destructive. This ideology is accepted as fact by large numbers of decision-makers everywhere.

It is absolutely critical to see that this ideology depends upon a body of theory which has had tremendous influence despite the fact that it is easy to show that it lacks all the credentials of a valid scientific theory.¹ What follows is a critical account of the theory of comparative advantage, the lynch pin of arguments which celebrate global free trade policies.²

Suranovic points out that there are two sources of misunderstandings. "First, the principle of comparative advantage is clearly counter-intuitive. Many results from the formal model are contrary to simple logic. Secondly, the theory is easy to confuse with another notion about advantageous trade, known in trade theory as the theory of absolute advantage. The logic behind absolute advantage is quite intuitive." Adam Smith clearly put forward this idea: "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it off them with some part of the produce of our own industry, employed in a way in which we have some advantage." (Book IV, Section ii, 12).

The theory of comparative advantage allows, however, that a nation may nevertheless benefit from free trade even though it is assumed to be technologically inferior to another nation in the production of everything. The critical move was to show that a "comparative advantage good requires a comparison of production costs across countries. But one does not need to compare the monetary costs of production, or the labor, or other resource costs of production. Instead one must compare the *opportunity* costs of producing goods across countries. Every choice has an opportunity cost, measured by the value of next best alternative sacrificed. Thus, "A country is said to have a comparative advantage in the production of a good (say cloth) if it can produce cloth at a lower opportunity cost than another country. The opportunity cost of cloth production is defined as the amount of wine that must be given up in order to produce one more unit of cloth. Thus England would have the comparative advantage in cloth production relative to Portugal if it must give up less wine to produce another unit of cloth than the amount of wine that Portugal would have to give up to produce another unit of cloth."

The modern version of the Ricardian model and its results are typically presented by constructing and analyzing an economic model of an international economy. In its most simple form the model assumes two countries producing two goods using labor as the only factor of production. Goods are assumed homogeneous (identical) across firms and

¹ See Peter T. Manicas, "Demystifying Mainstream Economic Theory." More thoroughly, Chapter 6 and Appendix D of Manicas, *A Realist Theory of Social Science, Explanation and Understanding* (Cambridge: Cambridge University Press, forthcoming).

² The following draws from Steven Suranovic's account on the world wide web, **The Theory of Comparative Advantage – Overview:** <http://internationalecon.com/v1.0/ch40/40c000.html>©1997-2004

countries. Labor is homogeneous within a country but heterogeneous (non-identical) across countries. Goods can be transported costlessly between countries. Labor can be reallocated costlessly between industries within a country but cannot move between countries. Labor is always fully employed. Production technology differences across industries and across countries and are reflected in labor productivity parameters. The labor and goods markets are assumed to be perfectly competitive in both countries. Firms are assumed to maximize profit while consumers (workers) are assumed to maximize utility.

It is clear that the theory of competitive advantage employs the entire apparatus of neo-classical price theory—including, accordingly, the full range of essential assumptions regarding rationality, competition, equilibrium and timelessness.

Unfortunately, it is quite plain that these assumptions are all false. Accordingly, it is hard to see why we should accept the conclusions of the theory. Suranovic could not be clearer on this fundamental issue:

**"Defending Against Skeptics:
The True Meaning and Intuition of the Theory of Comparative Advantage**

Many people who learn about the theory of comparative advantage quickly convince themselves that its ability to describe the real world is extremely limited, if not, non-existent. Although the results follow logically from the assumptions, the assumptions are easily assailed as unrealistic. For example, the model assumes only two countries producing two goods using just one factor of production. There is no capital or land or other resources needed for production. The real world, on the other hand, consists of many countries producing many goods using many factors of production. Each market is assumed to be perfectly competitive, when in reality there are many industries in which firms have market power. Labor productivity is assumed fixed, when in actuality it changes over time, perhaps based on past production levels. Full employment is assumed, when clearly workers cannot be immediately and costlessly moved to other industries. Also, all workers are assumed identical. This means that when a worker is moved from one industry to another, he or she is immediately as productive as every other worker who was previously employed there. Finally, the model assumes that technology differences are the only differences that exist between the countries.

With so many unrealistic assumptions it is difficult for some people to accept the conclusions of the model with any confidence, especially when so many of the results are counterintuitive. Indeed one of the most difficult aspects of economic analysis is how to interpret the conclusions of models. Models are, by their nature, simplifications of the real world and thus all economic models contain unrealistic assumptions. Therefore, to dismiss the results of economic analysis on the basis of unrealistic assumptions means that one must dismiss all insights contained within the entire economics discipline. Surely, this is not practical or realistic. Economic models in general and the Ricardian model in particular do contain insights that most likely carry over to the more complex real world.

But indeed the problem is not "simplifications of the real world," since all science requires abstracting from the concrete, nor is it there may be "insights that most likely carry over to the more complex world"—for example, that as prices rise, demand tends to fall. The problem rather is that because the simplifying assumptions are not only false, but essential to the conclusions drawn, that many of these conclusions serve only to promote ideology. For example, with a fall in demand, a new lower equilibrium price will be established—or as in this case, that "freer trade may not result in a domestic industry's decline just because the foreign firms pay their workers lower wages." Sadly, if neo-classical "theory" says that "it may not," history—and a better theory—says that it is almost certain that a domestic industry will decline "just because the foreign firms pay their workers lower wages"!!

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