Recardo’s Theory of International Trade: Comparative Cost Advantage theory

Comparative Cost Advantage Theory

The Comparative Cost Advantage Theory of Trade was developed by British political economist, David Ricardo in his book “ The Principles of Political Economy and Taxation” published in 1817.

According to Comparative Advantage Theory, a country has a comparative advantage if it can produce a good at a lower opportunity cost than another country. A lower opportunity cost means it has to forego less of other goods in order to produce it.

Assumptions of the Theory

The theory of comparative cost advantage is based on several assumptions:

(a) Trade takes place between two countries only, say England and Portugal.

(b) They are trading with only two commodities, say, Cloth and Wine.

(c) The cost of production of these two goods in both the countries is expressed in terms of labour only.

(d) The production of these two goods in both the countries taken place at constant costs.

(e) There is no transport cost, or the transport cost, if any, is so small a part of product prices that it is ignored.

Given the above assumptions, the theory of comparative Cost Advantage can be explained with the following table as below:

Output per worker in one year

-	clothing	aeroplanes
US	5	12
Brazil	4	1

The above Table showsthat the US has an absolute advantage in producing clothing (5>4) and also aeroplanes(12>1). Brazil does not have an absolute advantage in anything. However, that doesn’t mean the US should be the only producer. We should look at comparative advantage based on opportunity cost.

Opportunity Cost Table		
	CLOTHING	AEROPLANE
US	12/5=2.4	5/12=0.41
BRAZIL	¼=0.25	4/1=4

The above opportunity cost table shows that, the US has a comparative advantage in producing aeroplanes. This is because the opportunity cost of producing aeroplanes (5/12=0.41) is lower than that of Cloth (12/5=2.4) in US. Therefore, US should specialise in producing aeroplanes even though it has absolute advantage in both cloth and aeroplanes.

In contrast, Brazil has a comparative advantage in producing Cloth. Brazil produces clothing, the opportunity cost is 1/5 = 0.25 aeroplanes as the one shown in above table. This is because the opportunity cost of producing cloth (¼=0.25) is lower than that of aeroplanes (4/1=4) in Brazil. Therefore, Brazil should specialise in producing clothing even though it doesn't have an absolute advantage.

Therefore, we conclude that based on comparative cost advantage analysis, both US and Brazil will be benefited by trading each other.

Criticisms of the Theory

As with many other economic ideas there are criticisms to be levelled at comparative cost advantage theory:

(i) It is much more complicated in the real world in deciding in which goods countries have a comparative cost advantage. This is so because there are a large number of goods and many countries.

(ii) The theory ignores the effects of transport costs. However, once transport costs are added any comparative advantage may be lost.

(iii) Modern theories, no longer based on Ricardo's labour theory, have established that the only necessary condition for the possibility of gains from trade is that price ratios should differ between countries.

(iv) Ricardo ignored the role of demand completely and explained trade from supply side.

(v) Ricardo's analysis is based on the labour theory of value as costs are expressed in terms of labour hours. However, the classical labour theory itself has lost its relevance.

(vi) The theory applied their principle in case of trade with two countries only and with two commodities only. So, the principle has a limited scope of application in practice. It cannot explain multi-lateral trade.