Absolute and Comparative Advantage

For the students of 5th Semester

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Absolute Advantage Theory

The theory of absolute advantage has been put forwarded by Adam Smith. It is also called the theory of Absolute Cost Difference and it is one of the oldest theory of International trade. A country is said to have an absolute advantage in the production of a commodity if that country can produce the commodity at a lower cost than another country.

Assumptions of the theory:

i) There are two countries- Country I and Country II producing two commodities- Commodity X and Commodity Y.

ii) Labour is the only factor of production. All costs are being measured in terms of labour hours.

iii) The production techniques of two commodities are different in the two countries.

iv) There are constant returns to scale in the production of both the commodities in both the countries. Then unit cost of production is constant for each country.
v) There are no transport costs or other trade barriers
vi) There is full employment of labour in both the countries.

Explanation of the Theory:

With these assumptions ,let us try to explain the theory of absolute advantage. The unit cost of production of the two commodities in labour hours are shown in the following table:-

Unit cost of Production
(in labour hours)

Commodity / Country	Commodity X	Commodity Y
Country I	10	20
Country II	20	10

We see from the above table that commodity X can be produced more cheaply in country I than in country II and commodity Y can be produced more cheaply in country II than in country I. By spending 10 units of labour, country I can produce 1unit of commodity X, but to produce 1 unit of commodity Y, she has to spend 20 units of labour. So, country I has absolute advantage in the production of commodity X. Similarly, country II has absolute advantage in the production of commodity Y. Hence trade will take place. Country I will produce and exports commodity X while country II will produce and export commodity Y. Then both the countries will gain from trade.

Limitations of Absolute advantage theory:

i) The assumption of single factor of production is unrealistic.

ii) The assumption of full employment of labour in both the market is also unrealistic.

iii) The model considers only two countries and two commodities, but in the real world, there are many countries and commodities.

Comparative Advantage Theory

The theory of Comparative advantage has been put forwarded by David Ricardo. This theory was advanced as an alternative to Adam Smith's theory of absolute advantage. Smith did not consider whether trade will take place or not if a country enjoyed an absolute advantage in the production of both the commodities. But Ricardo has shown that even if one country has an absolute advantage in the production of both the commodities, trade can take place if there are differences in comparative costs. Comparative cost differences exist if the ratios of domestic unit costs differ between the two countries.

Assumptions of the theory:

i) There are two countries producing two commodities and international trade takes place in these two countries. Both countries can produce both the commodities.

ii) Each country uses only one factor of production, labour in the production of both the commodities. The cost of production of each commodity is measured in terms of labour hours required to produce each commodity. The value of any commodity is determined by the amount of labour required to produce one unit of that commodity. This is known as labour theory of value. The greater the labour hours, greater is the value of the commodity.
iii) There are constant returns to scale in the production of both the commodities.
iv) Free international trade takes place between the two countries and there is no restriction on the movement of commodities between the two countries.
v) The amount of labour in each country is given and fully employed.
vi) There is no movement of labour from one country to another though labour is perfectly mobile within each country.

Explanation of the Theory:

Ricardo's theory can be elaborated and explained with the help of Ricardo's famous example. Ricardo took two countries, Portugal and England, producing two commodities cloth and wine. The unit costs of labour hours of these two countries are shown in the table below:-

Unit Costs
(in labour hours)

Commodity / Country	Wine	Cloth
Portugal	80	90
England	120	100

From the table we see that Portugal has an absolute advantage in the production of wine as well as in the production of cloth, or England has an absolute disadvantages in the production of both wine and cloth. This is because the labour cost of production of each unit of the two commodities is less in Portugal than in England. According to Smith trade is not possible in this case. But Ricardo argues that even in this case, trade between England and Portugal is possible and trade will lead to gains for both the countries. He demonstrate this with the help of the concept of opportunity cost. The following table shows the opportunity costs of producing wine and cloth in Portugal and England.

Opportunity cost

Commodity / Country	Wine	Cloth
Portugal	80/90=0.89	90/80=1.125
England	120/100=1.20	100/120=0.83

Now, a country has a comparative advantage in producing a good if the opportunity cost of producing the good is lower at home than in the other country. Above opportunity cost table shows that Portugal has lower opportunity cost in producing wine, while England has lower opportunity cost in producing cloth. Thus Portugal has a comparative advantage in the production of wine and England has a comparative advantage in the production of cloth. If they trade then both country will be benefitted. Not only that if both country specialize in the production of the good in which it has comparative advantage, then world's output will also increase through trade.