International Trade Theories

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Lecture - 4

Topic covered

- Theory of Comparative Cost Advantage
- Assumptions of Theory of Comparative Advantage
- Criticism of Theory of Comparative Advantage

Theory of Comparative Advantage

In 1817, David Ricardo emphasized this theory stating that it is beneficial for a country to specialise in the production of those goods that is produced most efficiently and to buy the goods that it produces less efficiently from other countries.

To illustrate with an example – let us assume that the cost of one unit of tea and cloth in Country A and Country B are as shown below in the Table:

Country	Cost per Unit	
	Tea	**Cloth**
Country A	10	16
Country B	15	20

Theory of Comparative Advantage

Country A has absolute cost advantage in both the commodities. A country's comparative cost advantage in the production of a commodity is measured in relative value of one commodity in terms of other commodity. In Country A, cloth costs 1.5 times the cost of tea while in Country B cloth costs only 1.25 times the cost of tea. Thus, Country A has a comparative cost advantage in the production of tea while Country B has comparative cost advantage in the production of cloth. Therefore it would make sense for Country A to specialize in the production of tea and to import cloth from Country B in exchange of surplus tea.

Theory of Comparative Advantage

Thus, the Comparative Cost Advantage theory suggests that all countries can gain from International trade. It advocates that even countries that have no absolute advantage in the production of any commodity benefit in terms of more consumption. Regardless, the theory of Comparative cost theory has been criticized for its unrealistic assumptions and oversimplification.

Assumptions of Theory of Comparative Advantage

- There are two countries;
- There are two commodities; and
- One factor of production (i.e. labour).
- The supply of labour is unchanged.
- All labour units are homogeneous.
- Tastes are similar in both countries.
- The labour cost determines the price of the two commodities

Assumptions of Theory of Comparative Advantage

- The production of commodities is done under the law of constant costs or returns.
- The two countries trade on the barter system.
- Technological knowledge is unchanged.
- Factor of production (labour) are perfectly mobile within each country. However, they are immobile between the two countries.

Assumptions of Theory of Comparative Advantage

- Free trade is undertaken between the two countries. Trade barriers and restrictions in the movement of commodities are absent.
- Transport costs are not incurred in carrying trade between the two countries.
- Factors of production (labour) are fully employed in both the countries.
- The exchange ratio for the two commodities is the same.

Criticism of Theory of Comparative Advantage

- The theory only considers labour costs and neglects all non-labour costs involved in the production of the commodities.
- The theory considers all labour to be homogeneous. However, in reality, labour is heterogeneous due to different skills and abilities.
- The theory assumes similar tastes for all. However, the tastes differ with the growth of economies and income brackets.

Criticism of Theory of Comparative Advantage

- The theory assumes that a fixed proportion of labour is used in the production of all commodities. However, in reality, utilization of the proportion of labour depends on the type of commodity being produced.
- The theory has an unrealistic assumption of constant costs. However, large-scale productions lead to cost reduction and thereby increase the comparative advantage.
- Transport costs play an essential role in determining the pattern of trade. But the Ricardo theory neglects this independent factor of production.

Criticism of Theory of Comparative Advantage

- The assumption of the factors of production being mobile internally is unrealistic. The factors do not move freely from one region to another or one industry to another. The greater the degree of specializations in an industry, the more immobile the factor will be.

- The assumption of the theory of having only two countries and two commodities is unrealistic as international trade takes place among countries trading numerous commodities.

Criticism of Theory of Comparative Advantage

- Every country implements restrictions on the movement of goods to and from the countries. Thus, tariffs and trade restrictions play a role in world imports and exports. However, the theory assumes free and perfect world trade.
- The theory assumes full employment. However, every economy has an existence of underemployment.

Criticism of Theory of Comparative Advantage

- A country may or may not want to trade a commodity due to military, strategic or development considerations. Therefore, self-interest stands in the operation of the comparative advantage theory.

- The Ricardian theory considers only the supply side of world trade and neglects the demand side.

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Thank You