

# Theory of Comparative Advantage



Specialization

+

Trade

# Repeal the Corn Laws

**WORKING MEN!**

**You Pay a Tax of Tenpence**

*Upon every Stone of Flour you and your wives  
and little ones consume.*

If there was not the Infamous CORN LAW you and your Families might buy THREE LOAVES for the same money that you now pay for Two.

Upon every Shilling you spend for Bread, Meat, Bacon, Eggs, Vegetables, &c., you pay 4d. Tax for Monopoly.

**DOWN, DOWN**

WITH THE

**Infamous Bread Tax!**

# Production without specialization and division of Labor

	Wine	Cloth
England	3	5 (Total production =8)
Portugal	9	6 (Total production=15)

**Total goods produced = 23**

# Production with specialization before trade

- **Before Trade: Resources put where they are most efficient (specialization**

	Wine	Cloth
England	1	10
Portugal	16	0

Total goods produced = 27 note: efficiency increases total number of goods available

# With Specialization and Trade

England trades Portugal 4 units of cloth for 4 units of wine

Exchange rate is 1 to 1.

	Wine	Cloth
England	5	6 (available goods =11)
Portugal	12	4 (available goods =16)

Total goods produced is still 27 but each country is better off than before trade and both are better off than before “efficiency”

# Assumptions of Ricardo's Theory

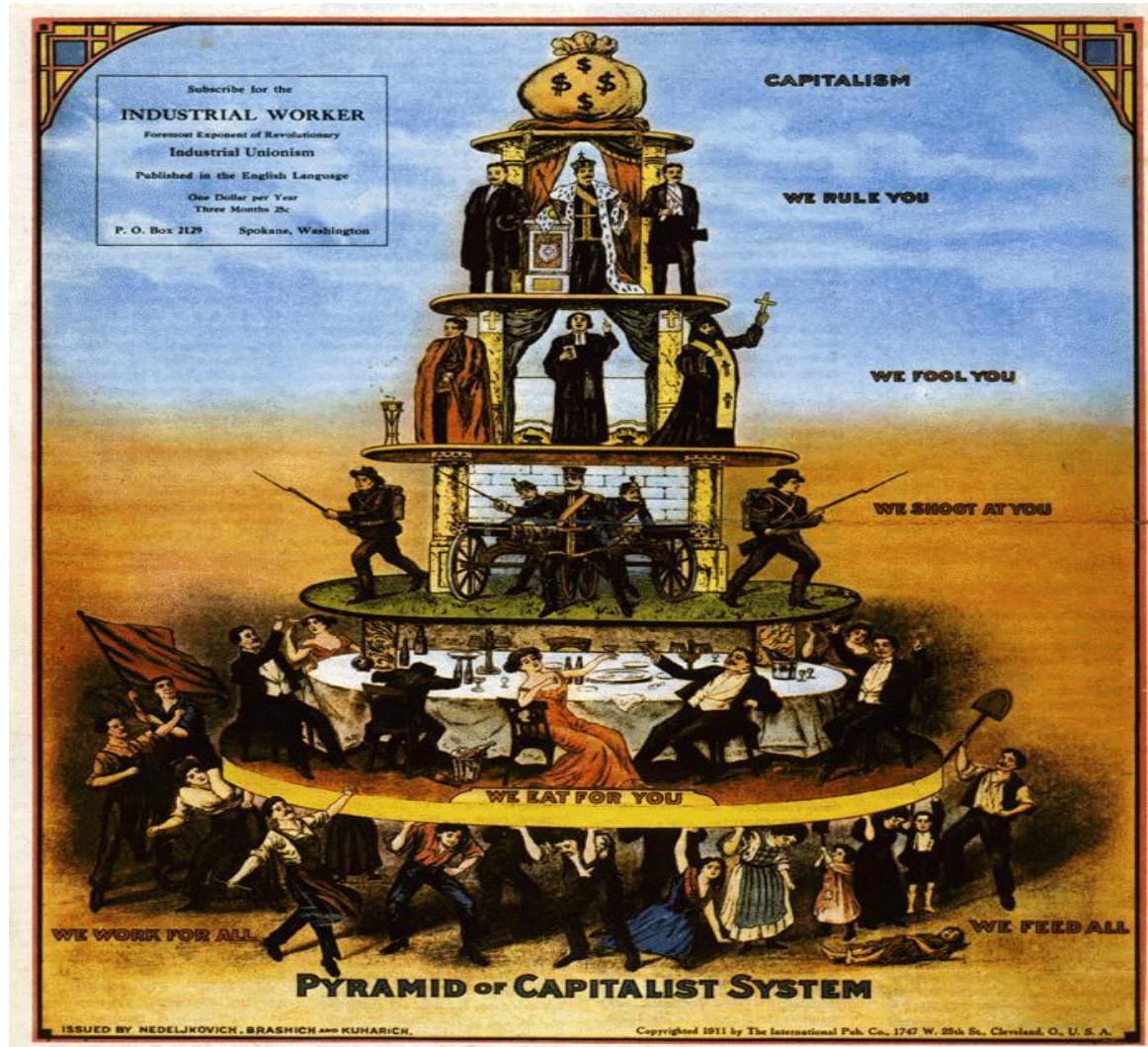
- assumes static givens in a country's economy
- and doesn't discuss technology as a factor of production.
- labor theory of value
- What?

David Ricardo →





# Labor Theory of Value (smith)



# Hechscher-Ohlin-Samuelson modernizes Ricardo

- This model maintains that a nation's comparative advantage is determined by the relative abundance and most profitable combination of its several factors of production, such as capital, labor, resources, management, and technology.



# Krugman expands on Heckscher-Olin and wins Nobel Prize



# Paul Krugman Defends Free Trade

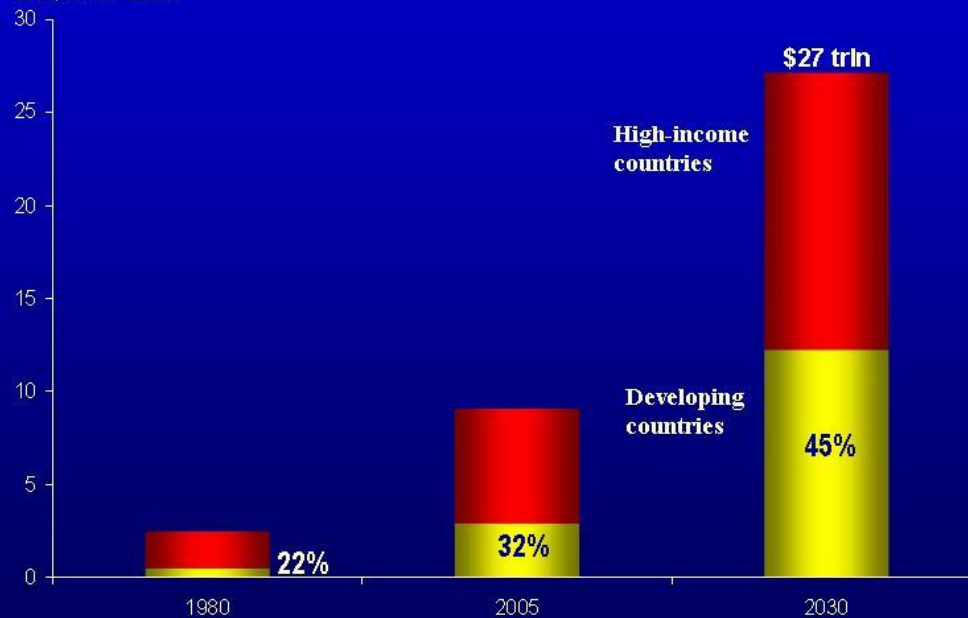
- "Ricardo's Difficult Idea,"
- People will specialize in producing the goods and services in which they have a comparative advantage.
- The result is that we never need to worry about low-wage countries competing us out of jobs;
- the most they can do is change those goods and services in which we have a comparative advantage.

# Free Trade leads to growth in Exports

## Globalization increases developing countries share in world trade

Exports from developing and developed countries, 2005-2030

US\$2001 trln.



Source: World Bank simulations with Linkage model.

# Comparative Advantage is Dynamic



# Sum: Effects of Free Trade

- Efficiency → Growth → Good life for everyone
- Harmonious International Relations
- Role of the State: To let producers produce most efficiently—to separate politics and economics:
- the key actors for liberals are firms and consumers, not states.
- Commerce → Peace Why?
  - Efficiency should be the basis of all political relations
- Does Free Trade make the state obsolete?

Is The Liberal Market system the most “natural” mode of resource allocation?

Enclosures, fictitious commodities,  
Speenhamland

# Liberal theorists say YES!

- Rational Choice Theory: Humans are INDIVIDUALS and they are self-interested and rational
- All Liberal Theorists: All humans want to be free (more than anything else)
- Adam Smith: “It’s natural to ‘truck, barter, and exchange”
- So an economic system to allocate material goods must allow maximum freedom to buy and sell what people want.
- When people are free to demand goods, competition will arise naturally among sellers to sell what people want
- Such a system will be the most efficient because nothing will be produced that people don’t want, and what people want will be produced. Supply and demand determines price at which markets will clear
- A division of labor will naturally arise as people specialize in what they can do best.....
- to the extent that they have a comparative advantage in the production of that good, they will be the most competitive in the market
- Freedom, Greed, rationality, competition, specialization, the division of labor, and “truck, barter, and exchange,” create economic growth,
- Growth creates welfare for everyone.
- Sum: because it harnesses the human desire for freedom (above all else) and key aspects of human nature that ensure survival, the market is the best system for resource allocation



# Is the Market the most “natural” mode of resource allocation? Polanyi says NO!....because

- Pre-Market modes of resource allocation
- It took powerful states to create markets by
  - Repeal the corn laws
  - enclosures
  - Creating Fictitious commodities



# Critique of Liberalism

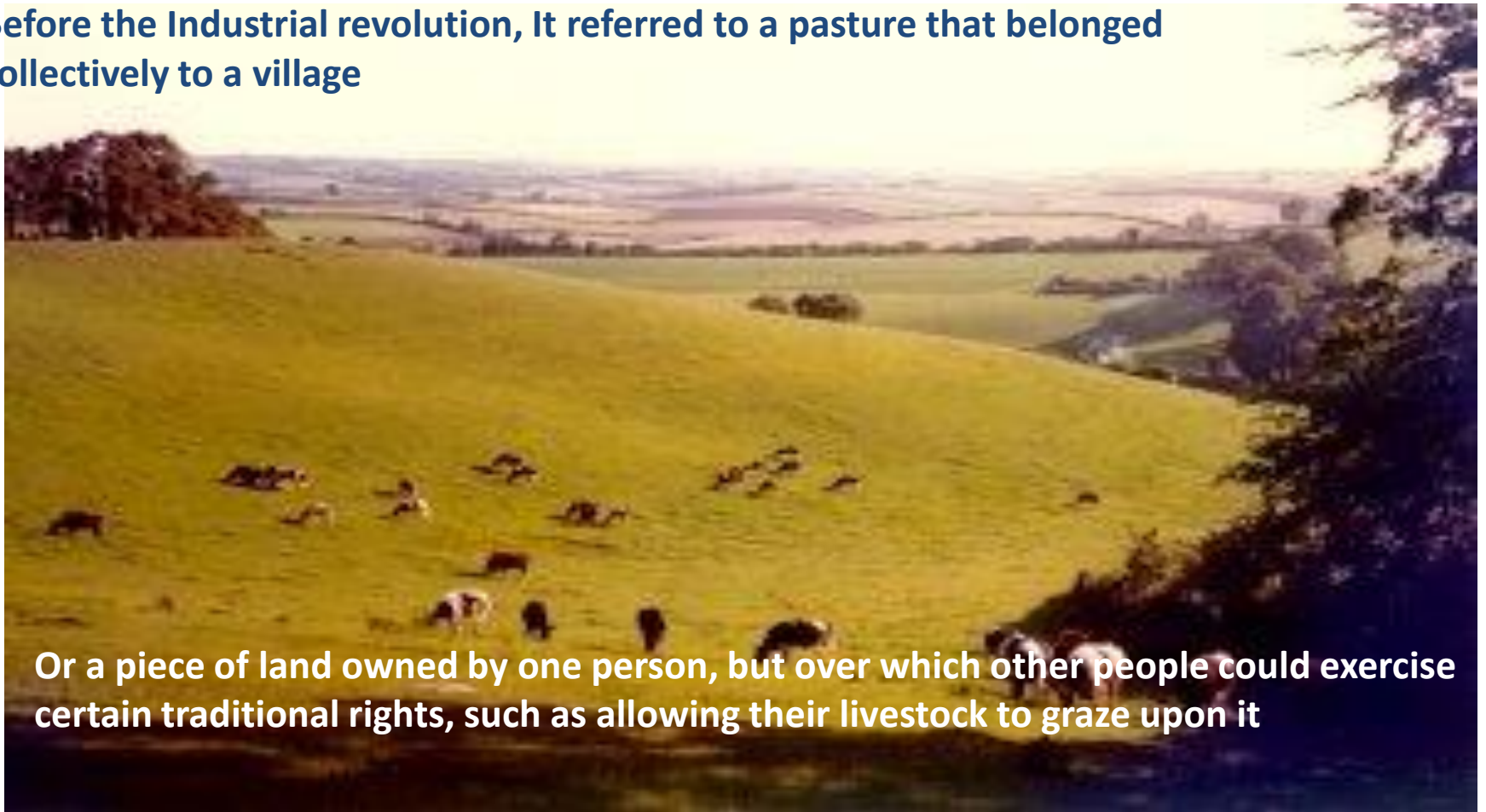
- Critiques liberal economic theory, especially two core assumptions:
  - 1. Assumption that the market is a uniquely “natural” form of economic organization of society
  - 2. Assumption that human economic behavior is naturally, inevitably motivated by the goal of maximizing self-interest and profits
  - Assumption that markets are self-regulating

# Economy and Society

- In a market economy, Social relations become submerged in the economy.
- This is a big historical change

# The “commons”

Before the Industrial revolution, It referred to a pasture that belonged collectively to a village



Or a piece of land owned by one person, but over which other people could exercise certain traditional rights, such as allowing their livestock to graze upon it

# The “commons” metaphor

- Think Planet Earth
- Think The Air we breathe, water, climate

# Fictitious commodities

