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

<table>
<thead>
<tr>
<th>Country</th>
<th>Wine</th>
<th>Cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>England</td>
<td>3</td>
<td>5 (Total production =8)</td>
</tr>
<tr>
<td>Portugal</td>
<td>9</td>
<td>6 (Total production=15)</td>
</tr>
</tbody>
</table>

Total goods produced = 23
Production with specialization before trade

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

<table>
<thead>
<tr>
<th></th>
<th>Wine</th>
<th>Cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>England</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Portugal</td>
<td>16</td>
<td>0</td>
</tr>
</tbody>
</table>

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.

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<tbody>
<tr>
<td>England</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(available goods =11)</td>
</tr>
<tr>
<td>Portugal</td>
<td>12</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(available goods =16)</td>
</tr>
</tbody>
</table>

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)

- The real price of every thing, what every thing really costs to the man who wants to acquire it, is the toil and trouble of acquiring it. What every thing is really worth to the man who has acquired it and who wants to dispose of it or exchange it for something else, is the toil and trouble which it can save to himself, and which it can impose upon other people. (Wealth of Nations, Book 1, chapter V)
Heckscher-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 Hechscher-Olin and wins Nobel Prize

• Krugman noticed that the accepted model economists used to explain patterns of international trade did not fit the data.
  – The Heckscher-Ohlin model predicted that trade would be based on such factors as the ratio of capital to labor, with “capital-rich” countries exporting capital-intensive goods and importing labor-intensive goods from “labor-rich” countries.
• Mr. Krugman noticed that most international trade takes place between countries with roughly the same ratio of capital to labor.
  – The auto industry in capital-intensive Sweden, for example, exports cars to capital-intensive America, while Swedish consumers also import cars from America.
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

Source: World Bank simulations with Linkage model

[Graph showing expected growth in exports from developing countries compared to high income countries over the years 1980, 2005, and 2030.]
Comparative Advantage is Dynamic

• While the United States has long imported oil and other raw materials from the third world, we used to import manufactured goods mainly from other rich countries like Canada, European nations and Japan.

• But recently we crossed an important watershed: we now import more manufactured goods from the third world than from other advanced economies. That is, a majority of our industrial trade is now with countries that are much poorer than we are and that pay their workers much lower wages (Krugman 2007).
Sum: Effects of Free Trade

• Efficiency $\rightarrow$ Growth $\rightarrow$ 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 $\rightarrow$ 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
What is a commodity? Objects produced for sale on the market.

Why are land, labor, and money “fictitious commodities?”

Because they are “obviously not commodities….anything that is bought and sold must have been produced for sale, but this is not true with regard to them.”

Land: “land is another name for nature.”

Labor: “Labor is another name for human activity that goes with life itself.”

Money: “money is merely a token of purchasing power.”