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The Theory of Comparative Advantage in the 21st Century

Abstract

Oliver De Mestre expresses his opinion on the working principles of the theory of comparative advantage, as it applies to 21st century.

Globalisation and free trade theory are mainly based upon David Ricardo's principle of comparative advantage (Ricardo, 1772-1823). The World Trade Organisation promotes the latter as follows (WTO, 2006)

“This is arguably the single most powerful insight into economics. Suppose country A is better than country B at making automobiles, and country B is better than country A at making bread. It is obvious (the academics would say “trivial”) that both would benefit if A specialized in automobiles, B specialized in bread and they traded their products. That is a case of absolute advantage. But what if a country is bad at making everything? Will trade drive all producers out of business? The answer, according to Ricardo, is no. The reason is the principle of comparative advantage.

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It states that countries A and B still stand to benefit from trading with each other, even if A is better than B at making everything. If A is greatly superior at making automobiles and only slightly superior at making bread, then A should still invest resources in what it does best—producing automobiles—and export the product to B. B should still invest in what it does best—making bread—and export that product to A, even if it is not as efficient as A. Both would still benefit from the trade. A country does not have to be best at anything to gain from trade. That is comparative advantage. The theory dates back to the classical economist David Ricardo.

It is one of the most widely accepted theories among economists. It is also one of the most misunderstood among non-economists, because it is frequently confused with absolute advantage. It is often claimed, for example, that some countries have no comparative advantage in anything. That is virtually impossible. Think about it...”

And, indeed, we do think about it because it seems that we have major problems in applying to the letter a theory dating back two hundred years. In fact, one cannot contradict the theory in principle, for it is substantiated by simple arithmetic. However, in order for a model to work as expected, a number of prerequisites are always necessary¹. Although it is conventional wisdom to account for the environmental context in which models are applied, it seems that economics is totally immune to pragmatism and common sense. The reason is that the prospects of profit on the one hand, and excessive technicalities on the other, tend to make one forget about the practical aspects of implementation and especially the human characteristics present in the real world.

¹For instance, the concept of representative democracy is subject to demographic evolution, and thus differs from the genuine version of universal democracy. This was designed by Ancient Greek citizens to govern their small city-states, whose population did not exceed 10,000 people.

Attractive though it may appear, Ricardo's theory is far from flawless. We suggest at least three major weaknesses that are present in today's world, and therefore could not possibly have been taken into account by Ricardo at the time.

Assumed willingness and goodwill

The law of comparative advantage assumes that all the parties to the system are naturally willing to co-operate and promote trade. Economics is therefore not linked to social issues and politics. Nevertheless, for political and strategic purposes, it is far from obvious that all nations worldwide wish to participate actively, or on an equal basis in a system that tends to undermine their independence and alter the power balance at their expense. National interest prevails over purely economic issues.

It is also assumed that the world is peaceful and all the parties to the system seek the same mutually beneficial goal, for the good of humanity as a whole. But, history demonstrates how wrong this view is. Social groups have always put such concepts as freedom, power and justice very high on their agendas. And, it cannot suffer undue interference from external powers, which seek to achieve the same abstract goals.

Furthermore, now that knowledge has become ever-increasingly instrumental, and the fierce battle for the protection of and access to intellectual property is on, the parties' sincere commitment to a common goal cannot be taken for granted. Curiously, a great number of former Cold War special agents have specialised in industrial intelligence. The business is reportedly doing very well. And, we wonder why this should be so, in the context of close collaboration and resource sharing, which the World Trade Organisation and other advocates of free trade theory advocate so passionately. Certainly, the world is not as open and co-operative as we might suppose.

Charity begins at home

In terms of socioeconomic development, protectionism is presented as evil in its purest form. It allegedly contradicts the most basic principles of a market economy that ensure sustainable economic development, and thus social progress. It is simply bad and must be eliminated at all costs. The problem is that liberalism, as opposed to protectionism, can be compared to the concept of justice we discussed earlier. It is all very well, as long as we are the chief beneficiaries. Whenever the benefit is not so obvious, our stance will change swiftly.

Nowadays, the most developed countries, the United States, France, Germany, Japan and the United Kingdom, will apply double standards in trade issues, depending on the circumstances.

There are innumerable decisions and events which occur that contradict the principle of natural willingness to co-operate on purely economic matters. No wonder Ricardo revered economics to the point that it seemed to him obvious countries would consider economic development as a top priority. But, social and political issues prevail over economics. History is littered with disputes, conflicts and alliances between communities for survival or supremacy. Economics has always been no more than a tool to be used to expand civilisation, increase power and, from time to time, justify political decisions. Economy is a means to an end. And, no matter how critical to societies economics is, raising it to the level of social matters, if not above, is a major flaw in the theory.

Assumed sufficient resources

On no occasion does Ricardo's theory of comparative advantage refer to the primary resources, called *land* in classical economics and *commodities* nowadays. That trade helps create wealth is beyond question. But, it is only value creation based upon finite resources. When supply exceeds demand, resources are not a major matter of concern. This was the case, at the time Ricardo conceived

his theory. In contrast, when resources are in short supply, one can no longer ignore the changes in working conditions. Furthermore, Ricardo's theory assumes that there is a kind of universal law very similar to Adam Smith's *invisible hand*, that regulates the market and ensures perfect competition. But, several countries may very well have a similar competitive advantage, which are comparable, and in a given sector, and thereby enter into a business war, whose socioeconomic consequences are serious.

In addition, Ricardo's theory denies non-economic interference. It is an open secret that international diplomacy has an unrestricted scope of action. The market and related matters are only a part of more general bargaining.

With an ever-increasing number of countries entering the race to develop and a greater amount of primary resources required for sustaining growth, humanity is putting a great deal of stress on its environment, to the point that sustainable development principles are incompatible with it. It seems clear that mankind will have to choose between sustainable development for the happy few, or unsustainable development for all. The choice is definitely ours, and it will not be that easy to make.

Assumed labour flexibility and full employment

As for labour, Ricardo assumed flexibility was high enough on a national scale to adjust to the economic circumstances. In other words, people could move easily from one sector to another to fuel comparative advantage-driven demand. It was also assumed that the job market benefitted the workforce. This might have been the case in the early 19th century, when the degree of specialisation and the unemployment rate were quite low. However, things have changed greatly. In a complex environment, which requires highly specialised manpower, and stiff competition, Ricardo's postulates are no longer valid.

Governments can no longer count on the workforce's total flexibility. Experience shows how hard it

may be to achieve total flexibility. Experience shows how difficult it may be for an employee, having been made redundant, in one sector to acquire new qualifications and find a job in another sector. Granted, a society that is less averse to risk and more in favour of flexibility may cushion the aforementioned negative effects. Nevertheless, owing to overspecialisation, it becomes reality when a certain level of socioeconomic development is reached.

Another factor, to take into account, is that of individuals seeking to express themselves as soon as survival is taken for granted. It results in even less flexibility, since personal aspiration prevails over necessity when seeking a job. And, the trend has become worldwide as sustained global economic growth, which lifts an ever-increasing number of communities out of poverty, and boundless mass communications, which promotes a more individualistic vision of self, tends to accelerate the process throughout the developing world as well.



References

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