The theory of comparative advantage states that if countries specialize in producing goods where they have a lower opportunity cost – then there will be an increase in economic welfare. Note, this is different to absolute advantage which looks at the monetary cost of producing a good.

David Ricardo developed the classical theory of comparative advantage in 1817 to explain why countries engage in international trade even when one country's workers are more efficient at producing every single good than workers in other countries.

Comparative Advantage Theory

- David Ricardo, 'The Principles of Political Economy & Taxation', 1817.
- ***Nations can still gain from trade even without an absolute advantage.***
- Facilitator – Difference in opportunity cost
- A country has a Comparative Advantage in producing a good if the *opportunity cost* of producing that good in terms of other goods is lower in that country compared to other countries

Definition Comparative Advantage: Comparative advantage refers to the ability of a country to produce particular goods or services at lower opportunity cost as compared to the others in the field.

Assumptions & Criticisms of the Ricardian doctrine of Comparative Advantage

Assumptions	Criticisms
Theory only considers labour costs	Neglects all non-labour costs involved in the production
All labour to be homogenous	Labour is heterogeneous due to different grades and kinds
Similar tastes for all	The tastes differ with the growth of economies and income brackets
A fixed proportion of labour is used in the production of all commodities	Utilisation of the proportion of labour depends on the type of commodity being produced
Full employment	Every economy has an existence of underemployment

Adam Smith propounded the theory of absolute cost advantage as the basis of foreign trade; under such circumstances an exchange of goods will take place only if each of the two countries can produce one commodity at an absolutely lower production cost than the other country.

Absolute differences in production costs

Country	Commodity	
	A	B
Country I	10	20
Country II	20	10

Suppose, there are two countries I & II and two commodities A and B. For example, country can produce a unit of commodity (A) with 10 and a unit of commodity (B) with 20 labour units, and that in country II, the production of a unit of (A) costs 20 and a unit of (B) 10 labour units. Now country I has absolute cost advantage in the production of (B) and it will confine itself to the production of (B) and country II in the production of (A). Exactly the same would happen if I and II were two regions of one country. We speak of an absolute- differences in costs because each country can produce one commodity at an abso!utely lower cost them the other. Thus, in such a situation, a division of labour between them must lead to an increase in total output.