Comparative Cost Theory

In 1817, Ricardo Published his Principles of political Economy and Taxation, in which he presented the law of comparative advantage.

According to this law, even if one nation is less efficient than the other nation in the production of both commodities, there is still a basis for mutually beneficial trade. The first nation should specialize in the production and export of the commodity in which its absolute disadvantage is smaller, and import of the commodity in which its absolute disadvantage is greater.

- Exported commodity will represent the situation of comparative advantage.
- while imported commodity will represent the Situation of comparative disadvantage.

	US	UK
wheat (bushels / hour)	6	1
Cloth (Yards / hour)	4	2

In the given table United Kingdom (UK) has absolute disadvantage in the production of both wheat and cloth with respect to the United States (US). Let U.K labour is half as productive in cloth but six times less productive in wheat with respect to the United states, the United Kingdom has a comparative advantage in cloth.

On the other hand, the United states has an absolute advantage in both wheat and cloth with respect to the United kingdom, but since its absolute advantage is greater in wheat (6:1) than in Cloth (4:2), the U.S has a comparative advantage in wheat.

According to this law both nations can gain if the U.S specializes in the production of wheat and exports some of it in exchange for British cloth.

In a two nations, two commodity model, once it is determined that one nation has a comparative advantage in one commodity, then the other nation must necessarily have a comparative advantage in the other commodity.

US would be indifferent to trade if it received only 4C from the U.K in exchange for 6W, since the U.S can produce exactly 4C domestically and would certainly not trade if it received less than 4C for 6W. Similarly, the U.K would be indifferent to trade if it had to give up 2C for each W it received from U.S and certainly would not trade if it had to give up more than 2C for W.

For gain of both the nations U.S could exchange 6W for 6C with U.K. The U.S would then gain 2C since the US could only exchange 6W for 4C domestically. And U.K would receive 6W from US which requires 6hours to produce in the United kingdom.

The U.K could use these six hours to produce 12C and give up. Only 6C for 6W from the U.S.

Hence both nations can gain from trade even if one of them is less efficient than the other in the production of both commodities.

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