Theory of absolute advantage

Science

“ If a foreign country can supply us with a commodity cheaper than we ourselves can make it, [we had] better buy it of them with some part of our own industry, employed in a way in which we have some advantage.”

-Adam Smith (WN, IV. ii. 12)

This means that a nation produces and exports those commodities which it can produce more cheaply than other nations, and imports those which it cannot. A nation will not produce a good that is produced more expensively at home than abroad –be it “ a thirtieth, or even a three hundredth part more” (WN, IV. ii. 15) In economics, absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce more of a good or service than competitors, using the same amount of resources.

Adam Smithfirst described the principle of absolute advantage in the context of international trade, using labor as the only input. Since absolute advantage is determined by a simple comparison of labor productivities, it is possible for a party to have no absolute advantage in anything; in that case, according to the theory of absolute advantage, no trade will occur with the other party. It can be contrasted with the concept of comparative advantage which refers to the ability to produce a particular good at a lower opportunity cost.

Origin of the theory

During the seventeenth and eighteenth centuries the dominant economicphilosophywas mercantilism, which advocated severe restrictions on import and aggressive efforts to increase export. The resulting export surplus was supposed to enrich the nation through the inflow of precious metals. Adam Smith (1776), who regarded as the father of modern economics, countered mercantilist ideas in his famous book, The Wealth of Nations, by developing the concept of absolute advantage.

He argued that it was impossible for all nations to become rich simultaneously by following mercantilist prescriptions because the export of one nation is another nation's import. However, all nations would gain simultaneously if they practiced free trade and specialized in accordance with their absolute advantage. This international specialization of factors in production would produce increase in world output. The theory of absolute advantage itself is normally presented with an example of two countries and two commodities (2x2 model). Each nation can produce one good with less expenditure of human labor than the other and thus more cheaply. As a result, each nation has an absolute advantage in the production of one good.
Example

Consider the table below, which shows that Nation A has an absolute advantage over Nation B in terms of producing sugar, while Nation B has an absolute advantage over Nation A in producing rice. If Nation A will concentrate in the production of sugar and Nation B will focus on the production of rice, the combined production of rice and sugar of both countries would be greater, and these two countries would share in this increase from exchange, and both will benefit from the higher output of both commodities.

If both nations start trading with each other, each nation will specialize in the production of the good it has an absolute advantage in and obtain the other commodity through international trade. More units of both commodities can be produced overall because the given resources are utilized more efficiently. Through trade, both nations are able to consume more units of at least one commodity. In our example above, Nation A would specialize completely in sugar and Nation B in rice.

There are no further gains from international trade beside this one-off increase in the overall production and thus consumption. Nothing more happens. Though Smith successfully established the case for free trade, he did not develop the concept of comparative advantage. Because absolute advantage is determined by a simple comparison of labor productivities, it is possible for a nation to have absolute advantage in nothing. Smith stressed the importance of division of labor

Smith's thoughts on the division of labor constitute the basis for his theory. For him, it is the division of labor that leads to " the greatest improvement in the productive powers of labor" (WN, I. i. 1). As a result of a more advanced division of labor, more output can be produced with the same amount of labor. The division of labor leads to quantitative and qualitative production improvements. This means that output is increased, technological development is stimulated, and workers' skills and productivity are enhanced. As a result, economic growth is promoted and national wealth increases. This can be summarized as " the more specialization, the more growth" (Staley 1989, 43)

Criticisms on Smith's theory

Subsequent economists did not pay attention to Smith's theory of absolute advantage. In general, it is not seen as relevant because of the predominance of the theory of comparative advantage, which " has been the bedrock on which all subsequent developments in the theory of international trade have rested" (Maneschi 1998, 10). As a result, Smith's theory was barely noticed and not developed any further. Nonetheless, many of today's textbooks deal briefly with the theory of absolute advantage, which is ascribed to Smith. They portray Smith's theory as " a stepping-stone to a more sophisticated theory" (Staley 1989, 52), namely the theory of comparative advantage that is attributed to David Ricardo.

The presentation of Smith's international trade theory in textbooks is essentially standardized and does not vary significantly. Textbooks emphasize that the theory of absolute advantage " can explain only a small part of world trade" (Salvatore 2011, 37). Thus, it is seen as a special case of the theory of comparative advantage and both theories are seen as complementary (Dieckheuer 2001, 50). Smith is often criticized for not being able to come up with the more sophisticated theory of comparative advantage (Zhang 2008, 3). In comparison to Ricardo, Smith is described as a " poor trade theorist" and his theory as a " naïve theory" (Mehmet, 1999, 47).