

MISCONCEPTIONS ABOUT COMPARATIVE ADVANTAGE

There is no shortage of muddled ideas about economics; this is particularly true in international economics. Pick up the paper and you're likely to find at least one article that makes foolish statements about international trade.¹

Myth #1: "Free trade is beneficial only if your country is strong enough to stand up to foreign competition."

Many well-educated people believe this. Well-known historian Paul Kennedy criticized the case for free trade, asking "What if there is nothing you can produce more cheaply or more efficiently than anywhere else, except by constantly cutting labor costs?"

What is Kennedy's argument? He believes that if you do not have an absolute advantage, then you cannot gain from trade. He worries that a country might not have an absolute advantage in anything. What is his error? The gains from trade depend on comparative advantage, not absolute advantage. An absolute productivity advantage over other countries in producing a good is neither a necessary nor a sufficient condition for comparative advantage in a good. In our simple example, Foreign had higher productivity in both sectors, but a comparative advantage in only one good. (This shows that absolute advantage is not sufficient to guarantee comparative advantage.) Home lacked absolute advantage in both sectors, yet still had a comparative advantage in one sector. (This shows that absolute advantage is not even necessary for comparative advantage.)

¹This section follows Krugman & Obstfeld, International Economics, sixth edition, pp. 23-26.

Why? The reason is clearly shown by our one factor model: The comparative advantage of an industry depends not only on its productivity relative to the foreign industry, but also on the domestic wage rate relative to the foreign wage rate. Both countries' wage rates depend, in turn, on the productivity of their other industries. In our numerical example, Home is less productive in both industries and its overall wage rate must be lower BEFORE trade.

It is axiomatic that, in the long run, a good will be produced where its production is least costly. Once trade begins, Foreign's comparative advantage means that it will have a lower production cost of one good (tea in our example). Since labor is the only cost of production, we can write the monetary cost of producing Tea as the money wage, W (\$/hour), divided by the output per hour, o_{LT} (bushels/hour). The result is the cost per unit of the good, as you can see from its units (\$/bushel).

$$\frac{w^*}{o_{LT}^*} < \frac{w}{o_{LT}} \quad \text{Foreign's tea production is less costly than Home's.}$$

$$\frac{o_{LT}}{o_{LT}^*} < \frac{w}{w^*} \quad \text{Rearrange to see that Home's relative wage exceeds its relative productivity in its comparative disadvantage good, T.}$$

$$\frac{2}{4} < \frac{w}{w^*} \quad \text{Substitute in the values of the output coefficients.}$$

$$0.5 < \frac{w}{w^*} \quad \text{Divide to reveal that Home's wage must be more than one-half Foreign's wage, to preserve Foreign's comparative advantage in tea.}$$

Home's comparative advantage means that it will have a lower production cost of one good (shoes in our example):

$$\frac{w}{o_{LS}} < \frac{w^*}{o_{LS}^*}$$

Home's shoe production is less costly than Foreign's.

$$\frac{w}{w^*} < \frac{o_{LS}}{o_{LS}^*}$$

Rearrange to see that Home's relative wage is less than its relative productivity in its comparative advantage good, S.

$$\frac{w}{w^*} < \frac{6}{8}$$

Substitute in the values of the output coefficients.

$$\frac{w}{w^*} < 0.75$$

Divide to reveal that Home's wage must be less than three-fourths of Foreign's wage, to preserve Home's comparative advantage in shoes.

In the real world, as you will read in the news analysis assignment on Aplya, Pakistan has lower productivity in producing clothing than the United States, but because Pakistan's productivity disadvantage is even greater in other industries, it pays low enough wages to have a comparative advantage in clothing all the same.

But isn't a comparative advantage based on low wages somehow unfair? Many people think so; their beliefs are summarized by our second misconception:

Myth #2: "Foreign competition is unfair and hurts other (importing) countries when it is based on low wages." This argument, also known as the *pauper-labor argument*, is a particular favorite of labor unions seeking protection from foreign competition.

Again, our simple example reveals the fallacy of this argument. Consider our example from the point of view of the high-wage country, Foreign. Foreign is more productive in both industries, and Home's lower cost of shoe production is entirely due to its lower wage rate. However, Home's lower wage rate is irrelevant to the question of whether Foreign gains from trade. Whether the lower cost of shoes produced in Home is due to high productivity or low wages does not matter. All that matters to Foreign is that it is cheaper *in terms of its own labor* to produce tea and trade it for shoes than to produce shoes for itself.

This is fine for Foreign, but what about Home? Isn't there something wrong with basing one's exports on low wages? Certainly, it is not an attractive situation. Yet, the idea that trade is good only if you receive higher wages than the other country is our final fallacy for today:

Myth #3: "Trade exploits a country and makes it worse off if its workers receive much lower wages than workers in other nations." This argument is often expressed in emotional terms. For example, one columnist (Bob Herbert, "Sweatshop Beneficiaries: How to Get Rich on 56 Cents an Hour," NYT 7/24/95, p. A13) contrasted the \$2 million annual income of the chief executive officer of The Gap with the \$0.56/hour paid to the Central America workers who produce some of its merchandise. It can seem hard-hearted to try to justify the terrifyingly low wages paid to many of the world's workers.

If one is asking about the desirability of free trade, however, the point is not to ask whether low-wage workers deserve to be paid more. Instead, we must ask whether they are

worse off exporting goods based on low wages than they would be if they refused to enter into such demeaning trade. And in asking this question we must also ask, *what is the alternative?*

Abstract though it is, our one-factor model makes the point that one cannot declare that a low wage represents exploitation unless one knows what the alternative is. In our example, Home's workers are paid less than Foreign's workers, and one could easily imagine a columnist writing angrily about their exploitation. Yet if Home refused to let itself be "exploited" by refusing to trade with Foreign (or by insisting on much higher wages in its export sector, which would have the same effect), real wages would be even lower: The purchasing power of a worker's hourly wage would fall from 2.5 to 2 (bu./hr.).

The columnist who pointed out the contrast in incomes between the executive at The Gap and the workers who make its clothes was angry at the poverty of Central American workers. But to deny them the opportunity to export and trade might well be to condemn them to even deeper poverty.

As a footnote to this discussion, it may be useful to discuss what we mean by exploitation. The Merriam-Webster dictionary offers two definitions for the root word exploit:

Main Entry: ²**ex·ploit**

Pronunciation: ik-'sploit, 'ek-"

Function: *transitive verb*

1 : to make productive use of : **UTILIZE** <exploiting your talents> <exploit your opponent's weakness>

2 : to make use of meanly or unjustly for one's own advantage
<*exploiting* migrant farm workers>

It is, of course, the second definition to which we refer above. Exploitation also has some much more specific definitions in economics. Karl Marx, a classical economist, believed that capitalism would always exploit the workers:

Specialty Definition: Exploitation theory

(From [Wikipedia](#), the free Encyclopedia)

The **exploitation theory** is the Marxist theory that profit is the result of the exploitation of wage earners.

It rests on the labor theory of value which claims that value is intrinsic in a product according to the amount of labor that has been spent on producing the product. Thus the value of a product is reflected in it's (sic) finished price which in turn is divided between labor (wages) and capital (profit) - the raw materials are further divided between labor and capital. Therefore the profit is taking away some of the value that results from labor away from the workers.

The Austrian economist Eugen von Böhm-Bawerk critiqued the exploitation theory. He argued that capitalists do not exploit workers; they accommodate workers-by providing them with income well in advance of the revenue from the output they helped to produce.

Source: the above text is adapted by [the editor](#) from [Wikipedia](#), the free encyclopedia under a [copyleft GNU Free Documentation License \(GFDL\)](#) from the article "[Exploitation theory](#)."

“There is a sense in which nothing is produced. The laws of physics tell us that the sum total of mass and energy can be neither increased nor reduced. What we call “production” is the rearrangement of matter and energy from less useful to more useful (to us) forms.

It is sometimes said that middlemen – retailers and wholesalers – merely move things about while absorbing some of the value that other people have produced. But all *anyone* does is to move things about – to rearrange from less to more useful. The producer rearranges iron ore and other inputs into automobiles; the retailer rearranges automobiles on a lot into automobiles paired up with particular customers. Both increase the value of what they work on and collect their income out of that increase.

It is sometimes said that some participants in the economy exploit others --- most commonly the employers exploit workers. Two different definitions of exploitation are implicit – simultaneously – in such discussions. The first is that I exploit you if I benefit by your existence. In this sense, I hope to exploit my wife and she hopes to exploit me; so far we have both succeeded. If that is what exploitation means, then it is the reason that humans are social animals and not, like cats, solitary ones.

The friends who rent our third floor are enthusiastic gardeners; we are not. We get free gardening; they get free use of a yard to garden in. Who is exploiting whom?

The second definition is that I exploit you if I gain *and you lose* by our association. The connection between the two can be made either by claiming that the world is a zero-sum game in which one person can gain only at another person's expense, or by arguing that *if I gain by our association you deserve to have the gain given to you, so my refusal to give it to you injures you*. The former argument is implausible. The *second* has a curious asymmetry. *If I give you all the gain, you have now gained by our association and should give it all back to me* (emphasis added). It may be more sensible to keep "exploitation" out of discussions of economics and reserve it for political invective."