FACULTY OF JURIDICAL SCIENCES

Lecture-6

Adam Smith’s Absolute Cost Advantage Theory

Adam Smith’s theory of absolute cost advantage in international trade was evolved as a strong reaction of the restrictive and protectionist mercantilist views on international trade. He upheld in this theory the necessity of free trade as the only sound guarantee for progressive expansion of trade and increased prosperity of nations. The free trade, according to Smith, promotes international division of labor.

Every country tends to specialize in the production of that commodity which it can produce most cheaply. Undoubtedly, the slogans of self- reliance and protectionism have been raised from time to time, but the self-reliance has eluded all the countries even up to the recent times. The free and unfettered international trade can make the countries specialize in the production and exchange of such commodities in case of which they command some absolute advantage, when compared with the other countries.

In this context, Adam Smith writes; “Whether the advantage which one country has over another, be natural or acquired is in this respect of no consequence. As long as one country has those advantages, and the other wants them, it will always be more advantageous for the latter, rather to buy of the former than to make.”

When countries specialize on the basis of absolute advantage in costs, they stand to gain through international trade, just as a tailor does not make his own shoes and shoemaker does not stitch his own suit and both gain by exchanging shoes and suits.

The trade theory that first indicated importance of specialization in production and division of labor is based on the idea of theory of absolute advantage which is developed first by Adam Smith in his famous book The Wealth of Nations published in 1776. Later on David Ricardo in his book titled On the Principles of Political Economy published in 1819 extended it to incorporate theory of comparative advantage and showed that it is the basis why nations need to trade and why trade is mutually beneficial to countries. Absolute Advantage: If a country or individual absolutely more efficient at production of a good than another country or individual, then we say that she has absolute advantage in the production of that good. Comparative Advantage: If a country or individual is relatively more efficient in the production of a good than another country or individual then we say that she has comparative advantage in production of that good. Comparative advantage measures efficiency in terms of relative magnitudes. Since countries have limited resources and level of technology they tend to produce goods or services in which they have a comparative advantage. Comparative advantage (from now on CA) implies an opportunity cost associated with the production of one good compared to another. That is why countries tend to specialize in production of certain products. This notion is called international division of labor.

Adam Smith, the father of economics, thought that the basis of international trade was absolute cost advantage. According to his theory, trade between two countries would be mutually beneficial if one country could produce one commodity at absolute advantage (over the other commodity) and the other countries could, in turn, produce another commodity at an absolute advantage over the first.

In other words, the principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce a greater quantity of a good, product, or service than competitors, using the same amount of resources. Adam Smith first 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 productiveness, 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 specific goods at a lower opportunity cost.

Assumptions of the Absolute Advantage Theory

1) Trade between the two countries.
2) He took into consideration a two-country and two-commodity framework for his analysis.

3) There is no transportation cost
4) Smith assumed that the costs of the commodities were computed by the relative amounts of labor required in their respective production processes.
5) He assumed that labor was mobile within a country but immobile between countries
6) He implicitly assumed that any trade between the two countries considered would take place if each of the two countries has an absolutely lower cost in the production of one of the commodities.

Criticisms

Adam Smith, no doubt, provided a quite lucid explanation of the principle of absolute cost advantage as the basis of international transactions, yet his theory has certain weaknesses.

Firstly, this theory assumes that each exporting country has an absolute cast advantage in the production of a specific commodity. This assumption may not hold true, when a country has no specific line of production in which it has an absolute superiority. In this context Ellsworth says "Smith's argument is not very convincing as it assumed without argument that international trade required a producer of exports to have an absolute advantage, that is, an exporting country must be able to produce with a given amount of capital and labor a larger output than any rival. But what if a country has no line of production in which it was clearly superior."

Most of the backward countries with inefficient labor and machinery may not be enjoying absolute advantage in any line of activity. So the principle of absolute cost advantage cannot provide complete and satisfactory explanation of the basis on which trade proceeds among the different countries.

Secondly, Adam Smith simply indicated the fundamental basis on which international trade rests. The absolute cost advantage had failed to explore in any comprehensive manner the factors influencing trade between two or more countries.

Thirdly, the 'Vent for Surplus' doctrine of Adam Smith is not completely satisfactory. This doctrine can have serious adverse repercussions on the growth process of the backward countries. These countries do not sell their surplus produce in foreign markets but are constrained to export despite domestic shortages for the reasons of neutralizing their balance of payments deficit.