THEORY OF ABSOLUTE COST ADVANTAGE

Divya Kishore

Guest Faculty

Dept of Economics

RDS college, Brabu

- Adam Smith's theory of absolute cost advantage was evolved as a strong reaction of the restrictive and protectionist mercantilist views on International trade.

- **He talked about necessity of free trade as only guarantee for prosperity of nations.**
- **Every country tends to specialize in the production of that commodity whichit can produce most cheaply.**

- **Countries specialize in the production and exchange of such commodities in which they get some absolute advantage.**
- **Suppose there are two countries A and B and they produce two commodities X and Y.**

- The cost of these commodities is measured in terms of labour involved in their production.
- If each counyhas it’s disposal 2 man- days and 1 man – day is devoted to the production of each of the two commodities.

- **The respective production in two countries can be shown through hypothetical table -**

Country	Units of labour	Commodities X.	Y	Ratio of exchange
A	1	20.	10	1 unit of X = 0.5 unit of Y
B	1	10.	20	1unit of X = 2 units of Y

- **From the above table , it is shown that, in a country A, 1 man- day of labour can produce 20 units of X but 10 units of Y.**
- **In country B , 1 man day of labour can produce 10 units of X but 20 units of Y**

- **It signifies that county A has an absolute advantage in producing X while country B enjoys absolute advantage in producing commodity Y.**
- **Country A may be willing to give up 1 unit of X fir having 0.5 unit of y.**
- **Country B may be willing to give up 2 units of y to have 1 unit of X.**

- **If country A specializes in the production and export of commodity x and country B specializes in production and export of commodity y, then both the countries stand to gain.**

- **The absolute cost advantage of country A in the production of X and that of B in production of Y can be expressed as –**

$$\frac{\text{20 units of X in A.}}{\text{10 units of X in B.}} > 1 >. \frac{\text{10 units of y in A}}{\text{20 units of y in B}}$$

CRITICISM OF THE THEORY

1. This theory assumes that each country has an absolute cost advantage in production of a specific commodity. This may not hold true if a country has no absolute advantage in any line of activity.
2. This theory failed to explore the favors influencing trade between two or more countries.