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Comparative Advantage, not *Competitive* Advantage

Please do not confuse the famous, big idea of **Comparative Advantage** by David Ricardo (1817) with M. Porter`s much more recent idea, popular in business schools, of `Competitive Advantage`.

Comparative advantage is a core idea in international trade theory and, indeed, the foundation for all trade, within a country`s borders as well. One could even say it is the core concept in micro theory as well. The gains from specialization and exchange in Ricardo`s international trade apply equally well among countries and across industries and professions *within* an economy.

In the 1980s, Michael Porter published several books and an article in the *Harvard Business Review* which talked about what he called the `Competitive Advantage of Nations`. It is a not a theory taught in economics, though many of the ideas he mentioned have entire subfields of economics dedicated to them, (for example, economies of scale, agglomeration effects, strategic trade theory, etc.) all of which pre-date Porter`s work.

From M. Porter`s 1990 Harvard Business Review article, "The Competitive Advantage of Nations", he writes:

"*National prosperity is created, not inherited. It does not grow out of a country's natural endowments, its labor pool, its interest rates, or its currency's value, as classical economics insists*."

He is responding, in direct contrast, to what "classical" economists teach. That is to say, he is arguing against what is taught in current classrooms in MIT, Harvard (Economics), the University of Tokyo and Yokohama National University. There are many theories in international trade theory (I will introduce some of them this year), but the main two theories to which Porter is referring are: 1) our Ricardian Theory (which we study this semester) and 2) the factor endowments, or "Heckscher-Ohlin" model, which is taught in other trade courses, my zemi, and all major textbooks today.

It is true, as Porter says, `National prosperity is sometime created`. But the standard (and rigorous) models we use in trade theory can tell us a lot about why trade occurs. Porter's concept is much broader, lacks any mathematical rigor, is quite vague, and is typically supported by anecdotal evidence rather than systematic, econometric testing. This is not to say that his idea is necessarily wrong. It is simply that his concept is not found to be very useful for trade economists in trying to answer questions as to why countries trade, who trades what, and what the sources of gains from trade are, and lastly what is the impact of various trade policy on consumers, producers, and the overall welfare of a nation.

So, comparative advantage is a very specific concept which can be expressed mathematically, either in the original Ricardian terms (with a single input of labor), or in a two-factor model (Heckscher-Ohlin model).

Economist do, *sometimes*, used the word “competitiveness” in the context of international trade. But this is not “*competitive advantage*”, which is the “construct” of Prof. Porter. We (international economists) do not use this term, though sometimes we use the word `international competitiveness`. By this we mean, for example, a country may not have a very large comparative advantage in a good, indeed, at first, it may have a small comparative *disadvantage*. But then, their country may keep its currency rate artificially low and this gives them a cost advantage in world markets. In textbooks by economists like Krugman and Obstfeld`s, we would say that the undervaluation of the currency increases the country`s *competitiveness* in exports. Related to this, we often talk of the fear of “competitive devaluations”. A competitive devaluation is a situation in which, for example, Japan depreciates the yen, in order to boost exports, but then, this, in turn, has “domino effect”, in which, say, South Korea then also brings about a depreciation in the won to better compete with Japanese exports, and so on and so on. We never say the word “competitive advantage”, unless we are (for some reason) referring the business school concept of Porter.

In principle, all students in Economics and Business Schools (undergrad and also MBAs) study microeconomics. It is a required course for all. They all learn absolute advantage and comparative advantage. Usually after they graduate they forget, and often confuse, the two (absolute and comparative advantage) theories. Aside from forgetting the brilliant insight of Ricardo’s comparative advantage which shows us that ALL countries gain from trade, no matter how unproductive (in absolute terms) a country is, sometimes people say, “Poor Country ABC; they don`t have a comparative advantage in anything…” This is wrong. This is impossible. Every country will, indeed, must have a comparative advantage in some good.[1]

The other big mistake people make is in saying that Comparative Advantage was Adam Smith`s idea. It was not. Smith`s idea (absolute advantage and the gains from trade) was great and began economics as a field of study, but Ricardo added to this with his deeper insight of Comparative Advantage.

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[1] There is the possibility, of course, that a country may have a comparative advantage in some good, but cannot export it due to “land-locked-ness” or other high transportation costs (think of the Democratic Republic of the Congo, or Nepal.) Also, while exports resulting from a true, underlying comparative advantage should bring gains, some trade, especially that which is artificially created by government intervention (for example, production or export subsidy) can make a country worse off. Consider a country which subsidies and exports a good for a price below market prices or cost. This will surely make the exporting country worse off, even though they may have a trade surplus.

David Ricardo’s education and background: He was working in finance (and was very successful) before becoming a member of parliament and political philosopher. He studied with and was friends with the great minds of the time, Malthus, James Mill, Jeremy Bentham.

Michael E. Porter is a Professor at the Harvard Business School.

His educational background: BA Engineering, Princeton Univ, MBA from Harvard Business School, then PhD in *Business Economics* from Harvard University.

References

By Porter

Porter, Michael E. (1980) “Competitive Strategy…”

Porter, Michael E. (1985) “The Competitive Advantage of Nations…” . This is a book that has many recent editions. It is almost 900 pages long.

By Ricardo

Ricardo, David (1817), “On the Principles of Political Economy and Taxation”

Full version here.

http://www.gutenberg.org/files/33310/33310-h/33310-h.htm

He discusses many topics in addition to his idea of Comparative Advantage (in Chapter VI, about 20 pages).