

Title: Reconciling Ricardo's Comparative Advantage with Smith's Productivity Theory

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Abstract

There are three main claims in this paper: First, there is sufficient evidence for affirming that Ricardo adhered to Smith's productivity theory; second, Ricardo's original demonstration of the comparative-advantage proposition is indeed compatible and complementary with respect to the latter; and third, Ricardo agreed with Smith's multifactorial explanation of the pattern of trade, which includes increasing returns and economies of scale.

These results open the way for the reincorporation of Ricardo's propositions into Smith's multifactorial explanation of trade patterns. They also add a new perspective to the ongoing process of reassessment of Smith's contributions to international trade theory, further strengthening the view that he was indeed a great international trade theorist.²

Keywords: comparative advantage, David Ricardo, Adam Smith, international trade theory, division of labor, free trade.

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Introduction

The end of all commerce is to increase production.

David Ricardo, Principles (1817)

Throughout the 19th century economists relied mostly upon Adam Smith's celebrated book *An Inquiry into the Nature and Causes of the Wealth of Nations* ([1776] 1976) for praising the benefits of specialization and free trade. For the most part of the 20th century, however, the perception prevailed that Smith was not an outstanding international trade theorist because he allegedly failed to discover the "law" of comparative advantage.³ Since the neoclassical theory of static comparative advantage was generally regarded as the high-point of free trade thinking (Viner, 1937, p. 104), all the other contributions to international trade theory had to be evaluated in terms of how close they came to the comparative-advantage statement (Elmslie and James, 1993). According to this yardstick, Smith's insights on international trade seem to be obsolete.⁴

In the late 1970s Smith's contributions to international trade theory started to receive more attention and appreciation.⁵ This process gained considerably more steam during the 1980s with the formulation of the so called *New Trade Theory*, in which traditional trade models based on the neoclassical theory of static comparative advantage were supplemented by new trade models emphasizing increasing returns and technical progress. The demand for these new trade models originated from the fact that the traditional neoclassical models of static comparative advantage were inadequate for explaining the real-world trade pattern in those years, which was predominantly intradustry-trade (Krugman, 1993; 2009).

³ The list of those who have criticized Smith for not discovering the "law" of comparative advantage is actually too long to mention here. Some of these critics, however, also acknowledge and appreciate Smith's positive contributions to international trade theory, like Bloomfield (1994 [1975]), Mynt (1977), Kurz (1992) and Blecker (1997). For a brief overview of other prominent critics of Smith, see Bloomfield (1994, pp. 109-110).

⁴ Bloomfield (1994, p. 111) states: "Admittedly, Smith was not a great trade theorist, but he comes up, on the whole, with a performance that deserves respectful consideration."

⁵ See West (1978).

The proponents of the New Trade Theory pioneered some novel modeling techniques, but the aspects they were trying to emphasize in their trade models were not new at all. They were already present in Smith's explanation of the benefits of international trade in the *Wealth of Nations*.⁶ This led to the current perception that Smith was a much better international trade theorist than he had previously been given credit for (Elmslie and James, 1993, p. 72).

Notwithstanding this remarkable comeback, the last remaining stumbling block towards Smith's complete rehabilitation as an international trade theorist is still in place: the critique that he failed to discover the "law" of comparative advantage as defined by the neoclassical theory of international trade. Furthermore, the greater emphasis on increasing returns has widened the perceived rift between Smith's contributions to international trade theory and the static view of comparative advantage attributed to fellow classical political economist David Ricardo. Some scholars have even gone as far as to affirm that Smith and Ricardo had opposing logics of trade.⁷

Prior research efforts have been headed towards discovering some traces of comparative advantage in the *Wealth of Nations* (Elmslie and James, 1993; Elmslie, 1994a) and re-evaluating the role of absolute advantage so that it is not perceived merely as a flawed antecedent of comparative advantage (Blecker, 1997). A more or less common theme of these efforts has been the view that in order to achieve the goal of completely rehabilitating Smith as an outstanding international trade theorist, one has to bring his insights on international trade somehow closer to the comparative-advantage proposition. The present paper will show that the same goal can be accomplished more easily by reintegrating the latter to Smith's framework.

Fortunately, all the necessary pieces for accomplishing the task are already in place. The point of departure is the accurate interpretation of the four numbers in the famous numerical demonstration of comparative advantage in Ricardo's book *On the Principles of Political*

⁶ The Smithean origin of the *New Trade Theory* have been highlighted by several authors, for example West (1990), Elmslie and James (1993), Kurz (1997) and Kibritcioglu (2002). It is also recognized by at least one of the leading proponents of the *New Trade Theory* (Krugman, 1990). For the relationship between the division of labor and technological progress see Elmslie (1994b).

⁷ See Buchanan and Yoon (2002). Russ Roberts has recently echoed the notion about Smith's and Ricardo's distinct and opposing logics of trade in his popular podcast EconTalk (http://www.econtalk.org/archives/2010/02/roberts_on_smit.html). This may lead to a greater divulgence of this notion among current economic students, which are presumably the largest group of subscribers to Roberts' podcast.

Economy and Taxation ([1817] 2004). As Ruffin (2002; 2005) has shown, they should be interpreted as the number of men working for a year required to produce *some unspecified amounts* of wine and cloth traded between England and Portugal.⁸ The correct interpretation of the numerical example has led to a better understanding of its original purpose. As I have argued in a previous paper (Morales Meoqui, 2011), the main purpose of the numerical example was to prove the new proposition that the labor theory of value does not regulate the relative value of commodities in international trade when the factors of production are immobile between countries. Ricardo then mentioned the associated corollary regarding comparative advantage, i.e. that a country might import a certain amount of a commodity although it can produce these commodities internally with less amount of labor than the exporting country.

Based on the above interpretation of the numerical example in the *Principles*, the present paper argues that Ricardo agreed with Smith's famous proposition that the extension of the market provided by foreign trade would lead to productivity gains at home. Furthermore, the paper refutes the notion that Ricardo offered an alternative explanation for international trade patterns by showing that he actually agreed with Smith's multifactorial explanation of the pattern of trade.

The first section of the paper outlines the two explanations of the origin and benefits of international trade and rejects the attribution of the constant-labor-costs assumption to Ricardo. The second section is dedicated to prove that Ricardo actually adhered to Smith's productivity theory. The third section identifies the relevant cost comparison for specialization and trade. The fourth section argues that Ricardo agreed with Smith's multifactorial explanation of trade patterns, which includes increasing returns and economies of scale. The last section before the conclusions outlines what all of this means for the reassessment of Smith's contributions to international trade theory.

⁸ Sraffa (1930, p. 541) interpreted Ricardo's numbers as number of men whose labor is required for one year in order to produce a given quantity of cloth and wine. Ruffin pointed out in a personal communication with me that Sraffa's interpretation was correct but incomplete since it did not say that Ricardo's numbers were the amounts of labor contained in the amounts of cloth and wine traded. Ruffin's interpretation has rapidly gained supporters – Maneschi (2004, 2008), Aldrich (2004) and Morales Meoqui (2011) and Rassekh (2012).

Two Explanations regarding the Origin and Benefits of Trade

As Smith explains in the *Wealth of Nations*, the division of labor plays a pivot role in increasing the wealth of individuals as well as nations.⁹ Individuals specialize and trade with each other within and between national borders because in that way they become more productive and can obtain a greater amount of commodities and services for consumption. Concentrating the individual productive effort on a narrow range of goods — or even a single type of commodity or service — in the vast majority of cases pays off, since trading is often a more efficient mean of procuring goods for consumption than self-production.

According Smith (*WN*, I.i.5, p. 17), the increase in productivity due to the division of labor can be attributed to three factors: first, “to the increase of dexterity in every particular workman; secondly, to the saving of the time which is commonly lost in passing from one species of work to another; and lastly, to the invention of a great number of machines which facilitate and abridge labour, and enable one man to do the work of many.”

Based on his well-known proposition that the division of labor is limited by the extent of the market (*WN*, I.iii.1, p. 31)¹⁰, Smith further argues that free trade would make a crucial contribution to the purpose of increasing the wealth of individuals and nations to the utmost, since the extension of the market beyond national borders encourages the division of labor and spurs labor productivity at home. Thus, specialization and free trade are intertwined with the quest for economic growth and development. In the present paper I will borrow the denomination coined by Hla Myint and refer to this benefit from trade as Smith’s productivity theory.¹¹

Despite the theoretical and empirical soundness of Smith’s productivity theory, for the most part of the 20th century the main framework for praising the benefits of specialization was an alternative view commonly attributed to Ricardo. This alternative view – which Buchanan and

⁹ Smith (*WN*, I.i.1, p. 13) famously states: “The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which it is any where directed, or applied, seem to have been the effects of the division of labour.”

¹⁰ Young (1928, p. 529) considers this proposition as one of the most illuminating and fruitful generalizations which can be found anywhere in the whole literature of economics.

¹¹ See Myint (1958, p. 318 and 1977, p. 242).

Yoon (2002) coined as the *Ricardian logic of trade* – locates the origins of exchange in the differences among individuals or countries in terms of their capacities to produce separate final goods. According to this alternative view, trade emerges because individuals or countries have different comparative advantages in producing different goods. If such differences exist, specialization will always prove to be mutually beneficial. If one assumes, on the contrary, that individuals or countries are identical in both their preferences and respective capacities to produce these final goods, then trade among them could not take place because it would not yield any benefits (Buchanan and Yoon 2002, p. 400).

As Buchanan and Yoon further point out, there is a subtle reversal of the logical sequence between these two alternative explanations of the origin and benefits of trade. According to the explanation provided by Smith, trade emerges because of the inherent advantages of specialization. The observed differences among trading partners are the consequence of their respective specialization — not the point of departure. As Smith famously wrote in the *Wealth of Nations*, the differences between a philosopher and a street porter may be small prior to their individual commitment to their respective profession (*WN* I.ii.4, pp. 28-29). In the alternative explanation currently attributed to Ricardo, though, specialization and subsequent trade can only emerge because of inherent and preexisting differences among potential trading partners. The interest in the exchange would continue as long as these differences persist, and would cease if the differences disappear over time.

When attributing this alternative explanation to Ricardo, it is usually assumed that the so called Ricardian trade model which can be found in contemporary economic textbooks is essentially equivalent to what is actually written in the *Principles*. As Ruffin (2002) and Maneschi (2004, 2008) have already acknowledged, though, Ricardo's demonstration of the comparative-advantage proposition is quite different from the typical textbook trade model. So although the current denomination suggests otherwise, one should not attribute the assumptions and implications of the Ricardian trade model automatically to Ricardo.

Take for example the constant-labor-costs assumption, upon which the whole notion about Ricardo's alternative logic of trade appears to rest. This prominent assumption of the textbook trade model stipulates that the amount of labor needed for producing a single unit of a commodity or service do not vary with the amount of commodities or services produced. The

constant-labor-costs assumption is indeed incompatible with Smith's productivity theory, since the latter stipulates that an ever-increasing amount of commodities and services is produced with less amount of labor, because the division of labor and the invention and deployment of sophisticated machinery spurs labor productivity. It implies increasing returns to scale and decreasing labor costs per unit of production, not constant returns to scale.

The problem with this alleged incompatibility between the international trade theories of Smith and Ricardo is that it is based on an erroneous attribution of the constant-labor-costs assumption to the latter. The mistaken association of Ricardo with this unrealistic assumption is the consequence of the widespread but inaccurate interpretation of the four numbers in the famous demonstration of the comparative-advantage proposition in the *Principles* as unitary labor costs, which are assumed to remain constant. If the four numbers are interpreted accurately as the amounts of men working for a year required to produce some unspecified amounts of cloth and wine traded between England and Portugal, there is absolutely no need for making such an unrealistic assumption. Moreover, since the amounts of cloth and wine were not specified, it is not even possible to calculate the unitary labor costs in Ricardo's original numerical example.

So far I have not found the slightest trace of the constant-labor-costs assumption in the *Principles*. What I have actually discovered there is the complete opposite assumption, as one can appreciate in the following passage:

“An alteration in the permanent rate of profits, to any great amount, is the effect of causes which do not operate but in the course of years; whereas alterations in the quantity of labour necessary to produce commodities, are of daily occurrence. Every improvement in machinery, in tools, in buildings, in raising the raw material, saves labour, and enables us to produce the commodity to which the improvement is applied with more facility, and consequently its value alters. In estimating, then, the causes of the variations in the value of commodities, although it would be wrong wholly to omit the consideration of the effect produced by a rise or fall of labour, it would be equally incorrect to attach much importance to it; and consequently, in the subsequent part of this work, though I shall occasionally refer to this cause of variation, I shall consider all the great variations which take place in the relative value of commodities to be produced by the greater or less quantity of labour which may be required from time to time to produce them” (Ricardo, Vol. 1, pp. 36-37).

In the above quote Ricardo clearly affirms that the alterations in the quantity of labor necessary to produce commodities often occur on a daily basis. His assumption is in fact the complete opposite to constant labor costs.

Ricardo's adherence to Smith's productivity theory

The removal of the constant-labor-costs assumption from Ricardo's demonstration of the comparative-advantage proposition is an important first step for rejecting the claim that he offered in the famous numerical example an alternative explanation of the origin and benefits of trade. As a second step I will further argue that there is enough evidence in the *Principles* for affirming that Ricardo actually adhered to Smith's productivity theory and its associated explanation of the origin and benefits of trade. It is not too much of a stretch to imagine that Ricardo had this theory in mind when he wrote the following paragraph about the virtues of free trade in the chapter on foreign trade in the *Principles*:

“Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each. This pursuit of individual advantage is admirably connected with the universal good of the whole. **By stimulating industry, by rewarding ingenuity**, and by using most efficaciously the peculiar powers bestowed by nature, **it distributes labour most effectively and most economically**: while, **by increasing the general mass of productions**, it diffuses general benefit, and binds together by one common tie of interest and intercourse, the universal society of nations throughout the civilized world. It is this principle which determines that wine shall be made in France and Portugal, that corn shall be grown in America and Poland, and that hardware and other goods shall be manufactured in England (Vol. 1, pp. 133–134, emphasis added).”¹²

But perhaps the best textual proof for his adherence to Smith's productivity theory is the following passage of the *Principles*, where he (Vol. 1, p. 273) clearly paraphrases it:

¹² Throughout this paper, all direct quotations of Ricardo are extracted from *The Works and Correspondence of David Ricardo*, Volume I to XI, 2004, edited by Piero Sraffa. I will refer to them usually by indicating the volume and page numbers only.

“The labour of a million of men in manufactures, will always produce the same value, but will not always produce the same riches. **By the invention of machinery, by improvements in skill, by a better division of labour, or by the discovery of new markets, where more advantageous exchanges may be made, a million of men may produce double, or treble the amount of riches, of “necessaries, conveniences, and amusements,”** in one state of society, that they could produce in another, but they will not on that account add any thing to value; for every thing rises or falls in value, in proportion to the facility or difficulty of producing it, or, in other words, in proportion to the quantity of labour employed on its production” (emphasis added).

Besides making here an explicit reference to the division of labor, Ricardo also mentions two of the three factors that Smith identified as causes for an increase in productivity due the division of labor, namely the improvements in skill of the specialized worker, which Smith (*WN*, I.i.5, p. 17) calls the “the increase of dexterity in every particular workman”; and the invention of machinery. The “discovery of new markets” is equivalent to Smith’s proposition about the extension of the market.

Ricardo explicitly deals with the effects of an extension of the market at the beginning of chapter 7 when he states (Vol. 1, p. 128): “No extension of foreign trade will immediately increase the amount of value in a country, although it will very powerfully contribute to increase the mass of commodities, and therefore the sum of enjoyments. As the value of all foreign goods is measured by the quantity of the produce of our land and labour, which is given in exchange for them, we should have no greater value, if by the discovery of new markets, we obtained double the quantity of foreign goods in exchange for a given quantity of our’s.”

A few pages later Ricardo (Vol. 1, p. 132) further states: “It is not, therefore, in consequence of the extension of the market that the rate of profit is raised, although such extension may be equally efficacious in increasing the mass of commodities, and may thereby enable us to augment the funds destined for the maintenance of labour, and the materials on which labour may be employed. It is quite as important to the happiness of mankind, that our enjoyments should be increased by the better distribution of labour, by each country producing those commodities for which by its situation, its climate, and its other natural or artificial advantages, it

is adapted, and by their exchanging them for the commodities of other countries, as that they should be augmented by a rise in the rate of profits.”

The above references to the extension of the market in the *Principles* further indicate Ricardo’s agreement with Smith’s productivity theory. It is well known that Smith considered the positive effects of the extension of the market on labor productivity as one of two distinct benefits of foreign trade (*WN*, IV.i.31, pp. 446-447). It is also well known that Ricardo (Vol. 1, pp. 291-295) rejected the other benefit of foreign trade mentioned by Smith, which is known in the literature as the vent-for-surplus theory. If Ricardo would have disagreed with both benefits, then why did he criticize and reject only one of them?

It might seem a bit odd that Ricardo indicated his support for Smith’s productivity theory always in connection with specific critiques towards other aspects of Smith’s international trade theory. The explanation for this can be found in the general plan of the *Principles*. Ricardo conceived his book first and foremost as a compilation of propositions and insights that were either new or opposed to already established propositions of political economy. Therefore, a separate and lengthy analysis on a particular proposition or insight of Smith he agreed with would have run against the general plan of the book.

By conceiving the *Principles* in this way, though, Ricardo may have contributed to the perception that he and Smith had divergent and incompatible explanations regarding the origin and benefits of trade. Since Smith was the highest authority in the nascent science of political economy back then, the general plan chosen artificially emphasizes the differences and minimizes the level of agreement with respect to Smith. Ricardo himself was well aware of this danger, as the following paragraph from the preface of the *Principles* clearly proves:

“The writer, in combating received opinions, has found it necessary to advert more particularly to those passages in the writings of Adam Smith from which he sees reason to differ; but he hopes it will not, on that account, be suspected that he does not, in common with all those who acknowledge the importance of the science of Political Economy, participate in the admiration which the profound work of this celebrated author so justly excites” (Vol. 1, p. 6).

Notwithstanding his awareness about the potential risk, Ricardo decided to proceed with this general plan for the *Principles* because of a personal virtue rarely seen in other famous scientists:

humility. Ricardo was indeed a very humble and unpretentious man that had great self-doubts about his writing skills.¹³ Because of this self-diagnosed shortcoming, he preferred to leave the major task of presenting a complete view of his ideas on political economy perhaps for a future book. Unfortunately, Ricardo died six years after the publication of the *Principles*, at the early age of fifty-one. Contrary to his original intention, this book became the main source of his thoughts on political economy in general and international trade in particular.

From a methodological perspective, these biographical facts are highly relevant for an accurate interpretation of the main propositions in the *Principles*. These propositions cannot be accurately understood without taking into consideration the relevant passages of the *Wealth of Nations*. More importantly, one can generally presume that Ricardo agreed with those propositions of Smith which are not explicitly criticized and rejected in the *Principles*, at least until some scholar offers a convincing proof that this general presumption does not apply to a particular proposition.

Taking into consideration the absence of critique towards Smith's productivity theory as well as the quoted passages from the *Principles* where one can easily infer Ricardo's support for this theory, I believe that it is safe to affirm that he agreed with Smith's famous proposition that an extension of the market provided by foreign trade leads to productivity gains and economic growth at home. This conclusion is further strengthened by the removal of the constant-labor-costs assumption in Ricardo's demonstration of the comparative-advantage proposition. This means that the differences in the explanation of the origin and benefits of trade highlighted by Myint (1977) and Buchanan/Yoon (2002) can be considered as substantially correct if the comparison is made between Smith's productivity theory and the neoclassical theory of international trade, but not between Smith and Ricardo.

The Relevant Cost Comparison for Specialization and Trade

Let's turn now to the critique that Smith failed to discover the "law" of comparative advantage as defined by the neoclassical theory of international trade. This critique is another

¹³ See, for example, Ricardo's letter to James Mill (Vol. 7, p. 112) on December 20th, 1816, responding to Mill's letter of December 16th (Vol. 7, p. 106), which is equally worth reading.

important consequence of the widespread misunderstanding of the essence and original purpose of Ricardo's numerical example. Besides the false attribution of the constant-labor-costs assumption to Ricardo, the textbook version of the Ricardian trade model has also contributed to spread the popular notion that he highlighted in the famous numerical example a new principle or law for international specialization known as comparative advantage. Despite investing considerable time and effort, however, I have not found in the *Principles* or any other document written by Ricardo the slightest evidence for such an interpretation. As already been said, what he originally intended to illustrate with the famous four numbers was the new proposition that the labor theory of value does not regulate the relative value of commodities in international trade when the factors of production are immobile between countries. He then mentioned the associated corollary regarding comparative advantage, i.e. that a country might import a certain amount of a commodity although it can produce these commodities internally with less amount of labor than the exporting country (Morales Meoqui, 2011).

These two propositions brilliantly demonstrated by Ricardo with a simple numerical example are indeed significant contributions to the classical theory of international trade. First and foremost, they prove that a country may be able to export commodities to another country even if the former incurs in higher real costs of production than the importing country. This implies of course that a country does not need to have a productivity-advantage over the rest of the world in the production of a certain commodity in order benefit from free trade. With the help of these two propositions one can also explain why higher real labor costs in developing countries do not command higher commodity prices in international markets. Thus, a country with relatively low labor productivity may nevertheless be the lowest nominal cost producer of a commodity. These issues are passionately contested and often misunderstood in the contemporary debate about economic globalization.

Notwithstanding the importance and continued relevance of Ricardo's propositions, they do not constitute — nor were they ever meant to be —, a new principle or law for the determination of the most beneficial trade pattern between countries. Ricardo did not make use of them for this purpose in the *Principles* nor in any other document he wrote, at least as far as I know. For the determination of a country's interest in a particular exchange he always used the classical rule of specialization.

This rule stipulates that it is beneficial for a country to import commodities whenever it can obtain them in exchange for exports whose production entails less real cost compared to the domestic production of the same amount of the imported commodities (Viner, 1937, p. 440). The economic gains of a particular international exchange can be measured for each of the participating countries by calculating the difference between the real costs of the exported commodities that have been sent in exchange for the imports, and the expected real costs of producing the imported commodities at home. The mutually beneficial nature of international trade is secured by the prevalence of this rule in each country simultaneously. If the terms of trade or the real costs of production change in a way that the classical rule of specialization cease to be valid in one of the countries, this country would ultimately withdraw from this particular exchange and start producing the imported commodities at home.

In a previous paper (Morales Meoqui, 2011) I have already indicated Ricardo's recurrent use of the classical rule of specialization in the *Principles*¹⁴, including his famous numerical example.¹⁵ Smith also used this rule frequently in the *Wealth of Nations*, not only for exchanges between countries, but also between individuals and regions.¹⁶ Given the widespread use of this rule throughout the classical school of political economy, I have proposed to use this denomination instead of other popular ones like the eighteenth-century-rule or the gains-from-trade proposition.

What is the relationship between the classical rule of specialization and the comparative-advantage proposition? Jacob Viner (1937, pp. 440-441) is essentially right when he states that the latter is an addition to and possible implication of the former.¹⁷ In order to prove this

¹⁴ See, for example, Vol. 1 p. 295 and p. 319.

¹⁵ Ricardo also used the rule in his personal correspondence, like the following letter to James Brown from October 1819 shows: "Even with this desire for manufactures, a country might continue to be purely agricultural, if by means of trade, she could in exchange for a portion of her agricultural produce obtain a larger quantity of manufactured goods, than, with the capital employed on the production of such portion of agricultural produce as she exported, she could manufacture at home (Vol. 8, pp. 102-103)."

¹⁶ See Smith's example of the tribe of shepherds and hunters (*WN*, I.ii.3, p. 27), the exchange between cities and the countryside (*WN*, III.i.1, p. 376), and of course foreign trade (*WN*, IV.ii.12, p. 457).

¹⁷ Ironically, Viner's correct assessment of the relationship between the classical rule of specialization and the comparative-advantage proposition makes more sense under the new interpretation of Ricardo's four famous numbers than under Viner's traditional interpretation as unitary costs (Viner, 1937, p. 439).

implication, though, one has to assume, as Ricardo did, that the labor theory of value does not hold for international exchanges. Furthermore, Viner is also correct when he points out that the comparative-advantage proposition adds nothing to this rule as a guide for policy. This is precisely why Ricardo stated his support for free trade based on Smith's productivity theory (Vol. 1, pp. 133-134) prior to the enunciation of the comparative-advantage proposition (Vol. 1, p. 135). Therefore, it seems wrong to judge Smith's merits as an international trade theorist primarily on the basis of whether he did or did not offer a convincing proof for the comparative-advantage proposition, all the more when one might find passages of the *Wealth of Nation* where he hints at the essence of this proposition.¹⁸

Multifactorial Explanation of International Trade Patterns

Besides agreeing on the beneficial effects of the division of labor and the extension of the market on labor productivity, as well as the common use of the classical rule of specialization, Ricardo also agreed with Smith's multifactorial approach in explaining the current pattern of international trade. This may sound surprising at first sight, because influential scholars behind the New Trade Theory like Nobel laureate Paul Krugman (2011) have stated that comparative advantage and increasing returns to scale are two separate and mutually exclusive explanations of the pattern of trade. This might be valid for the neoclassical theory of static comparative advantage, but not for Ricardo's notion of comparative advantage.

For any international exchange to continue over a period of time, it has to be of mutual interest for the trading partners. In order to determine whether a particular trade is indeed in the best interest of a country, one has to compare the real costs of the commodities that the country

¹⁸ Smith (*WN*, I.i.4, p. 16) states: "The most opulent nations, indeed, generally excel all their neighbors in agriculture as well as in manufactures; but they are commonly more distinguished by their superiority in the latter than in the former. Their lands are in general better cultivated, and having more labour and expence bestowed upon them, produce more, in proportion to the extent and natural fertility of the ground. But this superiority of produce is seldom much more than in proportion to the superiority of labour and expence. In agriculture, the labour of the rich country is not always much more productive than that of the poor; or, at least, it is never so much more productive, as it commonly is in manufactures. The corn of the rich country, therefore, will not always, in the same degree of goodness, come cheaper to market than that of the poor." I am indebted to Reinhard Schumacher for drawing my attention to this quote.

has to send abroad in order to pay for its imports with the real costs of producing the imported commodities internally, as stipulated by the classical rule of specialization. So when it is said that international trade patterns are determined by comparative costs, the relevant real cost comparison is invariably the one within a country – the real costs of obtaining the imported commodities from abroad versus home-production –, and not the real cost comparison between countries. Both Ricardo and James Mill were absolutely clear on this subject.¹⁹

When applying the classical rule of specialization in a numerical example, as Ricardo did in chapter 7 of the *Principles*, it is necessary to assume that the countries involved have different relative facilities to produce the commodities traded. Otherwise, one of them would lack the gains from trade necessary for continuing the exchange under these terms, and sooner or later would abandon this unfavorable exchange. In order to illustrate the need for this assumption, I will slightly modify Ricardo’s numerical example so that the amounts of cloth and wine traded between England and Portugal are produced with the same amount of labor in the two countries:

	Number of men working for a year required to produce a given quantity of cloth and wine traded	
	cloth	wine
England	100	120
Portugal	100	120

Table 1: Ricardo’s modified numerical example without real cost differences in the production of the amounts of cloth and wine traded.

If the production of the amounts of cloth and wine contained in a typical trade bundle between England and Portugal requires the respective amounts of labor indicated in the above table, such an exchange might not continue for a very long time, since it is in England’s but not

¹⁹ Ricardo (Vol. 2, p. 383) explicitly considered the comparison of real costs between countries as irrelevant for the interest of a country in importing commodities. See also James Mill (1826, p. 123).

in Portugal's interest. Portugal would gain the labor of 20 men if she starts to produce the amount of cloth at home instead of importing it from England.

Now let us assume that Portugal only needs 80 men working for a year to produce the amount of wine traded, as Ricardo indicated in his numerical example:

	Number of men working for a year required to produce a given quantity of cloth and wine traded	
	cloth	wine
England	100	120
Portugal	100	80

Table 2: Ricardo's modified numerical example with real cost differences in the production of the amount of wine traded.

Under these terms the exchange of English cloth and Portuguese wine would continue, since each country gains the labor of 20 men. It is important to realize that both countries do not have to gain the same amount of labor in order to continue trading. Thus, this exchange would also continue if the amount of labor required to produce the quantity of wine traded would increase to 90 men in Portugal, although the later would only gain now the labor of 10 men.

Thus, the assumption about the different relative facilities of countries for producing certain commodities is indeed necessary for international specialization, but unlike many other assumptions in the economic science, this one is quite realistic. What factors may enable Portugal to produce the amount of wine traded with the labor of only 80 men, i.e., 40 men less than England? A country's ability to produce certain commodities with less real costs than another can be explained by a variety of factors, including natural conditions — such as soil, climate and geographic location — and acquired or artificial advantages, for example education, production skills, economies of scale and historical development. These factors are usually labeled in the literature as sources of comparative advantage.

In the following passage of the *Principles* Ricardo (Vol. 1, p. 132) mentions several sources of comparative advantage: “It is quite as important to the happiness of mankind, that our enjoyments should be increased by the better distribution of labour, by each country producing those commodities for which by its situation, its climate, and its other natural and artificial advantages, it is adapted, and by their exchanging them for the commodities of other countries, as that they should be augmented by a raise in the rate of profits.” Ricardo explicitly mentions here two natural sources of comparative advantage, namely the climatic conditions and the geographic location of the country. His reference to other natural advantages may imply, for example, the abundance of fertile land and raw materials. Probably not a single economist would deny that these natural advantages are indeed important sources of real cost differences between countries, and that they certainly play a determining role in explaining the pattern of international trade. More controversial seems to be his general reference to artificial advantages. With artificial advantages Ricardo meant of course the product of human endeavor. Demand-side differences like taste and cultural traditions in specific countries, economies of scale and historical accident — all of these may be considered as artificial sources of comparative advantage.

Ricardo apparently sees no need for elaborating more specifically what he considers to be artificial advantages. Moreover, he does not even bother to differentiate between natural and artificial sources as the basis for an international division of labor. At the first look, his approach seems to be a bit careless, because it ignores the fact that people are much more willing to accept natural rather than artificial differences. The explanation for his undifferentiated treatment of natural and artificial sources of comparative advantage has to be found in the following paragraph of the *Wealth of Nations*:

“Whether the advantages which one country has over another, be natural or acquired, is in this respect of no consequence. As long as the 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. It is an acquired advantage only, which one artificer has over his neighbor, who exercises another trade; and yet they both found it more advantageous to buy of one another, than to make what does not belong to their particular trades” (*WN*, IV.ii.15, p. 458).

Smith states in the above paragraph that the specific causes of the real cost differences — whether natural or acquired — are irrelevant for grasping the benefits from internal as well as international trade. Contemporary economists have concentrated on a narrow set of factors in order to explain why a country has greater facility in producing certain types of commodities and services than others, such as consumer tastes, a superior technology, economies of scale or the relative abundance of certain factors of production. Mainstream international trade models usually highlight a single factor and exclude all others by assumption. Such a modeling approach seems inappropriate for explaining current international trade patterns, since they are the result of several factors working simultaneously.

In the *Wealth of Nations* there are actually very interesting examples of how Smith combines natural and artificial sources of comparative advantage in order to explain the optimal pattern of trade and specialization for the North American colonies and China. His recommendations are based on an accurate analysis of factor supplies and relative prices of the factors of production.

The North American colonies, whose Declaration of Independence in 1776 coincided with the publication of the *Wealth of Nations*, were accurately characterized by Smith as having abundant land and relative scarcity of labor and capital. In correspondence with its factor supply, rents would be generally lower and wages and profits higher in the North American colonies than in Europe. Therefore, the comparative advantage of the North American colonies would be in the production and exportation of agricultural products and raw materials rather than in the home-production of refined manufactures.

“Agriculture is the proper business of all new colonies; a business which the cheapness of land renders more advantageous than any other. They abound, therefore, in the rude produce of land, and instead of importing it from other countries, they have generally a large surplus to export. In new colonies, agriculture either draws hands from all other employments, or keeps them from going to any other employment. There are few hands to spare for the necessary, and none for the ornamental manufactures. The greater part of the manufactures of both kinds, they find it cheaper to purchase of other countries than to make for themselves” (*WN*, IV.vii.c.51, p. 609).

Imperial China, on the other hand, had abundant labor densely settled, resulting in low wages and high rents. In opposition to the economic policies of the Chinese government, which

avored agriculture more than all other employments²⁰, Smith identified China's comparative advantage in the production and exportation of manufactures. Furthermore, he indicated that China had been probably suffering from economic stagnation for many centuries, having obtained the amount of wealth that its actual institutions and economic policies permit it to acquire. The expansion of foreign commerce, which China had neglected, could however give a fresh impetus to her economic development.²¹

By taking into account the relative abundance of land and labor, as well as the corresponding relative prices of these factors in the North American colonies and China, Smith clearly preceded Eli Heckscher and Bertil Ohlin in explaining the international trade pattern based on factor endowments and relative factor prices. However, instead of assuming the artificial factor endowments of a country as exogenously given, Smith was able to treat the broad pattern of changes in the factor supplies and their relative prices as a part of the process of long-run economic development (Myint 1977, p. 235).

It is therefore a well-documented fact that the two highest authorities of the classical theory of international trade, Smith and Ricardo, explicitly acknowledged plenty of sources of comparative advantage. The simultaneous operation of natural and artificial sources explains the persistent differences in real as well as monetary costs that give rise to the international division of labor and the observable pattern of world trade.

Moreover, it is also proven that Ricardo did not consider comparative advantage and increasing returns to scale as two separate and mutually exclusive explanations for international trade patterns. On the contrary, he considered increasing returns as an integral part of a

²⁰ Consequently, Smith analyzes the economic policies of China in the chapter about Physiocracy. See Smith (*WN*, IV.ix.40, pp. 669ff.).

²¹ See Smith (*WN*, I.ix.15, pp. 111-112). He also wrote: "The home market of China is, perhaps, in extent, not much inferior to the market of all the different countries of Europe put together. A more extensive foreign trade, however, which to this great home market added the foreign market of all the rest of the world; especially if any considerable part of this trade was carried on in Chinese ships; could scarce fail to increase very much the manufactures of China, and to improve very much the productive powers of its manufacturing industry. By a more extensive navigation, the Chinese would naturally learn the art of using and constructing themselves all the different machines made use of in other countries, as well as the other improvements of art and industry which are practised in all the different parts of the world. Upon their present plan they have little opportunity of improving themselves by the example of any other nation; except that of the Japanese (*WN*, IV.ix.41, p. 681)."

multifactorial explanation of trade patterns based on comparative costs, whereas the relevant real cost comparison is invariably stated in accordance with the classical rule of specialization.

Reassessment of Smith's Contributions to International Trade Theory

The main results of this paper – the evidence presented regarding Ricardo's adherence to Smith's productivity theory; the reconciliation of the comparative-advantage proposition with the latter; and the reintegration of this proposition into a multifactorial explanation of the pattern of trade provided by Smith and supported by Ricardo – offer new arguments for the ongoing reassessment of Smith's contributions to international trade theory. Smith has been underrated as an international trade theorist because he had failed to properly formulate and prove the comparative-advantage proposition. Ricardo's own demonstration of this proposition, though, does neither contradict nor invalidate Smith's productivity theory. On the contrary, the accurate interpretation of the numerical example in the *Principles* demonstrates quite clearly that the comparative-advantage proposition is indeed a possible implication of the classical rule of specialization, although a very important one. Consequently, Ricardo's new proposition should be seen as a valuable addition rather than a point of disruption with respect to Smith's productivity theory.

This means of course that Smith's valuable contributions to international trade theory cannot be belittled anymore on the basis of his shortcomings with respect to the comparative-advantage proposition. Although Smith's productivity theory remains incompatible with the neoclassical theory of static comparative advantage, there is no reason for considering the latter as the high point of free trade thinking.

Before the accurate interpretation of Ricardo's numerical example, the match-up between Smith's productivity theory and the neoclassical theory of static comparative advantage was already shifting gradually in Smith's favor. In this respect, West (1990, p. 41) argued:

“It is now arguable that Smith's total analysis is the more comprehensive because it goes well beyond the neoclassical reasoning. For whereas the latter simply takes as a datum an existing structure of comparative advantage, Smith's approach affords opportunities for going behind and beyond it to explain its very foundation. Manufactured instead of “natural” differences stem from incentives that prompt inherently identical individuals (or countries) to

make “sunk cost” investments in an almost accidental variety of skills. In this light, many comparative advantages are man-made and the incentive for trade is an obvious development after this fact.”

Smith did not only preceded Eli Heckscher and Bertil Ohlin by including natural and artificial factor endowments and relative factor prices in the explanation of the pattern of trade, but one can argue that Smith’s approach was superior, since he was able to offer an endogenous explanation for the artificial factor endowments and their relative prices in particular countries, whereas the neoclassical trade theory treated them as exogenously given. Moreover, his multifactorial explanation of the pattern of trade is able to explain all sorts of trade, inter-industry as well as intra-industry.

On top of that, Smith clearly anticipated the main propositions of today’s New Trade and New Growth theories. Any meticulous reader of the *Wealth of Nations* would hardly find anything completely new or particularly innovative in these two currently fashionable economic theories. The recent renaissance of Smith’s insights in contemporary economic thought can be seen as a further proof for the continued relevance of his main propositions on international trade and economic growth.

After the reinsertion of Ricardo’s comparative-advantage proposition into the framework of Smith’s productivity theory, the match-up with the neoclassical theory of static comparative advantage seems to be overwhelmingly in favor of Smith. This might have important consequences for the mainstream theory of international trade. It may lead to a reinstatement of Smith’s insights regarding the division of labor and specialization as the foremost explanation regarding the origin and benefits of trade in contemporary economic thought.

A crucial advantage of Smith’s productivity theory over the neoclassical theory of static comparative advantage is that the former offers a unified analysis of foreign trade and the domestic economy, oriented towards the problem of long-run economic growth (Myint 1977, p. 246). In classical political economy there are indeed no inherent differences in the underlying principles between domestic and foreign trade. That does not mean, however, that classical political economists ignore the existence of institutional differences between domestic and international trade like, for example, different national currencies, sanitary and custom regulations or other types of administrative rules on cross-border trade. Ricardo in particular is

certainly aware of the differences in the degrees of factor mobility within and between countries, and the resulting implications for his labor theory of value. Notwithstanding the importance of these differences between domestic and foreign trade, they do not modify the underlying logical foundation of trade.

In more practical terms, a future preeminence of Smith's productivity theory over the neoclassical theory of static comparative advantage would bear important implications for the contemporary political debate on free trade and economic globalization. Smith's framework lends to a greater support for extending the division of labor and specialization beyond political borders, since such an international extension of the market would boost labor productivity in the domestic economy. Moreover, the case for free trade based on Smith's productivity theory does not rely on unrealistic assumptions like perfect competition and constant return to scale associated with the general economic equilibrium paradigm and neoclassical theory of international trade. Critics of free trade like Graham Dunkley (2004) and Ian Fletcher (2011) have pointed to these unrealistic assumptions as a proof for the inherent weakness of the current mainstream neoclassical case for free trade. Their critique does not apply though to the classical case for free trade.

Conclusions

There are three important claims in this paper: First, there is enough evidence for affirming that Ricardo adhered to Smith's productivity theory; second, Ricardo's original demonstration of the comparative-advantage proposition is indeed compatible and complementary with respect to the latter; and third, that Ricardo agreed with Smith's multifactorial explanation of the pattern of trade, which includes increasing returns and economies of scale.

The contrary notion that Smith and Ricardo had incompatible theories about the origin and benefits of international trade is largely a consequence of the widespread misinterpretation of the famous four numbers as unitary labor costs, as well as the presence of the constant-labor-costs assumption in the textbook trade model currently denominated as the Ricardian trade model. Ricardo did not make this assumption in the original numerical example or anywhere else in the *Principles*, for that matter. On the contrary, he agreed with Smith's assessment regarding the

importance of extending the market beyond national borders in order to increase labor productivity and production at home.

The textbook trade model is also responsible for the erroneous notion that Ricardo proposed a new law of international specialization called comparative advantage. The accurate understanding of the numerical example in the *Principles* proves beyond doubt that Ricardo relied upon the same rule of specialization as Smith and other classical political economists for defining the interest of a country in a particular exchange as well as measuring the gains from trade.

Finally, this paper may perhaps contribute to the reestablishment of Smith's productivity theory, in conjunction with Ricardo's additions and corrections, as the main explanation of the benefits of free international trade. Those who believe in the virtues of free trade should embrace such a development, since the reliance of the mainstream neoclassical case for free trade on unrealistic assumptions like constant returns to scale or perfect competition has given the numerous critics of free trade an easy target to rally against.

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