ADVANTAGE RICARDO

Adam Smith is usually seen as the founder of economics, but here we turn the spotlight on David Ricardo, the brilliant (but little-read) economist who first established the principle of comparative advantage

David Ricardo is generally acknowledged as one of the greatest economists, yet he is also one of the least read.

This reflects one of his main qualities, captured by John Kenneth Galbraith, who wittily and accurately described him as a man of great lucidity of mind and terrible obscurity of prose.

He was a brilliant thinker with an extraordinary ability to capture the theoretical essence that underlay the complexity and apparent confusion of the actual world.

But his analytical clarity was not matched by gifted exposition. He was also a person with an interesting life story, not least in becoming one of the few economists to make a huge fortune – by speculating on government debt and the outcome of the Battle of Waterloo no less!

While Adam Smith is usually seen as the founder of economics, it is actually Ricardo who first developed what we might call "the economic way of thinking".

His great contribution

was to lay bare and clarify the underlying nature of apparently complex phenomena by reducing them to simple yet well founded models. He was the first economic modeller.

One example of this was his using an economy consisting of just one activity (farming) and one product (corn) to make clear the principle of diminishing marginal returns, one of the greatest insights of economics.

Other examples were his demonstration that the costs of financing government activities from current tax revenue, or from short term and high interest debt, or from perpetual and low interest debt were effectively the same.

And he explained how you could simultaneously have a larger share of total income going to profits with a declining return on capital – something that is highly relevant today.

However, his greatest achievement, published just over two hundred years ago in 1817, was the principle of comparative advantage, unveiled in his seminal work *On the Principles of Politcial Economy and Taxation*.

Using the model of two countries (England and Portugal) and two products (wine and cloth), he showed by a deceptively simple argument that even if Portugal was more efficient at producing both products than was England – that is, the resources used to produce a given amount were less in Portugal – it would still make sense for Portugal to specialise in wine and England in cloth and for the two countries to exchange the goods for each other.

If they did this, there would be more goods in total produced even while nothing else (the amount of resources or the technology used) had changed.

Riccardo's insight was that the critical factor is not the absolute cost of production (the amount of resources used) but the comparative cost to each country of doing one thing at the expense of another (given that resources used for making one product can't be used to make the other).

on something they are even better at.

It means that in policy regarding trade, unrestricted free trade is always and everywhere the welfare maximising policy. This would be true even if you were the only country in the world practising it. So every country should adopt this policy unilaterally and not wait for others to play along.

Even Ricardo failed to grasp the full significance of his insight.

COMPARATIVE ADVANTAGE IS THE FUNDAMENTAL PRINCIPLE OF SOCIAL COOPERATION

Take another example of two neighbours, Jack and Jill. Jill is a brain surgeon and much better than Jack at that. She is also a better gardener than Jack.

However every hour she spends in the garden is an hour she cannot spend doing surgery, so the cost to her of doing gardening is high.

For Jack, by contrast, the cost of doing gardening is much less, since he is a hopeless surgeon.

So it makes sense and leaves both parties better off if Jill concentrates on surgery and pays Jack to look after her garden.

This is an insight with extraordinary and far reaching implications. It means, for example, that even if you are the most inefficient and incompetent person (or country) in the world, there will always be something that it will make sense for other people to pay you to do so that they can concentrate

His example looked at trade between people in England and Portugal. But the fact that the goods crossed national borders is irrelevant.

Sometimes traders are in different political jurisdictions (e.g. London and Tokyo), sometimes the same (e.g. Leeds and London). But the principle and relationship is exactly the same.

Comparative advantage is actually the fundamental principle of social cooperation.

It is because of trading for mutual benefit to take advantage of comparative costs of production that we live in complex and wealthy societies rather than as impoverished individuals in self-sufficient households•

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