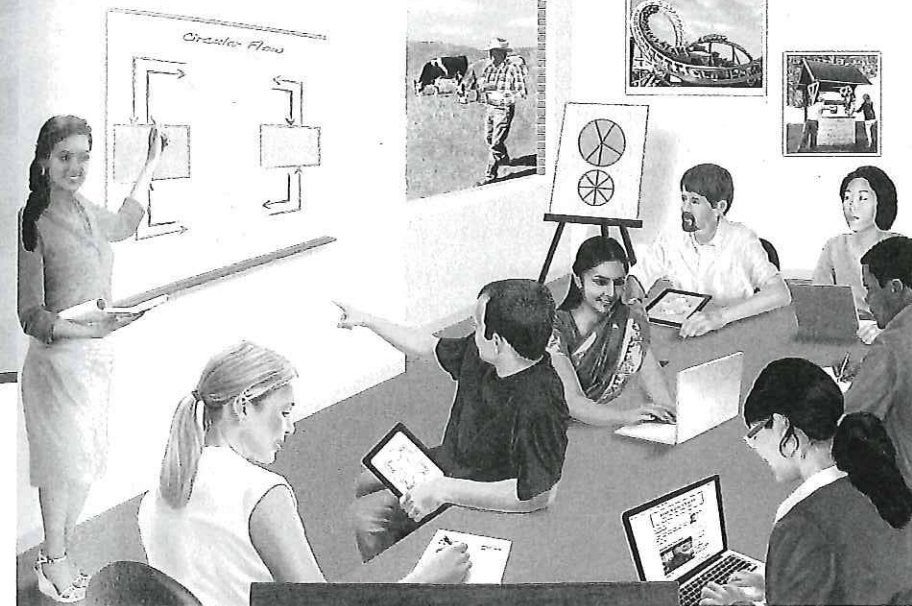




## CHAPTER 3

# Interdependence and the Gains from Trade

**C**onsider your typical day. You wake up in the morning and pour yourself juice from oranges grown in Florida and coffee from beans grown in Brazil. Over breakfast, you watch a news program broadcast from New York on your television made in China. You get dressed in clothes made of cotton grown in Georgia and sewn in factories in Thailand. You drive to class in a car made of parts manufactured in more than a dozen countries around the world. Then you open up your economics textbook written by an author living in Massachusetts, published by a company located in Ohio, and printed on paper made from trees grown in Oregon.

Every day, you rely on many people, most of whom you have never met, to provide you with the goods and services that you enjoy. Such interdependence is possible because people trade with one another. Those people providing you with goods and services are not acting out of generosity. Nor is some government agency directing them to satisfy your desires. Instead,

people provide you and other consumers with the goods and services they produce because they get something in return.

In subsequent chapters, we examine how an economy coordinates the activities of millions of people with varying tastes and abilities. As a starting point for this analysis, in this chapter we consider the reasons for economic interdependence. One of the *Ten Principles of Economics* highlighted in Chapter 1 is that trade can make everyone better off. We now examine this principle more closely. What exactly do people gain when they trade with one another? Why do people choose to become interdependent?

The answers to these questions are key to understanding the modern global economy. Most countries today import from abroad many of the goods and services they consume, and they export to foreign customers many of the goods and services they produce. The analysis in this chapter explains interdependence not only among individuals but also among nations. As we will see, the gains from trade are much the same whether you are buying a haircut from your local barber or a T-shirt made by a worker on the other side of the globe.

### 3-1 A Parable for the Modern Economy

To understand why people choose to depend on others for goods and services and how this choice improves their lives, let's look at a simple economy. Imagine that there are two goods in the world: meat and potatoes. And there are two people in the world—a cattle rancher named Rose and a potato farmer named Frank—each of whom would like to eat both meat and potatoes.

The gains from trade are most obvious if Rose can produce only meat and Frank can produce only potatoes. In one scenario, Frank and Rose could choose to have nothing to do with each other. But after several months of eating beef roasted, boiled, broiled, and grilled, Rose might decide that self-sufficiency is not all it's cracked up to be. Frank, who has been eating potatoes mashed, fried, baked, and scalloped, would likely agree. It is easy to see that trade would allow them to enjoy greater variety: Each could then have a steak with a baked potato or a burger with fries.

Although this scene illustrates most simply how everyone can benefit from trade, the gains would be similar if Frank and Rose were each capable of producing the other good, but only at great cost. Suppose, for example, that Rose is able to grow potatoes but her land is not very well suited for it. Similarly, suppose that Frank is able to raise cattle and produce meat but he is not very good at it. In this case, Frank and Rose can each benefit by specializing in what he or she does best and then trading with the other person.

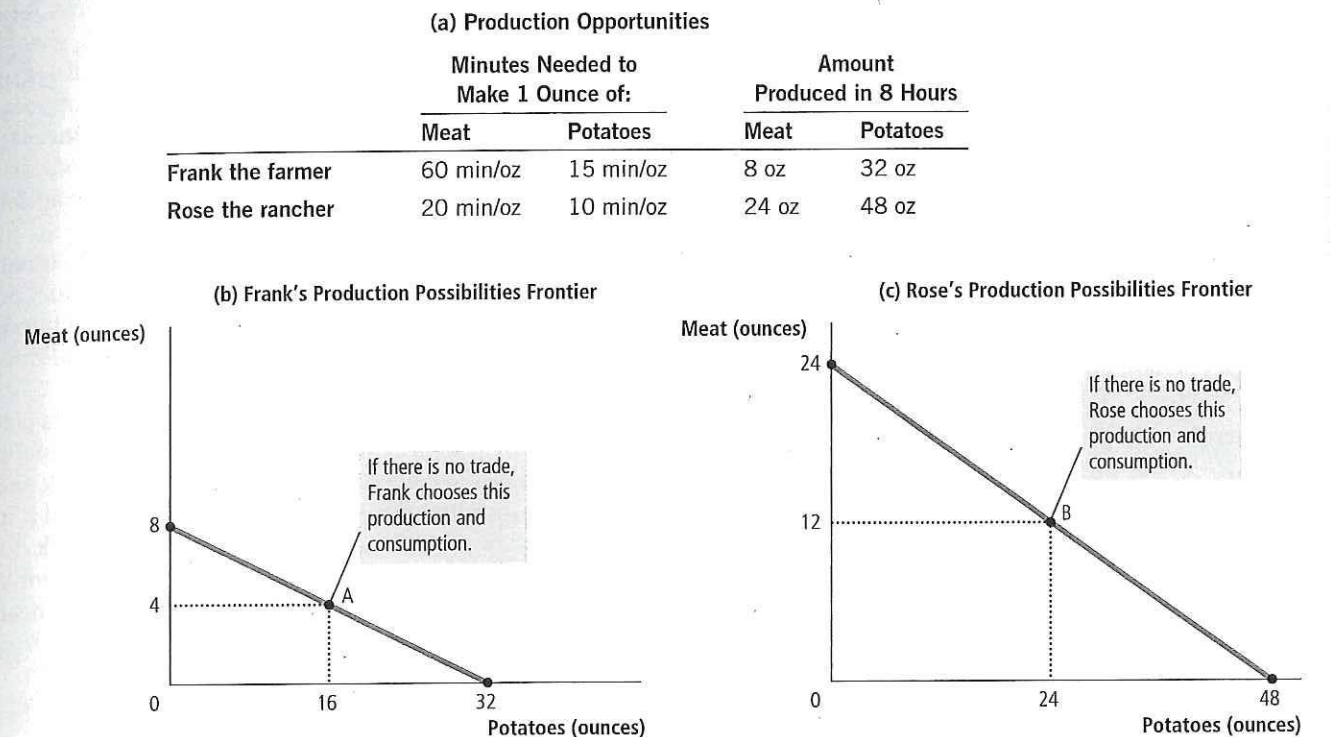
The gains from trade are less obvious, however, when one person is better at producing *every* good. For example, suppose that Rose is better at raising cattle *and* better at growing potatoes than Frank. In this case, should Rose choose to remain self-sufficient? Or is there still reason for her to trade with Frank? To answer this question, we need to look more closely at the factors that affect such a decision.

#### 3-1a Production Possibilities

Suppose that Frank and Rose each work 8 hours per day and can devote this time to growing potatoes, raising cattle, or a combination of the two. The table in Figure 1 shows the amount of time each person requires to produce 1 ounce of

**FIGURE 1**  
The Production Possibilities Frontier

Panel (a) shows the production opportunities available to Frank the farmer and Rose the rancher. Panel (b) shows the combinations of meat and potatoes that Frank can produce. Panel (c) shows the combinations of meat and potatoes that Rose can produce. Both production possibilities frontiers are derived assuming that Frank and Rose each work 8 hours per day. If there is no trade, each person's production possibilities frontier is also his or her consumption possibilities frontier.



each good. Frank can produce an ounce of potatoes in 15 minutes and an ounce of meat in 60 minutes. Rose, who is more productive in both activities, can produce an ounce of potatoes in 10 minutes and an ounce of meat in 20 minutes. The last two columns in the table show the amounts of meat or potatoes Frank and Rose can produce if they devote all 8 hours to producing only that good.

Panel (b) of Figure 1 illustrates the amounts of meat and potatoes that Frank can produce. If Frank devotes all 8 hours of his time to potatoes, he produces 32 ounces of potatoes (measured on the horizontal axis) and no meat. If he devotes all his time to meat, he produces 8 ounces of meat (measured on the vertical axis) and no potatoes. If Frank divides his time equally between the two activities, spending 4 hours on each, he produces 16 ounces of potatoes and 4 ounces of meat. The figure shows these three possible outcomes and all others in between.

This graph is Frank's production possibilities frontier. As we discussed in Chapter 2, a production possibilities frontier shows the various mixes of output that an economy can produce. It illustrates one of the *Ten Principles of Economics* in Chapter 1: People face trade-offs. Here Frank faces a trade-off between producing meat and producing potatoes.

You may recall that the production possibilities frontier in Chapter 2 was drawn bowed out. In that case, the rate at which society could trade one good for the other depended on the amounts that were being produced. Here, however, Frank's technology for producing meat and potatoes (as summarized in Figure 1) allows him to switch between the two goods at a constant rate. Whenever Frank spends 1 hour less producing meat and 1 hour more producing potatoes, he reduces his output of meat by 1 ounce and raises his output of potatoes by 4 ounces—and this is true regardless of how much he is already producing. As a result, the production possibilities frontier is a straight line.

Panel (c) of Figure 1 shows the production possibilities frontier for Rose. If Rose devotes all 8 hours of her time to potatoes, she produces 48 ounces of potatoes and no meat. If she devotes all her time to meat, she produces 24 ounces of meat and no potatoes. If Rose divides her time equally, spending 4 hours on each activity, she produces 24 ounces of potatoes and 12 ounces of meat. Once again, the production possibilities frontier shows all the possible outcomes.

If Frank and Rose choose to be self-sufficient rather than trade with each other, then each consumes exactly what he or she produces. In this case, the production possibilities frontier is also the consumption possibilities frontier. That is, without trade, Figure 1 shows the possible combinations of meat and potatoes that Frank and Rose can each produce and then consume.

These production possibilities frontiers are useful in showing the trade-offs that Frank and Rose face, but they do not tell us what Frank and Rose will actually choose to do. To determine their choices, we need to know the tastes of Frank and Rose. Let's suppose they choose the combinations identified by points A and B in Figure 1. Based on his production opportunities and food preferences, Frank decides to produce and consume 16 ounces of potatoes and 4 ounces of meat, while Rose decides to produce and consume 24 ounces of potatoes and 12 ounces of meat.

### 3-1b Specialization and Trade

After several years of eating combination B, Rose gets an idea and goes to talk to Frank:

ROSE: Frank, my friend, have I got a deal for you! I know how to improve life for both of us. I think you should stop producing meat altogether and devote all your time to growing potatoes. According to my calculations, if you work 8 hours a day growing potatoes, you'll produce 32 ounces of potatoes. If you give me 15 of those 32 ounces, I'll give you 5 ounces of meat in return. In the end, you'll get to eat 17 ounces of potatoes and 5 ounces of meat every day, instead of the 16 ounces of potatoes and 4 ounces of meat you now get. If you go along with my plan, you'll have more of *both* foods. [To illustrate her point, Rose shows Frank panel (a) of Figure 2.]

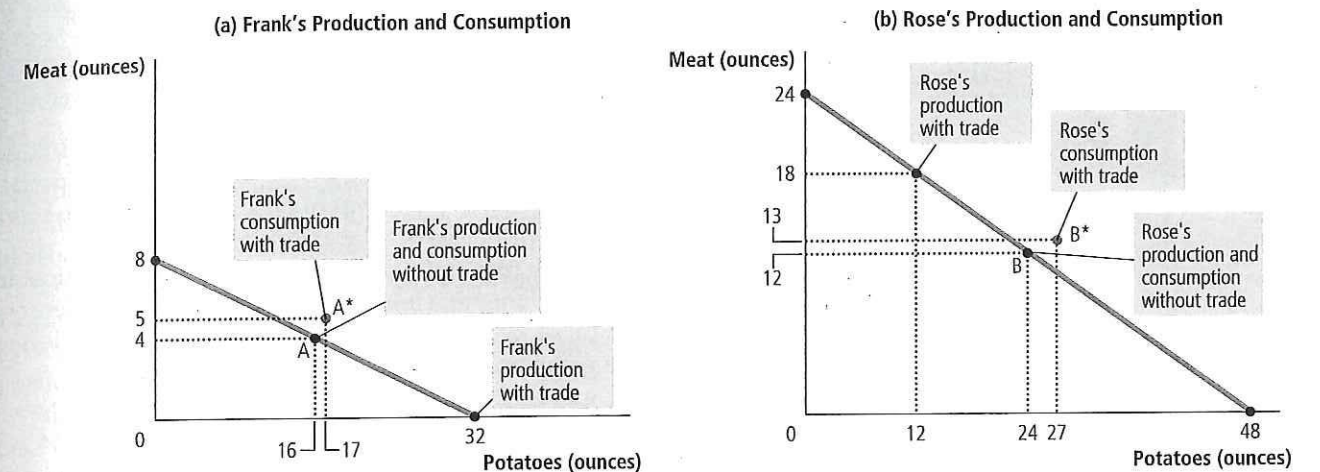
FRANK: (sounding skeptical) That seems like a good deal for me. But I don't understand why you are offering it. If the deal is so good for me, it can't be good for you too.

ROSE: Oh, but it is! Suppose I spend 6 hours a day raising cattle and 2 hours growing potatoes. Then I can produce 18 ounces of meat and 12 ounces of potatoes. After I give you 5 ounces of my meat in exchange for 15 ounces of your potatoes, I'll end up with 13 ounces of meat and 27 ounces of potatoes, instead of the 12 ounces of meat and 24 ounces of potatoes that I now get. So I will also consume more of both foods than I do now. [She points out panel (b) of Figure 2.]

**FIGURE 2**

**How Trade Expands the Set of Consumption Opportunities**

The proposed trade between Frank the farmer and Rose the rancher offers each of them a combination of meat and potatoes that would be impossible in the absence of trade. In panel (a), Frank gets to consume at point A\* rather than point A. In panel (b), Rose gets to consume at point B\* rather than point B. Trade allows each to consume more meat and more potatoes.



**(c) The Gains from Trade: A Summary**

|                            | Frank     |             | Rose       |            |
|----------------------------|-----------|-------------|------------|------------|
|                            | Meat      | Potatoes    | Meat       | Potatoes   |
| <b>Without Trade:</b>      |           |             |            |            |
| Production and Consumption | 4 oz      | 16 oz       | 12 oz      | 24 oz      |
| <b>With Trade:</b>         |           |             |            |            |
| Production                 | 0 oz      | 32 oz       | 18 oz      | 12 oz      |
| Trade                      | Gets 5 oz | Gives 15 oz | Gives 5 oz | Gets 15 oz |
| Consumption                | 5 oz      | 17 oz       | 13 oz      | 27 oz      |
| <b>GAINS FROM TRADE:</b>   |           |             |            |            |
| Increase in Consumption    | +1 oz     | +1 oz       | +1 oz      | +3 oz      |

FRANK: I don't know. . . . This sounds too good to be true.

ROSE: It's really not as complicated as it first seems. Here—I've summarized my proposal for you in a simple table. [Rose shows Frank a copy of the table at the bottom of Figure 2.]

FRANK: (after pausing to study the table) These calculations seem correct, but I am puzzled. How can this deal make us both better off?

ROSE: We can both benefit because trade allows each of us to specialize in doing what we do best. You will spend more time growing potatoes and less time raising cattle. I will spend more time raising cattle and less time growing potatoes. As a result of specialization and trade, each of us can consume more meat and more potatoes without working any more hours.

**Quick Quiz** Draw an example of a production possibilities frontier for Robinson Crusoe, a shipwrecked sailor who spends his time gathering coconuts and catching fish. Does this frontier limit Crusoe's consumption of coconuts and fish if he lives by himself? Does he face the same limits if he can trade with natives on the island?

3-2 Comparative Advantage:  
The Driving Force of Specialization

Rose's explanation of the gains from trade, though correct, poses a puzzle: If Rose is better at both raising cattle and growing potatoes, how can Frank ever specialize in doing what he does best? Frank doesn't seem to do anything best. To solve this puzzle, we need to look at the principle of *comparative advantage*.

As a first step in developing this principle, consider the following question: In our example, who can produce potatoes at a lower cost—Frank or Rose? There are two possible answers, and in these two answers lie the solution to our puzzle and the key to understanding the gains from trade.

3-2a Absolute Advantage

One way to answer the question about the cost of producing potatoes is to compare the inputs required by the two producers. Economists use the term **absolute advantage** when comparing the productivity of one person, firm, or nation to that of another. The producer that requires a smaller quantity of inputs to produce a good is said to have an absolute advantage in producing that good.

In our example, time is the only input, so we can determine absolute advantage by looking at how much time each type of production takes. Rose has an absolute advantage both in producing meat and in producing potatoes because she requires less time than Frank to produce a unit of either good. Rose needs to input only 20 minutes to produce an ounce of meat, whereas Frank needs 60 minutes. Similarly, Rose needs only 10 minutes to produce an ounce of potatoes, whereas Frank needs 15 minutes. Based on this information, we can conclude that Rose has the lower cost of producing potatoes, if we measure cost in terms of the quantity of inputs.

3-2b Opportunity Cost and Comparative Advantage

There is another way to look at the cost of producing potatoes. Rather than comparing inputs required, we can compare opportunity costs. Recall from Chapter 1 that the **opportunity cost** of some item is what we give up to get that item. In our example, we assumed that Frank and Rose each spend 8 hours a day working. Time spent producing potatoes, therefore, takes away from time available for producing meat. When reallocating time between the two goods, Rose and Frank give up units of one good to produce units of the other, thereby moving along the production possibilities frontier. The opportunity cost measures the trade-off between the two goods that each producer faces.

Let's first consider Rose's opportunity cost. According to the table in panel (a) of Figure 1, producing 1 ounce of potatoes takes 10 minutes of work. When Rose spends those 10 minutes producing potatoes, she spends 10 minutes less

absolute advantage  
the ability to produce a  
good using fewer inputs  
than another producer

opportunity cost  
whatever must be given  
up to obtain some item

TABLE 1

|                  | Opportunity Cost of: |                  | The Opportunity Cost of Meat and Potatoes |
|------------------|----------------------|------------------|-------------------------------------------|
|                  | 1 oz of Meat         | 1 oz of Potatoes |                                           |
| Frank the farmer | 4 oz potatoes        | ¼ oz meat        |                                           |
| Rose the rancher | 2 oz potatoes        | ½ oz meat        |                                           |

producing meat. Because Rose needs 20 minutes to produce 1 ounce of meat, 10 minutes of work would yield ½ ounce of meat. Hence, Rose's opportunity cost of producing 1 ounce of potatoes is ½ ounce of meat.

Now consider Frank's opportunity cost. Producing 1 ounce of potatoes takes him 15 minutes. Because he needs 60 minutes to produce 1 ounce of meat, 15 minutes of work would yield ¼ ounce of meat. Hence, Frank's opportunity cost of 1 ounce of potatoes is ¼ ounce of meat.

Table 1 shows the opportunity costs of meat and potatoes for the two producers. Notice that the opportunity cost of meat is the inverse of the opportunity cost of potatoes. Because 1 ounce of potatoes costs Rose ½ ounce of meat, 1 ounce of meat costs Rose 2 ounces of potatoes. Similarly, because 1 ounce of potatoes costs Frank ¼ ounce of meat, 1 ounce of meat costs Frank 4 ounces of potatoes.

Economists use the term **comparative advantage** when describing the opportunity costs faced by two producers. The producer who gives up less of other goods to produce Good X has the smaller opportunity cost of producing Good X and is said to have a comparative advantage in producing it. In our example, Frank has a lower opportunity cost of producing potatoes than Rose: An ounce of potatoes costs Frank only ¼ ounce of meat, but it costs Rose ½ ounce of meat. Conversely, Rose has a lower opportunity cost of producing meat than Frank: An ounce of meat costs Rose 2 ounces of potatoes, but it costs Frank 4 ounces of potatoes. Thus, Frank has a comparative advantage in growing potatoes, and Rose has a comparative advantage in producing meat.

Although it is possible for one person to have an absolute advantage in both goods (as Rose does in our example), it is impossible for one person to have a comparative advantage in both goods. Because the opportunity cost of one good is the inverse of the opportunity cost of the other, if a person's opportunity cost of one good is relatively high, the opportunity cost of the other good must be relatively low. Comparative advantage reflects the relative opportunity cost. Unless two people have the same opportunity cost, one person will have a comparative advantage in one good, and the other person will have a comparative advantage in the other good.

3-2c Comparative Advantage and Trade

The gains from specialization and trade are based not on absolute advantage but on comparative advantage. When each person specializes in producing the good for which he or she has a comparative advantage, total production in the economy rises. This increase in the size of the economic pie can be used to make everyone better off.

comparative advantage  
the ability to produce  
a good at a lower  
opportunity cost than  
another producer

In our example, Frank spends more time growing potatoes, and Rose spends more time producing meat. As a result, the total production of potatoes rises from 40 to 44 ounces, and the total production of meat rises from 16 to 18 ounces. Frank and Rose share the benefits of this increased production.

We can also look at the gains from trade in terms of the price that each party pays the other. Because Frank and Rose have different opportunity costs, they can both get a bargain. That is, each of them benefits from trade by obtaining a good at a price that is lower than his or her opportunity cost of that good.

Consider the proposed deal from Frank's viewpoint. Frank receives 5 ounces of meat in exchange for 15 ounces of potatoes. In other words, Frank buys each ounce of meat for a price of 3 ounces of potatoes. This price of meat is lower than his opportunity cost for an ounce of meat, which is 4 ounces of potatoes. Thus, Frank benefits from the deal because he gets to buy meat at a good price.

Now consider the deal from Rose's viewpoint. Rose buys 15 ounces of potatoes for a price of 5 ounces of meat. That is, the price of potatoes is  $\frac{1}{3}$  ounce of meat. This price of potatoes is lower than her opportunity cost of an ounce of potatoes, which is  $\frac{1}{2}$  ounce of meat. Rose benefits because she gets to buy potatoes at a good price.

The story of Rose the rancher and Frank the farmer has a simple moral, which should now be clear: *Trade can benefit everyone in society because it allows people to specialize in activities in which they have a comparative advantage.*

### 3-2d The Price of the Trade

The principle of comparative advantage establishes that there are gains from specialization and trade, but it raises a couple of related questions: What determines the price at which trade takes place? How are the gains from trade shared between the trading parties? The precise answer to these questions is beyond the scope of this chapter, but we can state one general rule: *For both parties to gain from trade, the price at which they trade must lie between the two opportunity costs.*

In our example, Frank and Rose agreed to trade at a rate of 3 ounces of potatoes for each ounce of meat. This price is between Rose's opportunity cost (2 ounces of potatoes per ounce of meat) and Frank's opportunity cost (4 ounces of potatoes per ounce of meat). The price need not be exactly in the middle for both parties to gain, but it must be somewhere between 2 and 4.

To see why the price has to be in this range, consider what would happen if it were not. If the price of meat were below 2 ounces of potatoes, both Frank and Rose would want to buy meat, because the price would be below each of their opportunity costs. Similarly, if the price of meat were above 4 ounces of potatoes, both would want to sell meat, because the price would be above their opportunity costs. But there are only two members of this economy. They cannot both be buyers of meat, nor can they both be sellers. Someone has to take the other side of the deal.

A mutually advantageous trade can be struck at a price between 2 and 4. In this price range, Rose wants to sell meat to buy potatoes, and Frank wants to sell potatoes to buy meat. Each party can buy a good at a price that is lower than his or her opportunity cost. In the end, each person specializes in the good for which he or she has a comparative advantage and is, as a result, better off.

**Quick Quiz** Robinson Crusoe can gather 10 coconuts or catch 1 fish per hour. His friend Friday can gather 30 coconuts or catch 2 fish per hour. What is Crusoe's opportunity cost of catching 1 fish? What is Friday's? Who has an absolute advantage in catching fish? Who has a comparative advantage in catching fish?

## FYI

### The Legacy of Adam Smith and David Ricardo

Economists have long understood the gains from trade. Here is how the great economist Adam Smith put the argument:

*It is a maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes but employs a tailor. The farmer attempts to make neither the one nor the other, but employs those different artificers. All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbors, and to purchase with a part of its produce, or what is the same thing, with the price of part of it, whatever else they have occasion for.*



David Ricardo

This quotation is from Smith's 1776 book *An Inquiry into the Nature and Causes of the Wealth of Nations*, which was a landmark in the analysis of trade and economic interdependence.

Smith's book inspired David Ricardo, a millionaire stockbroker, to become an economist. In his 1817 book *Principles of Political Economy and Taxation*, Ricardo developed the principle of comparative advantage as we know it today. He considered an example with two goods (wine and cloth) and two countries (England and Portugal). He showed that both countries can gain by opening up trade and specializing based on comparative advantage.

Ricardo's theory is the starting point of modern international economics, but his defense of free trade was not a mere academic exercise. Ricardo put his beliefs to work as a member of the British Parliament, where he opposed the Corn Laws, which restricted the import of grain.

The conclusions of Adam Smith and David Ricardo on the gains from trade have held up well over time. Although economists often disagree on questions of policy, they are united in their support of free trade. Moreover, the central argument for free trade has not changed much in the past two centuries. Even though the field of economics has broadened its scope and refined its theories since the time of Smith and Ricardo, economists' opposition to trade restrictions is still based largely on the principle of comparative advantage. ▴



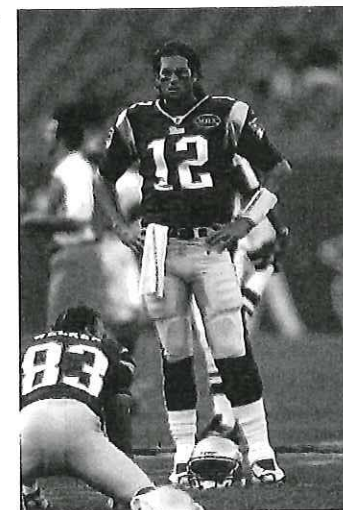
## 3-3 Applications of Comparative Advantage

The principle of comparative advantage explains interdependence and the gains from trade. Because interdependence is so prevalent in the modern world, the principle of comparative advantage has many applications. Here are two examples, one fanciful and one of great practical importance.

### 3-3a Should Tom Brady Mow His Own Lawn?

Tom Brady spends a lot of time running around on grass. One of the most talented football players of all time, he can throw a pass with a speed and accuracy that most casual athletes can only dream of. Most likely, he is talented at other physical activities as well. For example, let's imagine that Brady can mow his lawn faster than anyone else. But just because he *can* mow his lawn fast, does this mean he *should*?

To answer this question, we can use the concepts of opportunity cost and comparative advantage. Let's say that Brady can mow his lawn in 2 hours. In that same 2 hours, he could film a television commercial and earn \$20,000. By contrast,



*"They did a nice job mowing this grass."*

## IN THE NEWS

## Economics within a Marriage

*An economist argues that you shouldn't always unload the dishwasher just because you're better than your partner at it.*

## You're Dividing the Chores Wrong

By Emily Oster

No one likes doing chores. In happiness surveys, housework is ranked down there with commuting as activities that people enjoy the least. Maybe that's why figuring out who does which chores usually prompts, at best, tense discussion in a household and, at worst, outright fighting.

If everyone is good at something different, assigning chores is easy. If your partner is great at grocery shopping and you are great at the laundry, you're set. But this isn't always—or even usually—the case. Often one person is better at everything. (And let's be honest, often that person is the woman.) Better at the laundry, the grocery shopping, the cleaning, the cooking. But does that mean she should have to do everything?

Before my daughter was born, I both cooked and did the dishes. It wasn't a big deal, it didn't take too much time, and honestly I was a lot better at both than my husband. His cooking repertoire extended only to eggs and chili, and when I left him in charge of the

dishwasher, I'd often find he had run it "full" with one pot and eight forks.

After we had a kid, we had more to do and less time to do it in. It seemed like it was time for some reassignments. But, of course, I was still better at doing both things. Did that mean I should do them both?

I could have appealed to the principle of fairness: We should each do half. I could have appealed to feminism—surveys show that women more often than not get the short end of the chore stick. In time-use data, women do about 44 minutes more housework than men (2 hours and 11 minutes versus 1 hour and 27 minutes). Men outwork women only in the areas of "lawn" and "exterior maintenance." I could have suggested he do more chores to rectify this imbalance, to show our daughter, in the *Free To Be You and Me* style, that Mom and Dad are equal and that housework is fun if we do it together! I could have simply smashed around the pans in the dishwasher while sighing loudly in the hopes he would notice and offer to do it himself.

But luckily for me and my husband, I'm an economist, so I have more effective tools than passive aggression. And some basic economic principles provided the answer. We needed to divide the chores because it is simply not

efficient for the best cook and dishwasher to do all the cooking and dishwashing. The economic principle at play here is increasing marginal cost. Basically, people get worse when they are tired. When I teach my students at the University of Chicago this principle, I explain it in the context of managing their employees. Imagine you have a good employee and a not-so-good one. Should you make the good employee do literally everything?

Usually, the answer is no. Why not? It's likely that the not-so-good employee is better at 9 a.m. after a full night of sleep than the good employee is at 2 a.m. after a 17-hour workday. So you want to give at least a few tasks to your worse guy. The same principle applies in your household. Yes, you (or your spouse) might be better at everything. But anyone doing the laundry at 4 a.m. is likely to put the red towels in with the white T-shirts. Some task splitting is a good idea. How much depends on how fast people's skills decay.

To "optimize" your family efficiency (every economist's ultimate goal—and yours, too), you want to equalize effectiveness on the final



task each person is doing. Your partner does the dishes, mows the lawn, and makes the grocery list. You do the cooking, laundry, shopping, cleaning, and paying the bills. This may seem imbalanced, but when you look at it, you see that by the time your partner gets to the grocery-list task, he is wearing thin and starting to nod off. It's all he can do to figure out how much milk you need. In fact, he is just about as good at that as you are when you get around to paying the bills, even though that's your fifth task.

If you then made your partner also do the cleaning—so it was an even four and four—the house would be a disaster, since he is already exhausted by his third chore while you are still doing fine. This system may well end up meaning one person does more, but it is unlikely to result in one person doing everything.

Once you've decided you need to divide up the chores in this way, how should you decide who does what? One option would be randomly assigning tasks; another would be having each person do some of everything. One spousal-advice website I read suggested you should divide tasks based on which ones you like the best. None of these are quite right. (In the last case, how would anyone ever end up with the job of cleaning the bathroom?)

To decide who does what, we need more economics. Specifically, the principle of

comparative advantage. Economists usually talk about this in the context of trade. Imagine Finland is better than Sweden at making both reindeer hats and snowshoes. But they are much, much better at the hats and only a little better at the snowshoes. The overall world production is maximized when Finland makes hats and Sweden makes snowshoes.

We say that Finland has an *absolute advantage* in both things but a *comparative advantage* only in hats. This principle is part of the reason economists value free trade, but that's for another column (and probably another author). But it's also a



Illustration by Robert Neubecker

guideline for how to trade tasks in your house. You want to assign each person the tasks on which he or she has a comparative advantage. It doesn't matter that you have an absolute advantage in everything. If you are much, much better at the laundry and only a little better at cleaning the toilet, you should do the laundry and have your spouse get out the scrub brush. Just explain that it's efficient!

In our case, it was easy. Other than using the grill—which I freely admit is the husband domain—I'm much, much better at cooking. And I was only moderately better at the dishes. So he got the job of cleaning up after meals, even though his dishwasher loading habits had already come under scrutiny. The good news is another economic principle I hadn't even counted on was soon in play: *learning by doing*. As people do a task, they improve at it. Eighteen months into this new arrangement the dishwasher is almost a work of art: neat rows of dishes and everything carefully screened for "top-rack only" status. I, meanwhile, am forbidden from getting near the dishwasher. Apparently, there is a risk that I'll "ruin it."

Ms. Oster is a professor of economics at the University of Chicago. ▲

Source: *Slate*, November 21, 2012. The article is found in the link: [http://www.slate.com/articles/double\\_x/doublex/2012/11/dividing\\_the\\_chores\\_who\\_should\\_cook\\_and\\_who\\_should\\_clean.2.html](http://www.slate.com/articles/double_x/doublex/2012/11/dividing_the_chores_who_should_cook_and_who_should_clean.2.html)

Forrest Gump, the boy next door, can mow Brady's lawn in 4 hours. In that same 4 hours, Gump could work at McDonald's and earn \$40.

In this example, Brady has an absolute advantage in mowing lawns because he can do the work with a lower input of time. Yet because Brady's opportunity cost of mowing the lawn is \$20,000 and Gump's opportunity cost is only \$40, Gump has a comparative advantage in mowing lawns.

The gains from trade in this example are tremendous. Rather than mowing his own lawn, Brady should make the commercial and hire Gump to mow the lawn. As long as Brady pays Gump more than \$40 and less than \$20,000, both of them are better off.

## 3-3b Should the United States Trade with Other Countries?

Just as individuals can benefit from specialization and trade with one another, as Frank and Rose did, so can populations of people in different countries. Many of the goods that Americans enjoy are produced abroad, and many of the goods produced in the United States are sold abroad. Goods produced abroad and sold domestically are called **imports**. Goods produced domestically and sold abroad are called **exports**.

imports  
goods produced abroad and sold domestically

exports  
goods produced domestically and sold abroad

To see how countries can benefit from trade, suppose there are two countries, the United States and Japan, and two goods, food and cars. Imagine that the two countries produce cars equally well: An American worker and a Japanese worker can each produce one car per month. By contrast, because the United States has more and better land, it is better at producing food: A U.S. worker can produce 2 tons of food per month, whereas a Japanese worker can produce only 1 ton of food per month.

The principle of comparative advantage states that each good should be produced by the country that has the smaller opportunity cost of producing that good. Because the opportunity cost of a car is 2 tons of food in the United States but only 1 ton of food in Japan, Japan has a comparative advantage in producing cars. Japan should produce more cars than it wants for its own use and export some of them to the United States. Similarly, because the opportunity cost of a ton of food is 1 car in Japan but only  $\frac{1}{2}$  car in the United States, the United States has a comparative advantage in producing food. The United States should produce more food than it wants to consume and export some to Japan. Through specialization and trade, both countries can have more food and more cars.

In reality, of course, the issues involved in trade among nations are more complex than this example suggests. Most important among these issues is that each country has many citizens with different interests. International trade can make some individuals worse off, even as it makes the country as a whole better off. When the United States exports food and imports cars, the impact on an American farmer is not the same as the impact on an American autoworker. Yet, contrary to the opinions sometimes voiced by politicians and pundits, international trade is not like war, in which some countries win and others lose. Trade allows all countries to achieve greater prosperity.

**Quick Quiz** Suppose that a skilled brain surgeon also happens to be the world's fastest typist. Should she do her own typing or hire a secretary? Explain.

### 3-4 Conclusion

You should now understand more fully the benefits of living in an interdependent economy. When Americans buy tube socks from China, when residents of Maine drink orange juice from Florida, and when a homeowner hires the kid next door to mow the lawn, the same economic forces are at work. The principle of comparative advantage shows that trade can make everyone better off.

Having seen why interdependence is desirable, you might naturally ask how it is possible. How do free societies coordinate the diverse activities of all the people involved in their economies? What ensures that goods and services will get from those who should be producing them to those who should be consuming them? In a world with only two people, such as Rose the rancher and Frank the farmer, the answer is simple: These two people can bargain and allocate resources between themselves. In the real world with billions of people, the answer is less obvious. We take up this issue in Chapter 4, where we see that free societies allocate resources through the market forces of supply and demand.

### Summary

- Each person consumes goods and services produced by many other people both in the United States and around the world. Interdependence and trade are desirable because they allow everyone to enjoy a greater quantity and variety of goods and services.
- There are two ways to compare the ability of two people to produce a good. The person who can produce the good with the smaller quantity of inputs is said to have an *absolute advantage* in producing the good. The person who has the smaller opportunity cost of producing the good is said to have a *comparative*

*advantage*. The gains from trade are based on comparative advantage, not absolute advantage.

- Trade makes everyone better off because it allows people to specialize in those activities in which they have a comparative advantage.
- The principle of comparative advantage applies to countries as well as to people. Economists use the principle of comparative advantage to advocate free trade among countries.

### Key Concepts

absolute advantage, p. 52  
opportunity cost, p. 52

comparative advantage, p. 53  
imports, p. 57

exports, p. 57

### Questions for Review

- Under what conditions is the production possibilities frontier linear rather than bowed out?
- Explain how absolute advantage and comparative advantage differ.
- Give an example in which one person has an absolute advantage in doing something but another person has a comparative advantage.
- Is absolute advantage or comparative advantage more important for trade? Explain your reasoning using the example in your answer to Question 3.
- If two parties trade based on comparative advantage and both gain, in what range must the price of the trade lie?
- Why do economists oppose policies that restrict trade among nations?

### Quick Check Multiple Choice

- In an hour, David can wash 2 cars or mow 1 lawn, and Ron can wash 3 cars or mow 1 lawn. Who has the absolute advantage in car washing, and who has the absolute advantage in lawn mowing?
  - David in washing, Ron in mowing.
  - Ron in washing, David in mowing.
  - David in washing, neither in mowing.
  - Ron in washing, neither in mowing.
- Once again, in an hour, David can wash 2 cars or mow 1 lawn, and Ron can wash 3 cars or mow 1 lawn. Who has the comparative advantage in car washing, and who has the comparative advantage in lawn mowing?
  - David in washing, Ron in mowing.
  - Ron in washing, David in mowing.
  - David in washing, neither in mowing.
  - Ron in washing, neither in mowing.
- When two individuals produce efficiently and then make a mutually beneficial trade based on comparative advantage,
  - they both obtain consumption outside their production possibilities frontier.
  - they both obtain consumption inside their production possibilities frontier.
  - one individual consumes inside her production possibilities frontier, while the other consumes outside hers.
  - each individual consumes a point on her own production possibilities frontier.
- Which goods will a nation typically import?
  - those goods in which the nation has an absolute advantage

- b. those goods in which the nation has a comparative advantage
  - c. those goods in which other nations have an absolute advantage
  - d. those goods in which other nations have a comparative advantage
5. Suppose that in the United States, producing an aircraft takes 10,000 hours of labor and producing a shirt takes 2 hours of labor. In China, producing an aircraft takes 40,000 hours of labor and producing a shirt takes 4 hours of labor. What will these nations trade?
- a. China will export aircraft, and the United States will export shirts.
  - b. China will export shirts, and the United States will export aircraft.

## Problems and Applications

1. Maria can read 20 pages of economics in an hour. She can also read 50 pages of sociology in an hour. She spends 5 hours per day studying.
- a. Draw Maria's production possibilities frontier for reading economics and sociology.
  - b. What is Maria's opportunity cost of reading 100 pages of sociology?
2. American and Japanese workers can each produce 4 cars a year. An American worker can produce 10 tons of grain a year, whereas a Japanese worker can produce 5 tons of grain a year. To keep things simple, assume that each country has 100 million workers.
- a. For this situation, construct a table analogous to the table in Figure 1.
  - b. Graph the production possibilities frontiers for the American and Japanese economies.
  - c. For the United States, what is the opportunity cost of a car? Of grain? For Japan, what is the opportunity cost of a car? Of grain? Put this information in a table analogous to Table 1.
  - d. Which country has an absolute advantage in producing cars? In producing grain?
  - e. Which country has a comparative advantage in producing cars? In producing grain?
  - f. Without trade, half of each country's workers produce cars and half produce grain. What quantities of cars and grain does each country produce?
  - g. Starting from a position without trade, give an example in which trade makes each country better off.
3. Pat and Kris are roommates. They spend most of their time studying (of course), but they leave some time for their favorite activities: making pizza and

- c. Both nations will export shirts.
  - d. There are no gains from trade in this situation.
6. Mark can cook dinner in 30 minutes and wash the laundry in 20 minutes. His roommate takes half as long to do each task. How should the roommates allocate the work?
- a. Mark should do more of the cooking based on his comparative advantage.
  - b. Mark should do more of the washing based on his comparative advantage.
  - c. Mark should do more of the washing based on his absolute advantage.
  - d. There are no gains from trade in this situation.

brewing root beer. Pat takes 4 hours to brew a gallon of root beer and 2 hours to make a pizza. Kris takes 6 hours to brew a gallon of root beer and 4 hours to make a pizza.

- a. What is each roommate's opportunity cost of making a pizza? Who has the absolute advantage in making pizza? Who has the comparative advantage in making pizza?
  - b. If Pat and Kris trade foods with each other, who will trade away pizza in exchange for root beer?
  - c. The price of pizza can be expressed in terms of gallons of root beer. What is the highest price at which pizza can be traded that would make both roommates better off? What is the lowest price? Explain.
4. Suppose that there are 10 million workers in Canada and that each of these workers can produce either 2 cars or 30 bushels of wheat in a year.
- a. What is the opportunity cost of producing a car in Canada? What is the opportunity cost of producing a bushel of wheat in Canada? Explain the relationship between the opportunity costs of the two goods.
  - b. Draw Canada's production possibilities frontier. If Canada chooses to consume 10 million cars, how much wheat can it consume without trade? Label this point on the production possibilities frontier.
  - c. Now suppose that the United States offers to buy 10 million cars from Canada in exchange for 20 bushels of wheat per car. If Canada continues to consume 10 million cars, how much wheat does this deal allow Canada to consume? Label this point on your diagram. Should Canada accept the deal?

5. England and Scotland both produce scones and sweaters. Suppose that an English worker can produce 50 scones per hour or 1 sweater per hour. Suppose that a Scottish worker can produce 40 scones per hour or 2 sweaters per hour.
- a. Which country has the absolute advantage in the production of each good? Which country has the comparative advantage?
  - b. If England and Scotland decide to trade, which commodity will Scotland trade to England? Explain.
  - c. If a Scottish worker could produce only 1 sweater per hour, would Scotland still gain from trade? Would England still gain from trade? Explain.
6. The following table describes the production possibilities of two cities in the country of Baseballia:

|         | Pairs of Red Socks per Worker per Hour | Pairs of White Socks per Worker per Hour |
|---------|----------------------------------------|------------------------------------------|
| Boston  | 3                                      | 3                                        |
| Chicago | 2                                      | 1                                        |

- a. Without trade, what is the price of white socks (in terms of red socks) in Boston? What is the price in Chicago?
  - b. Which city has an absolute advantage in the production of each color sock? Which city has a comparative advantage in the production of each color sock?
  - c. If the cities trade with each other, which color sock will each export?
  - d. What is the range of prices at which trade can occur?
7. A German worker takes 400 hours to produce a car and 2 hours to produce a case of wine. A French worker takes 600 hours to produce a car and X hours to produce a case of wine.
- a. For what values of X will gains from trade be possible? Explain.

- b. For what values of X will Germany export cars and import wine? Explain.
8. Suppose that in a year an American worker can produce 100 shirts or 20 computers and a Chinese worker can produce 100 shirts or 10 computers.
- a. For each country, graph the production possibilities frontier. Suppose that without trade the workers in each country spend half their time producing each good. Identify this point in your graphs.
  - b. If these countries were open to trade, which country would export shirts? Give a specific numerical example and show it on your graphs. Which country would benefit from trade? Explain.
  - c. Explain at what price of computers (in terms of shirts) the two countries might trade.
  - d. Suppose that China catches up with American productivity so that a Chinese worker can produce 100 shirts or 20 computers. What pattern of trade would you predict now? How does this advance in Chinese productivity affect the economic well-being of the citizens of the two countries?
9. Are the following statements true or false? Explain in each case.
- a. "Two countries can achieve gains from trade even if one of the countries has an absolute advantage in the production of all goods."
  - b. "Certain very talented people have a comparative advantage in everything they do."
  - c. "If a certain trade is good for one person, it can't be good for the other one."
  - d. "If a certain trade is good for one person, it is always good for the other one."
  - e. "If trade is good for a country, it must be good for everyone in the country."

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