VI
COMPARATIVE ADVANTAGE AND DEVELOPMENT POLICY

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In the great revival of interest in economic development that has marked
the past decade, attention has centered on two main questions: first, what
determines the over-all rate of economic advance? second, what is the optimal
allocation of given resources to promote growth? Analysis of the
growth rate has relied mainly on the Keynesian tools and has produced a
multiplicity of aggregate growth models. The second question, however,
reopens more ancient economic issues, and their analysis must start from the
classical and neo-classical solutions. Only very recently have the two types
of discussion tended to come together in the more comprehensive framework
of general equilibrium analysis.

In the field of resource allocation, controversy centers around the implica­
tions of the classical principle of comparative advantage, according to which
growth is promoted by specialization. The defenders of this principle draw
their inspiration from David Ricardo, J. S. Mill, and Alfred Marshall, while
the lines of attack stem from Friedrich List, J. A. Schumpeter, A. A. Young,
and J. H. Williams. The chief criticism is that comparative advantage is
essentially a static concept which ignores a variety of dynamic elements.

This issue is of great practical importance to the governments of under­
developed countries, most of which take an active part in allocating invest­
ment funds and other scarce resources. The main purpose of the discussion
has therefore been to discover workable principles for the formulation of
development policy. The classical approach derives these principles from
international trade theory, while its critics base their analysis on modern
growth theory. Elements of a dynamic, general-equilibrium theory are
needed to resolve the differences between the two approaches. The more
general analysis is of very limited value, however, unless its empirical impli­
cations can be ascertained.

The present paper discusses the analysis of resource allocation in less­
developed economies from three points of view. Section I tries to ascertain
the extent to which the allocation principles derived from trade theory and

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from growth theory can be reconciled with each other without losing their operational significance. Section II compares various approaches to the measurement of optimal resource allocation in terms of their logical consistency and their applicability to different conditions. Section III examines some of the practical procedures followed in setting investment policy in underdeveloped countries in the light of the earlier discussion. Finally, some of the theoretical issues are re-examined to indicate their practical importance.

I. Conflicts Between Trade Theory and Growth Theory

The main contradictions between comparative advantage and other principles of resource allocation derive from their different orientation and assumptions. The classical analysis focuses on long-run tendencies and equilibrium conditions, while modern theories of growth are concerned with the interaction among producing and consuming units in a dynamic system. Since both approaches are familiar, I shall try to identify only the differences in assumptions and emphasis that lead to different policy conclusions.

A. The Implications of Comparative Advantage for Resource Allocation

The modern version of the comparative cost doctrine [20] is essentially a simplified form of static general equilibrium theory.¹ The optimum pattern of production and trade for a country is determined from a comparison of the opportunity cost of producing a given commodity with the price at which the commodity can be imported or exported. In equilibrium, no commodity is produced which could be imported at lower cost, and exports are expanded until marginal revenue equals marginal cost. Under the assumptions of full employment and perfect competition, the opportunity cost of a commodity, which is the value of the factors used to produce it in their best alternative employment, is equal to its market value. Market prices of factors and commodities can therefore be used to determine comparative advantage under competitive conditions. Long-term changes are not ignored, but they are assumed to be reflected in current market prices.

The Heckscher–Ohlin version of the comparative cost doctrine has been widely recommended as a basis for development policy because it provides a measure of comparative advantage that does not depend on the existence of perfect competition and initial equilibrium. This version states that a country will benefit from trade by producing commodities that use more of its relatively abundant factors of production. It will export these commodities and import commodities using more of its relatively scarce factors unless its pattern of domestic demand happens to be biased toward commodities using domestic factors. The critical assumptions in this analysis are that

¹ An excellent discussion and synthesis of the several versions of trade theory is given by Caves [7]. The terms “comparative advantage” and “comparative cost” are used interchangeably in most discussions.