Paging David Ricardo

Published on *Show-Me Institute* (https://showmeinstitute.org)

By: Abhi Sivasailam

A few weeks ago, I testified at the Missouri Tax Credit Review Commission's meeting in Columbia. I'd like to highlight one specific point from this speech.

One particular member of the commission (I do not remember which one) attacked a previous speaker who had recommended that all tax credits be abolished. The commission member suggested that since every other state uses tax credits, Missouri's exit from the business of providing tax credits would put us at such a disadvantage that could result in Missouri no longer producing anything. There are many possible responses to this complaint that tax credit opponents can employ; for brevity, I will note just one.

Comparative Advantage:

Consider two states: Missouri and California. Suppose that these two states have firms that can produce two goods: wine and computers. Now, suppose that firms in Missouri can produce six bottles of wine or three computers per hour, whereas firms in California can produce 12 bottles of wine and four computers per hour. In this case, California firms have a higher productivity and we would say that California has an **absolute advantage** in the production of both wine and computers. This does not, however, imply that California will, or should, produce both goods.

One of the key insights from introductory economics courses is that **comparative advantage** matters. Instead of evaluating productivity in terms of outputs, we can evaluate productivity in terms of opportunity cost. Note that, in this example, when a Missouri firm produces one bottle of wine, it misses an opportunity to produce half of a computer. Similarly, when a Missouri firm produces one computer, it misses an opportunity to produce two bottles of wine. We can think of these missed opportunities as costs. For California firms, the cost of producing one bottle of wine is a third of a computer, and the cost of producing one computer is three bottles of wine. So, our example shows that even when California has an absolute advantage in the production of both goods, Missouri still retains a comparative advantage in the production of computers because its opportunity cost (two bottles of wine) is lower than the opportunity cost for California firms (three bottles of wine). Thus, in this limited illustration, it would be more efficient for Missouri to produce computers and trade with California for wine.

We can apply this insight to tax credits. Suppose that California aggressively courts winemakers and computer manufacturers with tax incentives and Missouri does not. One way to think about these incentives is that they work to lower the marginal costs that firms face, which allows a firm to produce more. This makes it *appear* as though California firms are more productive in translating inputs (in dollars) into outputs (in product volume). As our example illustrates, even if these apparent increases in productivity give Californian firms an absolute advantage in the production of certain goods, it is likely that Missouri will still retain comparative advantage and will continue to produce many of the goods that California chooses to subsidize.

About the Author

Abhi Sivasailam

Read Online

https://showmeinstitute.org/blog/transparency/paging-david-ricardo#comment-0

Links

[1] https://showmeinstitute.org/blog/transparency/paging-david-ricardo
[2] http://www.econlib.org/library/Topics/Details/comparativeadvantage.html

Mission Statement

Advancing liberty with responsibility by promoting market solutions for Missouri public policy.

Show-Me Institute

5297 Washington Place	3645 Troost Avenue
Saint Louis, MO 63108	Kansas City, MO 64109
Phone: (314) 454-0647	Phone: (816) 287-0370
Fax: (314) 454-0667	

Email: info@showmeinstitute.org

Support Our Work

The Show-Me Institute is a tax-exempt 501(c)(3) nonprofit organization. Make your tax deductible contribution today: http://ShowMeInstitute.org/donate