

Comparative Advantage, the Heckscher-Ohlin Model, and Leadership Decisions

Alissa Kowalski

Niagara University

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Dr. Lueck

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Introduction

Although the theories of absolute and comparative advantage have their origins in trade and economics, there are a wide variety of implications for individuals, businesses, and organizations as well as within leadership and policy decision making. Organizational assessment research shows that economic theory plays a “significant role in determining the structure of organizations in an economy” (Lusthaus et al., 2002, p. 29). Borrowing and applying theories from a variety of industries will benefit organizations when it comes to developing new and competitive ideas. Particularly, utilizing these economic concepts related to allocation of labor and resources when evaluating how to divide tasks, capital, and other assets will allow organizations and individuals to work according to their strengths and maximize their production and wellbeing.

Absolute Advantage

The theory of absolute advantage developed by Adam Smith suggests that labor based on the productive advantages of each country would produce optimal results. Absolute advantage is the ability to produce more goods based on the same allocation of resources, and is not a mutual or reciprocal trade model (Krugman et al., 2017; Torelli, 2017). With increased international cooperation and trade, there is an increased reliance on reciprocal and mutually beneficial agreements between trade partners (Siddiqui, 2016). Absolute advantage is developing a skillset, product, or employee to a higher level than another organization. If a business or employee can complete a task more efficiently or at a higher level than another business or employee, then they would have absolute advantage in that situation. However, this does not necessarily consider other resources or competitors, instead remaining highly focused and specialized on what one business or employee is doing (Lusthaus et al., 2002). Because of this individualized approach,

the absolute advantage trade theory tends to be set aside by leaders and policy makers in favor of the comparative advantage theory, both within economics and beyond.

Comparative Advantage

With comparative advantage, David Ricardo argues for comparing production costs and opportunity costs among nations to determine the most effective division of labor. As the basis for modern trade theory, comparative advantage generally results in a mutually beneficial exchange and productivity growth among trade partners, regardless of respective products and prices (Siddiqui, 2016). The Ricardian model suggests that there will be a “very high degree of specialization” due to the interdependence and reciprocal nature of the theory, but this does not necessarily occur in global trade and a global economy as production is more diversified (Torelli, 2017, p. 72). When labor is considered the main factor of production and the only difference is the productivity of the labor in various industries, countries will “export goods in which they have relatively high productivity” (Krugman et al., 2017, p. 76). Although each country has the ability to produce and export whatever goods or resources they would like, when comparative advantage is followed, both trade partners will benefit. This is because, not only is labor being efficiently managed among the country producing the resources and labor, but the country consuming the goods benefits as they are able to dedicate their own resources in a manner that will also produce the most beneficial results for themselves. As with absolute advantage, this theory has applications outside of trade and economics when it comes to assigning tasks or allocating labor resources.

Heckscher-Ohlin Model

The Heckscher-Ohlin Model, or the factor proportions model, is an extension of comparative advantage and it assumes that each economy has a given amount of capital, labor,

technology, and various other resources. With these differences in factors of production, the model “predicts that the direction of trade between nations will be determined by differences in supply-side factor abundance” (Torelli, 2017, p. 73). In other words, countries must export products based on inputs and resources they have in abundance and import products based on inputs and resources that are scarce (Krugman et al., 2017; Siddiqui, 2016). Each nation will produce the good that makes greater use of the factor of production, be it capital, labor, technology, or something else, that it has in abundance. The overall result of the Heckscher-Ohlin Model is that countries “tend to produce relatively more of goods that use its abundant resources intensively” (Krugman et al., 2017, p. 143). Although evidence on the model is mixed, it can be utilized to predict certain patterns of trade, particularly between developed and developing nations. Like both absolute and comparative advantage, the Heckscher-Ohlin Model can also be applied to situations outside of economics and trade in a manner that is beneficial for leaders and organizations.

Impact on Leadership Decision Making

Economics play a major role in organizational environments as this will increase the ability for leaders to “develop competition policy framework and examine industrial sectors” (Lusthaus et al., 2002, p. 25). Understanding economic theories like absolute and comparative advantage and the Heckscher-Ohlin Model is necessary for leaders to make well-informed, competitive policy and organization decisions. One major impact of utilizing economic theories is implementing the appropriate allocation of resources and developing unique but viable strategies. Effective leadership is dependent on sharing information with followers, and more importantly, an individual in a leadership position “must also convince followers that she is transmitting the correct information; that is she must convince them that she is not *misleading*

them” (Hermalin, 1998, p. 1189). In this way, not only do leaders need to rely on understanding policy and theory, but also making and communicating decisions that are beneficial for both organizations and individuals. It is important to pull concepts from a wide variety of resources in order to communicate effectively with diverse organizations.

When there are decisions surrounding the allocation of labor and the distribution of wages, an understanding of absolute advantage, competitive advantage, and the Heckscher-Ohlin model can improve organizational outcomes. As previously explained, absolute advantage tends to be focused entirely on producing optimal results based on internal resources. In organizations, this would mean dividing tasks and labor using what each individual does best, but not necessarily taking into account the strengths and weaknesses of the organization holistically. Although each individual might be working at their highest level of production, it might cause problems if there are tasks that are being ignored or labor redundancies within an organization. The downside of the absolute advantage is that the leadership decision is not considering the larger picture of how each part of the organization is working together, or even how the organization fits in relation to others that might be similar.

In contrast to absolute advantage, a leader using comparative advantage to make these same decisions on labor allocation could create a vastly different organization. While comparative advantage is still concerned with productivity and appropriately distributing resources, it also takes into account the setting and culture of the organization in which these decisions are taking place. According to Torelli (2017):

Comparative advantage implies that each person should follow the career path or line of work which they are best at, to maximize their production and well-being, however measured. Within an organization, each member ought to work according to his or her

strengths; within each industry, every company has its own comparative advantage. (p. 69)

When leaders can identify an appropriate measure of an individual's productivity in relation to the rest of the organization members, each person will be allowed and encouraged to work at their full potential. This will benefit the individual and, by extension, the organization. Knowing how comparative advantage works, leaders can also make an argument for the theory benefiting the entire industry as a whole by allowing employees to excel in a role that could contribute to organization and industry innovation.

The Heckscher-Ohlin Model is a valuable tool for leaders to understand as it could encourage not only interdepartmental collaboration but also, similar to comparative advantage, collaboration between various organizations. The Heckscher-Ohlin Model predicts that trade will happen when there is a mutually beneficial opportunity to exchange abundant goods. Among organizations, this could happen between individuals collaborating on a project, departments working toward a common end goal, or even industry partners who can identify an area of common need. In this way, leaders can allocate their abundant resource – time, labor, expertise in a field, technology, physical space – and receive in return a resource they might be lacking. Like both absolute advantage and comparative advantage, utilizing this theory outside of a trade or economic industry can invite new opportunities for growth and development that might not be available otherwise.

Conclusion

Lusthaus et al. (2002) argues that “organizations do not exist in a vacuum” and that the environment in which it is located affects the “organization and its performance, what it produces, and how it operates” (p. 23). Because of this, leaders within every sector must

continue to be innovative in their approach to institutional leadership and policy. One way to expand organizational productivity, production, and overall wellbeing is to borrow trade and economic theories. By applying absolute advantage, comparative advantage, and the Heckscher-Ohlin Model to leadership decision making, there can be collaborative, reciprocal, and mutually beneficial developments within and between organizations and individuals beyond what the original scope of the theories predicted.

References

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