

University of Tübingen
Working Papers in
Economics and Finance

No. 30

Unilateral Trade Liberalization in the Melitz Model:
A Note

by

Gabriel Felbermayr & Benjamin Jung



Unilateral Trade Liberalization in the Melitz Model: A Note

Gabriel Felbermayr* & Benjamin Jung†

February 28, 2012

Abstract

In the two-country Melitz (2003) model, unilateral trade liberalization is often cast as a reduction of iceberg transportation costs and wages are determined by a linear outside sector. We show that welfare results reverse when wages adjust and trade frictions are revenue-generating tariffs.

JEL-Classification: F12, R12.

Keywords: Monopolistic Competition; Heterogeneous Firms; International Trade; Trade Policy

1 Introduction

Melitz & Ottaviano (2008) and Demidova (2008) use variants of the Melitz (2003) model to show that unilateral trade liberalization—cast as lower iceberg transportation costs—can be *immiserizing*. These models use a linear outside sector that pins down wages. Generalizing Demidova & Rodriguez-Clare (2009, 2011), we use a two-country framework with fully endogenous wages. Moreover, we contrast iceberg transportation costs (non-tariff import barriers) to revenue-generating tariffs.

In stark contrast to the case of a linear outside good, the model with fully endogenous wages predicts that a unilateral reduction of non-tariff import barriers *benefits both* countries. When trade liberalization comes as a unilateral reduction in an *ad valorem* import tariff, the liberalizing country typically loses, while the other country

*ifo Institute – Leibniz Institute for Economic Research at the University of Munich, Poschingerstraße 5, 81679 Munich, Germany; LMU Munich; CESifo; GEP; felbermayr@ifo.de.

†University of Tübingen, Economics Department, Nauklerstraße 47, 72074 Tübingen, Germany, benjamin.jung@uni-tuebingen.de.

always gains. Our analysis suggests that the assumption of a linear outside sector—often made for the sake of convenience—distorts the welfare predictions of the model. Equating trade liberalization with lower iceberg transportation costs—as also often done—is equally problematic.

2 Model

2.1 Setup

Our setup is a two-country version of Arkolakis, Demidova, Klenow & Rodriguez-Clare (2008), henceforth ADKR, to which we refer for a more detailed explanation of the model setup.¹ The major difference to ADKR is that we allow for revenue-generating *ad valorem* tariffs. Home and Foreign, indexed $i \in \{H, F\}$, are populated by representative consumers who inelastically supply the only factor of production, labor, L_i at price w_i . The consumers have identical standard Dixit-Stiglitz preferences with a constant elasticity of substitution given by $\sigma > 1$.

Firms compete monopolistically. After paying innovation costs $w_i f^e$, each draws its productivity level φ from a Pareto distributed c.d.f. $G[\varphi] = 1 - \varphi^{-\beta}$, where $\beta > \sigma - 1$ to guarantee the existence of a well-defined size distribution. Output is linear in φ . Fixed costs of accessing market j are given by $w_i f_{ij}$, where we set $f_{ii} = f_{jj} = f^d$ and $f_{ij} = f_{ji} = f^x$. Country i may levy an *ad valorem tariff* $t_{ij} > 1$ on its imports or may impose a non-tariff import barrier $\tau_{ij} > 1$, where $t_{ii} = t_{jj} = \tau_{ii} = \tau_{jj} = 1$. In line with the above cited papers, we model non-tariff import barriers as iceberg transportation costs.

2.2 Equilibrium conditions

The first set of equilibrium conditions is made up of four *zero cutoff-profit conditions* (ZCPs). They determine the productivity φ_{ij}^* of those firms in country i which just break even by selling to market j :

$$r[\varphi_{ij}^*] = \sigma w_i f_{ij}, \quad i \in \{H, F\}, \quad j \in \{H, F\}, \quad (1)$$

where $r[\varphi_{ij}] = E_j P_j^{\sigma-1} t_{ji}^{-\sigma} \left(\frac{\rho \varphi_{ij}}{\tau_{ji} w_i} \right)^{\sigma-1}$ is revenue of firm φ located in i earned from sales in j with $\rho = (\sigma - 1) / \sigma$. E_j is aggregate expenditure. The price index P_i is given by

$$P_i^{1-\sigma} = \theta \sum_{j \in \{H, F\}} m_{ji} M_j \left(\frac{\rho \varphi_{ji}^*}{w_j \tau_{ij} t_{ij}} \right)^{\sigma-1}, \quad (2)$$

¹In contrast to us, for their purposes, ADKR do not derive the complete comparative statics of their model.

with $\theta \equiv \beta / (\beta - (\sigma - 1)) > 0$. M_j denotes the mass of domestic firms operating in j and $m_{ji} = (1 - G[\varphi_{ji}^*]) / (1 - G[\varphi_{jj}^*]) = (\varphi_{jj}^* / \varphi_{ji}^*)^\beta$ is the probability of exporting.

The second set of conditions is made up of two *free entry conditions*, which make sure that expected profits equalize the costs of innovation.

$$(\theta - 1) (\varphi_{ii}^*)^{-\beta} \sum_{j \in \{H, F\}} m_{ij} f_{ij} = f^e. \quad (3)$$

Finally, there are two *labor market clearing conditions*

$$M_i = \frac{(\theta - 1) L_i}{\sigma \theta f^e} (\varphi_{ii}^*)^{-\beta}. \quad (4)$$

These conditions make up a system of eight equations in eight unknown endogenous variables $\{\varphi_{HH}^*, \varphi_{FF}^*, \varphi_{HF}^*, \varphi_{FH}^*; M_H, M_F; w_H, w_F\}$.

2.3 Welfare and auxiliary relationships

The variable of interest in this note is the representative agent's level of welfare. Under the Pareto assumption, we have

$$W_i = \theta (\sigma - 1)^\rho \sum_j m_{ji} M_j \left(\frac{f_{ji}}{\tau_{ij}} \varphi_{ji}^* \right)^\rho. \quad (5)$$

In contrast to tariffs, non-tariff barriers appear directly in this expression. To sign changes of W_i , we need to pin down changes in cutoffs φ_{ji}^* .

In the presence of tariffs, aggregate expenditure E_i relevant for welfare is

$$E_i = \sigma \theta \sum_{j \in \{H, F\}} w_j t_{ij} M_j \bar{r}_{ji} = \sigma \theta M_i w_i \sum_{j \in \{H, F\}} t_{ij} \bar{r}_{ij}, \quad (6)$$

where $\bar{r}_{ij} = \sigma \theta w_i m_{ij} f_{ij}$ denotes average revenues that a firm in i makes on market j . The second equality in (6) follows balanced trade, $M_i \bar{r}_{ij} = M_j \bar{r}_{ji}$, which is implied by agents being on their budget constraints.

Finally, different to the case of non-tariff barriers, equilibrium welfare will turn out to depend on both, the share of revenues earned domestically, α_i , and the share of expenditure spent on domestic varieties, $\tilde{\alpha}_i$:

$$\alpha_i \equiv \frac{M_i \bar{r}_{ii}}{M_i \bar{r}_{ii} + M_i \bar{r}_{ij}} = \frac{1}{1 + m_{ij} (f^x / f^d)}; \tilde{\alpha}_i \equiv \frac{M_i \bar{r}_{ii}}{M_i \bar{r}_{ii} + t_i M_j \bar{r}_{ji}} = \frac{1}{1 + t_i m_{ij} (f^x / f^d)}. \quad (7)$$

Importantly, $\tilde{\alpha}_i < \alpha_i$. Without tariffs, $\tilde{\alpha}_i = \alpha_i$.

3 Unilateral trade liberalization

We study the effect of a reduction in a given import tariff t_H and of a lower non-tariff import barrier τ_H on welfare in Home and Foreign.² In contrast to models with a linear outside sector, Home's relative wage $\omega \equiv w_H/w_F$ is free to adjust. After characterizing endogenous wage adjustment in the presence of tariff income, we derive the general equilibrium effects of unilateral trade liberalization on both countries' welfare.

3.1 Endogenous wage adjustment

To prepare the comparative statics, we totally differentiate the above equations, using the traditional 'hat' notation $\hat{x} \equiv dx/x$. Using Home's import cutoff condition (1) relative to its domestic cutoff condition, and totally differentiating, one obtains

$$\rho(\hat{\varphi}_{FH}^* - \hat{\varphi}_{HH}^*) + \hat{\omega} = \hat{t}_H + \rho\hat{\tau}_H. \quad (8)$$

Changes in tariffs or transportation costs can be absorbed by adjustment in cutoffs or the wage rate.

Home's export cutoff condition relates the change in the wage rate to changes in its export cutoff and foreign aggregate variables

$$\hat{\omega} = \rho\hat{\varphi}_{HF}^* + \rho\hat{P}_F + (1 - \rho)\hat{E}_F. \quad (9)$$

Foreign's price index can be written in exactly the same variables as (9)

$$\hat{P}_F = \frac{1 - \tilde{\alpha}_F}{\theta - 1 + \tilde{\alpha}_F}\hat{\varphi}_{HF}^* - \frac{\tilde{\alpha}_F}{\theta - 1 + \tilde{\alpha}_F}\frac{\hat{E}_F}{\sigma - 1} + \frac{(1 - \tilde{\alpha}_F)(\theta - 1)}{\theta - 1 + \tilde{\alpha}_F}\hat{\omega}, \quad (10)$$

where Foreign's domestic entry cutoff condition $\hat{\varphi}_{FF}^* = -\hat{P}_F - \hat{E}_F/(\sigma - 1)$ has been used. If tariff revenue melts away as in Ossa (2011), a tariff reform has no direct effect on aggregate income. Then, equation (9) simplifies to $\hat{\omega} = \beta/(1 - \tilde{\alpha}_F)\hat{\varphi}_{HF}^*$. With tariff revenue, this is no longer true. Differentiating (6) and using balanced trade,

$$\hat{E}_F = -\beta\hat{\varphi}_{FF}^* + (1 - \tilde{\alpha}_F)\hat{m}_{FH} = -\beta\frac{\alpha_F - \tilde{\alpha}_F}{\alpha_F}\hat{\varphi}_{FH}^* = -\beta\frac{\alpha_F - \tilde{\alpha}_F}{\alpha_F}\left(\hat{\varphi}_{HF}^* - \frac{\hat{\omega}}{\beta}\right), \quad (11)$$

where the second equality follows from balanced trade, $\hat{\omega} - \beta\hat{\varphi}_{HF}^* = -\beta\hat{\varphi}_{FH}^*$.

Equations (10) and (11) allow to rewrite (9) as a function of Home's export cutoff only

$$\hat{\omega} = \xi\hat{\varphi}_{HF}^*, \text{ where } \beta > \xi \equiv \frac{\beta\rho}{\rho + \alpha_F(\beta - \rho)} > \rho. \quad (12)$$

Hence, if an exogenous change in t_H or τ_H increases φ_{HF}^* , Home's wage relative to Foreign's must go up.

²Whenever convenient, we write t_H and τ_H for t_{HF} and τ_{HF} .

3.2 Welfare effects

Using (12), balanced trade, and the totally differentiated free entry condition $\hat{\varphi}_{ii}^* = -(1 - \alpha_i) \hat{\varphi}_{ij}^*/\alpha_i$, Home's relative import cutoff condition (8) implies

$$\hat{\varphi}_{FH}^* = \kappa (\hat{t}_H + \rho \hat{\tau}_H), \text{ where } \kappa \equiv \left(\rho + \frac{\beta \rho}{\beta - \xi} \left(\frac{\xi}{\rho} + \frac{1 - \alpha_H}{\alpha_H} \right) \right)^{-1} > 0. \quad (13)$$

Since balanced trade together with (12) implies a positive link between both export (import) cutoffs, $\hat{\varphi}_{HF}^* = \beta \hat{\varphi}_{FH}^*/(\beta - \xi)$, Foreign's import cutoff goes up, too. By free entry, domestic cutoffs move in the opposite directions.

Totally differentiating (5), using the labor market clearing conditions to replace M_j and the free entry conditions to substitute out φ_{ii}^* , the change in welfare is

$$\hat{W}_i = \frac{\beta - \rho}{\beta} \left[-\beta \frac{\alpha_i - \tilde{\alpha}_i}{\alpha_i} + \xi A_i \right] \hat{\varphi}_{HF}^* - (1 - \tilde{\alpha}_i) \rho \hat{\tau}_{ij}, \quad (14)$$

where $A_H = 1 - \tilde{\alpha}_H > 0$ and $A_F = -(1 - a_F) \tilde{\alpha}_F/a_F < 0$. In contrast to tariffs, τ_H directly appears in Home's utility function (5) due to its resource saving effect.

Let $\hat{\tau}_H = 0$ and consider a tariff reform. If initially $t_H = 1$, $\alpha_H - \tilde{\alpha}_H = 0$. Hence, $\hat{W}_H/\hat{t}_H > 0$ for a 'small' tariff (either revenue-generating or 'wasteful').³ In contrast, we always have $\hat{W}_F/\hat{t}_H < 0$.

Now, fix $t_H = 1$ and consider a unilateral liberalization of Home's non-tariff import barriers. τ_H has no direct effect on W_F . Noting $\hat{\varphi}_{FH}^*/\hat{\tau}_H > 0$ and the positive link between both export cutoffs implied by balanced trade, we have $\hat{W}_F/\hat{\tau}_H < 0$. Using the same relationships and $A_H = 1 - \tilde{\alpha}_H$ in \hat{W}_H , one obtains $\hat{W}_H/\hat{\tau}_H < 0$. The result follows from $(\beta - \rho) \kappa \xi / (\beta - \xi) = [1 + \beta \rho / \alpha_H (\beta - \rho)]^{-1} < 1$.

We may summarize:

Proposition 1 *In a two-country Melitz (2003) model with Pareto-distributed productivities, unilateral liberalization of a 'small' ad valorem import tariff lowers welfare of the liberalizing country and raises welfare of its trading partner, while a unilateral reduction of non-tariff import barriers always benefits both countries.*

So, lower non-tariff import barriers do not immiserize the liberalizing country or its trade partner.⁴ This is in contrast to Demidova (2008) or Melitz & Ottaviano (2008) where wages are technologically fixed. A unilateral reduction of the tariff can hurt the

³Our analysis shows that there exists a finite positive tariff in a one-sector Melitz (2003) model. This generalizes Demidova & Rodríguez-Clare (2009) who study the small economy case. It also summarizes Ossa (2011) who studies a wasteful tariff in a model with a linear outside sector.

⁴Demidova & Rodríguez-Clare (2011) have already shown the welfare effects for Home, albeit in a setup without tariffs; the proof for Foreign is new.

liberalizing country.⁵ In Ossa's (2011) model, due to the linear outside sector, without modeling tariff income, unilateral reduction of tariffs always lowers Home's welfare. Finally, note that our results qualitatively carry over to the Krugman (1980) model which is nested by our setup for $\beta \rightarrow \sigma - 1$.⁶

References

- [1] Arkolakis, C., S. Demidova, P. Klenow and A. Rodríguez-Clare (2009), 'Endogenous Variety and the Gains from Trade', *American Economic Review* **98**(2): 444-450.
- [2] Burstein, A.T. and J. Vogel (2011). 'Factor Prices and International Trade: A Unifying Perspective', *NBER Working Paper* 16904.
- [3] Demidova, S. (2008), 'Productivity Improvements and Falling Trade Costs: Boon or Bane?', *International Economic Review* **49**(4): 1437-1462.
- [4] Demidova, S. and A. Rodríguez-Clare (2009), 'Trade Policy under Firm-Level Heterogeneity in a Small Economy', *Journal of International Economics* **78**(1): 100-112.
- [5] Demidova, S. and A. Rodríguez-Clare (2011), 'The Simple Analytics of the Melitz Model in a Small Open Economy', *NBER Working Paper* 17521.
- [6] Felbermayr, G., B. Jung and M. Larch (2011), 'Optimal Tariffs, Retaliation and the Welfare Loss from Tariff Wars in the Melitz Model', *CESifo Working Paper* 3474.
- [7] Melitz, M.J. (2003), 'The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity', *Econometrica* **71**: 1695-1725.
- [8] Melitz, M.J. and G.I.P. Ottaviano (2008), 'Market Size, Trade, and Productivity', *Review of Economic Studies* **75**(1): 295-316.
- [9] Ossa, R. (2011), 'A "New Trade" Theory of GATT/WTO Negotiations', *Journal of Political Economy* **119**(1): 122-152.

⁵Demidova & Rodriguez-Clare (2009) show the existence of an optimal tariff in the *small* economy Melitz model. Our results pertain to a world of two large countries. Felbermayr, Jung & Larch (2011) study tariff wars in the Melitz model.

⁶See Burstein & Vogel (2011).