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Svetlana Demidova

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Trade Policies, Firm Heterogeneity, and Variable Markups*

Svetlana Demidova†
McMaster University

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Abstract

We study unilateral trade liberalization in a model of monopolistic competition with heterogeneous firms, endogenous wages, and non-separable and non-homothetic quadratic preferences that generate variable markups. We show that the optimal level of the revenue-generating import tariff is strictly positive so that protection is always desirable, whether the liberalizing economy is large or small. Yet, reductions in cost-shifting trade barriers are welfare-improving, making free trade optimal. Finally, we show that in both cases, variable markups result in negative pro-competitive effects, reducing gains from trade.

1 Introduction

In the last few decades there has been a general downward trend in import tariffs around the world that resulted in significant welfare gains. For example, by using the new tariff dataset on 189 countries, Caliendo et al. (2015) show that more than 90% of gains from trade liberalization between 1990 and 2010 can be attributed to falling MFN tariffs. Bown and Crowley (2016) demonstrate the similar downward trend in tariffs for their set of 31 major economies between 1993 and 2013. Yet, despite import tariffs being low on average, significant cross-country and cross-sectoral variation remains. Bown and Crowley (2016) report that as of 2013-2014, low-income countries tend to

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†Department of Economics, McMaster University, 1280 Main Street West, Hamilton, ON, Canada L8S 4M4. E-mail: demidov@mcmaster.ca. Phone: (905) 525 9140, ext. 26095. Fax: (905) 521 8232