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Endogenous Labor Supply and the Optimal Tariff

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ABSTRACT

A large body of literature in international economics has tried to calculate the optimal tariff in a setting with constant labor supply. However, this model introduces a consumption-leisure choice into a standard model of international trade with exogenously fixed labor supply. Therefore, this paper focuses on the response of labor to changes in trade barriers. Moreover, I show that there exists a positive optimal tariff rate which maximizes welfare in a setting with endogenous labor and compare this result quantitatively with the standard models using constant labor supply. This paper also focuses on the welfare implications of a decline in trade barriers (in terms of tariffs). I utilize a version of computational general equilibrium model of international trade (based on Armington assumption) where countries are potentially asymmetric in terms of labor endowment, productivity, etc. Eaton and Kortum (2002) derive a simple formula which shows the gains from trade and this formula is generalized by Arkolakis, Costinot, and Rodriguez-Clare (2012) in the case of iceberg costs and exogenously fixed labor supply. I generalize this formula in Armington setup with tariffs and endogenous labor supply and highlight the importance of both revenue generating tariffs and consumption-leisure choice.

KEYWORDS Endogenous Labor Supply; Optimal Tariff; Computational General Equilibrium

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