

The Role of Nonhomothetic Preferences and Rent Sharing for Trade Structure and Welfare in an Open Economy*

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Abstract

We develop a framework for studying how differences in the level and dispersion of per-capita income affect trade structure and welfare in a two-country model. Thereby, we assume that consumers have PIGL preferences, which admit a representative consumer and thus facilitate the aggregation of heterogeneous consumer demand even if Engel curves are not linear. We embed the resulting demand system into a textbook model of the home-market effect, with two sectors of production and one input factor. We associate the outside good with a necessity and the differentiated good with a luxury, and we assume that heterogeneity of income arises due to heterogeneity of households in their effective labor supply. Using this model, we show that in line with the home-market effect countries have a trade surplus in the good for which they have relatively higher domestic demand, making the country with a higher level and/or dispersion of per-capita income a net exporter of luxuries. However, the structure of trade is irrelevant for welfare in the open economy. This changes when considering rent sharing in the sector of luxuries, and we show that in this case feedback effects of trade on the level and dispersion of income can lead to losses from trade in the country exporting necessities.

Keywords: Nonhomothetic preferences; Rent sharing; Trade structure; Welfare effects of trade

JEL Classification: F12, F15, C33

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