

Abstract

How does the welfare gain from trade liberalization depend on the resource misallocation among firms? I investigate the effect of policy-induced distortions by extending Melitz model with firm-specific distortions that follow an arbitrary distribution. Trade liberalization impacts welfare by truncating and therefore changing the joint distribution of productivity and distribution. The sectoral contribution of the welfare is summarized by the price index, which now responds to trade through both intensive and extensive margins. Numerical results suggest both the dispersion of distortions and the correlation between the productivity and distortion affect the welfare gain from trade liberalization; when low-productivity firms receive larger subsidy, trade liberalization can lead to welfare loss.