

Consider a labor-abundant, less-developed country which produces two goods, urban manufacturing and rural agriculture. Manufacturing is capital-intensive, and agriculture is labor-intensive.

a) Under the normal assumptions and free trade, what would be the expected patterns of trade? Using an appropriate diagram, show how the standard model of trade explains the allocation of labor and wage determination in the two sectors, and compare how free trade and import substitution affect the relative prices of the two goods and labor allocation between the two sectors.

b) Assume that the marginal product of labor in agriculture is zero, so there is surplus rural labor, and traditional sharing arrangements lead to a subsistence wage for everyone in rural areas. Graph the Lewis model of labor allocation. Why does this model suggest that import substitution might be the best trade policy for economic development?

c) Assume instead that there is no surplus rural labor, but equally-skilled urban workers receive a much higher income due to policies of urban bias. Graph the Harris-Todaro model of labor allocation. Why might import substitution in this case be a bad policy? What other policies might be more likely to lead to economic development?

Bonus: In (c) above, suppose that the urban wage was 50% higher than the rural wage. What would the simple Harris-Todaro model predict would be the urban unemployment rate? What would be the rural unemployment rate?