Endogenous Transport Costs and Firm Agglomeration in New Trade Theory

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Abstract

Departing from the more usual exogenous treatment of transport costs, this study examines endogenous transport costs and its impact on firm location in a New Trade Theory framework. Previous studies indicate that if exogenous transport costs in a large country are sufficiently higher than that in a small country, the home market effect disappears. Hence, firms may agglomerate in the smaller country. In our model, while international transport costs are exogenous, the government can control domestic transport costs and can reduce these costs via public infrastructure investment. Our study presents persuasive evidence that a large country always collects more tax revenue for public investment than a small country, which results in lower domestic transport costs, and hence, the home market effect always prevails.