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Market size and industry location: Traded vs non-traded goods

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Abstract

We investigate the importance of market size as a determinant for industrial location patterns. In order to focus on a broad range of sectors, including services, both traded and non-traded goods are taken into consideration. In our model, traded goods industries always exhibit a ‘home market effect’ (HME), whereas the existence of such an effect for non-traded goods crucially hinges on the degree of product differentiation. High degrees of product differentiation generally support a HME, whereas a reverse HME may arise when products are sufficiently close substitutes. Our results are in accord with the observed existence of a market size dependent ‘functional hierarchy’, both within and between countries.

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1. Introduction

In recent years, spatial questions have attracted a great deal of attention, both from a theoretical and an applied point of view. In particular, there has been a significant increase in the number of contributions related to the so-called ‘home market effect’ (henceforth, HME) (Krugman [26]; Helpman and Krugman [23]). The HME emphasizes the central

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role of market size as an important determinant of industry location and trade patterns in sectors characterized by some form of imperfect competition (Feenstra et al. [15]; Head et al. [22]). More precisely, the main finding of the HME literature is the existence of a *disproportionate causation from demand to supply*. Increases in local market size map into more than proportional increases in local industry size, thus suggesting that larger regions host a disproportionate share of the imperfectly competitive sectors and are net exporters of the goods they produce.

Although the HME literature has mainly focused on international trade, the idea that market size matters for determining the location patterns of industries within countries has also been put forward since long in the urban economics literature (see, e.g., Christaller [9]; Berry [6]; Henderson [24]) and has become a major building block of ‘new’ economic geography (Krugman [27]; Fujita et al. [16]). There is indeed strong empirical support for such a relationship. As, e.g., recently shown for the North American case, “specialization varies to a substantial degree with a particular measure of market size—the concentration of population [...] even when we exclude rural areas and look only across urban areas, we find substantial variations in specialization based on market size” (Holmes and Stevens [25, p. 2800]).

As shown by the data, much of this specialization is of a ‘functional type’ (Duranton and Puga [14]; Holmes and Stevens [25]): larger agglomerations mainly host business services, high-end consumer services and management functions, whereas smaller cities mainly host manufacturing and more basic consumer services. A major shortcoming of the HME literature is, in this respect, that it offers only a fairly poor description of most service industries and is, therefore, not able to shed light on issues of ‘functional specialization’. This is because these models usually assume that goods are traded between locations, whereas a large fraction of consumer and business services remains de facto non-traded, despite the secular decline in transportation and communication costs (Daniels [11]). Helpman and Krugman [23, Chapter 10] investigate the impact of non-traded goods on industry location and the pattern of trade under imperfect competition. They show that when production technologies are homothetic and expenditure shares are constant, “larger countries will have both larger scale and greater diversity than smaller countries in every non-traded increasing-returns sector” (Helpman and Krugman [23, p. 203]). Albeit interesting, this result does not shed any light on the HME, since it does not imply a *more than proportionate positive causation from demand to supply*.

To get a clearer overall picture of the link between specialization and local market size, it is hence worthwhile to investigate whether and how the HME influences the location decisions of non-traded goods industries. This paper takes a first step in this direction by developing a HME model based on Ottaviano and Thisse [29] that allows for non-traded goods as in Behrens [4]. To keep the analysis simple and the results easily comparable with those of the existing literature, we rely on two simplifying assumptions:

- (i) We subsume both manufacturing goods and traded services under the general heading *traded goods*, whereas we let *non-traded goods* stand for non-traded services. Such a

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