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Countries, regions and trade: On the welfare impacts of economic integration

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Abstract

We study the impact of falling international trade costs and falling national transport costs on the economic geography of countries involved in an integration process. Each country is formed by two regions between which labor is mobile, whereas there is no international mobility. Goods can be traded both nationally and internationally at positive, but different, costs. A decrease in trade costs and/or in transport costs has a direct impact on prices and wages, which allows us to account for the impact of changes in these parameters on the economic geography and welfare of each country. We show that, as trade barriers fall, the benefits of integration come after its costs. We also show that national transport policies are of the beggar-thy-neighbor type. On both counts, policy coordination is required in the process of economic integration.
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1. Introduction

It is a well-documented fact that the growing openness of national economies to international trade has a significant impact on the location of economic activities within countries. First, using a cross-section of 85 countries, Ades and Glaeser (1995) show that higher tariff barriers lead to a higher degree of urban primacy. Second, studying the "cohesion group" of the European Union (Greece, Ireland, Portugal and Spain, but no regional data are available for Ireland), Quah (1996) notes that the two countries that have reached the highest rates of economic growth, Spain and Portugal, are those that have experienced the most striking rise in regional imbalances. This is consistent with the evidence reported by de la Fuente and Vives (1995) who observe that the process of economic integration within the EU fosters international convergence *across* countries rather than interregional convergence across regions *within* countries. Indeed, about half of the divergence across European regions is due to an increased polarization within some member-states.

All this evidence raises crucial policy issues that are often neglected when countries decide on trade agreements and the development of transportation infrastructure. For example, it suggests that the recent enlargement of the EU to 10 new countries and the planned infrastructural improvements are very unlikely to leave the economic geography of the new and the old members unaffected. Moreover, the ensuing changes will probably differ across countries, depending on their degree of internal integration and the quality of their already existing transportation infrastructure. Since "[t]here is undoubtedly a rich relationship between domestic and international trade costs, market structure, and political economy" (Anderson and van Wincoop, 2004, p. 748), major political disturbances and social turmoil could be triggered by a potentially uneven distribution of the gains and losses from enlargement as the geography of competition and employment changes.

While the practical importance of the foregoing issues is widely recognized, the understanding of the underlying economic mechanisms is still at an infant stage. The reason is the theoretical difficulty of characterizing the equilibrium spatial distribution of economic activity when many locations, as well as a genuine distinction between regions and countries, are simultaneously considered. At the very least, such an approach entails: (i) A distinction between international and interregional transaction costs and (ii) a distinction between interregional and international labor mobility. Moreover, the analysis requires some imperfectly competitive market structure. When taken together, these obstacles explain the existence of a very limited set of relevant contributions, all based on monopolistic competition, which either fail to distinguish between regions and countries or, being based on numerical simulations, fail to provide solid ground for comparative statics on policy sensitive parameters. For example, Martin and Rogers (1995) argue that a major determinant of national market size is the degree of interregional integration within countries. However, by ruling out any kind of labor mobility to focus on mobility of goods only, they neglect a defining dimension of interregional integration. Other studies introduce labor mobility between the regions of the same country. The associated results are mixed depending on the specificities of the models adopted. Krugman (1991) considers a two-region closed economy where agglomeration forces arise from demand linkages between firms and mobile workers, whereas dispersion forces arise from the costs that firms face to reach the exogenously dispersed demand of immobile farmers. In this setup,

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