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The political economy of regional integration projects at borders where poor and rich meet: The role of cross-border shopping and community sorting

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ABSTRACT

At borders between poor and rich countries, huge service price differentials could be exploited to mutual benefit, offering better-paid job opportunities to the poor as well as better shopping opportunities to the rich. However, cross-border shopping is often limited by the substantial transaction costs of crossing the border. Moreover, countries and regions frequently fail to cut these transaction costs even when they have the opportunity to do so. We provide a politico-economic analysis of cross-border integration projects. More specifically, we show how the political outcome depends on (i) intra-country mobility, (ii) decision making and housing ownership regimes, and (iii) federal grants and international border regulations. Our analysis builds on two key characteristics in which individuals differ: interregional mobility and intercultural ability.

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1. Motivation

In rich countries, many services are expensive. Yet rich countries frequently border on poor countries, where these same services are much less expensive. A hair cut in a poor country, say, may well cost as little as one fifth of its equivalent in a rich country. Such price disparities provide strong incentives to shop across the border. Cross-border shoppers from the rich country could obtain many services more cheaply, and at the same time service providers from the poor country could sell these services more expensively. Put differently, consumers from the rich border region could benefit from a lower cost of living and workers from the poor border region from a higher income.

While these are large potential benefits, they are also a long way from being fully realised. Transaction costs incurred whenever one crosses a border clearly have a role in this. These transaction costs are endogenous. Governments can almost always reduce transaction costs further. This is certainly true at the regional level where local governments can, e.g., introduce urban cross-border public transport, widen local roads leading up to border controls, publish information on service quality or shopping regulations, etc. Transaction costs are, ultimately, politically determined. From this paper's perspective, the interesting question is *why governments may fail to reduce transaction costs, and thereby may fail to realise the full gains from cross-border shopping.*

We offer a politico-economic analysis of a 'regional integration project' capable of reducing cross-border shopping's transaction costs ('the project' henceforth). This analysis is carried out in a model with two countries, one of them rich and one poor. Each country consists of a border region and an interior region. While imperfectly mobile residents within either country interact through intra-country, interregional migration, residents in the two countries' border regions interact with one another via cross-border trade. As a key assumption of the model, individuals differ with respect to both intra-country mobility and intercultural ability, with the latter capturing the individual's ability to be served by, or serve, individuals whose cultural background is very different from their own. Being less gifted interculturally reduces a rich shopper's potential benefit from crossing the border, or a poor worker's potential benefit from providing services to cross-border shoppers.

As an important application, the paper's border regions may well represent border municipalities. The example of two twin cit-

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ies on the Polish–German border, Słubice and Frankfurt (Oder), may illustrate this paper's regional integration project within an urban context. Since service prices are much lower in Poland than in Germany, a Frankfurt resident might wish to cross the border into Słubice. If a pedestrian, Frankfurt's shopper needs first to cross a long, and often cold and windy, bridge. To ease that shopper's passage, Frankfurt's local government proposed to extend Frankfurt's existing tram network by appending a cross-border line that would run into Słubice. In no way interfering with national or international regulations, this tram was for Frankfurt's voters' to decide on, and to pay for.[1] As it happened, a majority of Frankfurt's voters struck down the project in 2004.

Of course, setting up cross-border public transport has not always failed. Another twin city pair on the Polish–German border, that of Zgorzelec and Görlitz, started to run a cross-border bus as early as 1992. More generally then, the circumstances that shape regional integration projects' political success are likely to vary from one border crossing to the next. To best account for a broad possible variation in circumstances across different border crossings, we allow for (i) different types of housing property rights and (ii) different degrees of centralisation in decision making. First, two housing ownership structures are distinguished. With 'absentee ownership', the housing stock in a country's border region is owned by those native to that country's interior region. With 'native ownership', by contrast, the housing stock in a country's border region is owned by the natives of the border region.

Second, two decision making regimes are distinguished. In the case of 'decentralised decision making', it is the natives of the two countries' border regions who get to vote on the project. If approved, the project then is funded by taxes levied on border region residents only. In the case of 'centralised decision making', by contrast, all of a country's citizens get to vote on the project. Once approved, the project is then financed by taxes levied on both the border region residents and the interior region residents.

Our framework enables us to analyse not just the effects of the various forces that determine the project's political fate. It also permits us to explain the interaction between these forces. Here is an overview of our key results, showing the impact on the political outcome of intra-country mobility, ownership structure, and decision making regime.

First, support for the project among natives of the border regions is stronger with native ownership than with absentee ownership. The project promotes cross-border shopping by cutting transaction costs. In the poor country's border region, for instance, the resulting boost to trade leads to (i) higher wages in the sector providing services to cross-border shoppers as well as to (ii) higher rents due to the induced inflow of workers from the poor country's interior region. With native ownership, the latter capitalisation effect can only benefit border region natives. With absentee ownership, by contrast, this capitalisation effect effectively transfers gains arising from the project to landowners residing outside the border region. Consequently, the capitalisation effect depresses project support within the border region, and can thus act as a barrier to integration.

Second, with absentee ownership, increasing intra-country mobility in one of the two countries further erodes the political support for the project in that country's border region, whereas it strengthens project support in the neighbouring country's border region. Suppose mobility in the poor country rises. More natives of the poor country's interior region with high intercultural ability then find it worthwhile to take advantage of better-paid jobs in the border region sector providing services to cross-border shoppers. This additional inflow curbs the wage in this sector, thus reducing the project benefits accruing to natives of the poor country's border region. Support for the project coming from border region natives consequently falls. At the same time, the additional supply of workers moving from the interior to the border region to provide services to cross-border shoppers reduces the service price rich cross-border shoppers have to pay. This effect, in turn, enhances support for the project in the rich country.

The potential conflict indicated here, i.e., growing mobility in one country depresses support for the project in that country but reinforces support in the other, need not obtain with native ownership. Key again is that benefits from the project are partly capitalised into higher rents. With native ownership, some border region natives find it beneficial to withdraw to the interior region, renting out their border property and cashing in on the increased border region rent. As mobility increases, this group becomes larger, and thus so does support for the project among border region natives.

Third, with absentee ownership, switching from decentralised to centralised decision making depresses support for the project among border region natives. On the one hand, the removal of the regional tax (which finances the project under decentralised decision making) capitalises into higher border region rent, as this removal renders the border region more attractive. Removal of the regional tax thus benefits landowners outside, rather than tax payers within, the border region. On the other hand, the simultaneous introduction of a country-wide tax (which finances the project under centralised decision making) does not capitalise into any rent change anywhere, as it does not alter the relative attractiveness of the country's different regions. The country-wide tax thus is fully born by each tax payer, and hence also by border region natives. As a result, border region natives ultimately face an extra burden when subjected to centralised, rather than to decentralised, decision making.

More generally, we are able to give, and to rank, the number of project supporters across all combinations of ownership structure and decision making regime. In addition, we will argue that relaxing border crossing regulations may be more effective in stimulating border region support for the project than federal grants that reduce regional project costs. Here again we will argue that capitalisation effects are pivotal.

This paper analyses under which circumstances regional integration is likely to emerge, and how (regional) support for an integration project could be encouraged. These issues are of high political importance. For instance, the European Union intends to spend more than 8 billion euros between 2007 and 2013 on stimulating cross-border cooperation, under its 'European Territorial Cooperation Objective'. While funding generally is assigned to diverse purposes, part of this overall funding is clearly directed towards promoting local cross-border trade in services. This paper can shed some light on whether such funding is likely to stimulate, and to be matched by, regional integration policies.

Our analysis connects cross-border shopping to the political economy of local public infrastructure investment, to household sorting, to fiscal federalism, and, in a more figurative sense, to globalisation. We briefly address existing work on these themes. Cross-border shopping is prominent in the literature on tax competition (see, e.g., Kanbur and Keen, 1993 and, more recently, Haufler, 2001, Lucas, 2004; Nielsen, 2001, 2002). In these papers, competing governments strategically set commodity taxes to attract cross-border shoppers and to raise domestic tax revenues. Since in these papers cross-border shopping results from distortionary tax differentials between countries, it is welfare-reducing. In our framework, by contrast, cross-border shopping results from producer price differentials induced by an international productivity differential. Taking advantage of these latter price differentials is generally welfare-enhancing.

However, the extent to which comparative advantage can be fully exploited hinges on the project's political success as well as

[1] Słubice had already welcomed this particular integration project.

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