

DFI: labour cost vs trade cost

Suppose that production take place in two stages. In the first stage the design of components take places, while in the second stage production and assembling of components is realized. In the first stage is employed only skilled labour (one unit of labour for each unit of components) and in the second stage only unskilled labour is employed (one unit of labour for each unit of the final good).

Suppose that there are two country Northland, with a higher share of skilled labour and higher wages and Southland with a larger share of unskilled labour and lower wages.

1. If the firm decide to produce in Northland what would be their profit?

Suppose now that the firm decide to delocalize the second stage, i.e. the production, in Southland, where the wages are now lower by a fraction δ . However to delocalize the firm has to pay a cost of delocalization λ .

2. When will a firm decide to delocalize the production in Southland?