

Globalization, Contracts and the International Organization of Production

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Abstract

Despite the recent development of regional integration theory, the role of contractual incompleteness has been largely understudied. Hence, our paper investigates the trade-offs a firm faces when it decides where to locate a part of its supply-chain and whether or not to integrate this supplier. In order to shed new lights on these topics, we embed an incomplete contracts setting into a model of economic geography with heterogeneous firms whose process of production can be geographically separated. However, when the headquarter contracts with a southern supplier, he incurs an additional cost due to the incomplete nature of contracts, but benefits from a lower cost of labor. We show that less technological firms relocate first, using outsourcing. When southern industrialization is well advanced, more technological firms start to relocate also, but using FDI. Also, we argue that this change in the organizational structure of firms increases the speed of southern industrialization.

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