

# **New Economic Geography in Germany: Testing the Helpman-Hanson model**

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June 2001

SOM-theme D Regional Science

Also available (and downloadable) in electronic version: <http://som.rug.nl/>

## **ABSTRACT**

In this paper we find evidence that the new economic geography approach is able to describe and explain the spatial characteristics of an economy, in our case the German economy. Using German district data we estimate the structural parameters of a new economic geography model as developed by Helpman (1998) and Hanson (1998) and we find confirmation for a spatial wage structure. The advantage of the Helpman-Hanson model is that it incorporates the fact that agglomeration of economic activity increases the prices of local (non-tradable) services, like housing. This model thereby provides an intuitively appealing spreading force that allows for less extreme agglomeration patterns than predicted by the bulk of new economic geography models. Based on different estimation strategies and taking a number of features of the re-unified German economy into account, we do not only test for the spatial distribution of wages but also for the spatial structure w.r.t. German unemployment, employment and land prices.

JEL-code: R10, R12, R23

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## 1. Introduction

Initiated by Krugman (1991) there has been a renewed interest in mainstream economics in recent years for the question how the spatial distribution of economic activity comes about. The literature on the so called new economic geography or geographical economics, shows how modern trade and growth theory can be used to give a sound theoretical foundation for the location of economic activity across space.<sup>2</sup> The seminal book by Fujita, Krugman and Venables (1999) develops and summarizes the main elements of the new economic geography approach. The emphasis in this book is strongly on theory and empirical research into the new economic geography is hardly discussed at all. As already observed by Krugman (1998, p. 172) in his survey of the new economic geography, this is no coincidence since there is still a lack of direct testing of the empirical implications of the new economic geography models. In his review of Fujita, Krugman and Venables (1999), Neary (2001) reaches a similar conclusion. In order to make progress an empirical validation of the main theoretical insights is called for. The reasons that the empirical research lags behind is that the new economic geography models are characterized by non-linearities and multiple equilibria which makes empirical validation relatively difficult.

To date, there is a substantial amount of empirical research that shows that location matters, but there are indeed still relatively few attempts to specifically test for the relevance of the structural parameters of new economic geography models (see the survey by Overman, Redding and Venables (2001)). A notable exception is the work by Gordon Hanson (1998, 1999). Hanson uses a new economic geography model developed by Helpman (1998) and then directly tests for the significance of the model parameters. Based on US county-data he finds confirmation for his version of the Helpman model. In this paper we apply the Helpman-Hanson model to the case of Germany. The goal of the paper is twofold.

First, we want to establish whether the Helpman-Hanson model holds for Germany, that is to say we want to know whether the key model parameters are significant or not. The main equation to be estimated will be a nominal wage equation, central to this equation is the idea nominal wages will be higher in those regions that have easy

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<sup>2</sup> Elsewhere, see in particular Brakman, Garretsen and van Marrewijk (2001), we have argued that is more accurate to use the phrase “geographical economics” instead of “new economic geography” because the approach basically aims at getting more geography into economics rather than the other way around, but we stick here to the latter to avoid confusion.

access to economic centers because for those regions demand linkages are relatively strong.

Second, we want to extend the analysis by Hanson by taking on board several features of the German economy that set Germany apart from the case of the USA and analyze their empirical implications. Apart from wages we will incorporate “spatial” features of other variables. The geographical unit of analysis is the German city-district (*Stadtkreis*).

Even though the case of post-reunification Germany is thought to be well-suited for a new economic geography approach (see Brakman and Garretsen (1993) for an early qualitative attempt), the goal of the present paper is *not* to analyze whether or not our new economic geography model is the “best” model to analyze Germany after the fall of the Berlin Wall in 1989. In a similar vein, we do also not test the Helpman-Hanson model against possible alternative explanations of the regional distribution of economic activity in Germany. Furthermore, we are aware of the fact that the hypotheses to be tested may sound familiar to regional scientists but our goal is not point out hitherto unknown empirical spatial phenomena. Our goal is more limited, we want to assess the empirical relevance of a particular new economic geography model for Germany. By doing so we will take a number of characteristics of the German economy into account, which are of a 'geographical' nature. Basically this is the rationale for choosing Germany as an example to investigate the relevance of the New Economic Geography approach. In recent history Germany experienced the “rise and fall” of the Berlin Wall which from the point of view of the new economic geography creates a unique testing ground. In our paper we take the approach recommended by Hanson (2000) as a starting point. He concludes his survey of the empirical literature of spatial agglomeration by stating that the well-documented correlation of regional demand linkages with higher wages “*would benefit from exploiting the well-specified structural relationships identified by theory as a basis for empirical work*” (Hanson, 2000, p. 28).

The paper is organized as follows. In section 2 we briefly provide some data on the level of the German states (*Bundesländer*) to support the idea that geography might matter in Germany. In section 3 we first discuss the main elements of the theoretical model and focus on the derivation of the empirical specification of the wage equation that is our basic equation in the subsequent part of the paper. This wage equation is our vehicle to test for the presence of regional demand linkages that are central to the core new economic geography model in the underpinning of the spatial agglomeration of economic activity. Section 4 discusses some of the problems associated with estimating our wage equation and then gives the main estimation results for the basic wage equation and also supplies three alternative estimation

strategies. In section 5 we address the role of two features of the German economy that might have a bearing on our results: the role of transfers (as proxied by the difference between regional GDP and regional income tax base) and the alleged inflexibility of the German labor market. With respect to the latter we will provide estimation results on the spatial characteristics of additional variables (besides wages) notably regional unemployment, employment and land prices. We also discuss the limitations of our approach and some possibilities for future research. Section 6 concludes the paper. Our main conclusion will be that the Helpman-Hanson model performs rather well for the case of Germany and we thereby find support for the empirical relevance of the new economic geography approach.

## 2. Geography and Germany

In this section we briefly present some data in order to illustrate the spatial distribution of some key variables across Germany. A quick look at the Maps 1-3 below immediately shows that there are indeed geographical or spatial differences within Germany with respect to the economic variables that are at the heart of our model. Take, for instance, a look at Map 1 which gives GDP per km<sup>2</sup> for the German states (*Bundesländer*). This map shows that geographical differences with respect to GDP are quite large (and even more skewed than GDP per capita, not shown here). The map also indicates that GDP per km<sup>2</sup> is higher in the former West Germany and this is not only true for smaller city-states like Bremen, Hamburg and West-Berlin.<sup>3</sup>

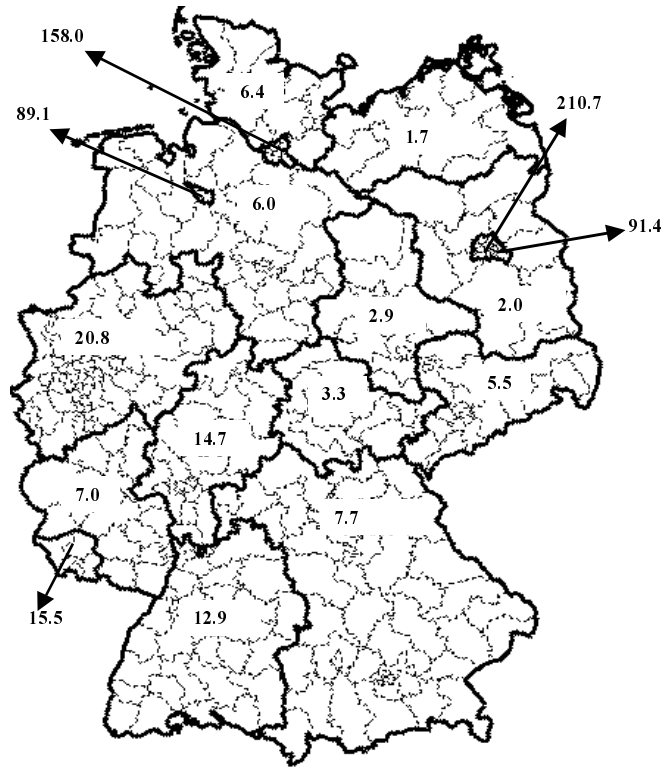
Central in this paper is the Helpman-Hanson model. The key equation in this model, as will be explained in the next section, describes the spatial nature of (nominal) wages. Map 2 indicates that not only hourly (manufacturing) wages differ remarkably between states, but the map also suggests that in the eastern part of Germany wages are on average lower than in western Germany. The dividing line between high and low wages to some extent identifies the former border between East and West Germany. In the Helpman-Hanson model wages in a region are higher if that region is part of or close to a large market, proxied by GDP. This is in line with Maps 1 and 2 because these two maps suggest a positive correlation between nominal wages and gdp (per km<sup>2</sup>).

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<sup>3</sup> Maps 1-3 are based on information of 441 districts (*Kreise*), which we aggregated to 16 states (*Bundesländer*), to avoid information overload in the maps. The solid lines indicate the states, the dashed lines the districts.

**Map 1.**

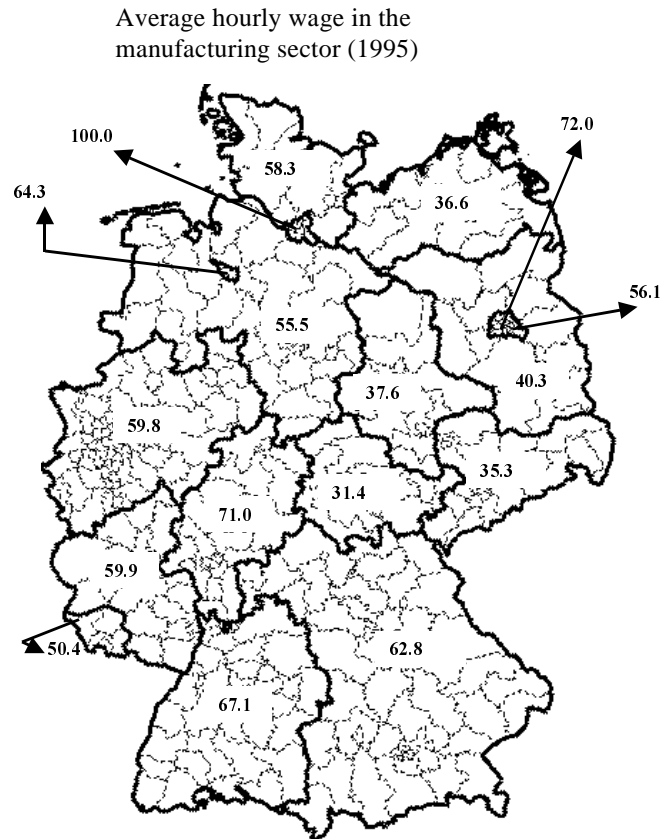
GDP per km<sup>2</sup> in millions of DM (1994)



**Source: Federal Statistical Office, Wiesbaden**

Agglomeration in new economic geography models is, as geographers have known for a long time, the result of the combination of agglomerating and spreading forces. An important agglomerating force is for instance the size of the market (see Map 2). Among the spreading forces are the demand from immobile workers in peripheral regions, but also negative feedbacks in the core-regions such as congestion or the relatively high cost of housing and other local goods. An indication for the presence of these spreading forces in core regions are, for example, land prices.

**Map 2.**



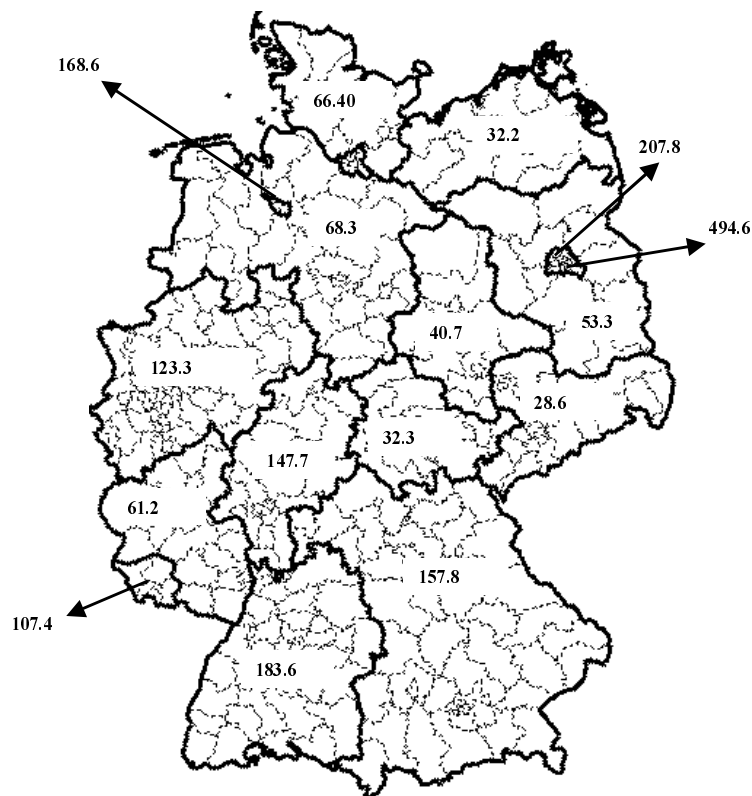
**Source: Federal Statistical Office, Wiesbaden**

As Map 3 indicates, land prices in eastern Germany seem on average lower than in western Germany, but a possible dividing line between eastern and western Germany is less clear-cut than with respect to regional wages. Land prices can be looked upon as a proxy for housing prices and as will become clear in Section 3 housing prices are the spreading force in the Helpman-Hanson model. Hence, Maps 1-3 give a first indication of the spatial distribution of the three key variables in the theoretical model, nominal wages, the size of the market (gdp) and housing prices (here proxied by land prices). Taken together these maps suggest that there is no random

distribution of economic activity across Germany and that high wages go along with high gdp and high land prices. A look at the *Kreise* data on which the Maps are based confirms this conclusion. The highest (lowest) values for the three variables are invariably observed in western (eastern) German *Kreise*.

**Map 3.**

Prices of land per km<sup>2</sup> (1995)



**Source: Federal Statistical Office, Wiesbaden**

Maps 1-3 do, however, only paint a static picture of the German economy and give no information about the underlying regional production structure. As was already

explained in Brakman and Garretsen (1993), new economic geography models predict that the fall of the Berlin Wall in 1989 and the subsequent reunification might result in substantial shifts in the spatial distribution of economic activity and thereby of the regional production structure. To illustrate this we calculated so-called Localization Quotients (LQ) for 1991 and 1998. The LQs are defined as:

$$LQ_r^i = \frac{Y_r^i / \sum_j Y_j^i}{\sum_j Y_r^j / \sum_k \sum_j Y_k^j}$$

In which  $r$  stands for the state ( $r=1..16$ ) and  $i$  for the type of economic activity. If  $LQ_r^i > 1$  region  $r$  is relatively specialized in economic activity  $i$  ( $i=1..5$ ). The change of  $LQ_r^i$ , given  $i$ , over time gives an indication whether or not that state has become more specialized, signifying a process of economic adjustment following reunification. Furthermore, the variance of  $LQ^i$  across states gives additional information with respect to the location of economic activity; a relative high variance (as measured by the standard deviation) of  $LQ^i$  reveals that industry  $i$  is relatively geographically concentrated. Table 1a gives the scores for  $LQ_r^i$  of 1998 and Table 1b gives the change in  $LQ_r^i$  from 1991 to 1998. The data are for 5 sectors, and for the 16 German states (Bundesländer). The grey rows specify the 5 states of former East Germany (excluding Berlin).

Table 1a shows that in 1998 the East German states are relatively specialized in the primary sector and the government sector while the reverse is true for services. It is also clear that for Germany as whole the primary sector (see the relatively high standard deviation) is geographically the most concentrated sector. The standard deviations for the other sectors and notably for the mining, manufacturing and construction sector (column 2) are much lower indicating a spreading of these activities. This is an important observation because it implies that for Germany we need a model in which the footloose economic activity (typically manufacturing) is not by definition only located in only a few regions.



Table 1a: Localization quotients (German States, 1998)

	Agriculture, Forestry, Fishery	Mining, manufacturing and construction sector	Trade and Transport	Services	Government and non-profit organizations
Baden-Württemberg	0.89	1.23	0.83	0.92	0.82
Bayern	0.85	1.02	0.86	1.07	0.87
Berlin	0.12	0.88	0.78	1.07	1.37
Brandenburg	1.76	1.21	0.84	0.72	1.34
Bremen	0.22	0.93	1.94	0.77	0.85
Hamburg	0.26	0.58	1.49	1.29	0.72
Hessen	0.41	0.72	1.10	1.30	0.75
Mecklenburg-Vorpommern	2.83	0.83	1.07	0.80	1.69
Niedersachsen	2.48	1.00	0.95	0.92	1.11
Nordrhein-Westfalen	0.60	1.01	1.10	0.96	0.98
Rheinland-Pfalz	1.16	1.08	1.00	0.85	1.15
Saarland	0.20	0.99	1.06	0.97	1.05
Sachsen	1.31	1.08	0.80	0.86	1.31
Sachsen-Anhalt	1.92	1.08	1.00	0.70	1.54
Schleswig-Holstein	2.15	0.76	1.19	1.02	1.20
Thüringen	1.65	1.09	0.95	0.76	1.41
Standard deviation	0.87	0.17	0.29	0.18	0.29

Table 1b: Change in the localization quotients (1998 -/- 1991, German States)

	Agriculture, Forestry, Fishery	Mining, manufacturing and construction sector	Trade and Transport	Services	Government and non-profit organizations
Baden-Württemberg	-0.04	0.06	0.02	-0.02	0.01
Bayern	-0.30	0.01	-0.01	-0.01	-0.01
Berlin	-0.12	-0.19	-0.11	0.20	0.11
Brandenburg	0.62	0.14	-0.19	0.12	-0.26
Bremen	0.00	0.03	0.19	-0.04	-0.10
Hamburg	0.12	-0.07	-0.05	-0.04	0.00
Hessen	-0.09	-0.07	0.04	-0.05	-0.01
Mecklenburg-Vorpommern	1.16	0.12	-0.22	0.10	-0.37
Niedersachsen	-0.03	0.05	0.02	0.00	-0.09
Nordrhein-Westfalen	-0.04	-0.04	0.06	0.02	0.01
Rheinland-Pfalz	-0.24	-0.01	0.07	0.01	0.07
Saarland	0.00	-0.04	0.00	0.03	0.03
Sachsen	0.63	0.16	-0.32	0.08	-0.22
Sachsen-Anhalt	0.86	0.07	-0.12	0.06	-0.06
Schleswig-Holstein	0.27	-0.08	0.09	0.06	-0.10
Thüringen	0.57	0.22	-0.13	0.03	-0.42
Standard deviation 1998 [increase (+) decrease (-) relative to 1991]	0.87(+)	0.18(+)	0.29(+)	0.18(-)	0.29(-)

The localized nature of agriculture, forestry, fishery probably reflects the differences in endowments between regions, but as can be seen from Table 1b the increase in the standard deviation combined with the positive sign of the change in  $LQ_r^i$  for the 5 eastern German states is also a sign that after the unification these industries tend to become more localized in the eastern part of Germany. The same holds true for mining, manufacturing and construction sector, which means that from 1991 to 1998 and given the initial specialization of western states in this sector, some spreading took place. From the change in the standard deviation and the change in  $LQ_r^i$  we also observe that the trade and transport sector became more concentrated in the western Germany.

### **3. Theoretical Model and Data**

#### *3.1 The rationale for the Helpman-Hanson model*

The benchmark model of the new economic geography, developed by Krugman (1991), is in general not suited for empirical validation, because it produces, in the long-run, for an intermediate range of trade costs only one, or at most a very few (equally sized) locations with manufacturing economic activity. This is clearly not in accordance with the facts about the spatial distribution of manufacturing activity for the US or any other industrialized country. Furthermore, it lacks some of the spatial characteristics of agglomerations, which have been found to be very relevant empirically, most importantly the tendency of prices of local (non-tradable) goods to be higher in agglomerations (see for example the survey by Anas, et al., 1998, and our Map 3 for that matter).

How can one arrive at a model that is better suited for empirical testing, that is to say a model that is less biased in favour of (complete) agglomeration? Krugman and Venables (1995) offer a useful starting-point. They assume, in contrast with Krugman (1991), no labour migration between regions, so when a sector expands the labour supply must come from other sectors in that region. Cumulative causation in this model comes from input-output linkages between firms, which are now assumed to use each other output as an intermediate input. Firms benefit from being close to each other by not paying transport cost on intermediate factors of production. In agriculture, only labor is used, with constant returns to scale and it can be costlessly traded. The latter assumption assures that as long as both regions produce both goods the wage rate equals unity (by choice of units). Typically this model produces two types of equilibria (see also Fujita, Krugman and Venables, 1999, chapter 14). For high trade costs of manufactures, a symmetric equilibrium, and for low trade costs a core-periphery solution (for intermediate transportation costs, asymmetric but

unstable equilibria are possible). So, without complete specialization this model produces in a qualitative sense still the same type of equilibria as the Krugman (1991) model. Krugman and Venables (1996) extend this model by assuming two manufacturing sectors, each of which sells and buys more to firms in the same sector than to firms of the other sectors. Complete agglomeration is now less likely, because favorable cost and demand linkages benefit firms in the same sector while competition in product and labor markets harm all firms in all sectors equally. For low trade costs this results in regions to become specialized in one sector only.

It is only a small step to make this Krugman-Venables model more in line with the stylized facts; simply assume that the production function in agriculture is increasing (in labor) and concave (see Puga, 1999 and Fujita, Krugman and Venables, 1999, p. 244). This introduces an extra spreading force into the model. Complete agglomeration is now less likely, as agglomeration drives up wages in the core region, making it attractive for firms to re-locate to a peripheral region where labor costs are lower. If one plots the share of industry in a specific region against trade costs this typically results in a  $\Omega$ -type of relationship between the share of industry in each region and trade cost (see in particular Puga, 1999, Figure 6 or Puga, 2001, Figure 8, and also Fujita, Krugman and Venables, 1999, Figure 14.8). For high trade costs, there is (equal) spreading of industrial activity, for intermediate levels of trade costs full as well as partial agglomeration results, and for low trade costs there is a return to spreading. Given the observation that full agglomeration is not in accordance with the facts, new economic geography models based on forward and backward linkages and with no interregional labor mobility seem therefore useful models for empirical testing. Unfortunately, however, direct testing of these models is rather cumbersome because it requires detailed information on input-output linkages between firms on a regional level (the importance of which is clearly illustrated by Krugman and Venables, 1996).

The reasons stated above are the main arguments why the model developed by Helpman (1998), with its empirical applications by Hanson (1998, 1999), is a useful alternative for empirical research. It combines the “best of the two worlds” since it shares with Krugman (1991) its emphasis on demand linkages (which are more easy to test for than input-output linkages). But at the same time through the inclusion of a non-tradable consumption good (i.e housing), the model is capable of producing similar equilibria as the aforementioned models based on input-output linkages and immobile factors of production.<sup>4</sup> The price of housing in the Helpman (1998) model

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<sup>4</sup> For the differences between Krugman (1991) and Helpman (1998), see Helpman (1998, pp. 49-53). For a very useful general framework to understand the different implications of models

which increases with agglomeration, serves as an analogous spreading force as the rising wages in Puga (1999). In fact, it can be shown that in terms of equilibrium outcomes the Helpman model yields similar results as, what has been dubbed, the second core model of new economic geography where there is no interregional labor mobility and the possibility of agglomeration arises through intricate input-output linkages between firms (Venables, 1996, Krugman and Venables, 1995, 1996, Puga, 1999).

### 3.2 *The Helpman-Hanson model*

We briefly discuss the theoretical approach in Hanson (1998, 1999) and focus on the equilibrium conditions because these are needed to arrive at the basic wage equation that will be estimated.<sup>5</sup> Consumers derive utility from consuming a manufacturing good, which is tradable albeit at a cost, and from housing which is a non-tradable good between regions. The manufacturing good consists of many varieties and each firm offers one variety and this is modeled with well-known Dixit-Stiglitz formulation of monopolistic competition. The only factor input in the model is labor and labor is needed to produce the manufacturing good and labor can move between regions in the long run. In this set-up of the model the perfectly competitive housing sector serves as the spreading force, because housing (a non-tradable good) is relatively more expensive in the centers of production where demand for housing is high. As we will see below apart from the inclusion of a homogenous non-tradable good (housing) at the expense of a homogenous tradable good (agriculture), there are no fundamental differences between Krugman (1991) and Helpman (1998). In particular in both models agglomeration is driven by demand linkages and the interregional mobility of labor.

This extension of core model thus allows for a richer menu of equilibrium spatial distributions of economic activity than the core model. As trade or transportation costs fall agglomeration remains a possible outcome but now also (renewed) spreading and partial agglomeration are feasible. Partial agglomeration means that all regions have at least some industry. Notwithstanding the different implications of Helpman (1998) compared to Krugman (1991) the equilibrium conditions (five in total) are very similar to the core model, in particular the equilibrium wage equation,

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with and without interregional labor mobility see Puga (1999, 2001). For the observation that the Helpman model is at home in the class of models that display the above mentioned  $\Omega$ -relationship see Puga (1999, p.324), Puga (2001, p. 16). Ottaviano and Thisse (2001, p. 175) also note that this relationship applies to Helpman (1998).

<sup>5</sup> For an in-depth analysis of the core model see Fujita, Krugman and Venables (1999, chapters 4 and 5) or Brakman, Garretsen and van Marrewijk (2001, chapters 3 and 4).

which is central to the empirical analysis, is identical to the (normalized) equilibrium wage equation in Krugman (1991):

$$(1) \quad W_r = \left[ \sum_s Y_s I_s^{\varepsilon-1} T^{D_{rs}(1-\varepsilon)} \right]^{\frac{1}{\varepsilon}}$$

$$(2) \quad I_r = \left[ \sum_s \lambda_s \left( T^{D_{rs}} \right)^{1-\varepsilon} W_s^{1-\varepsilon} \right]^{1/(1-\varepsilon)}$$

$$(3) \quad Y_r = \lambda_r L W_r$$

In which in equation (1)  $W_r$  is the region's  $r$  (nominal) wage rate,  $Y$  is income,  $I$  is the price index for manufactured goods,  $\varepsilon$  is the elasticity of substitution for manufactured goods.  $T$  is the transport cost parameter, and  $T_{rs} = T^{D_{rs}}$ , where  $D_{rs}$  is the distance between locations  $r$  and  $s$ . Transport costs  $T$  are defined as the number of manufactured goods that have to be shipped in order to ensure that one unit arrives over one unit of distance. Given the elasticity of substitution  $\varepsilon$ , it can directly be seen from equation (1) that for every region wages are higher when demand in surrounding markets ( $Y_s$ ) is higher (including its own market), when access to those markets is better (lower transport costs  $T$ ). Also regional wages are higher when there is less competition for the varieties the region wants to sell in those markets (this is the extent of competition effect, measured by the price index  $I_s$ ).

Equation (2) gives the equilibrium price index for region  $r$ , where this price index is higher if a region has to import a relatively larger part of its manufactured goods from more distant regions. Note that the price index  $I$  depends on the wages  $W$ . Equation (3) simply states income in region  $r$ ,  $Y_r$ , has to equal the labor income earned in that region, where  $\lambda_r$  is region  $r$ 's share of the total manufacturing labor force  $L$ .

The main aim of our empirical research is to find out whether or not a spatial wage structure, that is a spatial distribution of wages in line with equation (1), exists for Germany. Equation (1) cannot be directly estimated as there are typically no time series of local price indices for manufactures (where local refers to the US county level in Hanson's study and to the city-district level in our case). And, even more problematic (see equation (2)), the price index  $I$  is endogenous, and inter alia depends on each of the local wage rates, which makes a reduced form of equations (1) and (2) extremely lengthy and complex. These problems have somehow to be solved in order to estimate a spatial wage structure for Germany.

Hanson uses the following estimation strategy based on the remaining two equilibrium conditions. In order to arrive at a wage equation that can actually be estimated he rewrites the price index in exogenous variables which can actually be observed for his sample of US counties.

First, he uses:

$$(4) \quad P_r H_r = (1 - \delta) Y_r$$

Equation (4) states that the value of the fixed stock of housing equals the share of income spent on housing, where  $P_r$  is the price of housing in region  $r$ ,  $H_r$  is the *fixed* stock of housing in region  $r$  and  $(1-\delta)$  is the share of income spent on housing and  $\delta$  is thus the share of income spent on manufactures.<sup>6</sup>

Second, real wage equalization between regions is assumed:

$$(5) \quad \frac{W_r}{P_r^{1-\delta} I_r^\delta} = \frac{W_s}{P_s^{1-\delta} I_s^\delta}$$

Equation (5) is quite important. It is assumed that the economy has reached a long-run equilibrium in which real wages are identical. This implies that labor has no incentive to migrate (interregional labor mobility is solely a function of interregional real wage differences).<sup>7</sup> The assumption of interregional labor mobility and the notion that agglomeration leads to interregional wage differences are not undisputed for a country like Germany with an allegedly “rigid” labor market, see in particular Puga (2001, p. 18) for implications of low labor mobility and no interregional wage differences from a new economic geography perspective. We return to this issue in section 5.

The importance of a non-tradable housing sector as a spreading force is implied by (5). A higher income  $Y_s$  implies, *ceteris paribus*, higher wages in region  $r$ , see equation (1), but it also, given the stock of housing, puts an upward pressure on housing prices  $P_r$ , equation (4). Combining (4) and (5) allows us to rewrite the price index in terms of the housing stock, income and nominal wages. The equilibrium condition for the housing market can be written as  $P_r = (1-\delta) Y_r / H_r$  and this expression for  $P_r$  is then substituted into equation (5) which defines the price index  $I_r$  in terms of  $W_r$ ,  $Y_r$  and  $H_r$ . Substituting this in (1) results in a wage equation which can be estimated. This will also be the bench-mark wage equation in our empirical analysis.

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<sup>6</sup> Note, that direct observation of a housing price index could serve a similar purpose. We will return to this in section 4.

<sup>7</sup> Overman, Redding and Venables (2001, p. 17) discuss how the model used by Hanson can be seen as a specific version of a more general new economic geography model.

$$(6) \quad \log(W_r) = k_0 + \varepsilon^{-1} \log\left(\sum_s Y_s^{\varepsilon+(1-\varepsilon)/\delta} H_s^{(1-\delta)(\varepsilon-1)/\delta} W_s^{(\varepsilon-1)/\delta} T^{(1-\varepsilon)D_{rs}}\right) + err_r$$

Where  $k_0$  is a parameter and  $err_r$  is the error term. Equation (6) includes the three central structural parameters of the model, namely share of income spent on manufactures,  $\delta$ , the substitution elasticity,  $\varepsilon$  and the transport costs,  $T$ . Given the availability of data on wages, income, the housing stock, and a proxy for distance, equation (6) can be estimated. The dependent variable is the wage rate measured at the US county level and Hanson finds strong confirmation for underlying model to the extent that the three structural parameters are significant and have the expected sign which, in terms of equation (6), means that there is a spatial wage structure. In section 4 we will begin our empirical inquiry of the German case by estimating equation (6) for our sample of German city districts.

### 3.3 Data

Before we turn to the estimation results a few words on the construction of our data set are in order. Germany is administratively divided into about 440 districts (*Kreise*). Of these districts a total of 119 districts are so called city-districts (*kreisfreie Stadt*), in which the district corresponds with a city. 114 of these city districts are included in the sample. We use district statistics provided by the regional statistical offices in Germany. The data set contains local variables, like the value added of all sectors in that district (GDP), the wage bill and the number of hours of labor in firms with 20 or more employees in the mining and manufacturing sector. Combining the latter two variables gives the regional wage  $W_r$ , which is measured as the average hourly wage in the manufacturing and mining sector. Since we also want to analyze the cities' *Hinterland* we also included 37 aggregated (country) districts, constructed from a larger sample of 322 country districts.<sup>8</sup> The total number of districts in our sample is thus 151, namely 114 city districts and 37 country districts. Transport costs are, of course, a crucial variable. We do not use the geodesic distance between districts, because this measure does not distinguish between highways and secondary roads. Instead, distance is measured by the average number of minutes of travel by car it take to get from city district A to city district B. The data are obtained from the Route Planner 2000 (Europe, And Publishers, Rotterdam). For the data on the housing stock  $H_r$ , required to estimate equation (6), we use the number of rooms in residential

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<sup>8</sup> Many of these 322 country districts are very small. In order to arrive at a geographical unit that is more in line with that of the city-district we decided not to use the 322 corresponding *Kreise* but to use a larger geographical unit of analysis the so called *Bezirke* and this reduces the 322 districts to the 37 country districts, Furthermore, this simplifies the distance matrix considerably.



dwellings per district. In some of our estimations we also include one or more of the following regional variables, unemployment, employment, income (personal income tax base) and land prices. Since we only have one observation for each variable per district for the average hourly wage and for GDP (1994/1995) we estimate the wage equation in levels and restrict ourselves to cross-section estimations.

#### 4. Basic estimation results for Germany

##### 4.1 Estimating the benchmark wage equation

We now turn to the attempt to estimate the structural parameters using the wage equation (6) for Germany. In doing so, we will not only be able to estimate the structural parameters  $\delta$ ,  $\epsilon$  and  $T$  (and to establish the existence of a spatial wage structure) but we can also verify the so-called no-black hole condition, which gives an indication for the convergence prospects in Germany. In section 4 we first estimate equation (6) and then discuss three alternative estimation strategies.

Table 2a gives the estimation results for the estimation of equation (6). We also included a dummy variable for East German districts and a dummy variable for country districts. The dummy for East German districts is motivated by the fact that wages (and labor productivity) in East Germany are lower than in West Germany. As the inclusion of these two dummies turned out to be immaterial for the conclusions with respect to the structural parameters they are not reported here but we will return to them in subsequent estimations.<sup>9</sup>

Table 2a: Estimating the structural parameters for Germany

	coefficient	standard error	t-statistic
$\delta$	.869	0.887	2.105
$\epsilon$	.914	0.618	6.327
Log(T)	.008	0.001	7.257
Adj. R <sup>2</sup> = 0.481; number of observations = 151; non-linear least squares			
Implied values:			
$\epsilon/(\epsilon-1)$	1.343	$\epsilon(1-\delta)$	-3.401

<sup>9</sup> In our estimations we consider Germany to be a closed economy, elsewhere (see Brakman, Garretsen and Schramm, 2000) we have checked whether the inclusion Germany's main trading partners would influence the outcomes but this was not the case. We did not control for fixed regional endowments as f.i. climate. Hanson (1999) does control for these endowments in his study for the USA but for a relatively small country like Germany these kind of differences are thought not to be relevant.

All three structural parameters are found to be significant and they also have the correct sign thereby validating the Helpman-Hanson model. The substitution elasticity  $\varepsilon$  is significant and the coefficient implies a profit margin of 34% (given that  $\varepsilon/(\varepsilon-1)$  is the mark-up), see Table 1, which is fairly reasonable, although higher than found for the US by Hanson (1998, 1999). Note that the value  $\varepsilon(1-\delta)$  is used to determine whether a reduction of transport costs affects spatial agglomeration of economic activity: the so called no black hole condition for the Helpman (1998) model holds if  $\varepsilon(1-\delta) < 1$  (see below)<sup>10</sup>.

The coefficient for  $\delta$  is, however, (implausibly) large because it indicates that Germans do not spend any part of their income on housing (see equation (2)). The high value is in accordance with the findings of Hanson, who also finds that  $\delta$  is large for the USA (above 0.9 and in some cases also not significantly different from 1). Finally, the transport cost parameter has the expected sign and is highly significant. All in all, the estimation results provide support for the idea of a spatial nominal wage structure, to see this substitute the estimated coefficients into wage equation (6) and one can see how *ceteris paribus* the presence of nearby large markets (hence low  $T$  and high  $Y$ ) increases wages in district  $j$ . Given the fact that we find that  $\delta$  is not significantly different from 1,  $H_s$  does not exert an impact on wages, but  $W_s$  does.<sup>11</sup>

Furthermore, Table 2a enables us to see whether or not the *no black hole condition* is met. It is indeed the case that  $\varepsilon(1-\delta) < 1$ , although not significantly (except for the case in which  $\delta$  is fixed, see however note 12). This implies that transport costs has an impact on the degree of agglomeration, that is to say agglomeration is not inevitable if transport costs can be sufficiently reduced. For Germany this seems to indicate that a lowering of transport costs might lead to more even spreading of economic activity, which is good news for the peripheral districts, the bulk of which is located in

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<sup>10</sup> In Krugman (1991) the no black hole condition is met if  $\varepsilon(1-\delta) > 1$ . Helpman (1998) shows how this difference is ultimately due to the fact that the spreading force in the Krugman model is a homogeneous tradable good (the agricultural good) whereas in the Helpman model it is a homogeneous non-tradable good (housing which is in fixed supply) is responsible for this difference.

<sup>11</sup> Restricting  $\delta$  to actual values of the share of income spent on non-tradable services (or non-tradable housing services) has virtually no impact on the estimated size and significance of the transport costs  $T$ , or on the explanatory power of the estimated equation, which is still able to explain 46% of the variance in wages, as compared to 48% in the unrestricted specification. A likelihood-test indicates that the restricted model has to be rejected as being inferior compared to the unrestricted model.

Eastern Germany. In the Helpman-Hanson model if  $\epsilon(1-\delta) > 1$ , this means that a region's share of manufacturing production is a function of its (fixed) relative housing stock only (Helpman, 1998, p. 40).

The estimation of wage equation (6) provides empirical support for the new economic geography approach, here the Helpman-Hanson model, and our estimations for Germany lead to similar conclusions as Hanson's estimation for the USA. At the same time it is, however, clear, that the economy of post-reunification Germany differs in a number of important respects from the US economy to the effect that the our estimation results might be improved upon if we take more "German features" on board. This is the subject of the next section, where we will analyze the effects of changes in the basic wage specification as given by equation (6). Before we address these German features, we first turn to three alternative strategies to estimate wage equation (6). The first strategy is simply to replace the stock of housing  $H_s$  by the housing price  $P_s$ , using land prices as a proxy. The second and third strategy deal with the dismissal of the assumption of real wage equalization (recall equation (3)) and this will be discussed in the next subsection.

*Table 2b: Estimating the wage equation with land prices*

	oefficient	Standard error	t-statistic
$\delta$	.933	0.0192	48.376
$\epsilon$	1.304	1.8509	6.107
Log(T)	.0608	0.0038	15.948
Adj. $R^2 = 0.826$ ; number of observations = 146; non-linear least squares			
Implied values:			
$\epsilon/(\epsilon-1)$	1.1	$\epsilon(1-\delta)$	0.77

We do not have data on housing prices but instead we use land prices (*Baulandpreise*) as a proxy. From Figure 3 in section 2 we already know that, at least at the state level, land prices, are much higher in states with a higher GDP. An estimation of wage equation (6) with these price data provides a more direct test of the Helpman-Hanson model, because the influence of agglomeration on prices of local non-tradables is driving the spreading force in the Helpman-Hanson model. Table 2b gives the estimation results for 146 districts.<sup>12</sup> (we only have data on land prices for a subset of our 151 districts). The three structural parameters are again clearly significant. The main differences with Table 1a are that the coefficient

<sup>12</sup> For 1 East German city district and 5 West German city districts there are no data on land prices. So they are excluded, except for Hamburg, which is also a (city) state.

indicating the elasticity of substitution and transportation costs are now much higher whereas the  $\delta$ -coefficient is now found to be lower. The latter is especially relevant since now we find that  $\delta$  is significantly smaller than 1 which indicates that the part of income is indeed spent on housing and that the housing sector can indeed act a spreading force. The profit margin is now about 10% and the no black hole condition is again met ( $\epsilon(1-\delta)=0.77<1$ ).

#### 4.2 No Real Wage Equalization

The assumption of real wage equalization boils down to imposing a long-run equilibrium and this implies a sufficient degree of labor mobility and wage flexibility. In general, the requirement that interregional real wages are equal by assumption is not very appealing because it always assumes that the economy is in a long-run equilibrium. Furthermore, specifically in the German case this assumption seems at odds with the stylized fact that (real) wages differed between eastern and western German regions at the start of the reunification process. Our second and third alternative estimation strategies are to estimate a wage equation and the structural parameters *without* invoking real wage equalization.

The second strategy is simply to re-estimate equation (6) with land prices as our proxy for  $P_s$  (see Table 2b) and by adding the possibility for a real wage differential *between* (but not *within*) East and West Germany (see [appendix 1](#) for a derivation of the resulting wage equation). The coefficient  $\phi$  captures the east-west German real wage differential and is constructed in such a way that, for instance because of trade union preferences,  $\phi>1$  indicates that real wages in western Germany are higher. Table 3 shows that indeed  $\phi>1$  but the coefficient is insignificant which means that, perhaps surprisingly, real wages between West German and East German were similar in 1995. For the other coefficients the estimation results in Table 3 are very much like the ones reported in table 2b.<sup>13</sup> The insignificance of  $\phi$  implies that, contrary to what one might initially expect, the assumption of real wage equalization between the East and West German districts in our sample can not be rejected. Hence, wage equation (6) and its underlying model are reasonable first approximation for the German case. In addition (see for instance Sinn, 2000) there is evidence that following the reunification there has been a process of real wage equalization between the former FRG and GDR. Nominal wages are higher in western Germany but the data show (see also our Maps 1 and 3) that housing rents(!) and other local prices are also considerably higher on average in the western part of

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<sup>13</sup> We also estimated the wage equation with  $\phi$  using the housing stock  $H_s$  instead of our proxy for the housing price  $P_s$  and this also resulted in an insignificant  $\phi$  coefficient.

Germany thereby fostering, like the Helpman-Hanson model predicts, real wage equalization.

Table 3: *Estimating the wage equation with incomplete real wage equalization between East and West Germany*

	oefficient	Standard error	t-statistic
$\delta$	.93308	0.01971	47.3213
$\varepsilon$	1.2967	1.86113	6.06983
Log(T)	.06081	0.00382	15.8903
$\phi$	.42902	1491.08	0.00095

Adj.  $R^2 = 0.826$ ; number of observations = 146; non-linear least squares

Table 3 captures the possibility of real wage differences between western and eastern Germany but it is still rather stringent to the extent that it assumes that within eastern and western Germany real wage equalization holds. We thus still need equation (3) to estimate the wage equation. As our third estimation strategy we show how to estimate a wage equation that is based on a reduced form of equations (1) and (2) with its structural parameters without assuming real wage equalization beforehand. For this purpose it is necessary to simplify the price index defined in equation (2) by not considering all prices in all regions. Instead we consider only two prices: the price in region  $r$  of a manufactured good produced in region  $r$  and the *average* price outside region  $r$  of a manufactured good produced outside region  $r$ . For the determination of the simplified local price index for manufactures it also necessary to have a measure of *average* distance between region  $r$  and the regions outside. The distance from the economic center is an appropriate measure. This center is obtained by weighing the distances with relative  $Y$ .<sup>14</sup> The economic center of Germany turns out to be *Landkreis Giessen* (near Frankfurt), which is in the state of Hessen, West Germany. Equation (2) now becomes:

$$(4) \quad I_r = \left[ \lambda_r W_r^{1-\varepsilon} + (1 - \lambda_r) (\bar{W}_r T^{D_{r-center}})^{1-\varepsilon} \right]^{1/\varepsilon},$$

where  $\bar{W}_r$  is the average wage outside region  $r$ ,  $D_{r-center}$  is the distance from region  $r$  to the economic center, and weight  $\lambda_r$  is region  $r$ 's share of employment in manufacturing, which is proportional to the number of varieties.

<sup>14</sup> For each region  $r$  the weighted average distance to the other regions  $\sum_s weight_s D_{rs}$  is calculated, using  $weight_s = Y_s / \sum_j Y_j$ . The region with the smallest average distance is the economic centre.

This simplified price index makes it possible to directly estimate wage equation. Since we apply the wage equation to Germany we also take into account that the marginal productivity of labor (MPL) in East Germany is lower than in West Germany. A uniform level of MPL in the West,  $\theta_{west}$  and the East  $\theta_{east}$ , is assumed but the MPL of the East is lower than the MPL in the West. Incorporating this difference means that the wage equation (1) and the simplified price index equation (2') change into:<sup>15</sup>

$$(1') \quad W_r = \text{constant} \cdot \left( \frac{\theta_{west}}{\theta_r} \right)^{(1-\varepsilon)/\varepsilon} \left[ \sum_{s=1}^R Y_s (T^{D_{rs}})^{1-\varepsilon} I_s^{\varepsilon-1} \right]^{1/\varepsilon}$$

$$(2'') \quad I_r = \left[ \lambda_r \left( W_r \frac{\theta_{west}}{\theta_r} \right)^{1-\varepsilon} + (1-\lambda_r) (\bar{W} T^{D_{r-center}})^{1-\varepsilon} \right]^{1/(1-\varepsilon)}$$

Equation (2'') is finally substituted into (1'), which provides us with the reduced form of the equilibrium wage equation without having to invoke real wage equalization in order to approximate (2). The equation to be estimated is:

$$(6') \quad \log(W_r) = \kappa_0 + \varepsilon^{-1} \log \left[ \sum_{s=1}^R Y_s (T^{D_{rs}})^{1-\varepsilon} I_s^{\varepsilon-1} \right]$$

$$\text{where } I_r^{1-\varepsilon} = \left[ \lambda_r (W_r (1 + \kappa_1 D_{east}))^{1-\varepsilon} + (1-\lambda_r) (\bar{W} T^{D_{r-center}})^{1-\varepsilon} \right]$$

and where  $D_{east}$  = dummy variable which equals 1 if  $r$  is an East German district.

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<sup>15</sup> Employment in a typical Western firm in a typical Western region  $r$  for the production of manufacturing variety  $i$  is  $\alpha + \beta x_{ir}$ , where  $\alpha$  is the fixed cost parameter and  $\beta$  is the marginal costs parameter. Employment in a typical Eastern firm in a typical Eastern region  $r$  is  $\alpha + \beta x_{ir} (\theta_{west} / \theta_{east})$ . We thus assume that marginal labor costs in East Germany are higher than in West Germany which is the same as assuming that  $MPL_{west} > MPL_{east}$ . Sales of a firm located in region  $r$  equals total demand for its product. Dropping subscript  $i$  for the individual firm:

$$\frac{(\varepsilon-1)\alpha}{\beta(\theta_{west}/\theta_r)} = \sum_{s=1}^R \left[ \left( \frac{\varepsilon}{\varepsilon-1} \frac{\beta W_r T^{D_{rs}} (\theta_{west}/\theta_r)}{I_r} \right)^{-\varepsilon} T^{D_{rs}} \delta \frac{Y_r}{I_r} \right]$$

Which gives (1') above, where  $\theta_{west}/\theta_r = 1$  if  $r$  is in West, and  $\theta_{west}/\theta_r > 1$ , if  $r$  is in East. Ideally, one would like to use district-data on productivity here, see for instance Funke and Rahn (2000).

Table 4 shows the regression results of estimating equation (6'). The parameter  $\kappa_1$  is set equal to zero, as it turned out to be not significantly different from zero, implying that the productivity difference was not significant. An additional advantage of equation (6') compared to the basic wage equation (6) is that the share of income spent on manufactures  $\delta$  (which we thus found to be rather high in the previous section) does not need to be estimated now.

*Table 4: Estimating equation (6') for Germany*

	coefficient	Standard error	t-statistic
$\varepsilon$	0.564	2.599	4.064
LogT	.007	0.002	4.172

Adj.  $R^2 = 0.515$ ; number of observations = 151; non-linear least squares

The results in Table 4 show that the distance parameter is significantly positive, and virtually identical to previous estimates, indicating the robustness of the estimated transport costs with respect to the estimated specification. Again, see equation (6'), the results support the notion that nominal wages in district  $r$  are higher if this region has a better access (in terms of distance) to larger markets. This time, however, the elasticity of substitution between different types of manufactures increases substantially. The mark-up over marginal costs therefore reduces to about 10.

All in all, the estimation of the basic wage equation (6) for Germany (see Table 2a) and the three alternative estimation strategies pursued in section 4 (see Tables 2b, 3 and 4) provide support for the empirical relevance for the Helpman-Hanson model for Germany.

## 5. Incorporating German features: transfers and rigid labor markets

Two features of the German economy might have special consequences for the spatial distribution of wages; interregional transfers and the functioning of the labor market. We will first turn to the issue of the transfers and then in section 5.2 to the labor market.

### 5.1 Distinguishing between GDP and personal income: the role of transfers

So far we took for the size of the market in a region, GDP (measured as value added) in that region, where region thus refers to one of the 114 city-districts or one of the 37 country-districts in our sample. The size of the market can also be approximated by taking personal income instead of GDP. In the absence of large intra-regional

transfers, differences between the two measures will be small, but in the case of post-reunification Germany, one is less sure whether this is true. The main reason being the massive income transfers from western to eastern Germany. For eastern Germany as a region, income clearly is larger than GDP in 1995. To see whether this influences our results we replaced regional GDP by the regional local income tax base and with this alternative measure of  $Y_s$  we re-estimated the basic wage equation (6).<sup>16</sup> Table 5 gives the estimation results.

Table 5: *Estimating equation (6) with income instead of GDP*<sup>17</sup>

	coefficient	Standard error	t-statistic
$\varepsilon$	.202	0.420	9.996
$\delta$	.361	0.068	19.952
$\log(T)$	.0068	0.0007	9.323

Adj.  $R^2 = 0.484$ ; number of observations = 151; non-linear least squares

Comparing Table 5 with Table 2a makes clear that the results for the local income-regression are comparable to those for the local GDP-regression and that here also the share of income spent on manufactures exceeds 1.

Some regions receive more transfers than others. In order to control for these differences we constructed two new variables  $RY_{GDP}$  and  $RY_{inc}$  where  $RY_{GDP} = (\text{district GDP}/\text{German GDP})$  and where  $RY_{inc} = (\text{district personal income tax base}/\text{German personal income tax base})$ . We are in particular interested in the ratio of these two variables ( $RY_{GDP}/RY_{inc}$ ). A district for which this ratio is greater than 1 indicates that this region is a (net) donor of transfers (our measurement of transfers does not only include public transfers but the transfers of factor income as well). If this ratio is smaller than 1 this means this region's income and not so much its GDP exceeds the German averages and indicates that this region is a (net) recipient of transfers.

Given the massive transfers one might expect that ( $RY_{GDP}/RY_{inc}$ ) is relatively low for East German districts. We checked for this (not shown here) and this is indeed the case. It is also true that (for instance due to commuting and subsidies to the agricultural sector) that this ratio is also relatively low for 37 country districts. One

<sup>16</sup> To be able to compare results with the estimations with GDP (as shown by Table 2) we stick to equation (6). Data for 1995 on the income tax base (*Gesamtbetrag der Einkünfte*) at the district level were taken from the Statistik Regional database of the Federal Statistical Office of Germany.

<sup>17</sup> Re-estimating this equation, using  $P_s$  instead of  $H_s$ , gives similar results.



would like to know how this ratio affects regional wages. We therefore again estimated (6) but now with  $\kappa \log(RY_{GDP}/RY_{inc})$  added as an additional term and where  $\kappa$  is the coefficient to be estimated. The results are summarized in Table 6.

Table 6: *Estimating relative importance of transfers on the spatial wage structure*

	coefficient	Standard error	t-statistic
$\epsilon$	.974	.407	9.765
$\delta$	.434	.089	16.134
$\log(T)$	.0064	.00070	9.149
$\kappa$	.303	.074	4.094

Adj.  $R^2 = 0.534$ ; number of observations = 151; non-linear least squares

The results for the three structural parameters are very similar to those reported in Tables 1 and 5. Our main interest here is with the  $\kappa$ -coefficient and here we find that regions with a relatively ( $RY_{GDP}/RY_{inc}$ ) ratio have significantly higher wages which suggests that for local wages the economic size of that region in terms of its GDP matters more than its income. This also means that if a region receives a relatively large amount of transfers ( $RY_{GDP}/RY_{inc} < 1$ ) there is no upward effect on nominal wages. The main conclusion to be taken from Tables 5 and 6 is that our central wage equation holds up well if we replace GDP by income

## 5.2 *A spatial (un)employment structure and land price structure?*

The estimation results for Germany provide support for the Helpman-Hanson model in the sense that the key model parameters are found to be significant. Given the coefficients and in line with equilibrium wage equation (1), our central equation (6) illustrates that  $W_r$  is higher if district  $r$  is situated more closely to regions with a relatively high  $Y$ . We thus find confirmation for a spatial wage structure for Germany: regional wages become lower the further one moves away from manufacturing centers. To some extent this is a surprising result. Certainly compared to the case of the USA, the German labor market is considered to be rigid where the rigidity refers for instance to the idea agglomeration need not go along with interregional wage differences if, for whatever institutional reason, interregional wages are set at the same level. For a country like Germany one might thus very well expect that the spatial distribution of  $Y$  does *not* get reflected in spatial wage differences (see Puga, 2001 for this assertion for Germany).<sup>18</sup>

<sup>18</sup> Interregional wage differences are for instance not feasible if a union ensures centralised wage setting that is, irrespective of regional economic conditions,  $W_r = W_s$  (see Faini, 1999). Centralised wage setting (at the industry level) is a tenet of the German labor market, see also Appendix 2.

As we explained in section 3.1, the Helpman-Hanson model belongs to a class of new economic geography models in which a fall in transportation costs from a very high to a very low level typically results in spreading→(partial) agglomeration→ renewed spreading. If, however, agglomeration simply cannot lead to interregional wage differences the outcome will not only be, when trade costs fall from their intermediate to a very low level, that agglomeration continues to exist, but also that agglomeration “may get reflected instead into differences in unemployment rates” (Puga, 2001, pp 18-19). An observation that stresses the potential spatiality of (local) labour markets.

Is this last observation relevant for Germany? No definite answers are possible if only because we do not know if Germany 4 years into reunification was in 1995 anywhere near the regime of very low trade costs and we also only have cross-section data. In addition, Puga (1999, 2001) is also much more concerned with real instead of nominal wages. But the issue Puga (2001) raises is interesting in its own right: is there a spatial unemployment structure? Evidence on this issue clearly indicates that labour markets are indeed to a large extent 'local' and that fluctuations in economic activity are reflected in local (un)employment rates (Martin, 2000).<sup>19</sup> Like most new economic geography models, the Helpman-Hanson model does not allow for unemployment so we can not test an unemployment version of equation (6). But, as a second best solution, we can use a market potential approach, which captures some important elements of the new geography approach, but in a less sophisticated way. The central idea is that unemployment of a specific region is a function of how easy this region has access to large surrounding regions. The better this access, the lower unemployment: if it is true that  $W_r=W_s$  one would expect that “agglomerated” regions have a lower unemployment rate. Our market potential equation for unemployment has the following form<sup>20</sup>:

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<sup>19</sup> Interesting is that Martin (2000) also observes that not only (un)employment of workers is spatially segmented, but also that “*the spatial structure of the local housing stock and the way that local housing market institutions ...allocate that stock, ...reinforc[e] distinct spatialities of socio-economic advantage and disadvantage within local labour markets, p.461*”.

<sup>20</sup> The specification of equation (7) is similar to the “simple” wage equation used by Hanson, apart from the two dummies, the only difference is that  $U_r$  instead of  $W_r$  is the left-hand side variable. Brakman, Garretsen, Schramm (2000) test this market potential *wage* equation for the 114 German city-districts and find strong confirmation for the existence of a spatial wage structure or wage gradient. For the implications of introducing wage rigidity in a new economic geography model see Peeters and Garretsen (2000). From regional science as well as development economics (think of the Harris-Todaro model) we, of course, know that

$$(7) \quad \log(U_r) = K1 \log[\sum_s Y_r e^{-K2D_{js}}] + K_3 D_{east} + K_4 D_{country} + \text{constant}$$

where,  $U_r$ =unemployment rate in region  $r$ .

For a spatial *unemployment* structure to exist it is crucial that coefficients  $K_1$  and  $K_2$  are significant. Table 7 shows, however, that this is not the case. The hypothesis of a spatial unemployment structure must be rejected and only the two dummy-variables are significant (with  $D_{east}$  capturing the idea that unemployment in Eastern Germany is indeed much higher than in Western Germany).<sup>21</sup>

Table 7: *A Spatial Unemployment Structure?*

	oefficient	Standard error	t-statistic
$K_1$	.0435	784.43	0.00055
$K_2$	0.0001.	0.2419	-.0000559
$K_3$	.3519	0.0680	5.1357
$K_4$	0.1581	0.0399	-3.9534

Adj.  $R^2 = 0.368$ ; number of observations = 151; non-linear least squares

Because unemployment is to some extent a matter of definition we also turn to regional employment. With interregional nominal wage equalization (caused, for instance, by centralised wage setting) we test if we can observe a spatial *employment* structure under the restriction that  $W = W_r = W_s$  due to centralised wage setting. In Appendix 2 this employment equation is derived and equation (8) below has been estimated (the scaling of employment is in line with Hanson (1998, 1999) who also estimates for a spatial employment structure. Hanson does, however, not derive the employment equation from the underlying model.

$$(8) \quad \log\left(\frac{L_r}{area_r}\right) = \text{constant} + \log\left(\sum_{s=1}^R [e^{-c_0 D_{rs}} Y_s]\right) + c_1 D_{east} + c_2 D_{country}$$

$L_r$  = employment in district  $r$  measured in hours of employment in the manufacturing and mining sector scaled by the size of district  $r$  (in  $km^2$ ).

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unemployment (in absolute terms) if often found to higher in agglomerations, here we merely test for the unemployment implications that arise from our theoretical model.

<sup>21</sup> This is not to deny that district unemployment is irrelevant from a geographical perspective. If we re-estimate equation (7) as a market potential function with wages  $W_r$  as the left hand side variable and with district unemployment as the additional explanatory variable  $U_s$ , it turns out that we still find a spatial wage structure but the unemployment-coefficient has a negative sign and is significant thereby suggesting, in line with Blanchflower and Oswald (1994), the existence of a wage-curve on the regional level where higher unemployment means lower local wages. The unemployment-coefficient is  $-0.024$  (t-value 3.96).

The constant,  $c_0$ ,  $c_1$  and  $c_2$  are to be estimated. See Appendix 2 for the derivation that  $c_0 = (\varepsilon-1)\log(T)$ , and  $c_1 D_{\text{east}} = (\varepsilon-1)\log(\vartheta_j)$ , with  $\vartheta_j$  being a measure of the productivity gap between East and West Germany.

Table 8 shows that we can confirm the existence of a spatial employment structure because of the sign and significance of the  $c_0$  coefficient which implies that employment in region  $j$  is higher if this regions is situated more closely to economic centers. From an empirical point of view, this is perhaps not a very surprising conclusion because regional scientists have reached a similar conclusion in many other cases, but recall that our main concern here is merely to test for the relevance of one particular theoretical approach, the new economic geography. In this sense the model on which Table 8 is based, replicates a well-known result. Note that the  $c_1$  and  $c_2$  coefficients in Table 8 are also significant, indicating a lower employment in East German and country districts. The question arises how to reconcile a spatial employment structure with the absence of spatial *un*employment structure. After all, regional unemployment is the regional labor supply minus the regional employment. We can only speculate on some explanations, but empirical evidence indicates that unemployment is less responsive to agglomeration and spreading forces described in the model in an economy which relies relatively less on market forces and in which long-term unemployment leads to reduced employability thereby reducing effective labor supply (see also Decressin and Fatas, 1995). The fact that we find confirmation for the empirical relevance of both equation (6) and equation (8) implies that Germany finds itself in middle position between the 2 extremes of full labor mobility and wage flexibility and complete labor immobility and wage rigidity.

*Table 8: A Spatial Employment Structure?*

	oefficient	Standard error	t-statistic
$C_0$	.2363	0.0439	5.3818
Const.	4.2449	0.1147	-36.991
$c_1$	0.12945	0.18013	-0.71867
$c_2$	3.6872	0.17696	-20.8365

Adj.  $R^2 = 0.412$ ; number of observations = 151; non-linear least squares

The reason to stick to the Helpman-Hanson model is not only that it seems to perform well for Germany but also that, as we have said before, it combines the best features of the demand linkages model due to Krugman (1991) with the input-ouput linkages model due to Venables (1996) and Krugman and Venables (1995). The inclusion of housing as a non-tradable consumption good lies at the very heart of Helpman (1998) and to illustrate (nothing more but certainly also nothing less) that housing prices may indeed act as a spreading force we have finally estimated equation (9). This

estimation is also inspired by Maps 1-3 in section 2 where we showed that German states with relatively high wages and gdp also display higher land prices. As we explained before there are no district data on housing prices but we have German district data on land prices which serve as good 1st approximation. The estimation results, see Table 9, show that there is a “spatial land price” structure (see the coefficients  $K_1$  and  $K_2$ ) and this is precisely what the Helpman model predicts and this confirmation of such a structure also indicates that indeed the housing market can be looked upon as providing a spreading force. Also in line with other German evidence (see Sinn, 2000) is that land prices are significantly lower in country districts but notably also in East German districts.

$$(9) \quad \log(LP_i) = K_1 \log[\sum_s Y_r e^{-K_2 D_{js}}] + K_3 D_{east} + K_4 D_{country} + \text{constant}$$

where LP=land prices per km<sup>2</sup>

*Table 9: A Spatial Land Price Structure*

	coefficient	Standard error	t-statistic
$K_1$	.3687	0.0559	6.5937
$K_2$	.0756	0.0205	3.6759
$K_3$	0.6363	0.1517	-4.1942
$K_4$	1.3823	0.1490	-9.2718
constant	.8772	0.6032	3.1117

Adj.  $R^2 = 0.599$ ; number of observations = 151; non-linear least squares

## 6. Conclusions

The recent advances in the field of new economic geography have increased our understanding of spreading and agglomerating forces in an economy. Empirical testing, however, is difficult. Not only because the core models are characterised by multiple equilibria, but also because the lack of specific regional data makes approximations inevitable. Short-cuts cannot be avoided. Here we have tried to find evidence whether or not new economic geography models are in principle able to describe the spatial characteristics of an economy; here Germany. The answer basically is, yes. We found that the so-called Helpman-Hanson model, using data for Germany, is able to describe the spatial wage structure. The advantage of the Helpman-Hanson model is that it incorporates the fact that agglomeration of economic activity increases the prices of local (non-tradable) services. It thus provides a powerful spreading force, and leads to less extreme outcomes than the core model of the new economic geography as described by Krugman (1991). Once again, it must be emphasized that the goal of this paper neither has been to test the

new economic geography approach against alternative approaches nor did we set out to establish new empirical facts, we simply wanted to establish the empirical relevance of a particular new economic geography model.

The reason to choose Germany is that in the case of Germany and the fall of the Berlin Wall in 1989, there is a very obvious candidate for the kind of controlled or natural experiment that would address the problems with endogeneity that surround the estimation of new economic geography models. Overman, Redding and Venables (2001, p. 20) rightly point to Hanson (1997) as an example of such a natural experiment but we think the fall of Berlin Wall and hence the start of German re-unification is precisely the kind of exogenous shock one is looking for. In our ongoing research on Germany and the new economic geography we will test the Helpman-Hanson model before (1985), at about (1991) and after (1995) the start of German re-unification.

What are the next steps to be taken? The first thing that comes to mind is how the analysis can be made dynamic. In section 3.1 we indicated the importance of an  $\Omega$  characteristic of these models, i.e. in the first phase of economic integration (relative high transportation costs) economic activity is dispersed. When transportation costs starts to fall agglomeration starts, as demand and cost linkages make it advantageous to agglomerate, however, this drives up prices of local non-tradable services (here, housing) leading again to spreading of economic activity. This dynamic aspect is absent from our estimates. Due to data limitations we have only cross-section estimations and these give no information about the position of the German economy on the  $\Omega$ -curve. From section 2 we have some indirect information that after the fall of the Berlin Wall German the location of German industry is changing very rapidly. But in order to find out more about this process we need more years of observation. For now we are satisfied that the recent advances in this field find at least some support in the data.

## Appendix 1 The Wage Equation with Incomplete Real wage Equalization

Assume full real-wage equalization within East Germany and within West Germany, but not between East and West Germany (incomplete real-wage equalization)

We start with

$W_r = \left[ \sum_s Y_s I_s^{\varepsilon-1} T^{D_{rs}(1-\varepsilon)} \right]^{\frac{1}{\varepsilon}}$  (wage equation (1)) and, instead of equation (3),

$\frac{W_r}{P_r^{1-\delta} T_r^\delta} = \frac{W_s}{P_s^{1-\delta} T_s^\delta} \cdot \varphi_{rs}$ , where  $\varphi_{rs} = \phi > 1$ , if  $r$  is West and  $s$  is East, and  $\varphi_{rs} = 1/\phi < 1$ , if  $r$  is East and  $s$  is West.  $\phi$  Represents the real-wage gap between East and West Germany (incomplete real-wage equalization).

Substituting this last equation into wage equation (1) gives:

$$W_r = \left[ \sum_s Y_s \left( I_r \cdot \left\{ \frac{\varphi_{rs} W_s}{W_r} \right\}^{\frac{1}{\delta}} \cdot \left\{ \frac{P_r}{P_s} \right\}^{1-\delta/\delta} T^{-D_{rs}} \right)^{\varepsilon-1} \right]^{\frac{1}{\varepsilon}} \Rightarrow$$

$$W_r = \left[ \sum_s Y_s \left( I_r^{\varepsilon-1} \cdot \left\{ \frac{\varphi_{rs} W_s}{W_r} \right\}^{\varepsilon-1/\delta} \cdot \left\{ \frac{P_r}{P_s} \right\}^{(1-\delta)(\varepsilon-1)/\delta} T^{-D_{rs} \cdot (\varepsilon-1)} \right) \right]^{\frac{1}{\varepsilon}} \Rightarrow$$

$$(A1) \quad W_r = \omega_r^{1-\varepsilon/\delta\varepsilon} \cdot \left[ \sum_s Y_s \cdot \left\{ \varphi_{rs} W_s \right\}^{\varepsilon-1/\delta} \cdot \left\{ P_s \right\}^{(1-\delta)(1-\varepsilon)/\delta} T^{-D_{rs} \cdot (\varepsilon-1)} \right]^{\frac{1}{\varepsilon}},$$

where  $\omega$  is the real wage.

$\omega_r$  is  $\omega_{\text{WEST}}$  for each district  $r$  in West Germany,  $\omega_r$  is  $\omega_{\text{EAST}}$  for each district  $r$  in East Germany;  $\omega_{\text{WEST}} = \phi \cdot \omega_{\text{EAST}}$ . Note that in (A1)  $\omega_r$  is a constant for region  $r$  because real wage equalization still holds within East and West Germany.

The logtransformation of (A1)

$$\log(W_r) = \left(\frac{1}{\varepsilon}\right) \log \left[ \sum_s Y_s \left( \{\varphi_{rs} W_s\}^{\varepsilon/\delta} \cdot \{P_s\}^{(1-\delta)(1-\varepsilon)/\delta} T^{-D_{rs}(\varepsilon-1)} \right) \right] + \left(1 - \frac{\varepsilon}{\delta\varepsilon}\right) \log(\omega_r)$$

leads to the specification to be estimated:

(2)

$$\log(W_r) = \left(\frac{1}{\varepsilon}\right) \log \left[ \sum_s Y_s \left( \{\varphi_{rs} W_s\}^{\varepsilon/\delta} \cdot \{P_s\}^{(1-\delta)(1-\varepsilon)/\delta} T^{-D_{rs}(\varepsilon-1)} \right) \right] + \alpha_0 + \alpha_1 \text{Dummy}_{EAST}$$

where  $\alpha_1 = \frac{\varepsilon-1}{\delta\varepsilon} \log(\phi)$  and  $\alpha_0 = \frac{1-\varepsilon}{\delta\varepsilon} \log(\omega_{WEST})$ .



## Appendix 2 Derivation of the employment equation

With centralised wage-setting:

$$W_r = W_s = W$$

Assume a productivity gap between East and West:

$$L_{ir} = \alpha + \vartheta_{ir} \theta_{west} x_{ir}$$

where  $L_{ir}$  is employment in firm  $i$  in region  $r$ ,  $x$  is output,  $\theta_{west}$  is the marginal productivity of labour in West Germany, and  $\vartheta$  is 1 if region  $r$  is in West and  $\vartheta$  is  $\theta_{west}/\theta_{east} > 1$ , if region  $r$  is in East.

Free entry and exit leads to the no-profit condition:

$$x_{ir} = \frac{\alpha \cdot (\varepsilon - 1)}{\vartheta_{ir} \theta_{west}}$$

Labour demand at the micro level in East and West is:

$$L_{ir} = \alpha \varepsilon$$

Output expressed in units of labour is:

$$x_{ir} = \left( \frac{\varepsilon}{\varepsilon - 1} \right) \frac{L_{ir}}{\vartheta_{ir} \theta_{west}}$$

Using the Dixit-Stiglitz demand elasticities and dropping index  $i$  for the individual firm:

$$x_r = \sum_{s=1}^R \left[ \left( \frac{\varepsilon}{\varepsilon - 1} \frac{W_r T^{D_{rs}} (\theta_{west} \vartheta_r)}{I_s} \right)^{-\varepsilon} T^{D_{rs}} \delta \frac{Y_s}{I_s} \right]$$

where  $T$  is transport costs, and  $D_{rs}$  is the distance between regions  $r$  and  $s$ ,  $I$  is the price index of manufactures.

The employment equation expressed in logarithms:

$$\log(L_r) = \text{constant} + \log(\vartheta_r) + \log(x_r) \Rightarrow$$

$$\log(L_r) = \text{constant} + \log(\vartheta_r) + \sum_{s=1}^R \left[ \left( \frac{\varepsilon}{\varepsilon - 1} \frac{W_r T^{D_{rs}} (\theta_{west} \vartheta_r)}{I_s} \right)^{-\varepsilon} T^{D_{rs}} \delta \frac{Y_s}{I_s} \right] \Rightarrow$$

$$\log(L_r) = \text{constant} + \log(\vartheta_r) - \varepsilon \log(W_r) + \log\left(\sum_{s=1}^R \left[(\vartheta_r)^{-\varepsilon} (T^{D_{rs}})^{1-\varepsilon} Y_s I_s^{\varepsilon-1}\right]\right)$$

because of the assumption of uniform nominal wages:  $W_r = W$ , and

$$\log(L_r) = \text{constant} + \log(\vartheta_r) + \log\left(\sum_{s=1}^R \left[(\vartheta_r)^{-\varepsilon} (T^{D_{rs}})^{1-\varepsilon} Y_s I_s^{\varepsilon-1}\right]\right).$$

For an East German district  $r$  the employment equation is:

$$\log(L_r) = \text{constant} - (\varepsilon - 1)\log(\vartheta_r) + \log\left(\sum_{s=1}^R \left[(T^{D_{rs}})^{1-\varepsilon} Y_s I_s^{\varepsilon-1}\right]\right)$$

For a West German district  $r$  the employment equation is:

$$\log(L_r) = \text{constant} + \log\left(\sum_{s=1}^R \left[(T^{D_{rs}})^{1-\varepsilon} Y_s I_s^{\varepsilon-1}\right]\right)$$

To arrive at the specification to be estimated add a dummy variable that is 1 for East German districts and 0 for West German districts, the sign should be negative. Scale district employment by the variable  $area_r$  (=km<sup>2</sup> of a district) in order to account for the differences in district size in the sample. So the dependent variable becomes  $L_r/area_r$ . Using the long-run equilibrium in which real wages are equalized means that price indices of manufactures are equalized. So, the employment equation becomes:

$$\log(L_r) = \text{constant} + \log\left(\sum_{s=1}^R \left[(T^{D_{rs}})^{1-\varepsilon} Y_s\right]\right) + c_1 D_{east}$$

As this equation shows, it is *not* possible to estimate the structural parameters  $\varepsilon$  and  $T$  separately. So the equation in the main text that has actually been estimated is (as with unemployment) closest to the simple market-potential function (1'), with employment per km<sup>2</sup> as the dependent variable:

$$\log\left(\frac{L_r}{area_r}\right) = \text{constant} + \log\left(\sum_{s=1}^R \left[e^{-c_0 D_{rs}} Y_s\right]\right) + c_1 D_{east}$$

where the constant,  $c_0$  and  $c_1$  are to be estimated.

Note that  $c_0 = (\varepsilon - 1)\log(T)$ , and  $c_1 D_{east} = (\varepsilon - 1)\log(\vartheta_r)$ .

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