Heterogeneous Internal Trade Cost and Its Implications in Trade

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Abstract

Quantitative models of international trade typically assume that trade cost within a country (internal trade cost) is the same across countries. This paper presents evidence for heterogenous internal trade costs across countries and incorporates them into a standard quantitative trade model. Allowing heterogeneous internal trade costs improves the model's ability to predict prices and technology in data. This model also offers a novel answer to the question why small countries export less than large ones. That is small countries trade more with themselves because of lower internal trade costs they have.

Keywords: Heterogeneous internal trade cost, Domestic trade friction, Ratio type gravity estimation

JEL Codes: F10, F14, F17

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