Beyond the Iceberg Hypothesis: Opening the Black Box of Transport Costs

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Motivation

- Trade costs: A central role in international economic analysis
  - Declining over the second half of the 20^{th} century (Jacks et al., 2008, Novy, 2013)
  - But still significant: Average international trade costs = a 74% markup over production costs (Anderson & Van Wincoop, 2004)
- What exactly are "trade costs"?
  - Transaction costs, policy costs, time costs, and transport costs *per se*
- Transport costs: A sizeable share of international trade costs
  - Account for 21% of international trade costs (Anderson & Van Wincoop, 2004)

$\Rightarrow$ If much trade policy barriers have been removed, the transport cost component of trade costs remains sizeable

The paper: On international transport costs

Motivation (cont')

- Standard modeling of trade costs: As an ad-valorem tax-equivalent
  - As a constant percentage of the producer price per unit traded
  - $\Leftrightarrow$ The "iceberg cost" hypothesis (Samuelson, 1954)
- Yet... A debated question
- Wouldn't trade costs rather exhibit an additive structure ?
- The structure (additive vs iceberg) of transport costs, far from being anecdotal
  - Additive trade costs, an important role in shaping the pattern of trade flows: Martin (2012), Hummels & Skiba (2004), Irrarazabal et al. (2015)
  - With strong normative implications: Sorensen (2014), Irrarazabal et al. (2015)

$\Rightarrow$ Trade costs are likely to display an additive component, but precisely... by how much?

One objective of the paper: Provide an answer to this question

Our paper in 3 questions (and 3 answers)

An empirical decomposition of the structure of transport costs

(1) What is the size of the iceberg and the additive trade costs?

$\Rightarrow$ Provide a quantitative measure of both

- Iceberg cost: 2.5% and 3.2% of the export price in air and ocean transport (mean value over 1974-2013)
- Additive cost: 1.8% and 2.9% of the export price

(2) What do we lose by skipping the additive part of transport costs?

$\Rightarrow$ We lose much: With the additive term included,

- The estimated iceberg component reduces by a factor of 2
- A significantly better "goodness-of-fit"

(3) How have international transport costs evolved over time?

- Transport costs *per se* have fallen since 1985, by $\simeq$ 40%
- When additive costs are included, not much difference between air and sea transport, $\neq$ Hummels (2007) and Behar & Venables (2011)

Plan of the talk

- Data Sources
- Empirical Methodology
- Results
- Conclusion

Data sources

- Our measure of international transport costs: The difference between the export price and the import price
- Database: US Imports of Merchandise database More
  - The export (fas) price, $\widetilde{p}$: the price for one kg of merchandise at the country export gate
  - The import (cif) price, p: the price for one kg of merchandise at the entry in the US
  - Yearly basis, from 1974 to 2013, HS 10 digit classification level, by transport mode (air or vessel)

$\Rightarrow$ Our dependent variable: The ratio $p/\widetilde{p}$

- At the 3-digit classification level
- Estimation at the 4-digit level on some selected years as robustness
- Approximatively 200 products (3 digits), from around 200 countries
  - Around 600-700 products at the 4-digit level

Empirical specification: The estimated equation

- Relate the import price p to the export price $\widetilde{p}$ given both additive (per-kg) costs t and ad-valorem costs τ:

$$p = \tau\widetilde{p} + t, \qquad \text{with} \quad \tau \geq 1, \quad t \geq 0$$

- For product k, from country i
- Rewrite to get:

$$\frac{p_{ik}}{\widetilde{p}_{ik}} - 1 = \tau_{ik} - 1 + \frac{t_{ik}}{\widetilde{p}_{ik}}$$

$\Rightarrow$ Estimate this equation for each year over 1974-2013

- The equation being also year- and mode (air or vessel)- specific

Empirical specification: The estimation strategy

- With some assumptions on the specification of transport costs & the error term, and taking logs ▸ More

⇒ Estimate the following equation

$$\ln\left(\frac{p_{ik}}{\widetilde{p}_{ik}} - 1\right) = \ln\left(\tau_i \times \tau_k + \frac{t_i + t_k}{\widetilde{p}_{ik}} - 1\right) + \epsilon_{ik} \qquad (1)$$

  - Estimates performed using non-linear least squares ▸ More

- How to characterize the importance of additive costs relatively to iceberg?

⇒ Estimate Equation (1) constraining $t = 0$:

$$\ln\left(\frac{p_{ik}}{\widetilde{p}_{ik}} - 1\right) = \ln\left(\tau_i \times \tau_k - 1\right) + \epsilon_{ik}^{ice} \qquad (2)$$

- Taking the average over the product-country dimension, we finally get (by year and transport mode): ▸ More
  - When additive costs are included: $\widehat{\tau}^{adv}$, $\widehat{t}^{add}$
  - With only iceberg costs: $\widehat{\tau}^{ice}$

Result 1: Estimating transport costs over time

For both the ad-valorem and the additive components of transport costs (by year & transport mode)

- Average values over 1974-2013, in percent of the export price ▸ More

# digit	3 digits		4 digits (*)	
Mode	Vessel	Air	Vessel	Air
With only Ad-Valorem Trade Costs ($\widehat{\tau}^{ice}$)				
Mean	**5.8**	**5.1**	6.0	4.9
Median	5.1	4.2	5.2	3.7
With Additive & Ad-Valorem Trade Costs				
Ad-valorem term ($\widehat{\tau}^{adv}$)				
Mean	**3.2**	**2.5**	3.3	2.4
Median	2.8	1.8	2.8	1.6
Additive term ($\widehat{t}^{add}/\widetilde{p}$)				
Mean	**2.9**	**1.8**	2.8	1.9
Median	1.9	0.7	1.7	0.8
# obs.	29279	28207	29317	27680

- Transport costs are sizeable
  - Add $\simeq$ a 5% margin over the export price
- Opening the black box of transport costs
  - Iceberg cost: 2.5% and 3.2% of the export price in air & ocean resp.
  - Additive cost: 1.8% and 2.9% of the export price

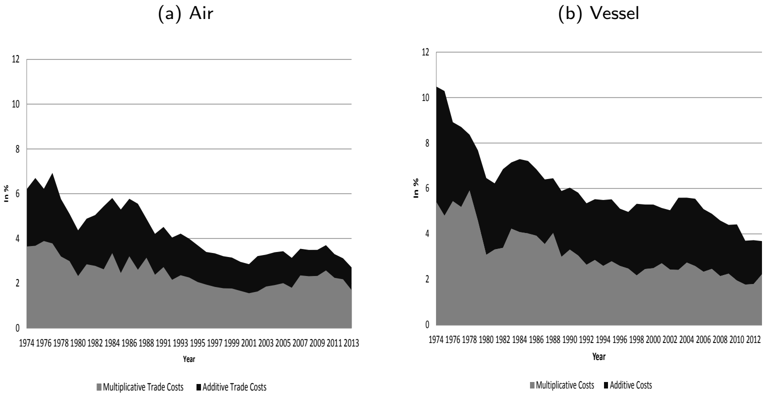
Result 2: Additive transport costs do matter

- International transport costs: A sizeable additive component
  - Omitting the additive term substantially biases the iceberg component upwards (Table 1)
    - The ad-valorem cost reduces by a factor of 2 when additive transport costs are included in the estimation
    - Amounts to 3.2% and 2.5% as mean values in vessel and air respectively in presence of additive costs
    - vs 5.8% and 5.1% when estimated alone
  - A sizeable share of the additive component in total transport costs
    - 48.2% in average for ocean, 42.3% for air
    - A result that holds throughout the period See Figure 1 later
- A result confirmed by goodness of fit comparisons
  - 4 measures of goodness of fit for Models (1) (with additive TC) and (2) (without additive TC)

  $\Rightarrow$ A systematically better goodness of fit when including the additive component More results

Result 3: Characterizing the trends of transport costs

- Study the shares of both ad-valorem and additive components in total transport costs ▸ Go back to Result 2 ▸ Go back to Result 3



⇒ Downward trend in overall transport costs, for both air and ocean shipping since 1974 ▸ Robustness of this result

- From 1980, a 1.5- 2 percentage points decrease in Air, a 2-3 percentage point decrease in Vessel

Time trends in transport costs & composition effects

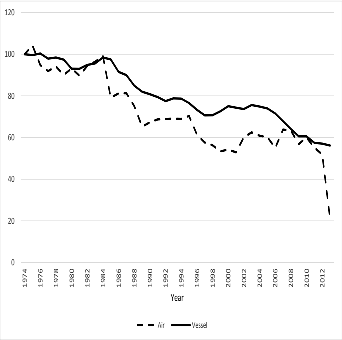
- Does it mean a decrease in transport costs *per se*? Not necessarily
- The change in overall transport costs over time:
  - Depend on the evolution of per product- per partner costs,
  - But also on the composition of trade flows
    - ⋆ Over time, import more goods that are cheaper to transport, and/or from countries with which it is cheaper to trade

$\Rightarrow$ Necessary to eliminate the composition effects of trade flows, to isolate the evolution of transport costs *per se*

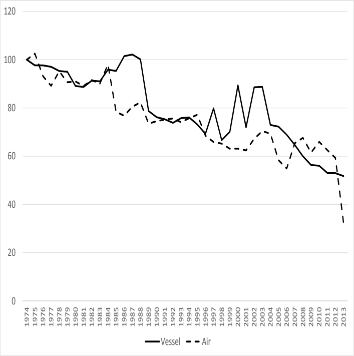
$\Rightarrow$ What we do, in accordance with Hummels (2007) More on the method

- Total transport costs (composition effects excluded) over time

(a) Iceberg alone



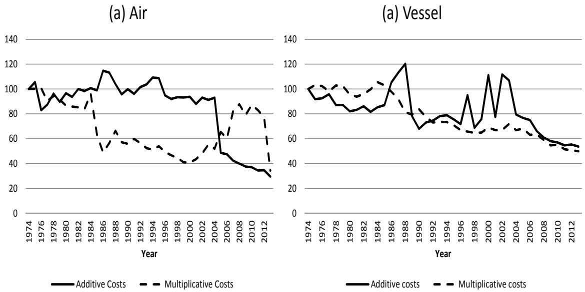
(b) With additive



Three main findings

- The importance of excluding composition effects
  - The reduction of the *pure* transport costs: Starts in 1985 (not in 1974)
  - The reduction between 1974 and 1984 (Figure 1), attributable to change in the composition of trade patterns
- Overall (pure) transport costs have declined by $\simeq 40\%$ since 1985
- The importance of the additive component of transport costs (again)
  - When only iceberg costs are modeled (Panel (a)): A stronger decrease in Air transport over the 1985-2005 period
  - In accordance with Hummels (2007), Behar & Venables (2011)
  - But... No more substantial difference when additive costs are included (Panel (b))

Decomposing (*pure*) transport costs over time



- For Vessel: Similar downward trend for both τ and t
- For Air: Much more contrasted trends
  - Substantial decrease in the ad-valorem costs over 1985-2005, but roughly constant additive costs
  - $\Rightarrow$ An explanation to the difference between Panels (a) and (b) above

$\Rightarrow$ The importance of modeling additive costs

Conclusion

Our paper: Empirical evidence about the role of the additive component in international transport costs

- Provide a quantitative evaluation of both the additive and the ad-valorem components
  - Additive cost: amount to 2.8% of the export price in ocean shipping, 1.8% in air transport
  - Iceberg cost: 3.2% and 2.5% for air and ocean respectively
- The importance of taking into account additive transport costs
  - Additive costs are far from negligible quantitatively
  - A better fit of the model when taken into account
- Characterize the evolution of transport costs over time
  - Importance of the composition effects
  - Biased picture of the time trends of transport costs in air when omitting the additive dimension

Conclusion

Two main possible extensions

- On the empirical side: Go deeper in the structural determinants of transport costs
  - Identify the respective roles of handling costs, insurance and freight costs at the root of the import-export prices gap
- On the theoretical side: Use our results to explore the role of additive costs
  - In shaping international trade flows (trade theory)
  - In affecting the international transmission of business cycles (business cycle theory)

More on our database

- Implications (and limitations)
  - Only cover international transport costs
  - Among transport costs, quantitative freight costs (not those related to the time value of goods)
- A rich database to exploit
  - US imports, large time period: Broad view of international trade flows
  - A reliable database, already used by Hummels (2007), but on a larger period of time
  - Have both the import and the export prices: Estimate both the levels of the ad-valorem and the additive trade costs ($\neq$ Irrarazabal et al., 2015)

Back to slide

More on the estimation strategy (1)

- Assumptions on the specification of transport costs (as in Irrarazabal et al., 2015)
  - Both iceberg and additive costs are separable between the origin country i and the product k dimensions
  - Separability in a multiplicative manner for ad-valorem costs and additive manner for per-kg costs

$\Leftrightarrow$ Write t_{ik} and τ_{ik} as:

$$\tau_{ik} = \tau_i \times \tau_k, \qquad t_{ik} = t_i + t_k \tag{3}$$

- Given the constraint $\frac{p_{ik}}{\widetilde{p}_{ik}} - 1$, the error term should be always positive and multiplicative

$\Rightarrow$ The estimated equation becomes:

$$\frac{p_{ik}}{\widetilde{p}_{ik}} - 1 = \left(\tau_i \times \tau_k - 1 + \frac{t_i + t_k}{\widetilde{p}_{ik}} \right) \times \exp(\epsilon_{ik})$$

- With ϵ_{ik} following a normal law centered on 0.

Back to slide

More on the estimation strategy (2)

- The non-linear least squares method
  - At the basis of the method: Approximate the model by a linear one and refine the parameters by successive iterations
  - The criterion for convergence: That the sum of the squares of the residuals does not not increase? from one iteration to the next
- Eliminate potential influence of outliers: Exclude the 5 percent of the upper and lower tails of the distribution
- Obtaining the final estimates: More details
  - After estimating Equations (1) and (2), re-built
    - ⋆ With additive costs:

$$\widehat{\tau}_{ik}^{adv} = \widehat{\tau}_i \times \widehat{\tau}_k, \qquad \widehat{t}_{ik}^{add} = \widehat{t}_i + \widehat{t}_k$$

    - ⋆ With only iceberg costs:

$$\widehat{\tau}_{ik}^{ice} = \widehat{\tau}_i \times \widehat{\tau}_k$$

  - Then, take the (weighted) average by country-product

Back to slide

Decomposing transport costs: Summary

Back to slide

Mean value over 1974-2013				
# digit	3 digits		4 digits (*)	
Mode	Vessel	Air (**)	Vessel	Air
With only Ad-Valorem Trade Costs				
Mean	1.058	1.051	1.060	1.049
Median	1.051	1.042	1.052	1.037
Std	0.032	0.042	0.036	0.045
Min. value	1.003	1.001	1.003	1.000
Max. value	1.304	1.685	1.408	2.051
With Additive & Ad-Valorem Trade Costs				
Ad-valorem term				
Mean	1.032	1.025	1.033	1.024
Median	1.028	1.018	1.028	1.016
Std	0.023	0.023	0.025	0.026
Min. value	1.001	1.000	1.000	1.000
Max. value	1.227	1.474	1.264	1.537
Additive term				
Mean	0.029	0.018	0.028	0.019
Median	0.019	0.007	0.017	0.008
Std	0.041	0.034	0.039	0.034
Min. value	0.000	0.000	0.000	0.000
Max. value	2.941	13.303	3.197	11.440
# obs.	29279	28207	29317	27680
# origin country	188	191	188	189
# products	230	211	666	567

Notes: Statistics are obtained weighting each observation by its value. The additive term is expressed in fraction of fab price. (*): Four 4-digit estimation: 0n selected years. (**): 1989 omitted in 3 digit estimation for air.

The role of additive costs: Goodness-of-fit evaluations

- Provide a systematic diagnosis about the importance of additive costs
- By comparing the goodness-of-fit of the regressions
  - Obtained under Specification (2) (no additive costs)
  - vs Specification (1) (with additive costs)
- Various measures of goodness of fit
  - The R^2 (the larger the value, the better the fit)
  - Standard Error of Regression (SER) (the smaller the value, the better the fit)
  - The log-likelihood function and two derived measures
    - The Akaike Information Criterion (the lower AIC, the better the fit)
    - The log-likelihood ratio test (H_0: both models are equivalent)

Goodness of fit comparison

- Air, 3 digit - level, selected years

Year	1980	1990	2000	2010	2013	Mean stat
R^2						
Term I only	0.27	0.25	0.32	0.42	0.34	0.31
Terms A & I	0.65	0.63	0.64	0.51	0.46	0.60
SER						
Term I only	0.86	0.81	0.84	0.86	0.92	0.85
Terms A & I	0.71	0.67	0.70	0.79	0.85	0.73
AIC criteria						
Term I only	41171.0	60715.6	87492.6	102297.6	88191.9	70498.1
Terms A & I	35738.4	52098.9	74954.9	95887.1	80873.7	62285.0
Log-likelihood						
Term I only	-20253.5	-29977.8	-43341.3	-50746.8	-43692.9	-34888.6
Terms A & I	-17263.2	-25393.5	-36788.4	-47277.5	-39751.9	-30508.3
LL ratio	5980.6	9168.7	13105.7	6938.6	7882.1	8760.69
nb of restrictions	369	393	426	426	427	402
p-value	0.00	0.00	0.00	0.00	0.00	0.00

Notes: SER = Standard Error of regression; AIC = Akaike Information Criterion. R^2 between the log of predicted ratio and the log of the observed ratio. For the LL ratio test, the number of restrictions is equal to the number of parameters estimated, i.e., the number of partner countries plus the number of products. The mean statistics is calculated as the average value over all years.

Back to slide

Goodness of fit comparison (cont')

- Vessel, 3 digit - level, selected years

Year	1980	1990	2000	2010	2013	Mean stat
R^2						
Term I only	0.415	0.456	0.401	0.350	0.339	0.39
Terms A & I	0.575	0.590	0.571	0.491	0.462	0.56
SER						
Term I only	0.62	0.59	0.65	0.74	0.76	0.66
Terms A & I	0.53	0.51	0.55	0.66	0.68	0.57
AIC criteria						
Term I only	33010.3	51142.6	71365.9	84789.9	88191.9	57848.6
Terms A & I	28067.3	43664.7	60475.9	76161.3	80873.7	49682.3
Log-likelihood						
Term I only	-16129.1	-25169.3	-35263.9	-41998.9	-43692.9	-28534.3
Terms A & I	-13353.7	-21171.4	-29491.0	-37418.7	-39751.9	-24151.3
LL ratio	5550.96	7995.88	11545.98	9160.56	7882.15	8766.0
nb of restrictions	395	411	436	424	427	417
p-value	0.00	0.00	0.00	0.00	0.00	0.00

Notes: SER = Standard Error of regression; AIC = Akaike Information Criterion. R^2 between the log of predicted ratio and the log of the observed ratio. For the LL ratio test, the number of restrictions is equal to the number of parameters estimated, i.e., the number of partner countries plus the number of products. The mean statistics calculated as the average value over all years.

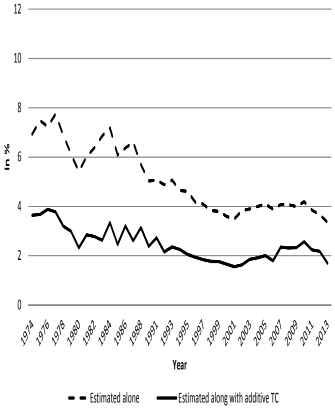
Back to slide

Ad-valorem costs over time

Back to slide

Figure: Ad-valorem Costs (Yearly mean value, 3 digits)

(a) Air



(b) Vessel

Excluding the composition effects of transport costs changes

- For the ad-valorem component, we estimate the following equation:

$$\begin{aligned}
\widehat{\tau}_{ikt} &= \delta \times \exp\left(\sum_{i \neq AFG} \alpha_i . \mathbb{1}_i\right) . \exp\left(\sum_{k \neq 011} \beta_k . \mathbb{1}_k\right) . \exp\left(\sum_{t \neq 1974} \gamma_t . \mathbb{1}_t\right) . \exp\left(\epsilon_{ikt}\right) \\
\Leftrightarrow \ln(\tau_{ikt}) &= \delta + \sum_{i \neq AFG} \alpha_i . \mathbb{1}_i + \sum_{k \neq 011} \beta_k . \mathbb{1}_k + \sum_{t \neq 1974} \gamma_t . \mathbb{1}_t + \epsilon_{ikt} \qquad (4)
\end{aligned}$$

  - With $\widehat{\tau}_{ikt} = \widehat{\tau}_{ikt}^{ice}, \widehat{\tau}_{ikt}^{adv}$ previously obtained

- For the additive component:

$$\begin{aligned}
\widehat{t}_{ikt} &= \left(\prod_{i \neq ARG} \alpha_i . \mathbb{1}_i + \prod_{k} \beta_k . \mathbb{1}_k\right) . \exp\left(\sum_{t \neq 1974} \gamma_t . \mathbb{1}_t\right) . \exp\left(\epsilon_{ikt}\right) \\
\Leftrightarrow \ln(t_{ijt}) &= \ln\left(\prod_{i \neq ARG} \alpha_i . \mathbb{1}_i + \prod_{k} \beta_k . \mathbb{1}_k\right) + \sum_{t \neq 1974} \gamma_t . \mathbb{1}_t + \epsilon_{ijt} \qquad (5)
\end{aligned}$$

- More on the estimation method
  - Equations (4) and (5): Preserve our specification of the ad-valorem and the additive costs (Equation (3))
  - Equation (4) estimated using OLS,
  - Equation (5) using non-linear least squares (by transport mode)
- Exclude the composition effects of transport costs changes $\Leftrightarrow$ Isolate the change in the time dimension
  - From the ad-valorem component estimation (Equation (4)), build the variable Γ_t ($\forall\ t \geq 1974$):

$$\Gamma_t = 100. \frac{\bar{\tau}_{1974}. \exp(\gamma_t) - 1}{\bar{\tau}_{1974} - 1}$$

  - For the additive cost, we build the variable ($\forall\ t \geq 1974$)

$$\Gamma_t^{add} = 100 \exp(\gamma_t)$$

- The Γ_t^{add} and Γ_t series: Interpretation in percentage changes with an initial value of 100 for $t = 1974$

Back to slide