Production location choice and risk aversion

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Received: January 2000/Accepted: July 2000

Abstract. This paper attempts to provide a general comparative static analysis on a firm’s choice of production location with respect to variations in the degree of risk aversion under demand price, input price, and technology uncertainties. Our analysis shows that whether and how the plant location varies with a change in the firm’s degree of risk aversion depend upon the nature of the production technology and how the input and location choice affect risk. It also demonstrates that some of our results are new, while some are generalizations of those obtained by Martinich and Hurter (1982).

JEL classification: D20, D80, R30

1. Introduction

In a stochastic environment, a firm’s degree of risk aversion may reflect the attitude of the firm’s management, their assessment of the stockholders’ preferences, etc. There have been many studies exploring the implications of changes in the degree of risk aversion on a firm’s production decisions in a non-spatial context (see, for example, Baron 1970; Blair 1974; Diamond and Stiglitz 1974; Pope and Kramer 1979; Macmillan and Holtmann 1983; and Hiebert 1983, 1992). Yet, there is a vacuum in research examining the impact of a change in risk aversion on a firm’s production/location decisions in the spatial context. Martinich and Hurter (1982), as far as we know, is the only attempt in the literature.

In their ingenious work, Martinich and Hurter (1982) examines the effects of changes in risk aversion, uncertainty, and production structure on the firm’s optimal solutions in detail. More pointedly, it is the first paper in the literature on the location theory of a firm under uncertainty which allows for general risk preferences by assuming that the firm’s risk preferences can be represented.

The authors are grateful to Professor Tschangho J. Kim, the Editor, and reviewers of this Journal for valuable comments and suggestions on our earlier draft. S.-K. Hsu also acknowledges the financial support from the National Science Council of the Republic of China.
by a von-Neumann Morgenstern utility function. In addition, the effect of incremental differences in risk aversion on the firm’s location choice has been first established, rather than simply comparing risk-averse with risk-neutral or risk prone firms. One of their major conclusions is that, in a world with input/output price uncertainty, the choice of plant location is invariant with any change in the firm’s degree of risk aversion (Martinich and Hurter 1982, Theorem 10).1

While our understanding about the spatial consequences of a change in risk aversion has been much enriched by Martinich and Hurter (1982), there are two assumptions stipulated by them render their findings rather restrictive. One is (MH1) the firm’s utility function is of a constant absolute risk aversion form, and the other, (MH2) the production function is linear homogeneous.

The purpose of this paper is to provide a general comparative static analysis on a firm’s location choice in response to a change in the degree of risk aversion under various types of uncertainty. The analysis is general in the sense that very general specifications of the production and utility functions are adopted. Moreover, in addition to demand/input price uncertainty, we consider also the case where the production technology is random. It will show that some of our results are new and some are generalizations of those obtained by Martinich and Hurter (1982).

The paper is organized as follows. In Sect. 2 we first set up the model and derive the optimal production and location conditions. In Sect. 3 we examine the effect of changes in the degree of risk aversion on the firm’s choice of plant location. Section 4 summarizes our findings.

2. The model

2.1. Spatial setting of the firm

Consider a competitive firm employing two transportable inputs, $M_1$ and $M_2$, to produce output $Q$. The potential location of the firm is limited to a set of points along a line of length $s$ (see Fig. 1). Let site $I$ be the market where

![Location line](image)

Fig. 1. Location line

1 Martinich and Hurter (1982) considered two optimization problems. The first, referred to as the ‘design-location’ problem, takes the rate of output as given and fixed. The second problem, referred to as the ‘production-location’ problem, includes the rate of output among the variables whose values are to be determined by the firm. The location invariance result for the former problem has been established as Theorem 4 in Martinich and Hurter (1982), while Theorem 10 is the result for the second problem. Since the ‘design-location’ problem is a constrained ‘production-location’ problem, the focus of this paper is on the latter only.