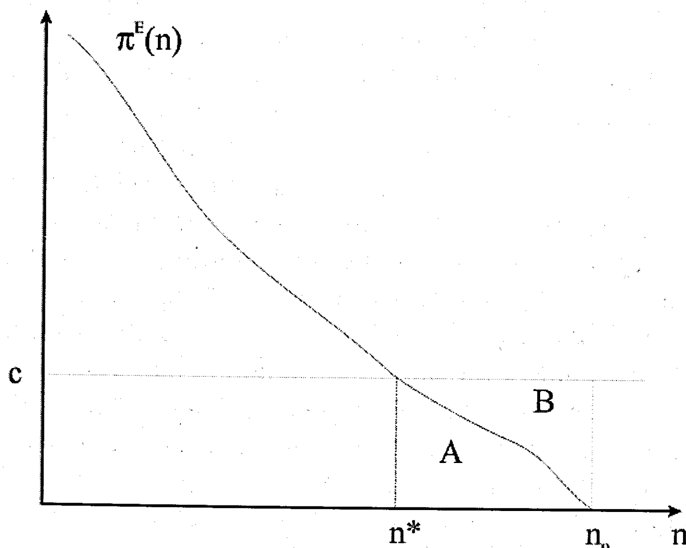
Hence while the subsidy would generate more exports, it would yield a net social loss of area B.

Figure 1: Sunk costs and the optimal number of exporting firms



This is essentially the classic argument raised by Baldwin (1969) against using fixed costs to justify infant industry protection. Baldwin's point was that the argument for intervention requires a market failure, and that fixed or sunk costs alone do not result in a market failure. The extensive recent literature which demonstrates that sunk costs play an important role in preventing some firms from entering foreign markets is not an indication of market failure, nor is it an argument for policies to promote exports or foreign investment. This does not mean that the existence of sunk or fixed costs of trading or investment are irrelevant to policy. As we discuss below, sunk costs in conjunction with market failures can lead to a case for intervention.

Dynamic gains from exporting

One of the most robust results to emerge from the literature on firm heterogeneity and international trade is that firms that ex-