

problem is that while governments have incentives to attract direct foreign investment to their country, once firms have borne the sunk costs of entry, there is an incentive for governments to alter policies to extract rent from the foreign firms. Knowing this, firms may be reluctant to invest. A regional trading agreement, especially if it includes provisions for national treatment on investment, can be a way for a government to credibly commit to treat foreign firms no differently than domestic firms, and this can increase investment and trade flows.

Response to export and investment promotion activity by foreign governments

Many governments have export and investment promotion agencies—Lederman et al. (2006) surveyed agencies in 92 different countries. Does the fact that foreign governments engage in promotion activities provide an additional argument for pursuing such activity?

If there are no externalities (information spillovers), then the presence of foreign export promotion activity does not provide an additional argument for export promotion. Referring again to Figure 1, export promotion activities by foreign governments will cause the expected export profit curve for domestic firms $pE(n)$ to shift in, and the equilibrium number of domestic firms exporting would fall. However, if we apply the same analysis of the effects of domestic export promotion as we did in our earlier discussion of Figure 1, we obtain the same result: in the absence of spillovers or other market failures, there is no case for government intervention. If firms fully internalize benefits and costs of exporting, governments cannot improve on market outcomes⁹.

If there are information spillovers, then foreign activity can affect the optimal domestic government response; however, the direction of the response is not clear. Consider the experimentation argument for export or investment promotion discussed ear-

⁹ Panagariya (2000) makes a similar point in his examination of the case against export subsidies more generally.