

Introduction

Despite major reductions in tariffs and other policy-induced barriers to trade over the past 50 years, there is a great deal of evidence that substantial trade frictions between countries still exist. This is not surprising—it is costly to trade, even within a country. There are transportation costs, costs of finding customers, costs of establishing, joining and maintaining distribution networks, costs of dealing with more than one regulatory environment, and so on. Some of these are a natural consequence of dealing with different types of customers, partners, and suppliers, possibly over large distances. Others are the result of heterogeneity in government regulations across countries due to differences in history, culture, and other local circumstances. Yet other costs are due to government policies which directly or indirectly restrict the movement of goods, services and people across borders.

Many costs must be borne prior to, or in the early stages of, attempting to export to foreign markets. To the extent that they reflect a need to acquire information relevant to dealing in new markets, these costs are sunk—they are for the most part not recoverable if the attempt to establish a foreign market presence is unsuccessful. Sunk informational costs also deter direct investment flows between countries—firms considering foreign investment have to develop knowledge of the foreign regulatory environment, foreign supply networks and foreign labour relations. Hence both trade and investment are lower than they would be in the absence of such costs.

It is tempting to argue that government policies aimed at reducing trade and investment costs would lead to welfare improvements; however, this depends on the source of the costs and the mechanism by which costs are reduced. In a world with heterogeneity in location, culture, and government behaviour, many of these costs are inevitable and attempts to provide subsidies or to introduce other policies to offset them would simply create other inefficiencies. Moreover, specialized firms exist to help importers and exporters cope with some of the difficulties