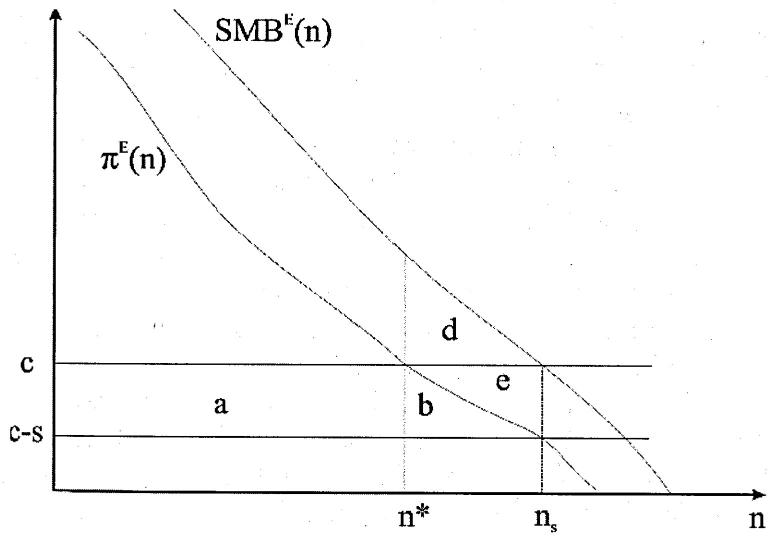
Figure 2: Spillover benefits from exporting



In practice, however, there are strong arguments against using explicit subsidies to promote exports. Not only would this violate WTO rules, but there are also a number of well known incentive problems that arise when governments hand out subsidies. Once a government starts handing out subsidies, firms that it did not intend to target have incentives to change their behaviour to collect subsidies. That is, there are incentive compatibility problems with subsidies. The literature on cash versus in-kind transfers (Blackorby and Donaldson, 1988) is relevant here, and strongly suggests that subsidies are not an appropriate instrument.

A better alternative is for the government to provide services (at below market cost) that are only useful to the types of firms the government wants to target. That is, rather than providing a cash subsidy, the government provides an indirect subsidy by providing (at below market cost) services useful to exporters entering new markets. These types of services include provision of information, facilitating access to the relevant foreign bureaucracy, setting up trade shows, and so on. The government may not know exactly what services to provide for particular industries and markets, and firms may not know what strategies will work