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Firms' export decisions—fixed trade costs and the size of the export market

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Abstract

This article presents a model of international trade under monopolistic competition. In the increasing returns sector firms face fixed, in addition to variable, trade costs, and both exporters and non-exporters may coexist. Exporters benefit from access to large foreign markets, thus a small country has a higher share of exporting firms than a large one. In contrast to standard models, the increasing returns sector will be more open in a small country than in a large one, and a small country may be a net exporter of such commodities, despite the disadvantage of a smaller home market.
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1. Introduction

Standard new trade theory predicts that the profitability of increasing returns to scale production depends positively on the size of the domestic market. A country with a large domestic market for a certain good will have a share of the world's production of that good that is more than proportional to the size of the domestic market. This effect was first identified by Krugman (1980) and is often called the

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home market effect. It is widely recognized in the new theory of international trade and economic geography (see Helpman and Krugman, 1985; and Fujita et al., 1999 for overviews). It is common for most models belonging to these traditions to assume that firms are symmetric so either all firms or no firms are exporters. A firm's decision to export is linked to its decision to produce, hence the home market effect applies to export as well as production. Consequently, a country with a large home market also has a larger than proportional share of the world's *export* of increasing returns to scale goods. In Helpman and Krugman (1985) the home market effect increases with trade liberalization. As trade costs decline, increasing returns to scale production becomes less profitable in the country with the small home market, and below a certain level of trade costs, it gets deindustrialized.

While it seems reasonable that a large home market should be beneficial for increasing returns to scale *production*, it seems less obvious that it should be beneficial also for *export*. Trade theory based on constant returns and comparative advantage, predicts countries to be net importers of goods for which they have large domestic demand, and empirical evidence on the home market effect is ambiguous (see e.g. Head and Ries, 2001). In general we should expect a large foreign market to create large demand for imports, and hence give large export from relatively small markets. In the new trade theory models, however, the opposite is true: while a country's export of increasing returns goods is positively related to its domestic market size it is in fact negatively related to the size of the foreign market.

Since standard new trade theory predicts either all firms or no firms to be exporters, changes in trade costs cannot affect the share of firms that export, but only each firm's export volume. In the real world, however, we observe that both exporters and non-exporters coexist within the same industry. One reason for this might be that there are fixed costs related to exporting, which can make it profitable for only a subset of firms to export. Both non-tariff trade barriers and other costs related to market research, the establishment of foreign distribution networks and foreign contacts, or adaption of foreign standards are examples of export costs with a fixed element. While empiric evidence confirms the importance of such costs (see e.g. Bernard and Wagner, 2001; or Roberts and Tybout, 1997), they are rarely considered in theoretical contributions. One exception is Venables (1994), who presents a model with fixed export costs, and both exporting and non-exporting firms. He shows that trade liberalization leads to an increase in the share of exporting firms, rather than an increase in each firm's export. Trabold (1998) finds empirical evidence for these results, investigating the effects of the southern enlargement of the EEC in 1986. Another exception is Jean (2002), who presents a model with fixed export costs and productivity differences, and shows that exporters will be more efficient than non-exporters. This is also supported by empirical analyses (see e.g. Bernard and Jensen, 1999).

In this article I argue that the size of the export market should affect the share of firms that export in increasing returns to scale sectors. The argument is twofold:

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