Referee Report for Economics

Manuscript: "Wage Subsidies and International Trade: When Does Policy Coordination Pay?" (MS681)

Summary:
The manuscript "Wage subsidies and international trade: When does policy coordination pay?" investigates cross-border effects of wage subsidies. Within a traceable theoretical setup, the authors examine spill-over effects that point to welfare benefits if labor market policies are internationally coordinated.

The authors investigate an international duopoly model, considering unionized labor markets in hand with internationally symmetric and asymmetric labor market institutions. While illuminating both, positive and negative spill-over effects of wage subsidies, they discuss benefits and costs arising with international policy coordination. Results show i.a. that institutional differences could be one possible explanation why countries do not cooperate in terms of labor market policies, even if welfare effects may be positive.

The paper is an interesting contribution. It presents a traceable theoretical model and discusses relevant issues for policy makers in international, globalized environments. Especially within the EU, where the integration process seems to be viscous at several points, the contribution might provide interesting insights.

With this report, I do not want to propose if the manuscript should be published or not. The editors, considering the special circumstances of the forthcoming special issue, should make this decision. Rather, I discuss several issues (without distinguishing between major and minor points) that might be interesting for the authors to consider while revising the manuscript:

- In media res, the authors start illuminating labor market interactions across boundaries. The reader might find it interesting to get some explanation about

which kind of labor market interactions the authors talk about. Not from a theoretical point of view, but from an intuitive or empirical point of view. Maybe the authors could provide some empirical examples, some numbers, etc. on how cross border labor market interaction could look like (if they exist). Which policies are harmonized? How does labor market harmonization look like in EU reality? This could be a good motivation for the theoretical set up, especially because the authors refer to the specific case of the EU in several paragraphs.

- The authors should discuss the costs of labor market harmonization in greater and also broader detail. While the simple model only points to some very stylized costs, there seem to be much more costs feared from international labor market harmonization then mentioned by the authors.
    - Especially when illuminating the European integration process, one of the core problems of harmonization of any kind (as you can see e.g. with the EMS and the actual debt crises) is that European countries might not be as similar as they look like. Similarity of countries, however, is one crucial assumption when it comes to international harmonization of any policy. If there are differences between countries, they may call for different policies to consider domestic peculiarities.
    - Additionally, what is completely neglected in the actual version of the manuscript, are any fears that may arise with asymmetric shocks. As we know, harmonized, internationally rigidified systems might increase welfare as long as there are no (e.g. macroeconomic) shocks. If these shocks occur, harmonized systems might provide too less space to adjust flexible to the single countries' circumstances.

- It need to be explained why firms' profits affect individual income (additionally to individual wages) in general equilibrium. In equations 3 and 4, individual income rises with firms' profits. This might be discussed further since it is not intuitive at first sight.

- As the authors mention frequently, the model focus on intra-industry trade. This, however, seems not to correspond to the design of the model they present. Intra-industry trade is traditionally formalized with some form of scale economies.

Since intra-industry trade must be treated quite differently from inter-industry trade, it is essential to be very clear on this issue. How might the model set up be interpreted with respect to the industry / goods composition? When it is an intra-industry trade model, how do the authors take account for this? What are the effects, implications, also relative to an inter-industry trade framework? What about the relevance when applying the model to the EU case. This may also be important when modeling firms' profits.

- Considering an economies of scale model, firms alteration in profits would affect export and import flows.
- In a competitive set up, where the firm has some kind of market power, it may not be assumed that the wage subsidy may reduce domestic prices. The firms could keep prices constant and use the increase in production to get market access abroad.

- Large formulas should not be presented in footnotes. They should be moved into the Appendix.

- It would be interesting for the reader if the authors could discussion the empirical side of the story (maybe in the introduction or the conclusions). Are there any examples of countries harmonizing labor market institutions?

- Considering the political economy side of the model would rise questions if it is even possible to harmonize labor market institutions. Since the authors consider unions, they might have additional political costs since (i) unions invest in lobby activities and (ii) they lose market power when the government decides to take international labor market policies as benchmark and not to bargain with domestic unions instead. Thus, under a political economy point of view (that seems to be necessary when the authors additionally include unions into their framework), discussing the welfare implications would conceal parts of the story?