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Endogenous Comparative Advantage, Gains From Trade and Symmetry-Breaking

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Abstract

Similar countries often choose very different policies and specialize in very distinct industries. This paper proposes a novel mechanism to explain policy diversity between similar countries from an open economy perspective. I study optimal policies in a two country model where policies affect the determinants of trade patterns. Symmetric countries choose asymmetric policies in equilibrium if aggregate income is sufficiently convex in own policy. Such high social increasing return to policy, despite constant returns to scale in production, generate enough gains from trade to sustain policy diversity in equilibrium. Any asymmetric equilibrium is welfare-improving compared to the common autarky optimum. Similarly, a more asymmetric Nash equilibrium Pareto dominates a less asymmetric one. As an application, I consider a model in which the government's choice of education policy affects skill distribution and comparative advantage. In this application, the existence of an asymmetric Nash equilibrium in education policy requires that the elasticity of the education cost of agents with respect to skill is relatively low. (JEL Classification: F11, E62.)

Keywords: Symmetry-breaking, Endogenous comparative advantage, Gains from trade, Education policy.

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