

# Rochester Center for Economic Research

## **Accounting for Growth**

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Working Paper No. 475  
July 2000

UNIVERSITY OF  
**ROCHESTER**

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May, 1999

Forthcoming in  
*New Directions in Productivity Analysis*, edited by Charles R. Hulten,  
Edwin R. Dean and Michael J. Harper. Chicago: University of  
Chicago Press (for NBER).

## Abstract

A satisfactory account of the postwar growth experience of the United States should be able to come to terms with the following three facts:

1. Since the early 1970's there has been a slump in the advance of productivity.
2. The price of new equipment has fallen steadily over the postwar period.
3. Since the mid-1970's the skill premium has risen.

Variants of Solow's (1960) vintage-capital model can go a long way toward explaining these facts, as this paper shows. In brief, the explanations are:

1. Productivity slowed down because the implementation of information technologies was both costly and slow.
2. Technological advance in the capital goods sector has led to a decline in equipment prices.
3. The skill premium rose because the new, more efficient capital is complementary with skilled labor and/or because the use of skilled labor facilitates the adoption of new technologies.

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# 1 Introduction

The story of technological progress is the invention and subsequent implementation of improved methods of production. All models of growth incorporate this notion in some way. For example, the celebrated Solow (1956) model assumes that technological progress and its implementation are both free. Technological progress rains down as manna from heaven and improves the productivity of all factors of production, new and old alike.

Based on his earlier model, Solow (1957) proposed what has since become the dominant growth-accounting framework. Its central equation is  $y = zF(k, l)$ , where  $y$  is output,  $k$  and  $l$  are the quality-uncorrected inputs of capital (computed using the perpetual inventory method) and labor, and  $z$  is a measure of the state of technology. If  $k$  and  $l$  were homogeneous, then this would be the right way to proceed. In principle, the framework would allow one to separate the contribution of what is measured,  $k$  and  $l$ , from what isn't measured,  $z$ . Now, neither  $k$  nor  $l$  is homogeneous in practice, but one could perhaps hope that some type of aggregation result would validate the procedure — if not exactly, then at least as an approximation.

The problem with this approach is that it treats all vintages of capital (or for that matter labor) as alike. In reality, advances in technology tend to be embodied in the latest vintages of capital. This means that new capital is better than old capital, not just because machines suffer wear and tear as they age, but also because new capital is better than the old capital was when *it* was new. It also means that there can

be no technological progress without investment. If this is what the “embodiment of technology in capital” means, then it can’t be captured by the Solow (1956, 1957) framework, for reasons that Solow (1960, p. 90) himself aptly describes:

It is as if all technical progress were something like time-and-motion study, a way of improving the organization and operation of inputs without reference to the nature of the inputs themselves. The striking assumption is that old and new capital equipment participate equally in technical progress. This conflicts with the casual observation that many if not most innovations need to be embodied in new kinds of durable equipment before they can be made effective. Improvements in technology affect output only to the extent that they are carried into practice either by net capital formation or by the replacement of old-fashioned equipment by the latest models ...

In other words, in contrast to Solow (1956, 1957), implementation is not free. It requires the purchase of new machines. Moreover, it requires new *human* capital too, because workers and management must learn the new technology. This will take place either through experience or through training, or both. This type of technological progress is labelled here as *investment specific*; you must invest to realize the benefits from it.

If this view is correct, growth accounting should allow for many types of physical

and human capital, each that is at least in part specific to the technology that it embodies. In other words, accounting for growth should proceed in a vintage-capital framework. This paper argues that a vintage-capital model can shed light on some key features of the postwar growth experience of the United States. The well-known models of Lucas (1988) and Romer (1990) do not fit into this framework. In Lucas’s model, all physical capital, new and old alike, “participates equally” in the technological progress that the human capital sector generates, and, as Solow’s (1960) quote emphasizes, this doesn’t fit in with casual observation about how technological progress works. In contrast, Romer’s model *is* a vintage-capital model. New capital goods are invented every period. But new capital isn’t better than old capital. It’s just different and expands the menu of available inputs. And production is assumed to be more efficient when there is a longer menu of inputs available. So, capital does not become obsolete as it ages — an implication that denies the obvious fact that old technologies are continually being replaced by new ones.

## **1.1 Summary of the argument and results**

Various variants of Solow (1960)’s vintage-capital model are explored here. To begin with; however, a stab is made at accounting for postwar U.S. growth using the standard Solow (1957) framework.

### 1.1.1 Why the model $y = zF(k, l)$ is unsatisfactory

Solow (1957) is the dominant growth-accounting framework, and Section 2 uses it in a brief growth-accounting exercise for the postwar period. The bottom line is that this model is unable to deal with these four facts:

1. *The prolonged “productivity slowdown” that started around 1973:* To explain it the model insists that technological progress has been dormant since 1973! This, of course, is greatly at odds with casual empiricism: personal computers, cellular telephones, robots, the internet, inter alia.
2. *The falling price of capital goods relative to consumption goods:* This price has declined by 4 percent per year over the postwar period, and it is a symptom of the obsolescence of old capital caused by the arrival of better, new capital. This relative price decline of capital is not consistent with a one-sector growth model such as Solow (1956, 1957).
3. *The productivity of a best-practice plant is much larger than that of the average plant:* They can differ by a factor of two, or three, or more, depending on the industry. This is at odds with a model such as Solow (1956, 1957) in which all firms use the same production function.
4. *The recent rise in wage inequality,* which the framework is silent on.

### **1.1.2 Why the baseline vintage-capital model is unsatisfactory**

Section 3 introduces the “baseline” vintage-capital model of Solow (1960) in which technological progress is exogenous and embodied in the form of new capital goods. Using the price of new equipment relative to consumption, the technological improvement in equipment is estimated to be 4 percent per annum during the postwar period. This makes the effective capital stock grow faster than it does in conventional estimates. As a consequence, the implied productivity slowdown after 1973 is even bigger than the estimate obtained from the Solow (1957) framework! This spells trouble for frameworks that identify total factor productivity as a measure of technological progress, a datum that Abramovitz once labelled as “a measure of our ignorance”. Can Solow’s (1960) framework rationalize the slowdown?

### **1.1.3 Adding diffusion lags and technology-specific learning to the baseline vintage model**

One adjustment to the vintage-capital model that can produce a productivity slowdown is the introduction of a technology-specific learning curve on the part of users of capital goods. The effects of learning can be amplified further if spillovers in learning among capital goods users are added. Another important adjustment is to include lags in the diffusion of new technologies. The analysis assumes that the vintage-specific efficiency of investment starts growing faster in the early 1970’s with the advent of information technologies, and that the new technologies have steep learning curves.

Furthermore, it is presumed that it takes some time for these technologies to diffuse through the economy. This leads to a vintage-capital explanation of the “productivity slowdown” as a period of above-normal unmeasured investment in human capital specific to the technologies that came on-line in the early 1970’s.

#### **1.1.4 Implications for wage inequality**

The productivity slowdown was accompanied by a rise in the skill premium. It is highly probable that the two phenomena are related, and Section 5 explains why. There are two kinds of explanations for the recent rise in inequality. The first, proposed by Griliches (1969), emphasizes the role of skill in the *use* of capital goods, and is labelled “capital-skill complementarity”. The second hypothesis, first proposed by Nelson and Phelps (1966), emphasizes the role of skill in *implementing* the new technology, and is labelled “skill in adoption”. Both explanations can be nested in a vintage-capital model.

#### **1.1.5 Endogenizing growth in the vintage model**

Section 6 presents three models in which growth is endogenous, each based on a different engine of growth. Each engine requires a different fuel to run it. For analyzing economic growth one needs to know what the important engines are: each one will have different implications for how resources should be allocated across the production of current and future consumptions.

*Learning by doing as an engine:* Section 6.1 describes Arrow’s (1962) model of



growth through learning by doing in the capital-goods sector. Learning by doing is the engine that fits closest with Solow's (1960) original vintage-capital model because the technological growth that it generates uses no resources. That is, all employed labor and capital are devoted to producing either capital goods or consumption goods. As capital-goods producers' efficiency rises, the relative price of capital goods falls.

*Research as an engine:* Section 6.2 highlights Krusell's (1997) model of research and development in the capital-goods sector. Here each capital-goods producer must decide how much labor to hire to increase the efficiency of the capital good he sells.

*Human capital as an engine:* Section 6.3 assumes that capital-goods producers can switch to a better technology if they accumulate the requisite technology-specific expertise. The section extends Parente's (1994) model in which the cost of raising one's productive efficiency is the output foregone while the new technology is brought up to speed through learning.

*What does the power system look like?* These three models have a common structure: Each has a consumption-goods and a capital-goods sector, and each has endogenous technological progress in the capital-goods sector only. This technological progress is then passed onto final output producers in the form of the "pecuniary external effect" transmitted by the falling relative price of capital. Each model focuses exclusively on one growth engine, however, and while this simplifies the exposition, it does not convey an idea of how much each engine matters to growth as a whole.

Unless its discovery was accidental, when a new technology appears on society's

menu, society pays an invention cost. Then, society must pay an implementation cost — the cost of the physical and human capital specific to the new technology. Society needs to pay an invention cost only once per technology, whereas the implementation cost must be paid *once per user*.<sup>1</sup> After this, there are just costs of using the technology — “production costs”. Not surprisingly, then, society spends much less on research than it does on the various costs of implementing technologies. Even in the U.S., Jovanovic (1997) has estimated that implementation costs outweigh research costs by a factor of about 20 to 1.

Since people must learn how to use new technologies, it follows that the learning costs associated with the adoption of such technologies — be they in the form of schooling, experience, or on-the-job-training — are inescapable at the level of a country. Since the object of this exercise is accounting for growth *in the United States*, one can conclude that schooling, experience, and training are, in some combination, essential for growth to occur.<sup>2</sup> Research, on the other hand, clearly isn’t, since the majority of the world’s nations have grown not by inventing their own technologies, but by implementing technologies invented by others. Presumably, the U.S. could do the same (assuming that other countries would then be advancing the frontiers of knowledge).

## 1.2 Why models matter for growth-accounting

In its early days, the Cowles Commission's message was that, aside from satisfying one's intellectual curiosity about how the world works, economic models would, on a practical level,

1. allow one to predict the consequences of out-of-sample variation in policies and other exogenous variables,
2. guide the measurement of variables, and
3. allow one to deal with simultaneity problems.

These points apply to economic models generally, and they certainly relate to the value of models that explain growth. It is worth explaining why.

*Policy analysis:* Denison (1960, p.90) claimed that “the whole embodied question is of little importance for policy in the United States.” He based this assertion on his calculation that a one-year change in the average age of capital would have little impact on the output. This misses the point. Different models will suggest different growth-promoting policies. For instance, in the version of Arrow's (1962) learning-by-doing model presented here, there are industry-wide spillover effects in capital-goods production, and a policy that subsidized capital-goods production would improve welfare. In Parente's (1994) model, however, capital goods producers fully internalize the effects of any investment in technology-specific expertise. Such a world is efficient. Government policies may promote growth, but only at the expense of welfare. Other

policy questions arise. Vintage-capital models predict a continual displacement of old technologies by more efficient new ones. If a worker needs to train to work a technology then as a technology becomes obsolete so does the worker. This may have implications for things such as unemployment. These considerations had, long ago, led Stigler to conclude that job-insecurity is the price that society must pay for progress.<sup>3</sup>

*The measurement of variables:* Economic theory provides a guide about what things should be measured and how to measure them. For example, the baseline vintage-capital model developed here suggests that the decline in the relative price of new equipment can be identified with the pace of technological progress in the equipment-goods sector. It also provides guidance on how the aggregate stock of equipment should be measured — and this stock grows more quickly than the corresponding National Income and Product Accounts (NIPA) measure. More generally, in a world with investment-specific technological progress, new capital goods will be more productive than old ones. The rental prices for new and old capital goods are an indicator of the amount of investment-specific technological progress. For example, the difference in rents between old and new office buildings (or the rent gradient) can be used to shed light on the amount of technological progress that there has been in structures.

Investment in physical capital is counted in the NIPA, while investment in knowledge is not. Yet, investment in knowledge may increase output tomorrow in just

the same way as investment in physical capital does. This is sometimes referred to as the “unmeasured investment problem.” In the U.S., R&D spending amounts to about 3 percent of GDP. The costs of implementing new technologies, in terms of schooling, on-the-job training, etc., may amount to 10 percent of GDP. The models of Krusell (1997) and Parente (1994) suggest that such expenditures are as vital to the production of future output as is investment in equipment and structures. In the NIPA such expenditures are expensed or deducted from a firm’s profits, as opposed to being capitalized into profits as when a firm makes a new investment good. By this accounting, GDP would be 13 percent higher if these unmeasured investments were taken into account.

This, indeed, is one way the vintage-capital model can perhaps explain the productivity slowdown — the vintage of technologies that arrived around 1974 was promising, but was subject to a protracted learning curve and high adoption costs. The productivity slowdown took place, in other words, because there was a lot of unmeasured investment. Conventional growth accounting practices will understate productivity growth to the extent that they underestimate output growth due to these unmeasured investments. This might suggest that more effort should be put into collecting aggregate data on R&D and adoption costs.

*Simultaneity problems:* Conventional growth accounting uses an aggregate production function to decompose output growth into technological progress and changes in inputs in a way that uses minimal economic theory. Clearly, though, a large part

of the growth in the capital stock — equipment and structures — is due to technological progress. The general equilibrium approach taken here allows for the growth in capital stock to be broken down into its underlying sources of technological progress. Furthermore, it links the observed decline in the price of new equipment with the rate of technological progress in the production of new equipment. More generally, models allow one to connect observed rent gradients on buildings to the rate of technological progress in structures, and they allow one to connect the long diffusion-lags of products and technologies to the costs of adopting them. Models lead to more precise inferences about such simultaneities.

## 2 Solow (1957) – Neutral Technological Progress

In one of those rare papers that changes the courses of economics, Robert Solow (1957) proposed a way of measuring technological progress. Suppose output,  $y$ , is produced according the following constant-returns-to-scale production function:

$$y = zF(k, l), \tag{1}$$

where  $k$  and  $l$  are the inputs of capital and labor. The variable  $z$  measures the state of technology in the economy, and technological progress is neutral. Over time  $z$  grows, reflecting technological improvement in the economy. Thus, for a given level of inputs,  $k$  and  $l$ , more output,  $y$ , can be produced.

For any variable  $x$ , let  $g_x \equiv (1/x)(dx/dt)$  denote its rate of growth. If the economy

is competitive, then the rate of technological progress can be measured by

$$g_z = g_y/l - \alpha g_{k/l}, \tag{2}$$

where  $\alpha$  represents capital's share of income.

The rate of technological progress,  $g_z$ , can easily be computed from (2), given data on GDP,  $y$ , the capital stock,  $k$ , hours worked,  $l$ , and labor's share of income,  $1 - \alpha$ . Figure 1 plots  $z$  for the postwar period. Note that the growth in  $z$  slows down dramatically around 1973.<sup>4</sup> This is often referred to as the "productivity slowdown". Does it seem reasonable to believe that technological progress has been dormant since 1973? Hardly. Casual empiricism speaks to the contrary: computers, robots, cellular telephones, etc., etc.

### Figure 1 around here

Perhaps part of the explanation is that some quality change in output goes unmeasured so that  $g_y$  was understated. But the above measures of  $k$  and  $l$  do not control for quality change, and this biases things in the other direction and makes the puzzle seem even larger. Is there is something wrong with the notion of technological progress in the Solow (1957) model? The remaining sections analyze vintage-capital models where technological progress is investment specific.

### 3 Solow (1960) – Investment-Specific Technological Progress

In a lesser-known paper, Solow (1960) developed a model where technological progress is embodied in the form of *new* capital goods.

*The production of final output:* Suppose that output is produced according to the constant-returns-to-scale production function

$$y = F(k, l). \tag{3}$$

Note that there is no neutral technological progress. Output can be used for two purposes: consumption,  $c$ , and gross investment,  $i$ . Thus, the economy's resource constraint reads

$$c + i = F(k, l).$$

*Capital accumulation:* Now, suppose that capital accumulation is governed by the law of motion

$$dk/dt = iq - \delta k, \tag{4}$$

where  $i$  is gross investment and  $\delta$  is the rate of *physical* depreciation on capital. Here  $q$  represents the current state of technology for producing new equipment. As  $q$  rises more new capital goods can be produced for a unit of forgone output or consumption. This form of technological progress is specific to the investment goods sector



of the economy. Therefore, changes in  $q$  are dubbed *investment-specific* technological progress. Two important implications of (4) are

- (a) In order to realize the gains from this form of technological progress there must be investment in the economy. This is not the case for neutral technological progress, as assumed in Solow (1957)
- (b) Efficiency units of capital of different vintages can be aggregated linearly in (3) using the appropriate weights on past investments:  $k(t) = \int_0^\infty e^{-\delta s} q(t-s) i(t-s) ds$ .<sup>5</sup>

*The relative price of capital:* In a competitive equilibrium the relative price of new capital goods,  $p$ , would be given by

$$p = 1/q,$$

since this shows how much output or consumption goods must be given up in order to purchase a new unit of equipment. Therefore, in the above framework it is easy to identify the investment-specific technological shift factor,  $q$ , by using a price series for new capital goods; i.e., by using the relationship  $q = 1/p$ .

*Growth accounting in the baseline model:* Figure 2 shows the price series for new equipment and the implied series for the investment technology shock. Look at how much better a representation of technological progress this series is. It rises more or less continuously throughout the postwar period; there is no productivity slowdown here.

## Figure 2 around here

So how much of postwar economic growth is due to investment-specific versus neutral technological progress? To gauge this, assume that output is given by the production function

$$y = zk_e^{\alpha_e} k_s^{\alpha_s} l^{1-\alpha_e-\alpha_s}, \quad (5)$$

where  $k_e$  and  $k_s$  represent the stocks of equipment and structures in the economy. Let equipment follow a law motion similar to (4) so that

$$dk_e/dt = qi_e - \delta_e k_e, \quad (6)$$

where  $i_e$  is gross investment in equipment measured in consumption units and  $\delta_e$  is the rate of physical depreciation. Thus, equipment is subject to investment-specific technological progress. The law of motion for structures is written as

$$dk_s/dt = i_s - \delta_s k_s, \quad (7)$$

where  $i_s$  represents gross investment in structures measured in consumption units and  $\delta_s$  is the rate of physical depreciation. The economy's resource constraint now reads<sup>6</sup>

$$c + i_e + i_s = y. \quad (8)$$

It is easy to calculate from (5), in conjunction with (6), (7) and (8), that along the economy's balanced path the rate of growth in income is given by

$$g_y = \left( \frac{1}{1 - \alpha_e - \alpha_s} \right) g_z + \left( \frac{\alpha_e}{1 - \alpha_e - \alpha_s} \right) g_q. \quad (9)$$

To use this formula numbers are needed for  $\alpha_e$ ,  $\alpha_s$ ,  $g_z$ , and  $g_q$ . Let  $\alpha_e = 0.17$  and  $\alpha_s = 0.13$ .<sup>7</sup> Over the postwar period the rate of investment-specific technological progress averaged 4 percent a year, a fact that can be computed from the series shown for  $q$  in Figure 2. Hence,  $g_q = 0.04$ . Next, a measure for  $z$  can be obtained from the production relationship (5) that implies  $z = y/(k_e^{\alpha_e} k_s^{\alpha_s} l^{1-\alpha_e-\alpha_s})$ . Given data on  $y$ ,  $k_e$ ,  $k_s$ , and  $l$  the series for  $z$  can be computed. These series are all readily available, except for  $k_e$ . This series can be constructed using the using the law of motion (6) and data for  $q$  and  $i_e$ . In line with the National Income and Product Accounts, the rate of physical depreciation on equipment was taken to be 12.4 percent, so that  $\delta_e = 0.124$ . Following this procedure the average rate of neutral technological advance was estimated to be 0.38 percent. Formula (9) then implies that investment-specific technological progress accounted for 63 percent of output growth while neutral technological advance accounted for 35 percent.<sup>8</sup>

*Why the baseline model isn't adequate:* All is not well with this model, however. With the quality change correction in the capital stock, it grows faster than  $k$  did in the version of Solow (1957). When this revised series is inserted into the production function for final goods, the implied productivity slowdown is even bigger than that arising from the Solow (1957) framework. How can this slowdown be explained? The introduction of lags in learning about how to use new technologies to their full potential, and lags in the diffusion of new technologies, seem to do the trick.

## 4 Adjusting the baseline Solow (1960) model

This section introduces lags in learning and diffusion of new technologies. The setting is necessarily one in which plants differ in the technologies they use. As will be seen, it turns out that aggregation to a simple growth model can not be guaranteed in such settings. Some conditions on technology and the vintage structure that ensure Solow (1960) aggregation are presented.

### 4.1 Heterogeneity across plants and the aggregation of capital

*Notation:* In what follows some variables will be plant specific. Since plants of different ages,  $\tau$ , will coexist at any date, one sometimes needs to distinguish these variables with a double index. The notation  $x_\tau(t)$  will denote the value of the variable  $x$  at date  $t$  in a plant that is  $\tau$  years old. The plant's vintage is then

$$v = t - \tau.$$

Variables that are not plant specific will be indexed by  $t$  alone. Moreover, the index  $t$  will be dropped whenever possible.

*Production of final goods:* Final goods are produced in variety of plants. A plant is indexed by its vintage. Thus, the output of an age- $\tau$  plant is described by the production function

$$y_\tau = z_\tau k_\tau^\alpha l_\tau^\beta, \quad 0 < \alpha + \beta < 1,$$

where  $z_\tau$  is the plant's total factor productivity and  $k_\tau$  and  $l_\tau$  are the stocks of capital and labor that it employs. For now,  $z_\tau$  is exogenous. A plant's capital depreciates at the rate  $\delta$  and it cannot be augmented once in place.

*Investment-specific technological progress:* Recall that  $g_q$  is the rate of investment-specific technological progress. Then, as before, an efficiency unit of new capital costs  $1/q(t) = p(t) = e^{-g_q t}$  units of consumption in period  $t$ . The period- $t$  cost of the capital for new plant is therefore  $k_0(t)/q(t)$ .

*Optimal hiring of labor:* A price-taking plant of age  $\tau$  will hire labor up to the point where the marginal product of labor equals the wage,  $w$ . Hence,  $\beta z_\tau k_\tau^\alpha l_\tau^{\beta-1} = w$ , so that

$$l_\tau = \left( \frac{\beta z_\tau k_\tau^\alpha}{w} \right)^{1/(1-\beta)}, \quad (10)$$

and

$$y_\tau = \left( \frac{\beta}{w} \right)^{\beta/(1-\beta)} z_\tau^{1/(1-\beta)} k_\tau^{\alpha/(1-\beta)}. \quad (11)$$

*Labor market clearing:* Suppose that there are  $n_\tau$  plants operating of age  $\tau$ . If the aggregate endowment of labor is fixed at  $h$  then labor market clearing requires that

$$\int_0^\infty n_\tau l_\tau d\tau = h.$$

Substituting (10) into the above formula then allows the following expression to be

obtained for the market clearing wage:

$$w = \beta \left[ \frac{\int_0^\infty n_\tau (z_\tau k_\tau^\alpha)^{1/(1-\beta)} d\tau}{h} \right]^{1-\beta}. \quad (12)$$

Plugging this into (11) yields the output of an age- $\tau$  plant:

$$y_\tau = z_\tau^{1/(1-\beta)} k_\tau^{\alpha/(1-\beta)} \left[ \frac{h}{\int_0^\infty n_\tau (z_\tau k_\tau^\alpha)^{1/(1-\beta)} d\tau} \right]^\beta.$$

*Aggregate output:* Aggregate output is the sum of outputs across all the plants:

$y = \int_0^\infty n_\tau y_\tau d\tau$ . It therefore equals

$$y = \frac{h^\beta \int_0^\infty n_\tau z_\tau^{1/(1-\beta)} k_\tau^{\alpha/(1-\beta)} d\tau}{\left[ \int_0^\infty n_\tau (z_\tau k_\tau^\alpha)^{1/(1-\beta)} d\tau \right]^\beta} = h^\beta \left( \int_0^\infty n_\tau z_\tau^{1/(1-\beta)} k_\tau^{\alpha/(1-\beta)} d\tau \right)^{1-\beta}. \quad (13)$$

*Solow (1960) aggregation:* This model is similar to the benchmark vintage-capital model. In fact, it aggregates to it exactly if the following three assumptions hold:

- (i) Returns to scale are constant (so that  $\alpha = 1 - \beta$ ).
- (ii) Total factor productivity is the same in all plants (so that  $z_\tau = z$ ).
- (iii) The number of plants of each vintage does not change over time. That is,  $n_{t-v}(t) = n_0(v)$ , or equivalently  $n_\tau(t) = n_0(t - \tau)$  since  $v = t - \tau$ . In other words, all investment is in the current vintage plants, and plants last forever — only their capital wears off asymptotically.

In this situation

$$y = zh^{1-\alpha} \mathbf{K}^\alpha,$$

where the aggregate capital stock  $\mathbf{k}$  is defined by  $\mathbf{k}(t) = \int_{-\infty}^t n_{t-v}(t)k_{t-v}(t)dv$ . Now capital in each plant depreciates at the rate  $\delta$ , which means that for any  $v \leq t$ ,

$$dk_{t-v}(t)/dt = -\delta k_{t-v}(t).$$

Moreover, by (iii),  $dn_{t-v}(t)/dt = 0$  for any  $v \leq t$ . Therefore,

$$d\mathbf{k}(t)/dt = -\delta\mathbf{k}(t) + q(t)i(t),$$

where  $i(t) = n_0(t)k_0(t)/q(t)$  is gross investment (measured in consumption units).<sup>9</sup> If one identifies  $h$  and  $\mathbf{k}$  with  $l$  and  $k$  in (3) and (4), the two models will have identical predictions.<sup>10</sup>

So, for the above vintage-capital model to differ in a significant way from the benchmark model with investment-specific technological progress, some combination of Assumptions (i), (ii), and (iii) must be relaxed. Without this, the model will be unable to resolve the productivity slowdown puzzle.

*Lumpy investment assumption:* Now, for the rest of Section 4, suppose that the blueprints for a new plant at date  $t$  call for a *fixed* lump of capital,  $k_0(t)$ . Let  $k_0(t)$  grow at the constant rate  $\kappa \equiv g_q/(1 - \alpha)$  over time.<sup>11</sup> That is, the efficiency-units of capital embodied by a new plant at date  $t$  are equal to

$$k_0(t) = e^{\kappa t}.$$

A plant built at date  $t$  then embodies  $e^{\kappa t} \equiv (e^{g_q t})^{1/(1-\alpha)}$  efficiency units of capital.

Thus, the consumption cost of building a new plant at date  $t$  is

$$\frac{e^{\kappa t}}{q(t)} = e^{(\kappa - g_q)t} = (e^{g_q t})^{\alpha/(1-\alpha)}. \quad (14)$$

Therefore the ratio of the capital stock between a new plant and a plant that is  $\tau$  periods old will be given by  $k_0/k_\tau = e^{(\kappa+\delta)\tau}$ , where  $\delta$  is the rate of physical depreciation on capital. Together with (11) this implies that  $\lim_{\tau \rightarrow \infty} y_\tau/y_0 = 0$  so that, relative to new plants, old plants will wither away over time. In what follows, set  $\delta = 0$ .

## 4.2 Learning Effects

Established skills are often destroyed, and productivity can temporarily fall upon a switch to a new technology. In its early phases, then, a new technology may be operated inefficiently because of a dearth of experience.

*Evidence on learning effects:* A mountain of evidence attests to the presence of such learning effects.

1. An interesting case study, undertaken by David (1975), is the Lawrence #2 cotton mill. This mill was operated in the U.S. antebellum period and detailed inventory records show that no new equipment was added between 1836 and 1856. Yet, output per hour grew at 2.3 percent per year over the period. Jovanovic and Nyarko (1995) present a variety of learning curves for activities such as angioplasty surgery to steel finishing — see Argotte and Epple (1990) for a survey of case studies on learning curves.
2. After analyzing 2,000 firms from 41 industries spanning the period 1973 to 1986, Bahk and Gort (1993) find that a plant's productivity increases by 15 percent over the first 14 years of its life due to learning effects.



*The learning curve:* A simple functional form for the learning curve will now be assumed. Suppose that as a function of its age,  $\tau$ , a plant's time- $t$  total factor productivity  $z_\tau(t)$  does not depend on  $t$  *per se*, but only on  $\tau$ , as follows:

$$z_\tau = (1 - z^* e^{-\lambda\tau})^{1-\beta}.$$

Thus, as a plant ages it becomes more productive, say due to learning by doing. Observe that  $z_0 = (1 - z^*)^{1-\beta}$ , so that  $1 - (1 - z^*)^{1-\beta}$  is the “amount to be learned”. Moreover,  $z_\tau$  is bounded above by one so that you can only do so much with any particular technology. Times of rapid technological progress are likely to have steeper learning curves. That is,  $z^*$ , is likely to be positively related to the rate of investment-specific technological progress,  $g_q$ . The bigger is  $g_q$ , the less familiar the latest generation of capital goods will look, and the more there will be to get acquainted with. Therefore assume that

$$z^* = \omega g_q^\nu. \tag{15}$$

In what follows assume that  $\beta = 0.70$ ,  $\lambda = 1.2$ ,  $\omega = 0.3$ , and  $\nu = 12$ . With this choice of parameter values, the learning curve show a fairly quick rate of learning in that a plant's full potential is reached in about 15 years (when  $g_p$  takes its postwar of 0.04)

.

### 4.3 Diffusion lags

*Evidence:* Diffusion refers to the spread of a new technology through an economy. The diffusion of innovations is slow, but its pace seems to be increasing over time. In

a classic study Gort and Klepper (1982) examined 46 product innovations, beginning with phonograph records in 1887 and ending with lasers in 1960. The authors traced diffusion by examining the number of firms that were producing the new product over time. On average, only 2 or 3 firms were producing each new product for the first 14 years after its commercial development; then the number of firms sharply increased (on average 6 firms per year over the next 10 years). Prices fell rapidly following the inception of a new product (13 percent a year for the first 24 years). Using a 21 product subset of the Gort and Klepper data, Jovanovic and Lach (1996) report that it took approximately 15 years for the output of a new product to rise from the 10 to 90 percent diffusion level. They also cite evidence from a study of 265 innovations that found that it took a new innovation 41 years on average to move from the 10 to 90 percent diffusion level. Grübler (1991) also presents evidence on how fast these products spread after they are invented. For example, in the U.S. it took the steam locomotive 54 years to move from the 10 to 90 percent diffusion level while the diesel (a smaller innovation took) 12 years. It took approximately 25 years from the time the first diesel locomotive was introduced in 1925 to the time that diesels accounted for half of the locomotives in use, which occurred somewhere between 1951 and 1952.

*Theories of diffusion lags:* Diffusion lags seem to have several distinct origins.

- (i) *Vintage-specific physical capital:* If, in a vintage-capital model, a firm can use just one technology at a time as in Parente (1994), it faces a replacement problem. New equipment is costly, while its old, inferior equipment has been paid

for. Hence it is optimal to wait a while before replacing an old machine with a new, better one.<sup>12</sup> Furthermore, everyone cannot adopt at the same time because the economy's capacity to produce equipment is finite. This implies some "smoothing" in adoption, and a smooth diffusion curve.

- (ii) *Vintage-specific human capital*: The slow learning of new technologies act to make adoption costly and slow it down, a fact that Parente (1994) and Greenwood and Yorukoglu (1997) emphasize. Adoption of a new technology may also be delayed because it is difficult at first to hire experienced people to work with them, as Chari and Hopenhayn (1990) emphasize.
- (iii) *Second-mover advantages*: If, as Arrow (1962) assumes, the experience of early adopters is of help to those that adopt later, firms have an incentive to delay, and it is not an equilibrium for firms to adopt a new technology "en masse"; some will adopt right away, others will choose to wait, as in models like Jovanovic and Lach (1989) and Kapur (1993).
- (iv) *Lack of awareness*: A firm may not be aware: (a) that a new technology exists, (b) that it is suitable, or (c), where to acquire all the complementary goods. Diffusion lags then arise because of search costs, as in Jovanovic and Rob (1989) and Jovanovic and MacDonald (1994).<sup>13</sup>
- (v) *Other differences among adopters*. [Griliches (1957), Mansfield (1963), Romeo (1975)]: Given that (i) - (iv) provide adopters a reason to wait, the optimal

waiting time of adopters will differ simply because adopters “are different”. For instance, the diffusion of hybrid corn was affected by economic factors such as the profitability of corn (relative to other agricultural goods) in the area in question, and the education of the farmers that resided there.

*Determining the number of entering plants,  $n_0(t)$ :* To get a determinate number of plants of any vintage, the constant returns to scale assumption must be dropped. Suppose that there are diminishing returns to scale so that  $\alpha + \beta < 1$ . The profits from operating an age- $\tau$  plant in the current period will be given by

$$\begin{aligned}\pi_\tau &\equiv \max_{l_\tau} [z_\tau k_\tau^\alpha l_\tau^\beta - w l_\tau] \\ &= (1 - \beta) \left[ \left( \frac{\beta}{w} \right)^\beta z_\tau k_\tau^\alpha \right]^{1/(1-\beta)}.\end{aligned}$$

The present value of the flow of profits from bringing a new plant on line in the current period,  $t$ , will read

$$\int_0^\infty \pi_\tau(t + \tau) e^{-r\tau} d\tau - k_0(t)/q(t) - \phi(t),$$

where  $r$  denotes the real interest rate. From (14),  $k_0(t)/q(t) = e^{\alpha/(1-\alpha)g_q t}$  is the purchase price of the newly installed capital, and  $\phi(t) = \phi_0 e^{\alpha/(1-\alpha)g_q t}$  is the fixed cost of entry. If there is free entry into production, then these rents must be driven down to zero so that

$$\int_0^\infty \pi_\tau(t + \tau) e^{-r\tau} d\tau - k_0(t)/q(t) - \phi(t) = 0. \quad (16)$$

This equation determines the number of new entrants  $n_0(t)$  in period  $t$ . Although

$n_0(t)$  does not appear directly in this equation, it affects profits because through (12) it affects the wage.

*Choosing values for  $\alpha$  and  $\beta$ :* In the subsequent analysis, labor's share of income will be assumed to equal 70 percent so that  $\beta = 0.70$ . From the national income accounts alone it is impossible to tell how the remaining income should be divided up between profits and the return to capital. Assume that capital's share of income is 20 percent implying that  $\alpha = .20$ , so that rents will amount to the remaining 10 percent of income. The real interest rate,  $r$ , is taken to be 6 percent.

*A parametric diffusion curve:* In what follows, a particular outcome for the diffusion curve for new inventions is simply postulated, as in Jovanovic and Lach (1997). Consider a switch in the economy's technological paradigm that involves moving from one balanced growth path, with some constant flow of entrants  $n^*$ , toward another balanced growth path, with a constant flow of entrants  $n^{**}$ . These flows of entrants should be determined in line with (16). Along the transition path there will be some flow of new entrants each period. Suppose that the number of plants adopting the new paradigm follows a typical *S*-shaped diffusion curve. Specifically, let

$$\frac{\int_0^t n_0(s) ds}{tn^{**}} = \frac{1}{1 + e^{(\Delta - \varepsilon t)}}$$

The parameter  $\Delta$  controls the initial number of users, or  $n_0(0)$ , while  $\varepsilon$  governs the speed of adoption. Assume that  $\Delta = 3.5$  and  $\varepsilon = 0.15$ . With this choice of parameter values, it takes approximately 25 year to reach the 50 percent diffusion level, or the point where about 50 percent of the potential users (as measured by

$tn^{**}$ ) have adopted the new technology.

### 4.3.1 Spillover effects in learning a technology

Suppose that a new technological paradigm (for instance, information technology) is introduced at date  $t = 0$ , for the first time. Better information technologies keep arriving, but they all fit into the new paradigm, and so as each new grade is adopted, the economy gains expertise about the entire paradigm. For someone that adopts a particular technological grade from this new paradigm, the ease of learning about this particular technological grade might be related to the cumulative number of users of the paradigm itself. The more users, the easier it is to acquire the expertise to run a new technological grade efficiently. In particular, let the starting point of the diffusion curve for a particular technological grade within the new paradigm depend positively on the number of plants that have already adopted a technology from the new paradigm. This number of adopters is an increasing function of time. Hence amend (15) to read

$$z^* = \omega g_q^\nu + \chi \left[ 1 - \frac{1}{1 + e^{(\Delta - \epsilon t)}} \right]^\sigma,$$

where  $\chi$  and  $\sigma$  are constants. Observe that  $z^*$  (a measure of the amount to be learned on one's own) is decreasing in  $t$  (the time elapsed since the first usage of the new paradigm in question). As  $t \rightarrow \infty$  the spillover term vanishes. The strength of the spillover term is increasing in  $\chi$  and decreasing in  $\sigma$ . In the subsequent analysis it will be assumed that  $\chi = 0.4$  and  $\sigma = 0.02$ .

## 4.4 An Example: The Third Industrial Revolution

Now, imagine starting off along a balanced-growth path where the rate of investment-specific technological progress is  $g_q^*$ . All of a sudden — at a point in time that will be normalized to  $t = 0$  — a new technological paradigm appears that has a higher rate of investment-specific technological progress,  $g_q^{**}$ . Because of the effect of  $g_q$  on learning, as specified in (15), learning curves become steeper once the new technological era dawns.

Perhaps the first balanced-growth path could be viewed as the trajectory associated with the second industrial revolution. This period saw the rise of electricity, the internal combustion engine, and the modern chemical industry. The second event could be the dawning of the information age, or the third industrial revolution. What will the economy's transition path look like? How does this transition path depend on learning and diffusion?

For this experiment let  $g_q^* = 0.035$  and  $g_q^{**} = 0.05$ . Figure 3 plots labor productivity for the economy under study. The straight line depicts what would have happened to productivity had information technology not been invented at all. The remarkable finding is how growth in labor productivity stalls during the nascent information age. Note that it takes productivity about 30 or so years to cross its old level.

**Figure 3 around here**

The importance of learning is shown in Figure 4, which plots the transition path

when there are no learning effects. It now takes ten years less for productivity to cross its old trend path. Last, Figure 5 shuts down the diffusion curve. There is still a productivity slowdown due to learning effects, but it is much weaker. The learning effects in the model are muted for two reasons. First, it takes no resources to learn. If learning required the input of labor, intermediate inputs, or capital the effect would be strengthened. Second, in the model labor can be freely allocated across vintages. Therefore, less labor is allocated to the low productivity plants (such as the new plants coming on line) and this ameliorates the productivity slowdown. If each plant required some minimal amount of labor to operate — another condition that would break Solow(1960) aggregation — then the learning effects would be stronger. Finally, a key reason for slow diffusion curves is high learning costs and this channel of effect has been abstracted away from here. Learning and diffusion are likely to be inextricably linked and therefore difficult to separate, except in an artificial way, as was done here.

### **Figures 4 and 5 around here**

These figures make it clear that the vintage-capital model can indeed explain the productivity slowdown if learning and diffusion lags matter enough, and the evidence presented here indicates that they do. Another appealing feature of the model is that it can also explain the concurrent rise in the skill premium, and this is the subject of the next section.



## 5 Wage Inequality

As labor productivity-growth slowed down in the early 1970s, wage inequality rose dramatically. Recent evidence suggests that this rise in wage inequality may have been caused by the introduction of new capital goods. For instance:

- (i) The era of electricity in manufacturing dawned around 1900. Goldin and Katz (1997) report that industries that used electricity tended to favor the use of skilled labor.
- (ii) Autor, Katz and Krueger (1997) find that the spread of computers may explain 30 to 50 percent of the growth in the demand for skilled workers since the 1970s.
- (iii) Using cross-country data, Flug and Hercowitz (1997) discover that an increase in equipment investment leads to both a rise in the demand for skilled labor and in the skill premium. In a similar vein, Caselli (1997) documents, from a sample of U.S. manufacturing industries, that since 1975 there has been a strong, positive relationship between changes in an industry's capital/labor ratio and changes in its wages.

Theories of how skill interacts with new technology are of two kinds. The first kind of theory emphasizes the role of skill in the *use* of capital goods that embody technology. Here it is assumed that technology is embodied in capital goods. This is labelled as the “capital-skill complementarity” hypothesis. The second hypothesis

emphasizes the role of skill in *implementing* the new technology, and this is referred to as “skill in adoption”.

## 5.1 Capital-Skill Complementarity — Griliches (1969)

*The hypothesis in its original form:* In its original form, the hypothesis fits in well with a minor modification of Solow (1956, 1957) that allows for two kinds of labor instead of one. Suppose, as Griliches (1969) proposed, that in production, capital is more complementary with skilled labor than with unskilled labor. Specifically, imagine an aggregate production function of the form

$$y = [\theta k^\rho + (1 - \theta)s^\rho]^{\alpha/\rho} u^{(1-\alpha)},$$

where  $s$  and  $u$  represent inputs of skilled and unskilled labor. Capital and skill are complements, in the sense that the elasticity of substitution between them is less than unity if  $\rho < 0$ . The skill premium, or the ratio of skilled to unskilled wage rate, is just the ratio of the marginal products of the two types of labor:

$$\frac{\partial y / \partial s}{\partial y / \partial u} = \frac{\alpha(1 - \theta)}{1 - \alpha} \left[ \theta \left( \frac{k}{s} \right)^\rho + (1 - \theta) \right]^{-1} \frac{u}{s}.$$

Now, suppose that the endowments of skilled and unskilled labor are fixed. Then, the skill premium will rise whenever the capital stock increases, and so will labor’s share of income.<sup>14</sup> Krusell *et al* (1998) argue that an aggregate production function of this type fits the postwar experience well, provided that  $k$  is computed as in the benchmark vintage-capital model of Section 3:  $k(t) = \int_0^\infty e^{-\delta s} q(t - s) i(t - s) ds$ .

*Shifts in the production structure:* In Griliches’s formulation, the skill premium depends on the supplies of the factors  $k$ ,  $s$ , and  $u$  only. But the premium will also change if the adoption of new technology is associated with a change in the economy’s production structure. This is the tack that Goldin and Katz (1997) and Heckman, Lochner and Taber (1998) take. For instance, suppose that the aggregate production function is

$$y = [\theta u^\rho + (1 - \theta) s^\rho]^{\alpha/\rho} k^{(1-\alpha)}. \quad (17)$$

Now, a change in  $k$  will not affect the skill premium,  $(\partial y/\partial s)/(\partial y/\partial u)$ , other things equal. But, imagine that a new technology, say computers or electricity, comes along that favors skilled relative to unskilled labor. Heckman *et al* (1998) operationalize this by assuming that the production function shifts in such a way that  $\theta$  drifts downwards.<sup>15</sup> This raises the skill premium. Note that (17) is an *aggregate* production function. Therefore, a decrease in  $\theta$  affects new and old capital alike. Hence, investment in new capital is *not* necessary to implement the technological progress.

A production structure that shifts towards skilled labor can easily extend to the case in which investment in new capital *is* required to implement new technologies. Suppose, as Solow (1960) does, that technological progress applies only to *new* capital goods, and write

$$y_v = A_v [\theta_v u_v^\rho + (1 - \theta_v) s_v^\rho]^{\alpha/\rho} k_v^{(1-\alpha)},$$

where  $y_v$ ,  $u_v$ ,  $s_v$ , and  $k_v$  are the output and inputs of the vintage “ $v$ ” technology, and  $\theta_v$  is a parameter of the production that is specific to that technology. The newer

vintage technologies are better, and so  $A_v$  is increasing in  $v$ . At each date, there will, in general, be a range of  $v$ 's in use, especially if there is some irreversibility in the capital stock. Now suppose that  $\theta_v$  is decreasing in  $v$ . That is, better technologies require less unskilled labor. The adoption of such technologies will raise the skill-premium. In this type of a model, the skill premium rises because of technological adoption and not directly because of a rise in the stock of capital.

Caselli (1997) suggests, instead, that each new technology demands its own types of skills, skills that may be easier or harder to acquire, relative to the skills required by older technologies. If the skills associated with a new technology are relatively hard to learn and if people's abilities to learn differ, a technological revolution may raise income inequality by rewarding those able enough to work with the new technology.

### **5.1.1 Matching workers and machines**

*Fixed proportions between workers and machines:* The above arguments presume that workers differ in skill, or in their ability to acquire it. A basic implication of the vintage-capital model is that a range of vintages of machines will be in use at any date. Can one somehow turn this implication into a proposition that workers, too, will be different? If a worker could operate a continuum of technologies and if he could work with infinitesimal amounts of each of a continuum of machines of different vintages, the answer would be “no”, because each worker could operate the “market portfolio” of machines. But as soon as one puts a finite limit to the number of

machines that a worker can simultaneously operate, the model generates inequality of workers' incomes. To simplify, assume that the worker can operate just one machine at a time and, moreover, that each machine requires just one worker to operate it. In other words, there are fixed proportions between machines and workers. Under these assumptions, inequality in workers' skills will emerge because of differential incentives for people to accumulate skills, and it translates into a nondegenerate distribution of skills. Here is an outline of the argument.

*Production function:* Suppose that one machine matches with one worker. The output of the match is given by the constant-returns-to-scale production function

$$y = F(k, s),$$

where  $k$  is the efficiency level of the machine, and  $s$  is the skill level supplied by the worker. Machine efficiency and skill are complements in that  $\partial^2 F / \partial k \partial s > 0$ .

*Growth of skills:* Let  $v$  be the fraction of his time that the worker spends working, and let  $h$  denote the level of his human capital. Then

$$s = vh.$$

Suppose that the worker can invest in raising  $h$  as follows:

$$dh/dt = \eta(1 - v)h,$$

where  $1 - v$  is the fraction of his time spent learning.

*Growth of machine-quality:* New machines, in turn, also get better. In other words, there is investment-specific technological progress. Suppose that anyone can

produce a new machine of quality  $k$  according to the linearly homogeneous cost function  $C(k, \mathbf{k})$ , where  $\mathbf{k}$  is the average economy-wide quality of a newly produced machine.

*Balanced growth:* This setup produces a balanced-growth path with some interesting features, as Jovanovic (1998) details:

- (i) It results in nondegenerate distributions of machine efficiency and of worker skill. This can be true even if everybody was identical initially. It occurs because the scarcity of resources means that it is not optimal to give everyone the latest machine. The distributions over capital and skills move rightward over time.
- (ii) Second, because  $\partial^2 F / \partial k \partial s > 0$ , better workers match with the better machines according to an assignment rule of the form  $s = \Phi(k)$ , with  $\Phi' > 0$ .
- (iii) Faster growing economies should have a greater range over machine quality and skills.

## 5.2 Skill in Adoption — Nelson-Phelps (1966)

The previous subsection was based on the notion that skilled labor is better at *using* a new technology. The alternative view is that skilled labor is more efficient at adopting a technology and learning it. The original Nelson and Phelps (1966) formulation, and its subsequent extensions like Benhabib and Spiegel (1994), do not invoke the vintage-

capital model. It will be invoked now.

### **5.2.1 Evidence on adoption costs and their interaction with skill**

When a new technology is adopted, output tends to be below normal while the new technology is “learned”. Indeed, output will often fall below that which was attained under the previous technology. In other words, the adoption of a new technology may carry a large foregone output cost incurred during the learning period. There is evidence that the use of skilled labor facilitates this adoption process.

1. Management scientists have found that the opening of a plant is followed by a temporary increase in the use of engineers whose job is to get the production process “up to speed” [Adler and Clark (1991)].
2. Bartel and Lichtenberg (1987) provide evidence for the joint hypothesis that (a) educated workers have a comparative advantage in implementing new technologies, and (b) the demand for educated versus less-educated workers declines as experience is gained with a new technology.
3. In a more recent study of 450 U.S. manufacturing industries from 1960 to 1990, Caselli (1997) finds that the higher an industry’s nonproduction/production worker ratio was before 1975 (his measure of initial skill intensity), the larger was the increase in its capital/labor ratio over 1975 to 1990 period (a measure of the adoption of new capital goods).

### 5.2.2 Modelling the role of skill in adoption

To implement the idea that skill facilitates the adoption process, let

$$y_\tau = z_\tau k_\tau^\alpha u_\tau^\beta,$$

be the production function for the an age- $\tau$  technology, and  $k_\tau$  and  $u_\tau$  represent the amounts of capital and unskilled labor. Assume that the *improvement* in a plant's practice,  $dz_\tau/d\tau$ , depends upon the amount of skilled labor,  $s_\tau$ , hired:

$$dz_\tau/d\tau = \vartheta(1 - z_\tau)s_\tau^\phi - \mu z_\tau.$$

There is an upper bound on the level of productivity that can be achieved with any particular vintage of capital. As the amount of unrealized potential  $(1 - z_\tau)$  shrinks it becomes increasingly difficult to effect an improvement. The initial condition for  $z$ , or its starting value as of when the plant is operational, is assumed to be inversely related to the rate of technological progress,  $g_q$ , in the following way:

$$z_0 = \varphi g_q^{-\varsigma},$$

where  $\varphi$  and  $\varsigma$  are positive parameters.

Such a formulation can explain the recent rise in the skill premium – the details are in Greenwood and Yorukoglu (1997). Suppose that in 1974 the rate of investment-specific technological progress rose, perhaps associated with the development of information technologies. This would have led to an increase in the demand for skill needed to bring the new technologies on line. The skill premium would then have risen, other things equal.



## 6 Three models of endogenous investment-specific technological progress

It's simple to endogenize investment-specific technological progress. How? Well, three illustrations will now be supplied based on three different engines of growth:

1. Learning by doing, as in Arrow (1962).
2. Research in the capital goods sector à la Krusell (1997).
3. Human capital investment in the capital-goods sector following Parente (1994).

### 6.1 Solow (1960) meets Arrow (1962): Learning-by-doing as an engine of growth

Arrow (1962) assumes that technological progress stems exclusively from learning by doing in the capital-goods sector. There is no learning curve or diffusion lags in the sector that produces final output. In the capital-goods sector, there are no direct costs of improving production efficiency. Instead, a capital-goods producer's efficiency depends on cumulative aggregate output of the entire capital-goods sector — or, what is the same thing, cumulative aggregate investment by the *users* of capital goods. Since each producer has a negligible effect on the aggregate output of capital goods, learning is purely external. The job of casting Arrow's notion of learning by doing in terms of Solow's vintage-capital framework will now start.

*Production of final goods, and accumulation of capital:* Population is constant; write the aggregate production function for final goods in per-capita terms as

$$c + i = k^\alpha,$$

where  $c$ ,  $i$ , and  $k$  are all per-capita values, an innocuous normalization if returns to scale are constant. Physical capital accumulates as follows:

$$dk/dt = iq - \delta k. \tag{18}$$

Once again,  $q$  is the state of technology in the capital-goods sector: Anyone can make  $q$  units of capital goods out of a unit of consumption goods.

*Learning by capital-goods producers:* Suppose that at date  $t$ ,  $q$  is described by

$$q(t) = \nu \left[ \int_0^\infty q(t-s)i(t-s)ds \right]^{1-\alpha}, \tag{19}$$

where  $i(t-s)$  denotes the level of industry-wide investment at date  $t-s$  in consumption units, and  $q(t-s)i(t-s)$  is the number of machine efficiency units produced at  $t-s$ . In (19), as in Arrow's model, the productivity of the capital-goods sector depends on economy-wide cumulative investment.<sup>16</sup>

Let  $\lambda$  be the mass of identical agents in this economy – the economy's “size” or “scale”. Then, in equilibrium,

$$i = \lambda i,$$

so that (19) becomes

$$q(t) = \nu \lambda^{1-\alpha} \left[ \int_0^\infty q(t-s)i(t-s)ds \right]^{1-\alpha}. \tag{20}$$

*Endogenous balanced growth:* Assume that consumers' tastes are described by

$$\int_0^\infty e^{-\rho t} \ln c(t) dt. \quad (21)$$

Let  $g_x$  denote the growth rate of “variable  $x$ ” in balanced growth. The production function implies that, since population is constant,  $g_y = \alpha g_k$ . Along a balanced growth path, output of the capital-goods sector, or  $q\lambda i$ , grows at rate  $g_k$  so that (20) implies that  $g_q = (1 - \alpha)g_k$ . Thus, the price of capital goods,  $1/q$ , falls as output grows.

**Lemma 1** *If a balanced-growth path exists,  $g_k$  satisfies the equation*

$$\underbrace{\rho + \delta + g_k}_{\text{Interest Rate}} = \underbrace{\alpha \nu \lambda^{1-\alpha} \left(1 + \frac{\delta}{g_k}\right)^{1-\alpha}}_{q \times MP_k}. \quad (22)$$

**Proof.** First, from (18),  $g_k = -\delta + qi/k$ . Since  $g_k$ , and hence  $qi/k$ , must be constant,  $g_k = g_q + g_i = g_q + g_y$ , where the second equality follows from assuming that consumption and investment are constant fractions of income along the balanced-growth path so that  $g_i = g_c = g_y$ . Second, consider the first-order condition of optimality for  $k$ . A forgone unit of consumption can purchase  $q$  units of capital that can rent for  $\alpha k^{\alpha-1}q$ . This must cover the interest cost,  $\rho + g_y$ , the cost of depreciation,  $\delta$ , and the capital loss  $g_q$ , due to the fact that capital-goods prices are falling. This gives the efficiency condition  $\alpha k^{\alpha-1} = (\rho + \delta + g_y + g_q)/q = (\rho + \delta + g_k)/q$ . Third,

in balanced growth,  $q(t-s)i(t-s) = e^{-(g_q+g_i)s}q(t)i(t) = e^{-g_k s}q(t)i(t)$ . Then using (20),  $q = \nu\lambda^{1-\alpha}(qi/g_k)^{1-\alpha}$ , which yields  $qk^{\alpha-1} = \nu\lambda^{1-\alpha}[(qi/k)/g_k]^{1-\alpha}$ . Substituting the fact that  $g_k = -\delta + qi/k$  into this expression gives  $qk^{\alpha-1} = \nu\lambda^{1-\alpha}[(g_k + \delta)/g_k]^{1-\alpha} = \nu\lambda^{1-\alpha}(1 + \delta/g_k)^{1-\alpha}$ . Recalling that  $\alpha qk^{\alpha-1} = (\rho + \delta + g_k)$  yields (22). ■

**Corollary 2** *There exists a unique and positive solution to (22).*

**Proof.** The left-hand side of (22) is positively sloped in  $g_k$ , with intercept  $\rho + \delta$ . The right-hand side is negatively sloped, approaching infinity as  $g_k$  approaches zero, and approaching  $\alpha\nu\lambda^{1-\alpha}$  as  $g_k$  approaches infinity. Therefore, exactly one solution exists, and it is strictly positive. ■

**Proposition 3** (*Scale Effect*): *A larger economy, as measured by  $\lambda$ , grows faster.*

**Proof.** Anything that raises (lowers) the right-hand side of (22) raises (lowers)  $g_k$ . Anything that raises (lowers) the left-hand side of (22) lowers (raises)  $g_k$ .<sup>17</sup> ■

**Example 1** *Set capital's share of income at 30 percent, the rate of time preference at 4 percent, and the depreciation rate at 10 percent. Hence,  $\alpha = 0.3$ ,  $\rho = 0.04$ , and  $\delta = 0.10$ . Now, values are backed out for the parameters  $\nu$  and  $\lambda$  that will imply the existence of an equilibrium in which capital-goods prices fall at 4 percent a year; i.e., an equilibrium with  $g_q = 0.04$ . This leads to the capital stock growing at rate  $g_k = 0.04/(1 - 0.3) = 0.057$ . To get this value of  $g_k$  to solve (22), it must transpire that  $\nu$  and  $\lambda$  are such that  $\nu\lambda^{1-\alpha} = 0.32$ .*

*Applying the model to information technology:* The pace of technological progress in information technologies has been nothing short of incredible. Consider the cost of processing, storing and transmitting information. Jonscher (1994) calculates that between 1950 and 1980 the cost of a MIP (millions of instructions per second) fell at a rate of somewhere between 27 and 50 percent per year. Likewise, the cost of storing information dropped at a rate of somewhere between 25 and 30 percent per year from 1960 to 1985. Last, the cost of transmitting information declined at a rate somewhere between 15 and 20 percent per year over the period 1974 to 1994.

Why such a precipitous fall in the cost of information technology? Arrow's model gives a precise answer. Information technology is a general purpose technology, usable in many industries. The scale of demand for the capital goods embodying it, and hence the cumulative output of these capital goods has therefore been large, and this may well have led to a faster pace of learning and cost reduction.

A more specialized technology such as, say, new coal-mining machinery, would be specific to a sector (coal mining) and would, as a result, be demanded on a smaller scale. Its cumulative output and investment would be smaller, and so would its learning-induced productivity gains. In terms of the model, the value of  $\lambda$  for information technologies exceeds the value of  $\lambda$  for coal mining equipment. This amounts to a scale effect on growth. A higher  $\lambda$  hastens the decline in capital-goods prices, a fact that Proposition (3) demonstrates.

## 6.2 Solow (1960) meets Krusell (1997): Research as an engine of growth

In Krusell's model the improvement in capital goods comes about through research.

*Final goods producers:* The production function for final goods,  $y$ , is:

$$y = l^{1-\alpha} \int_0^1 k_j^\alpha dj, \quad (23)$$

where  $l$  is the amount of labor employed in the final output (or consumption) sector, and  $k_j$  is the employment of capital of type  $j$ . The consumption sector is competitive and rents its capital from capital-goods producers each period.

*Capital accumulation:* Each type of capital,  $j$ , is produced and owned by a monopolist who rents out his stock of machines,  $k_j$ , on a period-by-period basis to users in the consumption goods sector. Technological progress occurs at the intensive margin;  $k_j$  grows as follows:

$$dk_j/dt = -\delta k_j + q_j x_j, \quad (24)$$

where  $x_j$  is spending by capital-goods producer  $j$ , measured in consumption-units, and  $q_j$  represents the number of type- $j$  machines that a unit of consumption goods can produce. In other words,  $q_j$  is the production efficiency of monopolist  $j$ .

*Research by capital-goods producers:* Capital-goods producer  $j$  can raise  $q_j$  by doing research. Because the markup he charges is proportional to  $q_j$ , he has the incentive to undertake research in order to raise  $q_j$ . If he hires  $h_j$  workers to do

research, then monopolist  $i$  can raise his efficiency as follows:

$$dq_j/dt = q_j^\gamma \bar{q}^{1-\gamma} R(h_j), \quad (25)$$

where  $R(\cdot)$  is an increasing, concave function. The term

$$\bar{q} = \int_0^1 q_j dj$$

is the average level of productivity across all sectors, and  $\gamma$  is an index of the product-specific returns to R&D. This term affects incentives to do research (if  $\gamma = 0$  no incentive exists) but it does not affect the growth accounting procedure as long as  $h_j$  lends itself to measurement.

*Symmetric equilibrium:* Consider a balanced-growth path where each monopolist is a facsimile of another so that  $k_j = k(t)$ ,  $q_j = q(t)$ , and  $h_j = h$ . The first three equations become

$$y = l^{1-\alpha} k^\alpha, \quad (26)$$

$$dk/dt = -\delta k + qx, \quad (27)$$

and

$$(1/q)(dq/dt) = R(h). \quad (28)$$

Then the capital stock can be represented as

$$k(t) = \int_{-\infty}^t e^{-\delta(t-s)} q(s)x(s)ds. \quad (29)$$

Equation (27) is of the same form as (4) of Section 4, and the evolution of  $q$  now has a specific interpretation: Investment-specific technological progress is driven by

research. Note from (27) that all new investment,  $x(t)$ , is in the frontier technology in the sense that it embodies  $q(t)$  efficiency units of productive power per unit of consumption foregone.

*Difficulties with research-based models:* Although it captures features that Section 2 argued were essential for understanding the U.S. growth experience, there are three problems with Krusell's model.

- (i) *A predicted secular increase in the growth rate:* Equation (28) implies that the rate of growth in the U.S. should have risen over time because in the U.S. data, and for that matter most economies,  $h$  has trended upwards. Jones (1995) discusses the incongruity of these implications of research-based models with evidence.
- (ii) *A positive scale effect:* To see this, take two identical economies and merge them into a single one that has twice as much labor and capital as the individual economies did. Now, hold the types of capital producers constant — since adding more types is tantamount to inventing new capital goods. If each agent behaves as previously described, then initially  $y = 2l^{1-\alpha}k^\alpha$ . Additionally, each firm could now use twice as much research labor so that  $q$  and  $k$  would grow faster. Alternatively, in this hypothetical experiment one could instead assume (realistically so perhaps) that the merged economy would have not a monopoly but a duopoly in each machine market. The consequences of such an assumption are not entirely clear, however, because the old allocation of labor to research



would still not be an equilibrium allocation in the new economy. Competition in the machine market would lead to lower profits for the producers of machines, and this would reduce their incentives to do research and reduce growth. This would partially offset, and even reverse, the positive effect of scale on growth. These arguments make it clear, moreover, that the scale problem in this model has nothing whatsoever to do with spillovers in research. The arguments go through intact even if  $\gamma = 1$ . The scale effect works through the impact that a larger product market has on firms' incentives to improve their efficiency.

(iii) *The resources devoted to research are small:* Most nations report no resources devoted to research. And only the 3 percent or so of U.S. output officially goes to R&D. Because so much technology is, even in the U.S., imported from other countries, research-based models make more sense at the level of the world than they do at the national level.

### **6.3 Solow (1960) meets Parente (1994): Vintage human capital as an engine of growth.**

Parente (1994) offers a vintage *human* capital model without physical capital. This section adds a capital-goods sector to his model. Once again, endogenous technological progress occurs in the capital-goods sector only. As in the Arrow and Krusell models, this technological progress is then passed onto consumption-goods producers in the form of a beneficial “pecuniary external effect” — the falling relative price of

capital.

Imagine an economy with two sectors of production: consumption and capital goods. The consumption goods sector is competitive and enjoys no technological progress. The productivity growth occurring in this sector arises because its capital input becomes less expensive over time relative to consumption goods and relative to labor.

The capital-goods sector is competitive too, and its efficiency rises over time. A capital-goods producer can, at any time, raise the grade of his technology, in Zeckhauser(1968)/Parente(1994) style, but at a cost. The producer has an associated level of expertise at operating his grade of technology. This increases over time due to learning by doing. The profits earned by capital-goods producers are rebated back each period to a representative consumer [with tastes described by (21) and who supplies one unit of labor].

*Consumption goods sector:* The production function for consumption-goods is

$$c = k^\alpha l^{1-\alpha}, \tag{30}$$

where  $k$  and  $l$  are the inputs of capital and labor. This technology is unchanging over time.

*Capital goods sector:* Capital goods are homogeneous, but the technology for producing them can change at the discretion of the capital-goods producer. A capital-

goods producer's technology is described by

$$o = Azh^{1-\alpha},$$

where  $o$  is his output of capital goods,  $A$  denotes the grade of the technology he is using,  $z$  represents his level of expertise, and  $h$  is the amount of labor he employs. Represent the price of capital by  $p$  and the wage by  $w$ , both in consumption units. At any date the producer's labor-allocation problem is static and gives rise to flow profits given by

$$\begin{aligned} \max_h \{pAz h^{1-\alpha} - wh\} &= \alpha[(1-\alpha)/w]^{(1-\alpha)/\alpha} (pAz)^{1/\alpha} \\ &\equiv \pi(A, z, p, w). \end{aligned}$$

*Learning by doing:* Suppose that a producer's expertise on a given technological grade,  $A$ , grows with experience in accordance with

$$dz/d\tau = \lambda(1 - z), \quad \text{for } 0 \leq z \leq 1,$$

where  $\tau$  is the amount of time that has passed since the producer adopted the technology. Observe that while  $z < 1$ , the producer learns by doing. In contrast to what Arrow assumes, this rate does not depend on the volume of output; however, but simply on the passage of time. Eventually, the producer learns everything and  $z \rightarrow 1$ , which is the maximal level of expertise.<sup>18</sup>

Let  $z_\tau$  represent the accumulated expertise of a producer with  $\tau$  years of experience. With an initial condition  $z_0 = z < 1$ , the above differential equation has the

solution

$$z_\tau = 1 - (1 - z) e^{-\lambda\tau} \equiv Z_\tau(z) \quad (31)$$

for  $\tau \geq 0$ .

*Upgrading:* A capital-goods producer can, at any time, upgrade the technology he uses. If he switches from using technology  $A$  to  $A'$  he incurs a switching cost of

$$\kappa + \vartheta A'/A,$$

measured in terms of lost expertise. The idea is that the bigger the leap in technology the producer takes, the less expertise he can carry over into the new situation. Observe that:

1. There is no exogenously specified technological frontier here. That is,  $A'$  is unconstrained,<sup>19</sup> and yet producers do not opt for an  $A'$  that is as large as possible.<sup>20</sup>
2. In sharp contrast to Arrow (and Krusell unless his  $\gamma = 1$ ), there is no technological spillover in human capital accumulation across producers.

Figure 6 plots the evolution of total factor productivity for a producer.

### **Figure 6 around here**

*Balanced growth:* The balanced-growth path will be uncovered through a guess and verify procedure. To this end, suppose that the economy is in balanced growth at

date zero. It seems reasonable to conjecture that consumption, investment, aggregate output, and the stock of capital will all grow at constant rates, denoted as before by  $g_c$ ,  $g_i$ ,  $g_y$ , and  $g_k$ . If consumption and investment are to remain a constant fraction of income then  $g_c = g_i = g_y$ . From (30),  $g_y = \alpha g_k$ .

*Properties of the conjectured steady-state growth path:*

- (i) Each capital-goods producer will choose to upgrade  $A$  after an interval,  $T$ , and by a factor  $\xi$ . Neither  $T$  nor  $\xi$  depend on time. Define  $g_A$  by  $\xi = e^{g_A T}$ . Then  $g_A = (1/T) \ln \xi$  is the average growth rate of each producer's  $A$ .
- (ii) At a point in time the age of the technologies in use are uniformly distributed over the interval  $[0, T]$ , with  $1/T$  producers using each type of technology.
- (iii) All producers using a technology of given grade have the same level of expertise.
- (iv)  $z_0$  solves the equation  $z_0 = Z_T(z_0) - \kappa - \vartheta \xi$ .

By (i) and (ii), the distribution of technologies will be shifting continually to the right over time and the maximal technological grade in use at time  $t$ , or  $A_0(t)$ , will grow exponentially;  $A_0(t) = A_0(0)e^{g_A t}$ . Let  $A_\tau$  denote the level of technology that was upgraded  $\tau$  periods ago. Then from the viewpoint of the producer that is using it,  $\tau$  is the age of the technology  $A_\tau$ . Then (i) and (ii) also imply that  $A_\tau(t) = A_0(t) e^{-g_A \tau}$ . In a steady state,  $[1/A_\tau(t)]dA_\tau(t)/dt = g_A$  for all  $\tau$ . The normalization  $A_0(0) = 1$  will be employed in what follows.

By (iii) and (iv),  $Z_\tau(z_0)$  is the level of expertise of each plant that uses the technology  $A_\tau$ . By (ii) and (iii), the output of capital goods is

$$\frac{A_0}{T} \int_0^T e^{-g_A \tau} Z_\tau(z_0) h_\tau^{1-\alpha} d\tau = \frac{i}{p}, \quad (32)$$

where  $i$  is aggregate investment measured in consumption units, and  $p$  is the price of capital in terms of consumption. The left-hand side of (32) implies that the output of capital goods grows at the rate  $g_k = g_A$ , given that  $h_\tau$  is constant over time (a fact demonstrated below). In growth-rate form, (32) then reads  $g_p = g_i - g_k$ . If investment is to remain a constant fraction of income,  $g_i = g_y$  must hold. Therefore,  $g_p = g_y - g_k = -(1 - \alpha)g_A$ .

It's easy to establish that distribution of labor remains constant across grades. That is,  $h_\tau(t)$  will not depend on  $t$ . Optimal labor hiring in the consumption-goods sector implies that  $(1 - \alpha)(k/l)^\alpha = w$ . If wages grow at the same rate as output,  $g_y = \alpha g_k$ , then  $l$  will be constant over time. Likewise, a capital-goods producer using an age- $\tau$  technology will hire labor according to the condition  $(1 - \alpha)h_\tau^{-\alpha} = w/(pA_\tau z_\tau)$ . Since  $g_p = -(1 - \alpha)g_A$  and  $g_A = g_k$ , the right-hand side of this expression is constant over time, and, therefore, so is  $h_\tau$ .

*Producer's problem:* In balanced growth, prices and wages grow at constant rates as a function of  $t$ , which therefore plays the role of the "aggregate state". To a capital-goods producer, the state variables are his expertise,  $z$ , and his technological

grade,  $A$ . Hence the Bellman equation pertaining to his decision problem is

$$V(A, z; t) = \max_{T^0, A^0} \left\{ \int_t^{t+T^0} \Pi(A, Z_{s-t}(z); s) e^{-r(s-t)} ds + e^{-rT^0} (VA', Z_{T^0}(z) - \kappa - \vartheta \frac{A'}{A}; t + T^0) \right\},$$

where  $\Pi(A, z; s) \equiv \pi(A, Z_{s-t}(z), p(s), w(s))$ . The interest rate  $r$  is presumed to be constant.

*A stationary  $(s, S)$  upgrading policy:* One still needs to verify that the balanced growth equilibrium has the property, conjectured in (i), that capital-goods producers choose to upgrade  $A$  by a constant factor  $\xi$ , and after a constant waiting time,  $T$ . If so, then there exists an  $(s, S)$  policy on the interval  $[z_0, z_T]$  so that  $z$  always starts from  $z_0 \geq 0$  (just after a technological upgrade) and increases up to the point  $z_T \leq 1$ , which triggers the next upgrade, a return of  $z$  to  $z_0$ , and so on. To show that the balanced-growth path is of this form the following property of the profit function is of help:

**Lemma 4** *Let  $a(t) \equiv A/A_0(t)$ . For  $s \geq t$ ,  $\Pi(A, Z_{s-t}(z); s) = e^{\alpha g_A t} \Phi(a(t), z, s - t)$ .*

**Proof.** Since  $g_p = -(1 - \alpha)g_A$  and  $g_w = \alpha g_A$ , it follows that profits for period  $s$ ,  $\Pi(A, Z_{s-t}(z); s)$ , can be expressed as  $[\alpha(1 - \alpha)/w(s)]^{(1-\alpha)/\alpha} [p(s)Az]^{1/\alpha} = e^{\frac{1}{\alpha}g_A t} a(t)^{1/\alpha} z^{1/\alpha} \times c(0)e^{-[(1-\alpha)/\alpha + 1 - \alpha]g_A s}$ , where  $c(0)$  is a constant whose value depends on some time-0 variables. Next, using the fact that  $\frac{1}{\alpha} - [(1 - \alpha)/\alpha + 1 - \alpha] = \alpha$  allows the statement  $\Pi(A, Z_{s-t}(z); s) = e^{\alpha g_A t} a(t)^{1/\alpha} z^{1/\alpha} \times c(0)e^{-[(1-\alpha)/\alpha + 1 - \alpha]g_A (s-t)}$

to be written. Finally, the claim follows by setting  $\Phi(a(t), z, s - t) = a(t)^{1/\alpha} z^{1/\alpha} \times c(0)e^{-[(1-\alpha)/\alpha+1-\alpha]g_A(s-t)}$ . ■

Let  $a' = A'/A_0(t+T')$ . Then since  $A_0(t) = e^{g_A t}$  and  $A'/A = [a'/a][A_0(t+T')/A_0(t)] = e^{g_A T'}(a'/a)$ , the Bellman equation becomes

$$\begin{aligned} V(ae^{g_A t}, z; t) &= e^{\alpha g_A t} \max_{T^0, a^0} \left\{ \int_t^{t+T^0} \Phi(a, Z_{s-t}(z), s-t) e^{-r(s-t)} ds \right. \\ &\quad \left. + e^{-rT^0 - \alpha g_A t} V(a' e^{g_A(t+T^0)}, Z_{T^0}(z) - \kappa - \vartheta e^{g_A T^0} a'/a; t+T') \right\}. \end{aligned}$$

Now observe that after a change of variable  $x = s-t$ ,  $\int_t^{t+T^0} \Phi(a, Z_{s-t}(z), s-t) e^{-r(s-t)} ds = \int_0^{T^0} \Phi(a, Z_x(z), x) e^{-rx} dx$ . Then, if one writes  $B(a, z, t) \equiv e^{-\alpha g_A t} V(ae^{g_A t}, z, t)$ , the Bellman equation becomes

$$\begin{aligned} B(a, z; t) &= \max_{T^0, a^0} \left\{ \int_0^{T^0} \Phi(a, Z_x(z), x) e^{-rx} dx \right. && \text{P(1)} \\ &\quad \left. + e^{-(r-\alpha g_A)T^0} B(a', Z_{T^0}(z) - \kappa - \vartheta e^{g_A T^0} \frac{a'}{a}; t+T') \right\}. \end{aligned}$$

**Proposition 5** *The upgrading policy is stationary.*

**Proof.** Consider problem P(1). For  $\kappa > 0$ , one can bound the optimal policy  $T'$  away from zero. Now, since  $\alpha g_A$  is the growth of consumption, optimal savings behavior by consumers implies that  $r - \alpha g_A > 0$ .<sup>21</sup> Therefore, the operator is a contraction, and by starting an iteration with a function  $B$  that does not depend on  $t$ , one finds that the unique fixed point,  $B(a, z)$  does not depend on  $t$ . Denote the optimal decision rules by  $T'(a, z)$  and  $a'(a, z)$ . Since  $T'$  and  $a'$  do not depend on  $t$ , upgrading by each producer will be periodic and by the same multiple. This is all conditional on the existence of a balanced growth-path. ■



*Definition of a balanced growth:* For a balanced-growth path to exist there must be a triple  $(\xi, T, z_0)$  such that, for all  $t$ ,

$$T'(1, z_0) = T, \tag{33}$$

$$a'(1, z_0) = 1, \tag{34}$$

and

$$z_0 = Z_T(z_0) - \kappa - \vartheta\xi. \tag{35}$$

In this case, output, consumption and investment grow at the rate

$$\alpha g_A = (\alpha/T) \ln \xi.$$

Together, (33)-(35) imply that an economy that starts on the steady state growth-path described by (i)-(iv) remains on it. Conditions (33) and (34) pertain to the optimal behavior of a producer right after he has ungraded his technology. Right after an upgrade, the producer has a technology  $A = A_0(t)$  and hence  $a = 1$ . He must then choose to wait  $T$  periods [this is condition (33)] and, at that point, he must choose to upgrade  $A$  by a constant factor  $\xi$  [this is condition (34)]. Finally, given the  $T$  and  $\xi$  that he has chosen, his expertise must be the same after each upgrade [and this is condition (35)].

*The change-over process:* The above model generates a balanced-growth path along which income grows and the relative price of capital falls. Technological progress in the capital-goods sector is endogenous. At each point in time there is a distribution

of capital-goods producers, using a variety of production techniques. Each capital-goods producer decides when to upgrade his technology. Because there is a cost of doing so, in terms of loss of expertise, he will economize on the frequency of doing this. In the real world such adoption costs may be quite high, implying that the change-over process will be slow.<sup>22</sup>

Salter (1966) noted some time ago that the change-over process at the plant-level is slow. He quotes (p.4) Hicks as stating: “(A)n entrepreneur by investing in fixed capital equipment gives hostage to fortune. So long as the plant is in existence, the possibility of economizing by changing the method or scale of production is small; but as the plant comes to be renewed it will be in his interests to make a radical change.” The above model captures this process, but here the capital investment is in knowledge.

As evidence of the slow change-over process, consider Table 1, compiled by Salter (1966). The first column presents labor productivity for plants using the best-practice or the most up-to-date techniques at the time. Average labor productivity across all plants is reported in the second column. As Salter (1966) notes (p. 6) “(i)n this industry, average labor productivity is only approximately half best-practice productivity. If all plants were up to best-practice standards known and in use, labor productivity would have doubled immediately. In fact, a decade and a half elapsed before this occurred, and in the meantime the potential provided by best-practice productivity had more than doubled.”

Salter's (1966) findings have weathered time well. For in a recent study of plants' total factor productivity (TFP) in twenty-one four-digit textile industries, Dwyer (1998) finds that average TFP among the second (from top) decile divided by the average TFP among the ninth-decile plants (a procedure that is relatively insensitive to outliers) falls between 2 and 3.

Table 1: Best and Average Practice in the U.S. Blast-Furnace Industry: 1911-1926<sup>1</sup>

<u>Year</u>	<u>Best-Practice Plants<sup>2</sup></u>	<u>Industry Average<sup>2</sup></u>
1911	0.313	0.140
1917	0.326	0.150
1919	0.328	0.140
1921	0.428	0.178
1923	0.462	0.213
1925	0.512	0.285
1926	0.573	0.296

<sup>1</sup>Source: Salter(1966)

<sup>2</sup>Tons of pig-iron per manhour

## 7 Conclusions: Solow (1956, 1957) vs. Solow (1960)

Forty years ago, Solow wrote some classic papers on economic growth. In the classic Solow (1956) paper technological progress rained down from heaven. The invention of new techniques and their implementation was free. Technological progress affected

the productivity of all factors of production, capital and labor, both new and old, alike. By contrast in Solow (1960) technological advance was embodied in the form of new capital goods. Its implementation is not free since you need to invest to realize the benefits from it. This form of technological advance is dubbed investment specific.

So, which framework is better? It is argued here that the Solow (1960) vintage capital model is. First, over the postwar period there has been tremendous technological advance in the production of new capital goods. The relative price of capital goods has declined at about 4 percent a year. Second, the variation in productivity across plants in the U.S. is tremendous. It's hard to believe that some of this is not due to differences in capital goods employed. In fact, Bahk and Gort (1993) have found that a one year change in the average age of capital is associated with a 2.5 to 3.5 percent change in a plant's output. Now, there is evidence suggesting that the pace of investment-specific technological progress has picked up since the 1970s with the advent of information technologies. Suppose that this is true. Variants of the Solow (1960), modified to incorporate implementation costs and skilled labor, can go some way in explaining the recent productivity slowdown and the rise in wage inequality.

Why does the source of technological progress matter? It may have implications for economic growth, unemployment, or other issues that society cares about. For example, if technological progress is embodied in the form of new capital goods, then policies that reduce the costs of acquiring new equipment (such as investment

tax credits for equipment buyers or R&D subsidies for equipment producers) may stimulate growth.<sup>23</sup>

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## 8 Appendix

### 8.1 Data Definitions and Sources

The sample period is 1948-1992 and all data is annual. Real income,  $y$ , is defined as nominal GDP minus nominal Gross Housing Product deflated by the implicit price deflator for personal consumption expenditure on nondurables and non-housing services. The GDP series were obtained from the Bureau of Economic Analysis (STAT-USA website) while the prices series were taken from CITIBASE. Real Private Sector Nonresidential Net Capital Stock,  $k$ , and its equipment and structures components ( $k_e$  and  $k_s$  respectively), were again downloaded from the BEA. Total Private Sector Hours Employed,  $l$ , is obtained from CITIBASE (series name LHOURLS). Labor share,  $1 - \alpha$ , was constructed by dividing Nominal Total Compensation of Employees by Nominal Income minus Nominal Proprietor's Income. The data are again from the website of The BEA. The (standard) rate of technological progress is calculated by using

$$\ln z_t - \ln z_{t-1} = \ln (y_t/l_t) - \ln (y_{t-1}/l_{t-1}) - \frac{(\alpha_t + \alpha_{t-1})}{2} [\ln (k_t/l_t) - \ln (k_{t-1}/l_{t-1})],$$

so that

$$z_t = \exp \left( \sum_{j=1949}^t (\ln z_j - \ln z_{j-1}) \right),$$

with  $z_{1948} = 1$ .

The price index for producer's durable equipment is taken from Gordon (1990) [until 1983 and Krusell *et al* (1996) after 1983]. The relative price of equipment,  $p$ ,

is calculated by deflating this price index by the consumer price index. Investment-specific technological progress,  $q$ , is then just equal to  $1/p$ .

To calculate the  $k_e$  series used in Section 3 a discrete approximation to equation (6) is used. The starting point for the equipment series was taken to be the value for  $k_e$  implied by the model's balanced-growth path for the year 1947 as taken from the relationship

$$k_e = \frac{q^{i_e}}{(g_y + 1)(g_q + 1) - (1 - \delta_e)},$$

where  $i_e$  is nominal gross private domestic fixed investment in producer's durable equipment (from the BEA website) deflated by the price index for personal consumption expenditure on nondurables and non-housing services.

## 8.2 The Mismeasurement of Neutral Technological Progress in Traditional Growth Accounting

To simplify, assume that the labor force is constant. Now, suppose that a growth accountant failed to incorporate investment-specific technological progress into his analysis. He would construct his capital stock series according to

$$d\tilde{k}/dt = i - \delta\tilde{k}. \tag{36}$$

This corresponds to measuring the stock of capital at *historical cost* in output units. Using (2) he would obtain the following series describing neutral technological progress

$$g_z = g_y - \alpha g_{\tilde{k}}.$$

Since by assumption all growth in output must derive from growth in the capital stock, it must transpire from (3) that  $g_y = \alpha g_k$  so that

$$g_z = \alpha (g_k - g_k^{\sim}).$$

Hence, any change in the measured Solow residual arises solely from mismeasurement in the capital stock. To gain an understanding of this equation, suppose that the economy was gliding along a balanced growth path. From (4) and (36) it is clear that in this situation

$$g_k - g_k^{\sim} = g_q,$$

implying

$$g_z = \alpha g_q.$$

While the growth accountant may have killed off investment-specific technological progress in his misspecification of the law of motion of capital it has resurrected itself in the form of neutral technological progress.

The model demands that GDP should be measured in consumption units, the numeraire. Doing so is important. What would happen if the growth accountant used standard real GDP numbers. Specifically, let GDP be measured as

$$\tilde{y} = c + \bar{p}qi,$$

where  $\bar{p}$  is some base year price for capital goods. Applying (2) the growth accountant would obtain

$$g_z = g_y - \alpha g_k$$

$$= g_{\tilde{y}} - g_y. \tag{37}$$

The difference in the growth rates between the traditional measure of GDP,  $\tilde{y}$ , and the consumption based one,  $y$ , will be picked up as neutral technological progress.

Now,

$$g_{\tilde{y}} = (c/\tilde{y})g_c + \bar{p}(iq/\tilde{y})g_i + \bar{p}(iq/\tilde{y})g_q.$$

Along a balanced-growth path  $g_c = g_i = g_y$ . Since  $q$  is growing, it must therefore transpire that  $c/\tilde{y} \rightarrow 0$  and  $\bar{p}iq/\tilde{y} \rightarrow 1$ . Hence, asymptotically

$$g_{\tilde{y}} = g_i + g_q = g_y + g_q,$$

so that from (37)

$$g_z = g_q.$$

Once again, investment-specific technological progress has masqueraded itself as neutral technological progress.

## 9 Endnotes

& Jeremy Greenwood is a professor of economics at the University of Rochester. Boyan Jovanovic is a professor of economics at New York University and a research associate at the National Bureau of Economic Research. The authors thank Levent Kockesen for help with the research. The National Science Foundation and the C.V. Starr Center for Applied Economics at New York University are also thanked for financial support.



1. The average cost of implementation may, however, be declining in the number of users because of synergies in adoption.

2. Jovanovic and Rob (1998) compare Solow's 1956 and 1960 frameworks against the backdrop of cross country growth-experience.

3. "We should like to have both a rapid increase in aggregate output and stability in its composition – the former to keep pace with expanding wants, and the latter to avoid the losses of specialized equipment of entrepreneurs and crafts of employees and creating 'sick' industries in which resources are less mobile than customers. It is highly probable that the goals are inconsistent." (Stigler 1947, p. 30)

4. In fact over the whole period it grew on average at the paltry rate of 0.96 percent per year.

5. Benhabib and Rustichini (1991) relax this assumption and allow for a variable rate of substitution in production between capital stocks of different vintages.

6. This structure has been used Greenwood, Hercowitz and Krusell (1997) for growth accounting. Hulten (1992) employs a similar setup, but replaces the resource constraint with  $c + i_e q + i_s = y$ . See Greenwood, Hercowitz and Krusell (1997) for a discussion on the implications of this substitution.

7. This is what Greenwood, Hercowitz and Krusell (1997) estimated.

8. The second part of the Appendix works out what would happen if a growth accountant failed to incorporate investment-specific technological advance into his analysis.

9. It makes sense that under constant returns to scale only the aggregate amount of investment matters, and not how it is divided among plants.

10. Even without these assumptions, the model will behave similarly in balanced growth. Assume for the moment that the number of plants is constant through time so that  $n_\tau = n$  and that  $z_\tau$  grows at rate  $g_z$ . The supply of labor will be constant in balanced growth. Now, along a balanced growth path output and investment must grow at a constant rate,  $g_y$ . This implies that  $i = nk_0/q$  must grow at this rate too. Therefore,  $k_0$  must grow at rate  $g_y + g_q$ . Clearly, to have balanced growth all of the  $k_\tau$ 's should grow at the same rate. Consequently,  $k_\tau$  will grow at rate  $g_y + g_q$ . It is easy to deduce from (13) that the rate of growth in output will be given by

$$g_y = \frac{1}{y} \frac{dy}{dt} = \frac{1}{1-\alpha} g_z + \frac{\alpha}{1-\alpha} g_q.$$

This formula is identical in form to (9). [To see this set  $\alpha_s = 0$  and  $\alpha_e = \alpha$  in (9)].

11. From the previous footnote, it is known that along a balanced growth path  $k_0(t)$  must grow at rate  $g_y + g_q$ , where  $g_y$  is the growth rate of output, and  $g_q$  is the growth rate of  $1/q$ . It is easy to check that  $g_y + g_q = g_q/(1-\alpha) \equiv \kappa$ .

12. For instance, David (1991) attributes the slow adoption of electricity in manufacturing during the early 1900s partly to the durability of old plants using mechanical power derived from water and steam. Those industries undergoing rapid expansion and hence rapid *net* investment — tobacco, fabricated metal, transportation and equipment — tended to adopt electricity first.

13. The diffusion of technology has steadily gotten faster over the last century

(Federal Reserve Bank of Dallas 1997, Exhibit D). Search-theoretic models of technological advance naturally attribute this trend to the secular improvement in the speed and quality of communication.

14. Unskilled labor's share of income remains constant while skilled labor's share increases.

15. They estimate that  $\ln[(1 - \theta)/\theta]$  has grown at a rate of 3.6% since the 1970s. This yields roughly the right magnitude of the increase in the college/high school wage gap.

16. In order to simplify things, Arrow's (1962) assumption that there are fixed, vintage-specific proportions between machines and workers in production is dropped. This assumption can lead to capital getting scrapped before the end of its physical life span. (In his analysis capital goods face sudden death at the end of their physical life span, unless they are scrapped first, as opposed to the gradual depreciation assumed here.) Also, Arrow assumes that machine producers' efficiency is an isoelastic function of the cumulative number of machines produced, whereas here it's assumed to be an isoelastic function of cumulative number of *efficiency units* produced.

17. It follows immediately that  $g_k$  is increasing in  $\nu$ , and decreasing in  $\rho$ .

18. The functional form of the learning curve is taken from Parente (1994). Zeckhauser (1968) considers a wider class of learning curves.

19. One caveat on Parente's model: The choice of  $A'$  is constrained by the fact that the level expertise following an adoption,  $z_0$ , cannot be negative. This constraint

could be removed by choosing a different form for the loss of expertise caused by upgrading. An example of a functional form that would accomplish this is

$$z_0 = \left( \frac{A^0}{A} \right)^\vartheta (z_T - \kappa),$$

where  $z_T$  is the level of expertise just before the adoption and  $\vartheta < 0$ .

20. Chari and Hopenhayn (1991), and Jovanovic and Nyarko (1996) also focus on human-capital-based absorption costs. These models provide a microfoundation for why switching costs should be larger when the new technology is more advanced. This implies that when a firm does switch to a new technology, it may well opt for a technology that is inside the frontier. This implication separates the human capital vintage models from their physical capital counterparts, because the latter all imply that all new investment is in frontier methods.

Search frictions can also lead firms to adopt methods inside the technological frontier. In the models of Jovanovic and Rob (1989) and Jovanovic and MacDonald (1994) it generally doesn't pay for firms to invest time and resources to locate the best technology to imitate.

21. Suppose that tastes are described by (21). Then, along a balanced-growth path  $r = \rho + g_y = \rho + \alpha g_k$ . Hence,  $r - \alpha g_k = \rho$ .

22. This type of model may have some interesting transitional dynamics. Imagine starting off with some distribution of technologies where producers are bunched up around some particular technique. What economic forces will come to bear to encourage them not to all upgrade around the same date in the future? How long will

it take for the distribution to smooth out?

23. Stimulating growth does not necessarily improve welfare. The sacrifice in terms of current consumption may be prohibitively high.

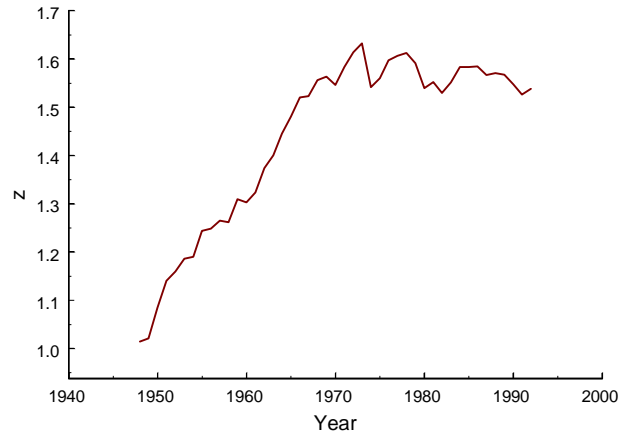


Fig. 1: Standard measure of neutral technological progress

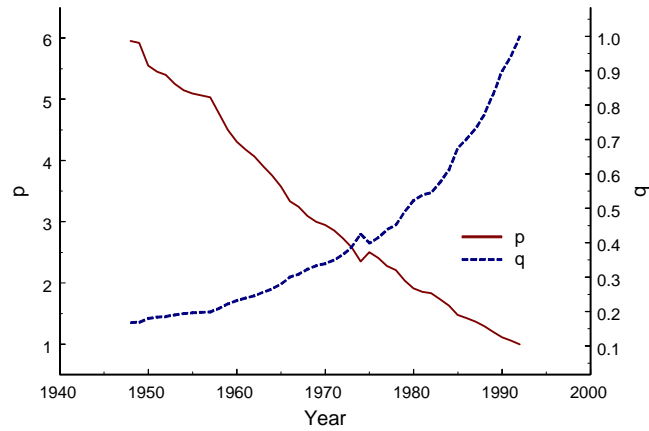


Fig. 2: Relative price of equipment,  $p$ , and investment-specific technological progress,  $q$

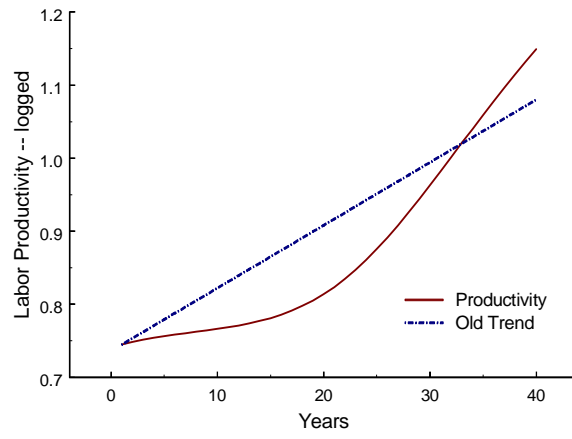


Fig. 3: Transitional dynamics

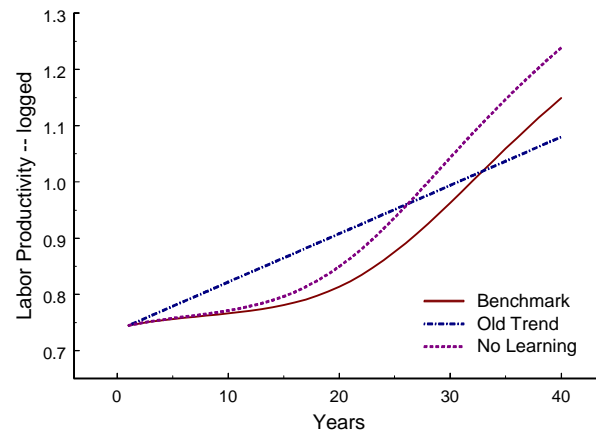


Fig. 4: Transitional dynamics — no learning

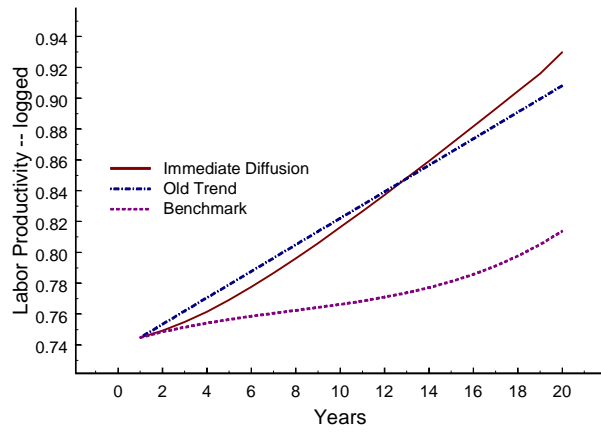


Fig. 5: Transitional dynamics — immediate diffusion

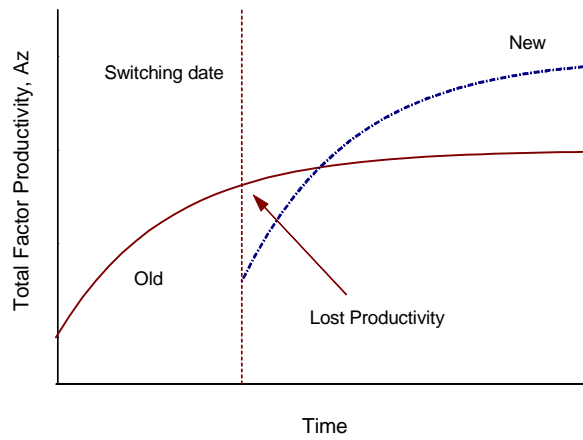


Fig. 6: Evolution of productivity