

On the Role of Productivity in Economic Structure and Development

Job Market Paper

Yu Sun*

Abstract

There exist "stages of diversification" along the development path: countries tend to start out with employment specialized in a few industries, then they diversify, and finally they re-specialize as they develop. The existing literature relates this pattern of industry specialization to openness to trade and volatility. However, this paper shows that in an autarkic economy without uncertainty, these "stages of diversification" may be obtained if the economy starts out being specialized in industries that are not those that dominate the economic structure in the long run, as a matter of productivity-driven structural change. A calibrated multi-industry growth model with many industries that experience different rates of productivity growth replicates the main features of the "stages of diversification." This paper also presents evidence that, in the long run, high-TFP growth manufacturing industries tend to dominate economic structure.

Keywords: Stages of diversification, productivity differences, structural change, development.

JEL Codes: O11 O14 O33 O41.

**Department of Economics, The George Washington University, 2115 G St NW Suite 340, Washington, DC 20052. Tel: +1 (202) 994-6150, Fax: +1 (202) 994-6147, Email: yusun03@gwmail.gwu.edu.* I am grateful to Jean Imbs and Romain Wacziarg for providing me with their dataset. I am deeply indebted to invaluable guidance and comments from Professor Roberto Samaniego, Pamela Labadie and Chao Wei. All errors are the author's.

1 Introduction

It is known that countries appear to start out with employment concentrated in a few industries and sectors, diversify until reaching a certain threshold in income per capita, after which they begin to re-specialize. In other words, industrial specialization is U-shaped along the development path. Imbs and Wacziarg (2003, hereafter IW) refer to this pattern as "stages of diversification."

There are several factors suggested in the literature that may lead to the U-shaped stages of diversification. IW suggest that the interaction of trade and economic development is the driver of industrial specialization. Higher aggregate income enables an economy to diversify, while openness to trade encourages domestic industries to specialize in those with comparative advantages. So, in their view economic development and trade jointly determine the stages of diversification. Koren and Tenreyro (2007) interpret the "stages" in terms of shifts between sectors with differing levels of volatility. They argue that poor countries tend to specialize in industries with high volatility, while rich countries shift to industries with low volatility.

However, before we conclude that the stages of diversification are driven by these factors, we need to understand how economic structure evolves under autarky, and compare that to the stylized facts about how economic structure varies along the development path. The existing literature about the stages of diversification omitted one important factor, namely, productivity. This paper shows that persistent productivity differences across industries can account for observed patterns of economic restructuring along the development path, which is an important finding. An important characteristic of the process of economic development is the reallocation of resources among industries with different rates of productivity growth. The results therefore support a productivity-driven theory in accounting jointly for economic development and structural change.

I show this using a multi-sector model that highlights TFP growth differences across manufacturing industries, in a closed economy and in the absence of industry volatility. I calibrate initial productivity levels so as to reproduce the composition of manufacturing makeup of each of the countries in the IW data set in the starting year. Then, I allow the

structure of the model economies to evolve over time as a result of persistent productivity growth differences across industries, calibrated to U.S. data. Along the development path, the labor shares of different industries evolve due to differences between their TFP growth rates. Using the model-generated series of industrial diversification and applying the same non-parametric method as IW, I am able to replicate the U-shaped stages of diversification found in IW. This paper shows that the stages of diversification can be accounted for simply by the dynamics of industry structure resulting from TFP growth differences. The results are robust to a number of variations in the calibration procedure. I conclude that disparities in TFP growth across industries can account for differences in economic structure along the development path. To my knowledge, the literature has not previously developed an explicit, quantifiable theoretical model that attempts to account for the stages of diversification in IW.

The intuition behind the model is simple. Suppose that there are two goods that are substitutes. Differences in TFP growth rates will lead to an increase in the output share of the industry with high productivity growth, as the good it produces will register a decline in its relative price.¹ However, if the economy starts out being specialized in the *other* industry, then the economy will diversify as the share of the *other* industry decreases and the one with the most rapid productivity growth gradually catches up, until half of the resources are devoted to each industry, after which it will appear to specialize again. The economy will display a "U" shaped pattern of specialization as countries grow.

Notably, the results in my model suggest that goods within manufacturing are substitutes so that, within manufacturing, resources should shift towards high-TFP growth industries. This is exactly what I find in the data, underlining the empirical relevance of the productivity mechanisms in the paper for understanding the process of economic development.

My model is built on Ngai and Pissarides (2007) by performing a rigorous quantitative analysis of the implications of productivity-driven structural change for a large set of coun-

¹Conversely, suppose the goods are complements. Then, persistent differences in TFP growth rates will lead to an increase in the GDP share of the industry with the *slowest* productivity growth. This case turns out not to be empirically relevant for understanding structural change within manufacturing. In Samaniego and Sun (2012), I extend the model to replicate the stages of diversification across broad sectors, not just within manufacturing.

tries. Ngai and Pissarides (2007) show that persistent productivity differences across sectors can result in structural change, and study conditions under which this may occur along a balanced growth path. However, they focus on the behavior of agriculture and services (as do most studies of structural change), and do not study "stages of diversification."² My analysis is based on an unbalanced growth path and focuses on more disaggregated manufacturing industries. In addition, I find that the restrictions Ngai and Pissarides (2007) identify that are required for a balanced growth path with structural change do not hold empirically – specifically, the elasticity of substitution across capital goods is not equal to one – so my analysis requires the computation of a multi-industry growth model on an unbalanced growth path.³ Moreover, I focus on an equilibrium where the initial condition for the capital stock satisfies the Euler equation at date zero, which I refer to as an *Euler growth path*. However, the results do not rely on this condition.

Acemoglu and Guerrieri (2008) allow both productivity growth rates and capital shares to vary across industries. However, I do not find clear evidence that differences in capital shares are related to the "stages." Instead, I do find evidence that countries systematically shift resources between industries with different rates of productivity growth, as predicted by my model. Therefore, to emphasize the productivity mechanism in my paper, I assume that capital intensity is the same for all industries in my model (as do Ngai and Pissarides (2007)).

Duarte and Restuccia (2010) examine the impact of productivity differences across countries in agriculture and services on aggregate productivity, but my experiment is different. I assume that the rate of productivity growth in a given industry is constant across countries, and focus on accounting for economic structure rather than aggregate productivity. My model is also much more disaggregated, allowing me to provide a more detailed picture of industrial structure along the development path within manufacturing. Indeed, a contri-

²Ilyina and Samaniego (2012, henceforth IS) conjecture but do not explore the possibility of a U-shaped specialization pattern *over time*, not in relation to GDP per person.

³This is something that to my knowledge has not been done before in an infinite-horizon multi-industry model with capital accumulation, and my methodology may be of independent interest. Rogerson (2008), Duarte and Restuccia (2010) and others compute transition dynamics in growth models with many industries: however, their models do not have capital so there are no intertemporal decisions.

bution of the paper is to account for the largely hitherto-neglected patterns of structural change within manufacturing. The assumption that the industry TFP growth rate does not vary across countries is driven by the nature of the experiment, as it allows me to talk of high- and low-TFP growth industries. It is also consistent with the finding in Rodrik (2012) that there is unconditional convergence in labor productivity across countries among disaggregated manufacturing industries. Still, I perform a variety of robustness checks to examine the importance of this assumption, finding that the results are robust to significant variation in TFP growth rates across countries.

The results in this paper do not imply that other factors, e.g., trade, might not account for differences in economic structure. However, I show that these alternatives are not *required* to generate the observed stylized facts. Future work may sort out the relative contribution of one or other factors to patterns of economic structure along the development path.

The rest of the paper is organized as follows. Section 2 describes the link between industry productivity differences and industrial diversification in a simple heuristic framework. Section 3 presents a general equilibrium model economy with many industries and characterizes the equilibrium. Section 4 calibrates the model economy with a focus on manufacturing, and reports the results concerning the evolution of industrial structure in the model economy within manufacturing. Section 5 discusses extensions and possibilities for future work.

2 Diversification and TFP Growth Differences

2.1 Economic structure along the development path

IW use a nonparametric methodology to investigate the relationship between industrial diversification and income. Manufacturing industry data are drawn from the INDSTAT3 database distributed by UNIDO, and data on aggregate income per capita are from the Penn World Tables. The industry share is defined as the share of manufacturing employment or value added.

IW use the Gini coefficient of industry shares $GINI_{c,t}$ to measure the degree of industrial concentration in any country c at date t : the more equal the industry shares (i.e., the

lower the Gini), the more diversified the economic structure. Then, they apply a procedure related to robust locally weighted scatterplot smoothing (lowess) to uncover the link between income per capita $GDP_{c,t}$ and specialization. Specifically, they regress the Gini coefficients of industrial specialization on income per capita with country fixed effects, using rolling income windows.

$$GINI_{c,t} = \hat{\alpha}_c(x) + \hat{\beta}(x) GDP_{c,t} + \varepsilon_{c,t}, \quad GDP_{c,t} \in [x - \Delta/2, x + \Delta/2]. \quad (1)$$

The income interval Δ is fixed in each regression (\$5,000 in 1985 dollars) and the midpoint x of the interval gradually moves away from the previous income range (the increment across regressions is \$25). Then, they plot the fitted Gini coefficients estimated at the midpoint of the income interval in each regression. They find a U-shaped relationship between Gini coefficients and income levels. Their U-shaped relationship is robust using both employment and value added data within manufacturing⁴. Figure 1 reproduces their main results.

⁴IW also provide evidence that the relationship is robust across broader sectors. This paper will focus on manufacturing industries.

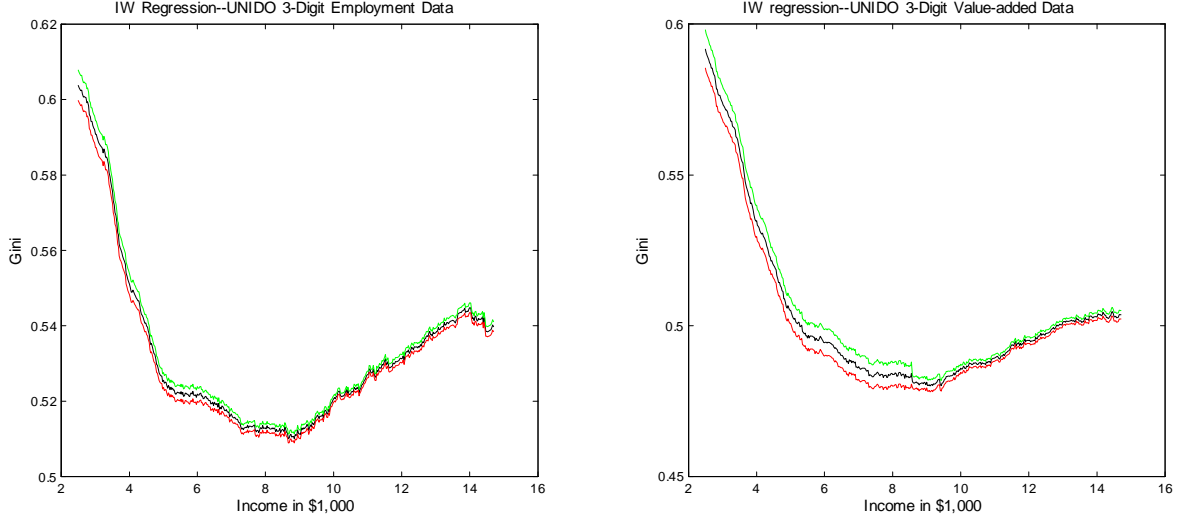


Figure 1. IW results. Each point in the Figure is the fitted value $\hat{\alpha}_c(x) + \hat{\beta}(x)x$ from equation (1), where x is GDP per capita. Confidence bands represent two standard errors of the coefficient $\hat{\beta}(x)$. The left panel is industry concentration within manufacturing estimated using INDSTAT3 employment data provided by UNIDO. The right panel is industry concentration within manufacturing estimated using value added data.

2.2 Productivity and economic structure

To illustrate the main mechanisms in my model, consider the following simple setup. Suppose there are N competitive industries, with production functions of the form:

$$y_{it} = A_{it}K_{it}^{\alpha}n_{it}^{1-\alpha} \quad (2)$$

where $A_{it} = A_{i0}g_i^t$. The growth factor g_i may vary across industries, but capital shares α are assumed to be constant to highlight the productivity mechanism. Producers solve the problem

$$\max_{k_{it}, n_{it}} \{p_{it}y_{it} - w_t n_{it} - r_t K_{it}\} \quad (3)$$

subject to (2), where p_{it} is the price of good i , w_t is the wage and r_t is the rental rate of capital. For now, the series for w_t and r_t may be arbitrary.

Assume these goods are consumed and that preferences are CES, so that, if $\mathbf{y}_t = \{y_{1t}, \dots, y_{Nt}\}$, then

$$u(\mathbf{y}_t) = \left[\sum_{i=1}^N \xi_i \times y_{i,t}^{\frac{\varepsilon-1}{\varepsilon}} \right]^{\frac{\varepsilon}{\varepsilon-1}}, \quad \sum_{i=1}^N \xi_i = 1 \quad (4)$$

where ε is the elasticity of substitution among goods.

Let v_{it} be value added in industry i , so $v_{it} = p_{it}y_{it}$ where p_{it} is the price of good i . Then define the growth factor of value added G_{it} as:

$$G_{it} = v_{i,t+1}/v_{it}.$$

On the demand side, the consumer's first order conditions imply $\frac{p_{it}}{p_{jt}} = \left(\frac{y_{j,t}}{y_{i,t}} \right)^{\frac{1}{\varepsilon}} \frac{\xi_i}{\xi_j}$, so that

$$\frac{G_{it}}{G_{jt}} = \left[\frac{\frac{p_{i,t+1}}{p_{it}}}{\frac{p_{j,t+1}}{p_{jt}}} \right]^{1-\varepsilon}. \quad (5)$$

On the supply side, the optimal capital labor ratio is a constant across industries, so that $\frac{A_{it}}{A_{jt}} = \frac{p_{jt}}{p_{it}}$.⁵ Thus, for any industries i and j , $\left(\frac{p_{i,t+1}}{p_{it}} \right) \div \left(\frac{p_{j,t+1}}{p_{jt}} \right) = \left(\frac{g_i}{g_j} \right)^{-1}$. In equilibrium (5) becomes:

$$\frac{G_{it}}{G_{jt}} = \left[\frac{g_i}{g_j} \right]^{\varepsilon-1}. \quad (6)$$

Let $s_{i,t}$ be the share of manufacturing of industry i at date t . Given shares $s_{i,t}$ for one year t , I can compute shares for the next year $t+1$ by multiplying $s_{i,t}$ by $g_i^{\varepsilon-1}$ and repeating this procedure to get predicted shares for as many years as desired⁶. Thus, given initial conditions, a value of ε , and productivity growth factors g_i , I can compute model-generated industry shares of manufacturing, and subject the resulting industry structure to the same nonparametric methodology as in IW to study whether productivity differences might be able to generate a U-shaped specialization pattern.

⁵To see this, the conditions can be written $p_{it}\alpha y_{it}/K_{it} = r_{it}$ and $p_{it}(1-\alpha)y_{it}/n_{it} = w_{it}$. Dividing one condition by the other I get that $\frac{1-\alpha}{\alpha} \left(\frac{K_{it}}{n_{it}} \right) = \frac{w_{it}}{r_{it}}$. Then, dividing any of these conditions for industry i by that for j yields the result.

⁶Literally, this procedure would yield shares that do not add to one. To be precise, let $z_{i,t+1} = g_i^{\varepsilon-1} s_{i,t}$, Then $s_{i,t+1} = \frac{z_{i,t+1}}{\sum_{n=1}^N z_{n,t+1}}$.

This might occur if "initial" industry composition is skewed towards low-tech industries. For example, suppose that $N = 2$ and that "specialization" is measured using the Gini coefficient. If s_{jt} is the share of industry j , then the Gini coefficient equals $0.5 - \min\{s_{1t}, 1 - s_{1t}\}$.⁷ Now suppose that $g_1 < g_2$. Then, if $\varepsilon > 1$, for a sufficiently low initial share of industry 2 the economy will start off specialized in industry 1, whereas in all periods thereafter the share of 2 will increase and that of 1 will decrease. Thus, the minimum of the two (s_{2t}) will rise until it reaches 0.5 and the Gini coefficient has dropped to 0. After this, the minimum of the two becomes s_{1t} and, as its share continues to decrease, the Gini coefficient rises again. Thus, for a time, specialization decreases, until s_{1t} drops below half – after which specialization will begin increasing again. Alternatively, if $\varepsilon < 1$, for sufficiently low initial share in 1 the economy will start off specialized in industry 2, whereas in all periods thereafter the share of 1 will increase, and the same dynamics obtain.

I now examine whether the heuristic model presented above can generate a U-shaped specialization pattern for the 28 manufacturing industries examined in IW. I use the initial industry shares in 1963 from the UNIDO employment data, and simulate a time series of future industry shares until 1992 using equation (6). I then include the same country-time pairs as IW, so that I have a model-generated unbalanced panel that is of the same dimensions as that in the IW database. I simulate industry shares for the 28 manufacturing industries in the ISIC revision 2 industry classification used by the UNIDO INDSTAT3 database, from 1964 until 1992 given the initial share in 1963 drawn from the UNIDO employment data. To perform this simulation I adopt the value $\varepsilon = 3.75$, which is estimated in Ilyina and Samaniego (2012) by observing that the logarithm of (6) indicates that regressing value-added growth rates (or employment growth rates) on TFP growth rates yields a coefficient equal to $\varepsilon - 1$.⁸ Finally, TFP growth data are computed using the NBER manufacturing productivity database. Note that the NBER industry classification is 4-digit SIC. I use

⁷To see this, note that the Lorenz curve of industry composition when $N = 2$ is a line joining $(0, 0)$ to $(0.5, \min\{s_1, s_2\})$ and another line joining $(0.5, \min\{s_1, s_2\})$ to $(1, 1)$. The Gini coefficient is defined as the integral of the area above this line.

⁸To see this, consider that (6) is equivalent to $\log G_i = \alpha + (\varepsilon - 1) \log g_i + \epsilon_i$ where $\alpha = \log G_j - \log g_j$ for some arbitrary industry j and ϵ_i is any unmodeled noise in the relationship. Ilyina and Samaniego (2012) estimate this coefficient using the industry TFP and value-added data reported in Jorgenson et al (2007).

Domar weights to convert NBER SIC industry TFP growth data into ISIC revision2 data (see Table 4 in the Appendix for values). The value of g_i is the industry average over time. GDP per-capita data are drawn directly from the data for each country-year combination.⁹

2.3 Basic Model: Results

I regress Gini coefficients generated from my TFP growth simulation on income per capita for countries and periods, following the IW methodology. The results display a similar U-shaped relation between industry concentration and income levels: see Figure 2. In addition, the turning point is roughly \$9,000, as found by IW, something that lends weight to the empirical relevance of the productivity mechanism.

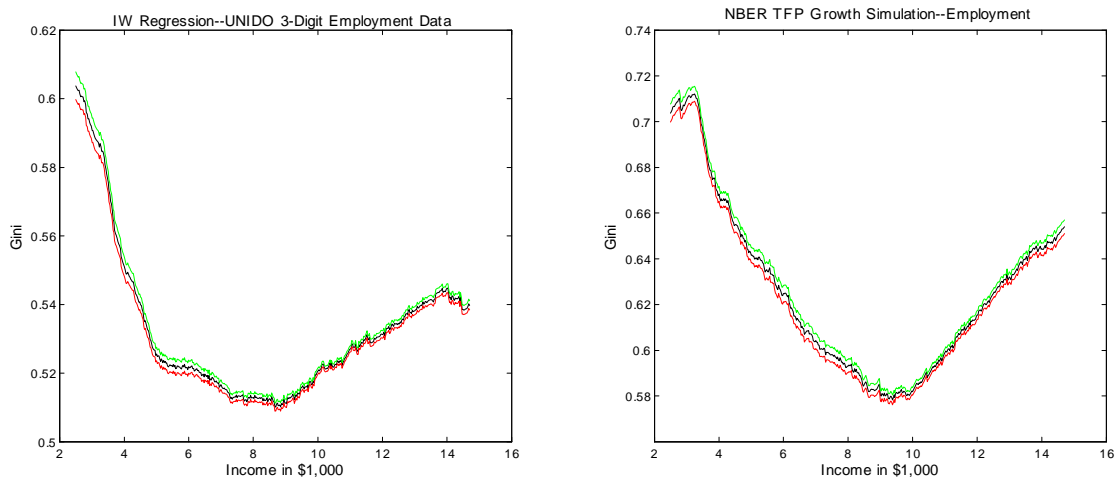


Figure 2. Industry structure along the development path in the simple model.

The left panel is the relationship between income and specialization within manufacturing reported in IW. The right panel is the same relationship in the pseudo-data generated using equation (6).

As a robustness check, I use an alternative way of measuring TFP growth rates. Using the UNIDO data set, I compute the TFP growth rates for the 28 UNIDO manufacturing

⁹It is worth mentioning that the correlation between the NBER productivity values and US industry employment growth in the UNIDO database is 0.46**. In what remains of the paper, one, two and three asterisks represent standard statistical significance at the 10, 5 and 1 percent levels respectively.

industries in the United States using the following equation:¹⁰

$$\ln(TFP_{it}) = \ln(Y_{it}) - (1 - \alpha) \ln(L_{it}) - \alpha \ln(K_{it}) \quad (7)$$

where Y_{it} is the production index, L_{it} is the total amount of labor and K_{it} is capital used in industry i at time t . See the Appendix for details.

Also I compute industry price growth rates as a robustness check, so that equation (5) rather than (6) dictates industry dynamics. The price index is computed using value added divided by the production index from the UNIDO data set.¹¹ Both TFP and price growth rates (in Table 5, see Appendix) are averages over the period 1963–1992 and assumed to be the same for all countries. TFP growth rates computed this way are highly correlated with those derived from the NBER data, with a correlation coefficient of 0.6 (significant at the 5 percent level). The TFP growth and price growth series based on UNIDO data are highly negatively correlated with a coefficient of -0.9 (significant at the 5 percent level). All of this is encouraging as to the robustness of the productivity measures.

I simulate industry shares following equation (5) for UNIDO price growth and (6) for TFP growth and apply nonparametric methodology to model simulated Gini coefficients on income. Again, I obtain a U-shape in both cases, see Figure 3.

¹⁰It is an important part of the experiment that industry TFP growth rates be the same across countries: all that varies are initial conditions. When I used this procedure to measure industry TFP growth rates in different countries I found that the estimated values in some countries were sometimes absurdly high. I interpret this as indicating that the input data in those countries are likely mismeasured. This implies that I cannot reliably estimate country-specific industry growth rates using the UNIDO data: however, this does not affect the usefulness of the reported initial conditions, which do not depend on input data.

¹¹Recall that value added $v_{it} = p_{it}y_{it}$. The assumption is that growth in the UNIDO industrial production index proxies for growth in y_{it} .

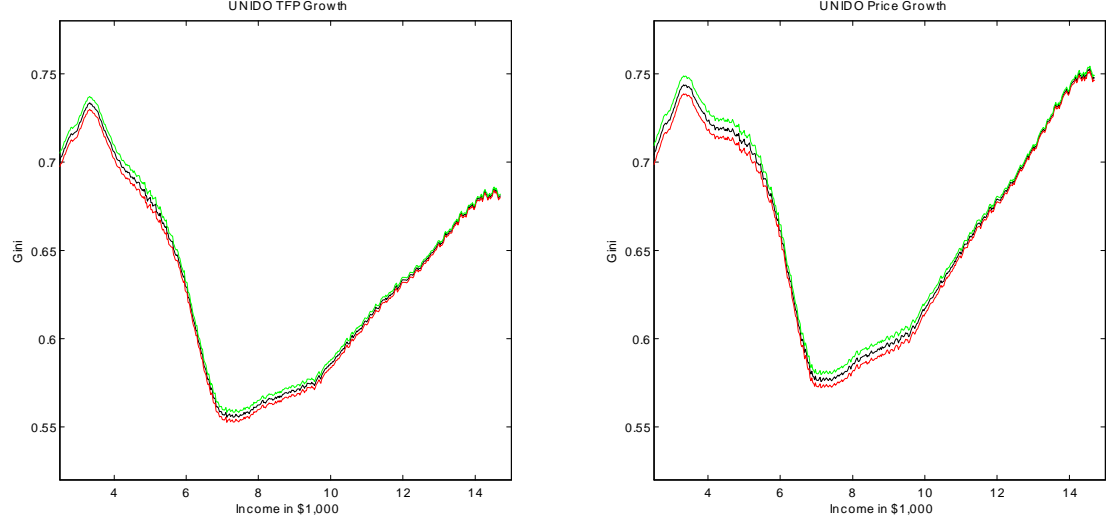


Figure 3. IW nonparametric regression using simulated industry concentration measures based on equation (6) using UNIDO TFP growth rates, and based on equation (5) using UNIDO price growth rates.

So far, I only show the results of employment shares of manufacturing industries. IW show that the stages of diversification also hold for value added data. Notice that, in the model, the relative employment share is in fact equal to the relative value added share. While I defined $G_{it} = v_{i,t+1}/v_{it}$, (6) would also hold if $G_{it} = n_{i,t+1}/n_{it}$. To see this, remember the household's first order conditions imply that $\frac{p_{it}}{p_{jt}} = \left(\frac{y_{j,t}}{y_{i,t}}\right)^{\frac{1}{\varepsilon}} \frac{\xi_i}{\xi_j}$. Plugging in the production functions and recalling that capital labor ratios are constant across industries yields $\frac{p_{it}}{p_{jt}} = \left(\frac{A_{jt}n_{jt}}{A_{it}n_{it}^{1-\alpha}}\right)^{\frac{1}{\varepsilon}} \frac{\xi_i}{\xi_j}$. Rearranging, I have that $\frac{n_{it}}{n_{jt}} = \frac{p_{it}y_{it}}{p_{jt}y_{jt}}$. I then repeat the simulation procedure using industry value added shares and NBER TFP growth factors. The results from Gini coefficients from value added shares still generate a U-shaped stages of diversification (see Figure 4). In the

discussion below, I will only focus on the employ shares of manufacturing industries.

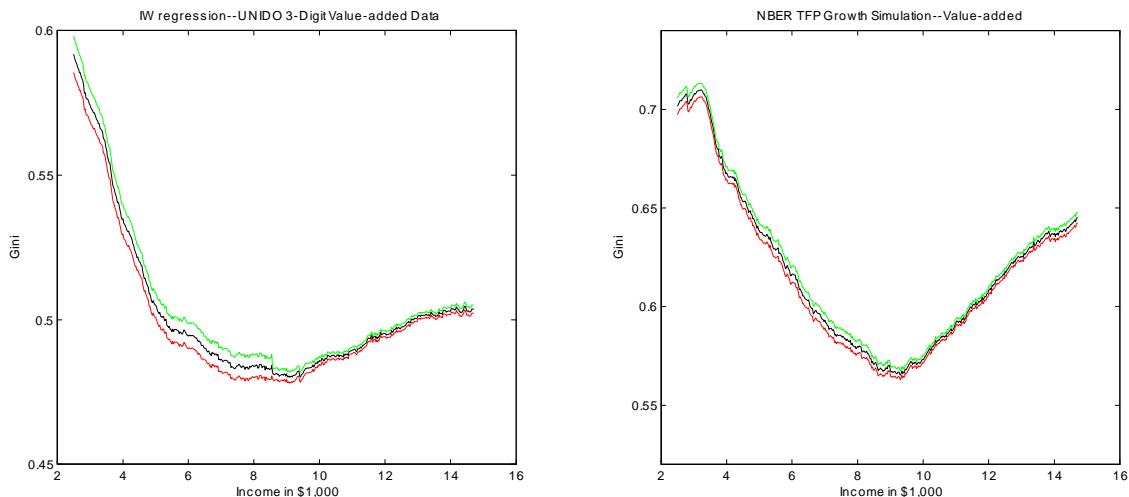


Figure 4. Industry structure along the development path in the simple model.

The left panel is the relationship between income and specialization within manufacturing using value-added shares reported in IW. The right panel is the same relationship in the pseudo-data generated using equation (6).

2.4 Productivity and structural change

In the model, the value of ε , elasticity of substitution, is very important. $\varepsilon > 1$ is relevant for manufacturing, so that, *within manufacturing*, as countries develop they shift resources towards high-TFP growth industries.

To test whether the data support this prediction, I compute a time series for the weighted average of the measure of industry TFP growth rates in manufacturing for each country and at each date. First, I take the NBER productivity numbers g_i , and normalize them so that the mean measure is zero and the standard deviation is one. Then, for each country at each date, I compute the weighted average TFP growth measure, where the weights are the value added shares of each industry in total manufacturing, computed using UNIDO data. Then, I apply the nonparametric method in IW to this measure, examining its relationship to real GDP per capita. TFP growth rates are assumed constant in each industry across time and across countries, so any patterns are solely due to patterns of specialization among industries

with different average rates of TFP growth.

Figure 5 shows the estimated curve (nonparametric) weighted average TFP growth rate for manufacturing sector. There is a mostly positive relationship with income, indicating that, behind the "stages of diversification", economic structure shifts towards manufacturing industries with rapid TFP growth. These results strongly support the assumption that TFP growth differences can be a driving force behind structural change along the development path.

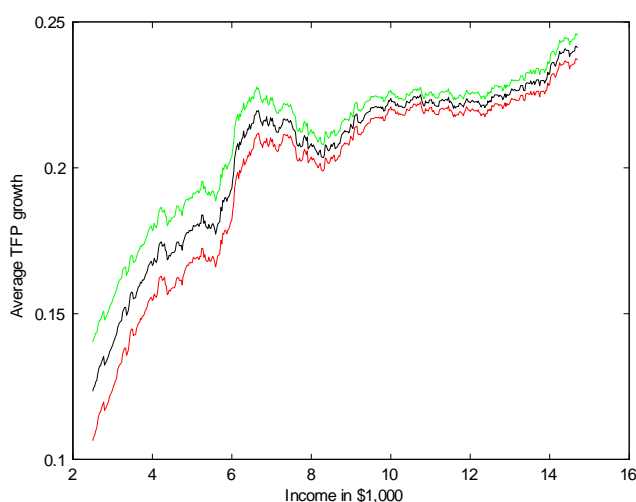


Figure 5 – Trends in average TFP growth within manufacturing along the development path.

2.5 Other factors of structural change

In the paper I focus on productivity differences as the mechanism that drives structural change. However, there are other theories of long-run structural change that imply a shift in resources towards particular industries in the long run. As long as countries begin specialized in industries other than those that dominate in the long run, those models too might display stages of diversification.

At least four general equilibrium frameworks have recently been developed to think about long-term structural change:

1. Ngai and Pissarides (2007, NP) emphasize persistent productivity differences across industries, as I do.
2. Ilyina and Samaniego (2012) emphasize productivity differences driven by differences in desired R&D intensity. This theory is not at odds with that of NP, but digs deeper as to the underlying causes of TFP growth differences.
3. Acemoglu and Guerrieri (2008) consider both productivity differences and differences in capital shares. Specifically they predict that TFP growth rates divided by labor shares determine which industries tend to dominate in the long run.
4. Buera et al. (2011) argue that structural change is affected by industry differences in firm size, with poorer countries less able to finance large-scale technologies.

To see whether structural change appears related to any of the factors of structural change other than TFP growth rates (R&D intensity, labor intensity, firm size), I repeat the experiment illustrated in Figure 5 and compute series for the weighted average of each of these measures (R&D intensity, etc.) for each country over time. Industry R&D intensity and labor intensity measurements are 3-decade averages of the measures *RND* and *LAB* drawn from Ilyina and Samaniego (2011). The industry firm size is the average number of employees per establishment in the US over the period 1963-1992, as reported by UNIDO in INDSTAT3. Again, each measure is normalized so that the mean measure is zero and the standard deviation is one. Then, as before, weighted averages are computed for each country-year, where the weights are value added shares of each industry in total manufacturing, computed using UNIDO data. Finally, I apply the same nonparametric method to these measures, examining their relationship to real GDP per capita.

Figure 6 shows the estimated curve (nonparametric) for each of these measures. Average R&D displays a positive relationship with income within manufacturing, indicating that, behind the "stages of diversification", economic structure shifts towards industries with rapid TFP growth, and industries with high R&D intensity. These results support the assumption that TFP growth differences can be a driving force behind structure change along the development path, and that TFP growth is related to R&D intensity.

Regarding the other measures, Acemoglu and Guerrieri (2008) argue that differences in labor shares could also be a driving force behind structural change. I also report the estimated curve (nonparametric) of the weighted average labor intensity in the manufacturing sector. We can see that labor intensity shows a hump-shaped relationship with income. In particular, labor intensity declines beyond the income level of \$10,000. Thus, structural change seems more closely linked to productivity differences than to differences in labor shares.¹² This justifies my focus on a model with productivity differences, abstracting from differences in labor shares. As for firm size, average firm size declines along the development path, which contradicts the idea that countries are more able to overcome large optimal scales of production as they develop.¹³

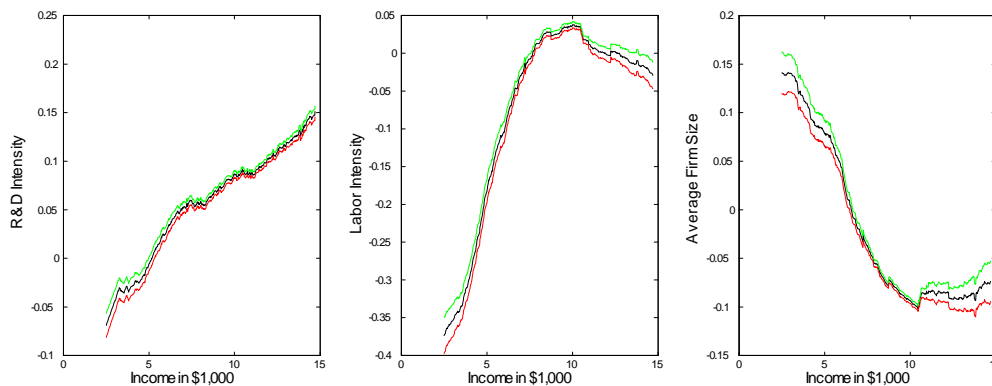


Figure 6 – Trends in R&D intensity, labor intensity and average firm size within manufacturing along the development path.

3 Model Economy

There are several reasons why the above results might not extend to the "full" growth model. First, manufacturing can be separated into capital goods and non-capital goods, which serve

¹²More specifically, Acemoglu and Guerrieri (2008) argue that the relevant variable is the productivity growth rate divided by the labor share. The weighted average of this variable across manufacturing industries is a hump shape with an upturn towards the right tail.

¹³This result, however, is consistent with high TFP growth industries having a relatively small firm size, as found by Mitchell (2002).

different purposes and which may hence have different elasticities of substitution. Second, the share of capital goods within manufacturing will be determined by agents' investment behavior, whereas the share of non-capital goods will be determined by their consumption behavior. Third, capital also includes structures, which are built by the construction sector but which is not part of manufacturing. Fourth, the basic model does not generate a series for income per capita: I simply took the data values as given. The general equilibrium model addresses all of these issues to see whether productivity differences can account for the observed evolution of economic structure along the development path within an integrated theoretical framework.

I now develop a general equilibrium multi-industry growth model to test whether the mechanisms described above can generate "stages of diversification" in a "full" growth model.

3.1 Preferences and Technology

Time is discrete and there is a $[0, 1]$ continuum of agents. In the baseline economy, there are S sectors, each of which produces an aggregate of I industries. Let I_s be the set of industries that supplies sector s . I focus on the case in which each industry supplies only one sector, so that $I_s \cap I_{s'} = \emptyset, \forall s \neq s'$. Note that this is without loss of generality, as one could have two industries identical in all ways that are distinguished by the fact that they provide a given good to two different sectors.

I assume that sectors $s \in \{1, \dots, S-1\}$ produce consumption goods. Only one sector, S , produces capital goods. Now for each sector $s \in \{1, \dots, S\}$, the production function has the CES form:

$$y_{st} = \left[\sum_{i \in I_s} \xi_{s,i} \times u_{s,i,t}^{\frac{\varepsilon_s - 1}{\varepsilon_s}} \right]^{\frac{\varepsilon_s}{\varepsilon_s - 1}}, \quad \sum_{i \in I_s} \xi_{s,i} = 1, \quad s = 1, \dots, S \quad (8)$$

where u_{sit} is use of good i by sector s , $\xi_{s,i}$ is the weight on good i , and ε_s is the elasticity of substitution among goods within sector s .

Agents consume a CES aggregate c_t of the output of the different consumption sectors:

$$c_t = \left[\sum_{s=1}^{S-1} \zeta_s y_{st}^{\frac{\varepsilon-1}{\varepsilon}} \right]^{\frac{\varepsilon}{\varepsilon-1}}.$$

Finally, agents have isoelastic preferences over c_t and discount the future using a factor $\beta < 1$, so that:

$$\sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\theta} - 1}{1-\theta}. \quad (9)$$

They are endowed with one unit of labor every period which they supply inelastically, and start at period zero with capital K_0 . Let q_{st} be the price of the sector aggregate s , with r_t as the interest rate and w_t as the wage. Agents choose expenditure on each good so as to maximize (9) subject to the budget constraint

$$\sum_{s=1}^S q_{st} y_{st} \leq \sum_{s=1}^S \sum_{i \in I_s} r_t K_{it} + \sum_{s=1}^S \sum_{i \in I_s} w_t n_{it} \quad (10)$$

and the capital accumulation equation

$$K_{t+1} = y_{St} + (1 - \delta) K_t. \quad (11)$$

On the supply side, each industry features a Cobb-Douglas production function:

$$y_{it} = A_{it} K_{it}^{\alpha} n_{it}^{1-\alpha}, \quad A_{it} = A_{i0} g_i^t \quad (12)$$

where $g_i = A_{i,t+1}/A_{it}$ is the TFP growth factor of industry i and A_{i0} is given. Producers maximize profits

$$\max_{n_{it}, K_{it}} \{p_{it} y_{it} - w_t n_{it} - r_t K_{it}\} \quad (13)$$

subject to (12), where p_{it} is the output price of industry i at time t . Capital and labor are freely mobile across sectors.

3.2 Equilibrium

The producers' first order conditions imply that the capital labor ratio is constant across industries, which implies that $A_{it} p_{it} = A_{jt} p_{jt}$. Thus, as in related models, goods that experience rapid productivity growth display a decline in their relative price. This result, combined with the consumer's first order conditions implies that the ratio of value added $p_{it} y_{it}$ in any two industries in the same sector s depends on preference parameters and the productivity terms.

$$\frac{p_{it} y_{it}}{p_{jt} y_{jt}} = \left(\frac{\xi_{s,i}}{\xi_{s,j}} \right)^{\varepsilon_s} \left(\frac{A_{it}}{A_{jt}} \right)^{\varepsilon_s - 1} = \frac{n_{it}}{n_{jt}} \quad \forall s \quad (14)$$

Notice that the same relationship holds for the ratio of employment – just as with the basic model – except that it only holds comparing industries that are in the same sector.

Define the growth factor of employment (or value added) in industry i as

$$G_{it} \equiv \frac{n_{i,t+1}}{n_{i,t}} = \frac{p_{i,t+1}y_{i,t+1}}{p_{it}y_{it}}. \quad (15)$$

Then, the expression G_{it}/G_{jt} then denotes the growth of employment (or value added) in industry i relative to industry j . Using (14) I have that

$$\frac{G_{it}}{G_{jt}} = \left(\frac{g_i}{g_j} \right)^{\varepsilon_s - 1} \quad \forall s. \quad (16)$$

Consequently, within sectors, structural change depends on relative TFP growth factors $\frac{g_i}{g_j}$ and on the elasticity of substitution ε_s . For comparing industries *across* sectors requires characterizing shifts in expenditure across sectors, as well as investment behavior.

3.3 Sectoral and Aggregate Growth

Notice that in equilibrium I can aggregate the industries in a given sector into a sectoral production function. To see this, define q_{st} as the price index for final goods in sector s , so that

$$q_{st}y_{st} = \sum_{i \in I_s} p_{it}A_{it}k_t^\alpha n_{it}$$

where k_t is the equilibrium capital-labor ratio, which is common across industries. Define input use in sector s as $K_{st} = \sum_{i \in I_s} K_{it}$ and $n_{st} = \sum_{i \in I_s} n_{it}$. Then, define a sectoral production function:

$$y_{st} = A_{st}K_{st}^\alpha n_{st}^{1-\alpha}, \quad A_{st} = A_{s0}\bar{g}_s^t \quad (17)$$

The problem of the sector firm and the industry firms can be combined as

$$\max_{n_{it}} q_{st} \left[\sum_{i \in I_s} \xi_{s,i} \times (A_{it}k_t^\alpha n_{it})^{\frac{\varepsilon_s - 1}{\varepsilon_s}} \right]^{\frac{\varepsilon_s}{\varepsilon_s - 1}} - r_t k_t \sum n_{it} - w_t \sum n_{it} \quad (18)$$

The first order conditions imply that:

$$\frac{n_j}{n_i} = \left(\frac{\xi_{s,j}}{\xi_{s,i}} \right)^{\varepsilon_s} \left(\frac{A_i}{A_j} \right)^{1-\varepsilon} \quad (19)$$

I also have that $\sum_i n_i = n_s$ by definition, so I can use (19) write n_i in terms of n_s . Substituting this back into the problem (18), I have

$$\max_{n_{it}} q_{st} A_{st} k_t^\alpha n_s - r_{st} k_{st} n_{st} - w_{st} n_{st}$$

where

$$A_{st} = \left[\sum_{i \in I_s} \xi_{s,i}^{\varepsilon_s} \times A_{it}^{\varepsilon_s - 1} \right]^{\frac{1}{\varepsilon_s - 1}} = \left[\sum_{i \in I_s} \xi_{s,i}^{\varepsilon_s} \times A_{i0}^{\varepsilon_s - 1} g_i^{t(\varepsilon_s - 1)} \right]^{\frac{1}{\varepsilon_s - 1}} \quad (20)$$

and

$$\bar{g}_s = \prod_{i \in I_s} g_i^{x_{it}/X_{st}} \quad (21)$$

where

$$x_{it} = \xi_{s,i}^{\varepsilon_s} A_{it}^{\varepsilon_s - 1}, \quad X_{st} = \sum_{i \in I_s} x_{it}.$$

Since the total production of consumption sectors $c_t = \left[\sum_{s=1}^{S-1} \zeta_s y_{st}^{\frac{\varepsilon-1}{\varepsilon}} \right]^{\frac{\varepsilon}{\varepsilon-1}}$, I can also aggregate all the consumption goods production sectors. Then I have that

$$c_t = A_{c_t} K_{c_t}^\alpha n_{c_t}^{1-\alpha}, \quad A_{c_t} = \left[\sum_{s=1}^{S-1} \zeta_s^\varepsilon \times A_{st}^{\varepsilon-1} \right]^{\frac{1}{\varepsilon-1}} \quad (22)$$

As a result, the aggregate behavior of the model economy with many sectors is the same as that of a 2-sector economy that produces c_t using technology (22) and produces capital goods using technology (17). In the consumption goods sector, firms maximize

$$\max_{K_{c_t}, n_{c_t}} \{ p_{c_t} A_{c_t} K_{c_t}^\alpha n_{c_t}^{1-\alpha} - r_t K_{c_t} - w_t n_{c_t} \}$$

where $A_{c_t} = \left[\sum_{s=1}^{S-1} \zeta_s^\varepsilon \times A_{st}^{\varepsilon-1} \right]^{\frac{1}{\varepsilon-1}}$

whereas in the capital goods sector:

$$\max_{K_{S_t}, n_{S_t}} \{ p_{S_t} A_{S_t} K_{S_t}^\alpha n_{S_t}^{1-\alpha} - r_t K_{S_t} - w_t n_{S_t} \}$$

where $A_{S_t} = \left[\sum_{i \in I_S} \xi_i^{\varepsilon_S} \times A_{it}^{\varepsilon_S - 1} \right]^{\frac{1}{\varepsilon_S - 1}}$

Consumers choose consumption c_t and investment S_t to solve:

$$\max_{c_t, S_t} \left\{ \sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\theta} - 1}{1-\theta} \right\} \quad (23)$$

$$s.t. \quad p_{c_t} c_t + p_{S_t} S_t \leq r_t K_t + w_t \quad (24)$$

$$K_{t+1} = K_t (1 - \delta) + S_t \quad (25)$$

$$K_0 \text{ given.} \quad (26)$$

In equilibrium, capital and labor markets must clear at all dates, so

$$c_t = A_{c_t} K_{c_t}^\alpha n_{c_t}^{1-\alpha} \quad (27)$$

$$S_t = A_{S_t} K_{S_t}^\alpha n_{S_t}^{1-\alpha}$$

$$K_t = K_{S_t} + K_{c_t} \quad (28)$$

$$n_{c_t} + n_{S_t} = 1 \quad (29)$$

It will be convenient to set $p_{S_t} = 1 \forall t$, so that consumption goods prices p_{c_t} are expressed relative price to the price of capital goods.

Solving the 2-sector problem and using the equilibrium conditions, I obtain expressions for labor shares in the capital goods sector n_{S_t} and the consumption goods' sector $n_{c_t} = 1 - n_{S_t}$ along an unbalanced growth path¹⁴. These turn out to be functions only of the productivity growth rates g_i , parameters, and of the equilibrium growth rate of aggregate consumption $g_{c_t} = \frac{p_{c_t,t+1} c_{t+1}}{p_{c_t} c_t}$ which is endogenous. This will be true at all dates except possibly date zero, where n_{S_t} is determined by the initial condition K_0 .

Define real GDP as $y_t = S_t + p_{c_t} c_t$. Notice it is measured in units of capital.

¹⁴I do not focus on the balanced growth path (BGP), because BGP results understate the impact of productivity differences on the stages of diversification. One reason is that I ruled out stages of diversification among capital producing industries when assuming Cobb-Douglas production (which leads to constant growth rate and is required for the existence of BGP) in the capital sector. Moreover, from my estimations of the elasticity of substitution for both capital and non-capital manufacturing sectors, I find that the elasticities of substitution in both sectors are not statistically different from each other, and that the elasticity of substitution of the capital sector is statistically different from one. So I abandon the Cobb-Douglas production function in the capital sector. Instead, I use CES function for the capital sector and focus on an unbalanced growth path in this paper.

Proposition 1 *In equilibrium, the growth factors of total capital K , capital per capita k , and total output y depend on the growth factors of TFP in the consumption and capital sectors and on the growth factor of consumption sector (as well as parameters):*

$$g_{kt} = \frac{k_{t+1}}{k_t} = \frac{K_{t+1}}{K_t} = \bar{g}_{A_{St}}^{\frac{1}{1-\alpha}} \left(\frac{r_t}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} \quad (30)$$

and

$$g_{yt} = \frac{y_{t+1}}{y_t} = \bar{g}_{A_{St}}^{\frac{1}{1-\alpha}} \left(\frac{r_t}{r_{t+1}} \right)^{\frac{\alpha}{1-\alpha}} \quad (31)$$

where GDP is defined as $y_t = S_t + p_{ct}c_t$ and the equilibrium interest rate is $r_t = \frac{\left(\frac{\bar{g}_{A_{St-1}}}{\bar{g}_{A_{ct-1}}}\right)^{1-\theta} g_{ct-1}^\theta}{\beta} - 1 + \delta$ for $t > 0$. At date zero, r_0 is determined by market clearing given K_0 .

Proposition 2 *The model economy converges to a balanced growth path where in each sector*

$$\lim_{t \rightarrow \infty} A_{st} = A_{jt} \text{ where } j = \begin{cases} \arg \max_{i \in I_s} \{g_i\} & \text{if } \varepsilon_s > 1 \\ \arg \min_{i \in I_s} \{g_i\} & \text{if } \varepsilon_s < 1 \end{cases},$$

and in the consumption goods sector

$$\lim_{t \rightarrow \infty} A_{ct} = A_{st} \text{ where } s = \begin{cases} \arg \max_{s < S} \{g_s\} & \text{if } \varepsilon > 1 \\ \arg \min_{s < S} \{g_s\} & \text{if } \varepsilon < 1 \end{cases}.$$

Proposition 2 predicts that for each sector, the sector productivity will asymptotically converge to the productivity of industry with highest (lowest) TFP growth rate if the sector elasticity of substitution is greater (smaller) than one. The aggregate TFP of the consumption goods sector will asymptotically converge to the productivity of the sector with highest (lowest) TFP growth rate if the elasticity of substitution of the consumption sector is greater (smaller) than one. The prediction is confirmed by the evidence in the manufacturing industries in Figure 4. Within manufacturing, as countries develop they shift resources towards high-TFP growth industries, since $\varepsilon_s > 1$ is relevant for manufacturing.

Recalling that the only endogenous variable that affects r_t for $t > 0$ is g_{ct} ,¹⁵ Proposition 1 implies that I can compute the equilibrium for the multi-industry model economy in transition, provided I can derive the series for g_{ct} . The economy with many consumption goods

¹⁵In general, at $t = 0$, the value of r_0 is determined by market clearing and the value of K_0 .

sectors will asymptotically converge to an economy with one consumption sector which has either the highest or lowest TFP growth rate depending on the elasticity of substitution. The same occurs within the capital goods sector. As a result, the expression r_t converges to some constant r and, although in general the model does not possess a balanced growth path (see Ngai and Pissarides (2007)), it converges to one. This suggests that the equilibrium may be computed by finding a sufficiently good approximation to the series for g_{ct} . In the limit, since by assumption $\varepsilon_s \neq 1$ for all $s \leq S$, one industry will end up dominating each sector. However, I wish to study the behavior of the model economy in transition, where sectors are relatively diversified.

4 Calibration

In the remainder of the paper I will focus on a particular type of equilibrium. Observe that the capital stock will be set to satisfy the Euler equation (30) at all dates except date zero. In other words, the investment share of the model economy will in general be smooth over time, except between dates zero and one. The model will be calibrated to the available data and, since the initial year in which data for a given country become available has no economic content, it is difficult to justify why the first year I have data for (generally 1963) happens to be the only date when the intertemporal optimization (30) is not satisfied. For this reason, I focus on an equilibrium where this does not occur.

Definition 3 *An Euler Growth Path (EGP) is an equilibrium and an initial condition K_0 such that equation (30) holds at date zero.*

The Euler growth path is a generalization of a balanced growth path which may exist in models that do not exhibit balanced growth. For the benchmark results, I calibrate the model to match an Euler growth path by matching the composition of manufacturing but not necessarily its *size*. Details are in the Appendix. Nonetheless, it is important to underline that the results concerning the structure of the economy turn out not to hinge on whether I focus on an Euler growth path: results on the equilibrium calibrated to match the initial conditions in the data are almost indistinguishable.

Table 1: Sectors and Industries in the model economy

Sector	Industries			
	Services, etc.	Agriculture	UNIDO	Construction
Services, etc.	X	-	-	-
Agriculture	-	X	-	-
Capital Manufacturing	-	-	X	X
Non-Cap Manufacturing	-	-	X	-

Calibrating the model economy requires a choice of industries, and values of the following parameters and variables.

1. Technological parameters α, δ .
2. Preference coefficients $\xi_{s,i}, \zeta_s, \beta$.
3. Elasticities of substitution ε_s for $s \leq S$, and ε , the elasticity across consumption sectors
4. The intertemporal elasticity parameter θ .
5. Productivity growth values g_i .
6. Productivity initial conditions A_{i0} .

In this section, I calibrate the model so as to focus on the "stages" in manufacturing in the UNIDO data. The simulation requires computing transition dynamics in a model without a balanced growth path, and the procedure is described in the Appendix for the interested reader.

For calibration, I group all industries into four sectors: Agriculture, Services, Capital and Non-capital manufacturing. Agriculture, services and non-capital manufacturing sectors produce consumption goods, and the capital sector only produces capital goods. Industries include agriculture, services, the 28 UNIDO manufacturing industries, and construction (see Table 1). Thus, the agriculture and services industries only contain one industry. The

Table 2: Capital good-producing manufacturing industries

Industry	ISIC code
Wood products	331
Furniture, except metal	332
Fabricated metal products	381
Machinery, except electrical	382
Machinery, electric	383
Transport equipment	384
Prof. & sci. equip.	385
Other manufactured prod.	390

UNIDO industries serve either the capital or the non-capital manufacturing sectors. I assigned an industry to the capital sector if the US NIPA tables count it in their "fixed asset" tables (see Table 2). Construction serves capital sector too. The initial shares of agriculture, services, manufacturing and construction sectors out of GDP are derived from World Development Indicators data (WDI).¹⁶

1. I assume that $\delta = 0.06$ as in Greenwood et al. (1997): this is a standard values in models in which the productivity of the investment technology exceeds that in the consumption sector. I use a standard value for the capital share, $\alpha = 0.3$.
2. To calibrate the utility weights $\xi_{s,i}$, it should be noted that in a sense these weights are arbitrary, as they depend on the exact unit of measurement for good i .¹⁷ Thus, without loss of generality, I set $\xi_{s,i} = \frac{1}{I_s}$, where I_s is the number of industries in sector s . The same applies to ζ_s , so $\zeta_s = \frac{1}{S-1}$. I set $\beta = 0.95$, a standard value.

¹⁶For countries with missing data, I use predicted values computed by regressing sector shares on income, income squared and UNIDO industry shares in the manufacturing sector for all countries and years in my sample.

¹⁷For example, if I measure apples and get $\xi_{s,apples} = 2$ (and $A_{apples,0} = 3$), I could choose to measure apples in units of "half an apple" and then $\xi_{s,apples} = 1$ (and $A_{apples,0} = 1.5$).

3. For each sector, equation (16) is equivalent to $\log G_i = \alpha + (\varepsilon - 1) \log g_i + \epsilon_i$ where $\alpha = \log G_j - \log g_j$ for some arbitrary industry j and ϵ_i is any unmodeled noise in the relationship. I regress U.S. value added growth rates on TFP growth rates¹⁸ for capital and non-capital manufacturing goods respectively, finding that they were not statistically significantly different: $\varepsilon_{noncapmanuf} = \varepsilon_{capital}$. Pooling the data, I estimate that $\varepsilon_{noncapmanuf} = \varepsilon_{capital} = 3.73$. Across consumption sectors, I use the value $\varepsilon = 0.3$ ¹⁹, which is the estimate in Ngai and Pissarides (2004).
4. The preference parameter θ is calibrated so that in the long run the investment share of GDP converges to 12 percent, which is roughly the share in the US: investment shares in transition turn out not to be very different. This implies that $\theta = 3$: typical values used in calibration fall in the range $\theta \in [1, 5]$,²⁰ so it is encouraging that my value falls in the middle.
5. Productivity growth values g_i are drawn from the NBER productivity database, as described in Section 2. I use the average value over the period 1963-1992 (See Table 4). To calibrate the growth factors of the consumption goods sectors, first I use equation (20) to compute TFP growth in the capital sector (excluding construction) over the period 1963-1992, and get the average value $\tilde{g}_S = 1.0241$. According to NIPA, the relative price of construction has risen at a rate of 0.0109 each year relative to other capital. This means the growth factor of construction sector $g_{construction} = \tilde{g}_S / e^{0.0109} = 1.0130$. For the services sector, the relative price of services has risen at a rate of 0.0103 each year relative to other capital. This means the growth factor of services sector $g_{services}$ is then $\tilde{g}_S / e^{0.0103} = 1.0136$. For agriculture, I have that the relative price of agriculture has dropped at a rate of 0.004 each year relative to other capital. So the

¹⁸I use data from Jorgenson et al (2007): although they are a little more disaggregated, I want a value estimated at roughly the same level of aggregation as the UNIDO data. The UNIDO data themselves are too few so I was unable to obtain a good estimate from them directly.

¹⁹I examine other values of $\varepsilon \in [0.1, 0.9]$ and find results to be visually indistinguishable, as the value of ε has negligible impact on what occurs *within* the manufacturing sector.

²⁰Growth models tend to use $\theta = 1$, whereas asset pricing studies tend to use larger values. For an example with $\theta = 5$, see for example Jermann (1998).

Table 3: Calibrated Parameters: Baseline Model

$g_{construction}$	$g_{services}$	$g_{agriculture}$	$\varepsilon_{capital}$	$\varepsilon_{consumption}$
1.0130	1.0136	1.0282	3.73	0.3
$\varepsilon_{noncapmanuf}$	θ	δ	α	β
3.73	3	0.06	0.3	0.95

growth factor of the agricultural sector is $g_{agriculture} = \tilde{g}_S/e^{-0.004} = 1.0282$.

6. For the initial productivities of the capital and consumption sectors, I initially set $A_{capital,0} = 1$ and $A_{consumption,0} = 1$. The former is a normalization, and the latter is without loss of generality because the size of the non-investment sectors is independent of the level of $A_{consumption,0} = 1$.²¹ Then, using (14) and (20), for the capital sector industries $i \in I_S$, I set initial TFP to equal $A_{i0} = \left[\frac{n_{i0}}{\sum \xi_{S,i}^{\varepsilon_S} n_{i0}} \right]^{\frac{1}{\varepsilon_S - 1}}$, thus matching the initial share of capital industries in each country. For the consumption sectors, set A_{s0} (where $s \in \{\text{services, agriculture and non-capital manufacturing}\}$) so as to match the initial share of that sector in each country: $A_{s0} = \left[\frac{n_{s0}}{\sum \xi_s^{\varepsilon_s} n_{s0}} \right]^{\frac{1}{\varepsilon_s - 1}}$. Finally, for industry productivity in non-capital manufacturing, I have again that $A_{i0} = \left[\frac{n_{i0} A_{s0}}{\sum \xi_{s,i}^{\varepsilon_s} n_i} \right]^{\frac{1}{\varepsilon_s - 1}}$. Industry shares are drawn from UNIDO and sector shares are based on the WDI.²² Finally, I multiply A_{i0} in all industries and sectors by a country-specific constant so that the country GDP per head relative to US GDP per head in the initial year is the same as in the data.

²¹Proof available upon request.

²²As mentioned, an adjustment to industry shares is required due to my focus on an EGP: see the Appendix for details.

4.1 Simulation

For each country I use initial conditions from 1963²³ as starting points, and simulate the share of GDP n_{it} of any industry or sector along unbalanced growth path.²⁴

Figure 7 shows the estimated curve of Gini using industry shares simulated in the baseline model. We can see that the baseline model is able to capture the U-shape of stages of diversification very well. Again, the turning point is around \$9,000, as found by IW. Thus, the results derived using the simple model are robust to allowing the composition and size of the capital sector to evolve independently of the non-capital manufacturing sector, and to allowing the model to generate the GDP series as well as just industry structure. It is notable that, in the full growth model, the re-specialization after the turning point is slower than the initial specialization, just as in IW.²⁵

²³For some countries initial data in 1963 are not available: then I use the earliest available year.

²⁴In my derivations, the model measures GDP in terms of capital goods (remember I normalize capital goods price to 1 and consumption goods prices are expressed as relative to capital goods price). In the data, however, GDP is measured in terms of consumption goods, see Greenwood et al (1997). Since in the model, $A_{h_t} = p_{c_t} A_{c_t}$, I can express the GDP growth factor measured in units of *consumption* using the formula $\tilde{g}_{yt} = g_{yt} \frac{g_{A_h}}{g_{A_c}}$. This is the notion of GDP I use in the graphs below. The model simulated using GDP defined in terms of capital goods yields very similar results. An issue here is that the values of A_{h_0} and A_{c_0} are arbitrary in the calibration, but not when I wish to express cross-country GDP in common units. I handle this by assuming that the real GDP data are measured in units of consumption and are internationally comparable, and then use the model to compute growth rates (which do not depend on GDP levels) extrapolating from initial GDP in the data.

²⁵If I extend the simulated curve from \$15,000 to \$20,000, the rising right hand side of the curve continues to increase linearly.

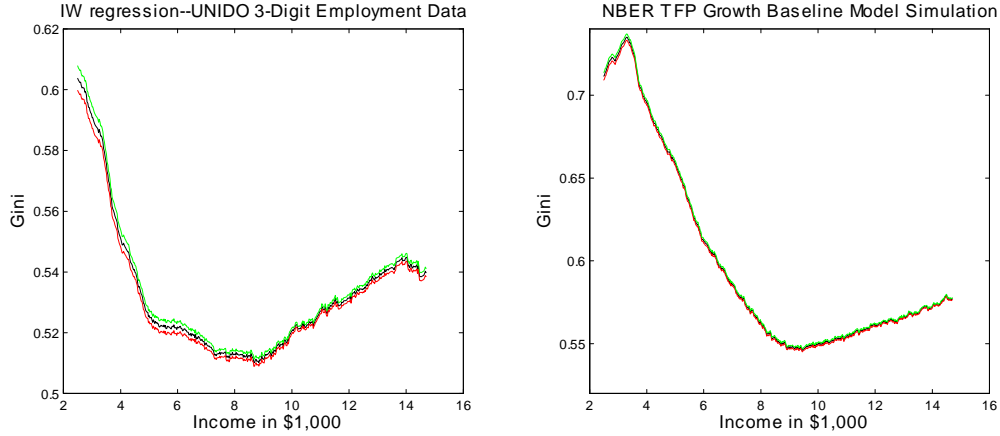


Figure 7. Industry structure along the development path in the full model. The left panel is the relationship between income and specialization within manufacturing reported in IW. The right panel is the same relationship in the pseudo-data generated from the model economy. The range of income is the same as that reported in IW.

For robustness, I also repeat my calibration using the TFP measures in table 5 which were derived from the UNIDO data instead of the NBER data. The simulated Gini displays similar U-shape as the baseline model, and the turning point appears between \$8,000 and \$10,000. See Appendix.

In the model economy, the concept of capital includes any goods that are durable. Some items that are not classified in the fixed asset tables may be thought of as durable goods. As a result I redefined capital in broader terms to include things that could be durable but are not classified as such (e.g., pottery, iron products, and so on). This raises the number of capital goods to 15, plus construction. The calibrated parameters using the alternative classification of capital industry is listed in Table 6 in the Appendix. The simulated industry shares display similar stages of diversification to the baseline model (see Appendix).

5 Discussion and extensions

5.1 Country-Specific Productivity Growth

There are many country factors the literature has related to growth which are not featured in the model (see for example Barro (1991) or Sala-i-Martin (1997)). Thus, I would not expect the model to match per capita GDP growth rates around the world.²⁶ Still, one might ask whether modifying the model so as to match country GDP growth rates might affect the results regarding economic structure. To check, I add country-specific productivity growth factor that affects all industries, and calibrate it to match average GDP growth rates in each country over the sample period. This factor could be interpreted as capturing policies that affect technological diffusion, trends in policy, or any of the factors commonly included in growth regressions. When I do this to the full model, I find that results are almost identical, just that the curve appears slightly stretched to the left (see Figure 8). From all the experiments discussed in my paper, I can conclude that the U-shape generated in my TFP growth differences driven model is robust.

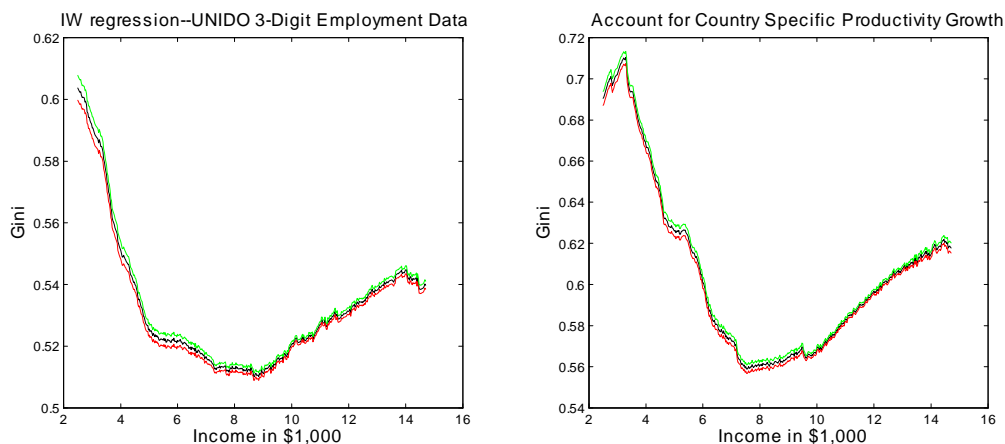


Figure 8 – Industry structure along the development path.

Account for Country Specific Productivity Growth

²⁶In general I do not find a robust statistically significant correlation between model GDP growth rates and those in the data, even though in the manufacturing calibration the correlation is generally positive. Still, it is worth noting that the mean annual growth rate in the model is 1.9%, compared to 2.0% in the data.

5.2 Variation in TFP growth rates across countries

So far I have assumed that industry TFP growth rates are similar across countries. This assumption seems reasonable in view of the results of Rodrik (2012), which reports unconditional convergence in labor productivity at the industry level within manufacturing.²⁷ Still, the fact is that comprehensive internationally comparable TFP data are lacking. Hence, it is important to check the robustness of the results to variation in industry productivity growth rates across countries. For simplicity in what follows I focus on the basic model, so that all manufacturing industries are substitutes with a common elasticity of substitution.

First, suppose that all countries differ by some country specific productivity factor – which could be time-varying (as, for example, along a productivity convergence path). Notice that equation (6) dictates patterns of structural change, and that any country-specific productivity factor would appear in both the numerator and the denominator, dropping out and not affecting economic structure. Thus, the only way in which country variation in TFP growth rates might affect the results is if there is a systematic pattern of variation across countries in TFP growth rates at the *industry* level that offsets the findings in this paper, or if there is so much noise in productivity growth rates across countries that the U-shaped pattern washes out.

There are two possibilities here. One is that less developed countries experience catch-up particularly fast in industries that have relatively rapid TFP growth. This is as in the model of Ilyina and Samaniego (2012), where productivity convergence is more rapid in high-tech industries. Another possibility raised in Ilyina and Samaniego (2012) is that developing countries are poor precisely because of institutional barriers (e.g., financial development) and that these disproportionately inhibit convergence in high-tech industries (since they need external finance to fund R&D).²⁸

I further conduct an experiment to see what kind of variation in productivity growth rates

²⁷This finding does not extend to the service sector but difficulties measuring productivity in the service sector suggest that this result should be taken with some caution.

²⁸Although it does not address structural change, Samaniego (2006) finds that labor market regulation may skew the composition of the economy away from high-tech industries. Messina (2006) also finds that entry costs can affect structural change. Thus, there are other barriers that might disproportionately slow convergence in high-tech industries.

preserves the results. The point of the experiment is not to generate "realistic" cross-country variation in industry TFP growth rates. Rather, I will generate a large space of potential country-industry variation, and explore under what circumstances the results continue to hold – particularly, the results that the Gini-earnings relationship is U-shaped, and that the trough is around \$9,000.

I repeat the experiment above, except that in each country industry TFP growth rates may be different

$$\log g_{i,c} = \log g_{i,US} + \varepsilon_{i,c}, \varepsilon_{i,c} \sim N(0, \sigma_\varepsilon^2)$$

where $g_{i,US}$ is the calibrated value of g_i , and $g_{i,c}$ is the value of g_i in country c . Thus, there is random variation in industry TFP growth rates across countries. I set σ_ε^2 to equal the cross-sectional variance of industry TFP growth rates. This allows for large variation across countries in industry TFP growth rates – so I can see if a high variance per se matters for the results. Then I see if the model generates a U shaped specialization profile, as reflected in a regression of the fitted IW Gini curve on income and income squared, as well as a constant. Success requires a positive and statistically significant coefficient on income squared. I also check whether the trough is between \$8,500 and \$9,500, so that it is close to the IW results. I run the model 1000 times (so there are 1000 draws of the $I \times C$ vector $\varepsilon_{i,c}$), and study the circumstances under which the results satisfy these criteria.

Specifically, I pool all the $\varepsilon_{i,c}$ vectors from all 1000 runs, and estimate the following regression:

$$\begin{aligned} \varepsilon_{icr} = & \alpha_{c,r} + \gamma_{no} \log(\text{initialGDP}) \times \log(g_{i,US}) \\ & + \gamma_{yes} \log(\text{initialGDP}) \times \log(g_{i,US}) \times I(r) + v_{icr} \end{aligned}$$

where $r \in \{1, 1000\}$ indexes the simulation run, and $I(l)$ is an indicator variable that equals one iff the run r satisfies the success criteria (that the Gini profile is U-shaped and lies in the desired bounds). I am interested in seeing whether there is a statistically significant difference between γ_{no} and γ_{yes} , and also in the sign.

First, I find that only 61 of the runs satisfy the success criteria. At the same time, both γ_{no} and γ_{yes} are statistically significant. γ_{no} is small in magnitude and positive (.003***), whereas γ_{yes} is larger in magnitude and negative (-.017**). This indicates that a successful

simulation requires high GDP countries to have relatively low $g_{i,c}$ in industries with high g_i in the US. In other words, convergence must be relatively fast in high TFP-growth industries.

Interestingly, I also find that the variance of ε in the successful and unsuccessful samples is the same. This indicates that a small variance is not the issue, rather it is the systematic relationship between initial GDP and ε that is required for success (or failure).

5.3 Concluding Remarks

I develop a multi-sector model in which differential TFP growth rates across manufacturing industries lead to structural change along an unbalanced growth path. The model accounts for the pattern of diversification followed by specialization that is well-known in the literature. The results are robust to a variety of extensions and modifications. The results suggest that a productivity driven theory can account for both income levels and economic structure. This lends further emphasis to the question of the ultimate determinants of productivity growth rates. Ngai and Samaniego (2011) relate productivity growth rates to the technological determinants of R&D intensity and Ilyina and Samaniego (2012) are able to account for country *differences* in industry productivity growth rates based on an interaction of research intensity and institutional frictions, suggesting fruitful avenues for future research.

I do not exclude other possible factors, such as differences in factor shares (as in Acemoglu and Guerrieri (2008)) or international trade (as in IW). However, the paper provides quantitative evidence that productivity differences on their own can account for the dynamics of industrial structure along the development path. It would be interesting in future work to develop a theoretical or empirical model that nests all the various possibilities, and estimate the contribution of different factors to the evolution of economic structure. At the same time, it is useful to understand how economic structure evolves under autarky, and compare that to the stylized facts about how economic structure varies along the development path.

In the paper I take initial conditions as a given for my quantitative experiments. The results suggest that poorer countries tend to begin specialized in industries where TFP growth is low. Although it is beyond the scope of this paper, it is interesting to think about why initial conditions might be biased in this way. One possibility is that there are non-homothetic preferences (see Kongsamut et al. (2000)), so that consumption patterns in poor countries

are dominated by subsistence considerations that wear off later. If manufacturing industries that produce goods necessary for subsistence (e.g., food products) happen to have slow TFP growth, whereas sectors that are necessary for subsistence (e.g., agriculture) happen to have rapid TFP growth, then I would observe these initial conditions. This explanation, however, relies on coincidence. Another possibility that does not require non-homothetic preferences involves the transition from a "traditional" technology with low productivity growth to a "modern" technology with more rapid productivity growth. Ngai (2004) shows that small differences across countries in barriers to technology adoption can lead to very large differences in income by delaying the transition from the "traditional" to the "modern" technologies. Initial conditions would be determined by the traditional technology and the date of transition between technologies. The idea that the transition between the "traditional" and "modern" technologies could explain historical economic structure as well as income levels is an interesting topic for future research.

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A Proofs

Proof of decentralized economy. For consumers:

$$\begin{aligned}
 & \max_{y_{st}} \sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\theta} - 1}{1-\theta} \\
 c_t &= \left[\sum_{s=1}^{S-1} \zeta_s y_{st}^{\frac{\varepsilon-1}{\varepsilon}} \right]^{\frac{\varepsilon}{\varepsilon-1}} \\
 s.t. \quad & \sum_{s=1}^{S-1} q_{st} y_{st} + K_{t+1} = \sum_{s=1}^S \sum_{i \in I_s} r_t K_{it} + \sum_{s=1}^S \sum_{i \in I_s} w_t n_{it}
 \end{aligned}$$

Capital and labor market clearing conditions are:

$$K_t = \sum_{s=1}^S \sum_{i \in I_s} K_{it}$$

$$1 = \sum_{s=1}^S \sum_{i \in I_s} n_{it}$$

F.O.C w.r.t y_{st} :

$$\frac{q_{st}}{q_{s't}} = \left(\frac{y_{s't}}{y_{st}} \right)^{\frac{1}{\varepsilon}} \frac{\zeta_s}{\zeta_{s'}} \quad s, s' = 1, \dots, S-1 \quad (32)$$

or

$$\frac{y_{st}}{y_{s't}} = \left(\frac{\zeta_s p_{s't}}{\zeta_{s'} p_{st}} \right)^{\varepsilon} \quad s, s' = 1, \dots, S-1 \quad (33)$$

Final Goods Sector s maximizes profit:

$$\begin{aligned} & \max_{u_{s,i,t}} q_{st} y_{st} - \sum_{i \in I} p_{it} u_{s,i,t} \\ & = q_{st} \left[\sum_{i \in I} \xi_{s,i} \times y_{i,t}^{\frac{\varepsilon_s - 1}{\varepsilon_s}} \right]^{\frac{\varepsilon_s}{\varepsilon_s - 1}} - \sum_{i \in I} p_{it} y_{i,t} \end{aligned}$$

F.O.C w.r.t $y_{i,t}$:

$$q_{st} \left[\sum_{i \in I} \xi_{s,i} \times y_{i,t}^{\frac{\varepsilon_s - 1}{\varepsilon_s}} \right] \xi_{s,i} y_{i,t}^{\frac{-1}{\varepsilon_s}} = p_{it}$$

similarly for $y_{j,t}$:

$$q_{st} \left[\sum_{i \in I} \xi_{s,i} \times y_{i,t}^{\frac{\varepsilon_s - 1}{\varepsilon_s}} \right] \xi_{s,j} y_{j,t}^{\frac{-1}{\varepsilon_s}} = p_{jt}$$

So I have:

$$\frac{p_{it}}{p_{jt}} = \left(\frac{y_{j,t}}{y_{i,t}} \right)^{\frac{1}{\varepsilon_s}} \frac{\xi_{s,i}}{\xi_{s,j}} \quad (34)$$

or

$$\frac{y_{i,t}}{y_{j,t}} = \left(\frac{\xi_{s,i} p_{jt}}{\xi_{s,j} p_{it}} \right)^{\varepsilon_s} \quad (35)$$

For industry i in a given sector:

$$\max p_{it} A_{it} K_{it}^{\alpha} n_{it}^{1-\alpha} - r_t K_{it} - w_t n_{it}$$

F.O.C w.r.t K_{it} :

$$p_{it} \alpha A_{it} K_{it}^{\alpha-1} n_{it}^{1-\alpha} = r_t \quad (36)$$

F.O.C w.r.t n_{it} :

$$p_{it}(1 - \alpha)A_{it}K_{it}^\alpha n_{it}^{-\alpha} = w_t \quad (37)$$

Dividing one F.O.C. by the other I get that

$$\frac{1 - \alpha}{\alpha} \left(\frac{K_{it}}{n_{it}} \right) = \frac{w_t}{r_t} \Rightarrow k_t = \frac{w_t}{r_t} \times \frac{\alpha}{1 - \alpha} \quad (38)$$

where the capital labor ratio $k_t \equiv K_{it}/n_{it}$ is a constant across industries. Applying this result to (36) implies that

$$\frac{A_{it}}{A_{jt}} = \frac{p_{jt}}{p_{it}} \quad (39)$$

Using (35), (38) and (39) yields

$$\frac{n_{it}}{n_{jt}} = \left(\frac{\xi_{s,i}}{\xi_{s,j}} \right)^{\varepsilon_s} \left(\frac{A_{it}}{A_{jt}} \right)^{\varepsilon_s - 1} \quad (40)$$

which, rearranging (34), implies that $\frac{n_{it}}{n_{jt}} = \frac{p_{it}y_{it}}{p_{jt}y_{jt}}$. Define the industry i growth factor as :

$$G_{it} = \frac{p_{i,t+1}y_{i,t+1}}{p_{it}y_{it}}$$

and the expression G_{it}/G_{jt} then denotes the growth of industry i relative to industry j

$$\begin{aligned} \frac{G_{it}}{G_{jt}} &= \frac{\frac{p_{i,t+1}y_{i,t+1}}{p_{it}y_{it}}}{\frac{p_{j,t+1}y_{j,t+1}}{p_{jt}y_{jt}}} = \frac{p_{i,t+1} \left(\frac{\xi_{s,i}}{\xi_{s,j}} \frac{p_{j,t+1}}{p_{i,t+1}} \right)^{\varepsilon_s}}{p_{jt} \left(\frac{\xi_{s,i}}{\xi_{s,j}} \frac{p_{jt}}{p_{it}} \right)^{\varepsilon_s}} \\ &= \frac{\left(\frac{p_{i,t+1}}{p_{j,t+1}} \right)^{1 - \varepsilon_s}}{\left(\frac{p_{it}}{p_{jt}} \right)^{1 - \varepsilon_s}} = \frac{\left(\frac{A_{i,t+1}}{A_{it}} \right)^{\varepsilon_s - 1}}{\left(\frac{A_{j,t+1}}{A_{jt}} \right)^{\varepsilon_s - 1}} \\ &= \left(\frac{g_i}{g_j} \right)^{\varepsilon_s - 1} \end{aligned}$$

■

Proof of Proposition 1. Solving the 2 sector problem and using the equilibrium conditions, I have:

$$A_{St} = p_{c_t} A_{c_t} \quad (41)$$

$$r_t = \frac{p_{c_t} c_t^\theta}{p_{c_{t-1}} c_{t-1}^\theta} - 1 + \delta = \frac{\left(\frac{\bar{g}_{A_{St-1}}}{\bar{g}_{A_{c_{t-1}}}} \right)^{1-\theta} g_{c_{t-1}}^\theta}{\beta} - 1 + \delta \text{ IF } \beta \neq 0 \quad (42)$$

$$\text{where } g_{c_{t-1}} \equiv \frac{p_{t} c_t}{p_{t-1} c_{t-1}} \text{ is the growth factor of aggregate consumption} \quad (43)$$

$$\bar{g}_{A_{c_{t-1}}} = \frac{A_{c_t}}{A_{c_{t-1}}}, \bar{g}_{A_{St-1}} = \frac{A_{St}}{A_{St-1}} \text{ are known} \quad (44)$$

Let $\phi_t = \alpha^{-1} r_t^{\frac{-\alpha}{1-\alpha}} - \bar{g}_{A_{S_t}}^{\frac{1}{1-\alpha}} r_{t+1}^{\frac{-1}{1-\alpha}} + (1-\delta) r_t^{\frac{-1}{1-\alpha}}$

$$\begin{aligned} k_t &= \frac{K_{S_t}}{n_{S_t}} = \frac{K_{c_t}}{n_{c_t}} = \left(\frac{\alpha A_{S_t}}{r_t} \right)^{\frac{1}{1-\alpha}} \\ K_t &= k_t \end{aligned}$$

The growth factor of capital per capita in each sector is:

$$g_{k_t} = \frac{k_{t+1}}{k_t} = \bar{g}_{A_{S_t}}^{\frac{1}{1-\alpha}} \left(\frac{r_t}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} \quad (45)$$

Similarly, I get aggregate capital growth factor:

$$g_{K_t} = g_{k_t}$$

Using (41) and (25), I derive capital sector output, i.e., investment:

$$\begin{aligned} S_t &= \left(\frac{\alpha A_{S_{t+1}}}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} - (1-\delta) \left(\frac{\alpha A_{S_t}}{r_t} \right)^{\frac{1}{1-\alpha}} \\ &= (\alpha A_{S_t})^{\frac{1}{1-\alpha}} \left[\left(\frac{\bar{g}_{A_{S_t}}}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} - (1-\delta) \left(\frac{1}{r_t} \right)^{\frac{1}{1-\alpha}} \right] \end{aligned} \quad (46)$$

and the growth factor of investment S_t is:

$$g_{S_t} = \frac{S_{t+1}}{S_t} = \bar{g}_{A_{S_t}}^{\frac{1}{1-\alpha}} \frac{\left(\frac{\bar{g}_{A_{S_{t+1}}}}{r_{t+2}} \right)^{\frac{1}{1-\alpha}} - (1-\delta) \left(\frac{1}{r_{t+1}} \right)^{\frac{1}{1-\alpha}}}{\left(\frac{\bar{g}_{A_{S_t}}}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} - (1-\delta) \left(\frac{1}{r_t} \right)^{\frac{1}{1-\alpha}}}$$

so that the labor in capital sector is:

$$n_{S_t} = \alpha \left[\frac{1}{r_t} \left(\frac{\bar{g}_{A_{S_t}} r_t}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} - \frac{(1-\delta)}{r_t} \right] \quad (47)$$

and the growth factor of n_{S_t} is:

$$g_{n_{S_t}} = \frac{n_{S_{t+1}}}{n_{S_t}} = \frac{\frac{1}{r_{t+1}} \left(\frac{\bar{g}_{A_{S_{t+1}}}}{r_{t+2}} \right)^{\frac{1}{1-\alpha}} - \frac{(1-\delta)}{r_{t+1}}}{\frac{1}{r_t} \left(\frac{\bar{g}_{A_{S_t}}}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} - \frac{(1-\delta)}{r_t}} \quad (48)$$

Notice that n_{S_t} (and hence $n_{c_t} = 1 - n_{S_t}$) is independent of the level of technology in c and S as long as the interest rate is too. I can get capital in capital sector:

$$K_{S_t} = \alpha \left[\frac{1}{r_t} \left(\frac{\bar{g}_{A_{S_t}} r_t}{r_{t+1}} \right)^{\frac{1}{1-\alpha}} - \frac{(1-\delta)}{r_{t-1}} \right] \left(\frac{\alpha A_{S_t}}{r_t} \right)^{\frac{1}{1-\alpha}} \quad (49)$$

Define the aggregate output per capita as $y_t = S_t + p_{ct}c_{ct}$. Since $K_{ct} = K_t - K_{St}$ and $n_{ct} = 1 - n_{St}$,

$$\begin{aligned}
y_t &= S_t + p_{ct}c_{ct} \\
&= A_{St}K_{St}^\alpha n_{St}^{1-\alpha} + p_{ct}A_{ct}K_{ct}^\alpha n_{ct}^{1-\alpha} \\
&= A_{St}k_t^{\frac{\alpha}{1-\alpha}} = \left(\frac{\alpha}{r_t}\right)^{\frac{\alpha}{1-\alpha}} A_{St}^{\frac{1}{1-\alpha}}
\end{aligned} \tag{50}$$

and its growth factor is:

$$g_{yt} = \frac{y_{t+1}}{y_t} = \bar{g}_{A_{St}}^{\frac{1}{1-\alpha}} \left(\frac{r_t}{r_{t+1}}\right)^{\frac{\alpha}{1-\alpha}} \tag{51}$$

Aggregate consumption is:

$$\begin{aligned}
C_t &= p_{ct}c_{ct} = y_t - S_t \\
&= \left(\frac{\alpha}{r_t}\right)^{\frac{\alpha}{1-\alpha}} A_{St}^{\frac{1}{1-\alpha}} \\
&\quad - (\alpha A_{St})^{\frac{1}{1-\alpha}} \left[\left(\frac{\bar{g}_{A_{St}}}{r_{t+1}}\right)^{\frac{1}{1-\alpha}} - (1-\delta) \left(\frac{1}{r_t}\right)^{\frac{1}{1-\alpha}} \right]
\end{aligned} \tag{52}$$

$$\tag{53}$$

The growth factor of consumption is:

$$g_{ct} = \frac{C_{t+1}}{C_t} = \bar{g}_{A_{St}}^{\frac{1}{1-\alpha}} \frac{\phi_{t+1}}{\phi_t}. \tag{54}$$

Notice that as $t \rightarrow \infty$ the expressions for $\bar{g}_{A_{St}}$ and $\bar{g}_{A_{ct}}$ converge to constants. ■

Proof of Proposition 2. Corollary of the proof of Proposition 1 and (16). ■

B Measurement of productivity in Manufacturing

I measure productivity using the NBER Manufacturing Productivity Database. The data are more disaggregated than the ISIC3 Classification I need for the UNIDO data, so I aggregate them using Domar weights.

In addition, I use an alternative way of measuring TFP growth rates. Using the UNIDO data set, I compute the TFP growth rates of 28 UNIDO manufacturing industries of the United States using the following equation:

$$\ln(TFP_{it}) = \ln(Y_{it}) - (1-\alpha)\ln(L_{it}) - \alpha\ln(K_{it}) \tag{55}$$

where Y_{it} is the production index. This requires computing the capital stock at the industry level. The UNIDO data set provides investment data but not capital stock data K_{it} , so I use a perpetual inventory method

$$K_{it+1} = (1 - \delta)K_{it} + I_{it}q_{it} \quad (56)$$

to compute growth rate of capital stock, where I_{it} is investment and q_{it} represents investment-specific technical progress²⁹. Then the growth rate of K_{it} is the sum of growth rates of I and q . I set $q_{it} = g_{iq}^t$, so that growth rates of q_i vary across industries. I use growth factor g_{iq} from Ilyina and Samaniego (2012). (see table 5) Also, $\delta = 0.06$ and $\alpha = 0.3$. These are standard numbers in the literature.³⁰ Then, if $\Gamma(x)$ is the log growth rate of x over the time period in the data, note that

$$\ln g_i = \Gamma(Y_i) - (1 - \alpha)\Gamma(L_i) - \alpha\Gamma(K_i) \quad (57)$$

I obtain $\Gamma(Y_i)$ and $\Gamma(L_i)$ from UNIDO, and set $\Gamma(K_i) = \Gamma(I_i) + \log g_{iq}$, which is the long run relationship in (56).

C Simulation procedure

Simulating the model requires overcoming two distinct problems.

The first concerns matching the model with the data. Notice that the model is essentially a 2 sector model where consumption and investment are made by different sectors. As shown in Greenwood, Hercowitz and Krusell (1997), this is the same as a one-sector model with investment specific technical change. In the one-sector growth model, the equilibrium for any initial conditions is a jump to the stable branch of a saddle path that leads to the long run equilibrium (which in this case is the model where the capital sector has converged to contain only one industry). Thus, for general initial conditions K_0 , the share of investment will jump

²⁹I need to allow for investment-specific technical progress because the model is one with many industries where productivity growth rates in capital-producing industries may be different from productivity growth elsewhere.

³⁰The value of δ is from Greenwood, Hercowitz and Krusell (1997) and is a value typical in models with investment-specific technical change, in other words where $g_q > 1$.

after period 1, so that the structure of the manufacturing sector will change abruptly after period zero (and smoothly thereafter).

I handle this problem in two ways. First, I computed everything without worrying about the jump. Second, I calibrated the model so as to focus on an Euler growth path – which are the results reported in the paper (results were very similar either way).

I did not set the initial value of the capital stock K_0 to match the investment share of GDP in each country. The reason was that, in all other periods after $t = 0$, the investment share will follow the Euler equation. It seems arbitrary to assume that in all countries the Euler equation is satisfied in all years except 1963, or whatever happens to be the year for which data are initially available. As a result, I assume that the Euler equation is also satisfied at date zero. I call this an "Euler growth path" or EGP. To do this requires setting the investment share of GDP at a value that is different from that in the data. At the same time, it is critical that I preserve the composition of manufacturing. Hence, I adopted a recursive strategy. I know from the data the composition of investment in year zero. Given an assumption on the investment to GDP ratio, I can preserve the ratio of capital to manufacturing and find a value for the size of manufacturing that preserves its composition.³¹ Then I check whether the assumption on the investment to GDP ratio matches an EGP.³² If not, then I generate another guess based on the predicted EGP value from the last iteration. I find that 3 loops is sufficient for very tight convergence. Then, the sector shares in the rest of the economy are set so as to preserve their relative values. When I regress data on initial manufacturing shares on the model initial manufacturing shares, I find a coefficient of 1.16 (positive and close to one) and an intercept of -0.026 (close to zero), both significant at the 1% level. I take this to imply that, in general, my procedure does not significantly distort the sector structure of the model economy.

The second computational issue I confront is the fact that I am simulating a model economy that does not have a balanced growth path (although it converges to one). Recall

³¹Other sectors are resized so that, relative to each other, shares of GDP are preserved.

³²Recall that computing the equilibrium, including the initial share of investment, requires a series for g_c , which in turn depends on sector productivity growth rates. However, sector productivity growth rates depend on the initial composition and size of the economy. This is why an iterative procedure is necessary to find an EGP.

that the aggregate behavior of the model is the same as a one-sector model with investment specific technical change. In the one-sector growth model, any approximation to the saddle path will "shadow" it for a period of time, eventually diverging infinitely from it: see Colucci (2001). As a result, I adopt a procedure to provide this "shadowing" without suffering a significant divergence.

The procedure is to assume limited computational ability among the agents, a procedure I call "rolling windows of consciousness." Specifically, the structure of the model economy can be computed exactly given the investment share of employment. This can be computed exactly given a series for g_{ct} , which is determined by (54) and the transversality condition. This series eventually converges to $g_{ct} = \bar{g}_{ASt}^{\frac{1}{1-\alpha}}$, where \bar{g}_{ASt} is known given initial conditions. I assume that an agent at date t acts as though up to some period $t + T$ difference equation (54) characterizes g_{ct} , whereas after $t + T$ the agent believes that $g_{ct} = \bar{g}_{ASt}^{\frac{1}{1-\alpha}}$. I tried $T = 50$, 90 and 200. For $T = 90$, the error between the realized value of g_{c1} and the value forecast by the agent in period 0 is about 1% of the actual value (because the series for g_{ct} converges uniformly to its long run value, the forecast errors are the highest in the first period). For $T = 200$ these values are indistinguishable to eight decimal places. At the same time, for all values of T , the Gini nonparametric regressions were indistinguishable regardless of the value of T .

This indicates two results. First, this procedure could yield an arbitrarily accurate approximation to the correct aggregate equilibrium dynamics, given a sufficiently large (but finite) value of T . This is distinct from the shadowing property, which provides arbitrarily precise approximations only for a finite period, after which there is increasing divergence. Second, industry dynamics are robust to using values of T such that aggregate dynamics are computed with some degree of imprecision.

Table 4: NBER TFP Growth Rates for the ISIC revision 2 industry classification. Source: NBER productivity database and author's calculations.

Industry	ISIC code	NBER TFP Growth Rate
Food products	311	0.0101
Beverages	313	0.0303
Tobacco	314	-0.0345
Textiles	321	0.0269
Apparel	322	0.0121
Leather	323	-0.0034
Footwear	324	-0.0035
Wood products	331	0.0113
Furniture, except metal	332	0.0066
Paper and products	341	0.0088
Printing and publishing	342	-0.0022
Industrial chemicals	351	0.0214
Other chemicals	352	0.0135
Petroleum refineries	353	0.0196
Misc. pet. and coal products	354	0.0223
Rubber products	355	0.0142
Plastic products	356	0.0339
Pottery, china, earthenware	361	0.0078
Glass and products	362	0.0051
Other non-metallic mineral prod.	369	0.0120
Iron and steel	371	0.0047
Non-ferrous metals	372	0.0016
Fabricated metal products	381	0.0029
Machinery, except electrical	382	0.0285
Machinery, electric	383	0.0347
Transport equipment	384	0.0160
Prof. & sci. equip.	44 385	0.0126
Other manufactured prod.	390	0.0089

Table 5: UNIDO TFP and Price Growth Rate

Industry	ISIC code	UNIDO TFP Growth Rate	UNIDO Price Growth Rate
Food products	311	0.0067	0.0424
Beverages	313	0.0244	0.0295
Tobacco	314	-0.0212	0.0941
Textiles	321	0.0090	0.0328
Apparel	322	0.0060	0.0371
Leather	323	-0.0196	0.0570
Footwear	324	0.0034	0.0438
Wood products	331	-0.0014	0.0464
Furniture, except metal	332	0.0064	0.0352
Paper and products	341	0.0019	0.0410
Printing and publishing	342	-0.0062	0.0499
Industrial chemicals	351	0.0225	0.0201
Other chemicals	352	0.0146	0.0322
Petroleum refineries	353	-0.0089	0.0507
Misc. pet. and coal products	354	-0.0168	0.0552
Rubber products	355	0.0287	0.0172
Plastic products	356	0.0321	0.0132
Pottery, china, earthenware	361	-0.0116	0.0428
Glass and products	362	0.0005	0.0358
Other non-metallic mineral prod.	369	0.0040	0.0375
Iron and steel	371	-0.0006	0.0377
Non-ferrous metals	372	-0.0103	0.0472
Fabricated metal products	381	0.0034	0.0392
Machinery, except electrical	382	0.0330	0.0025
Machinery, electric	383	0.0218	0.0167
Transport equipment	384	-0.0118	0.0488
Prof. & sci. equip.	385	-0.0027	0.0425
Other manufactured prod.	390	45	0.0170

D Industry TFP growth data

E Robustness results

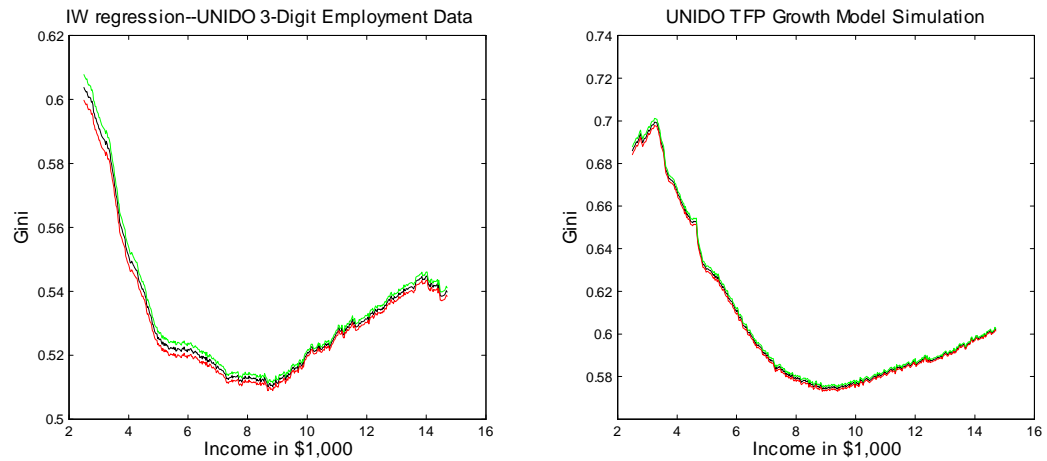


Figure 9. Industry structure along the development path.

TFP growth rates are derived from the UNIDO data.

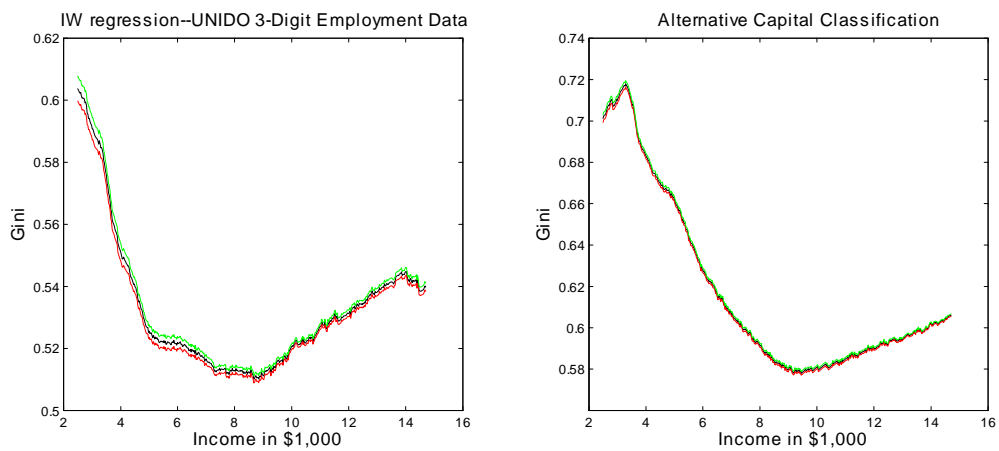


Figure 10. Industry structure along the development path.

Alternative Classification of the Capital Industry.

Table 6: Capital Industries

Industry	ISIC code
Wood products	331
Furniture, except metal	332
Rubber products	355
Plastic products	356
Pottery, china, earthenware	361
Glass and products	362
Other non-metallic mineral prod.	369
Iron and steel	371
Non-ferrous metals	372
Fabricated metal products	381
Machinery, except electrical	382
Machinery, electric	383
Transport equipment	384
Prof. & sci. equip.	385
Other manufactured prod.	390