

Prettner, Klaus

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## Public education, technological change and economic prosperity: semi-endogenous growth revisited

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# Public education, technological change and economic prosperity

Klaus Prettner<sup>a\*</sup>

a) Harvard University  
Center for Population and Development Studies  
9 Bow Street  
Cambridge, MA 02138, USA

## Abstract

We introduce publicly funded education in R&D-based economic growth theory. The framework allows us to i) incorporate a realistic process of human capital accumulation for European countries, ii) reconcile R&D-based growth theory with the empirical evidence on the relationship between economic prosperity and population growth, iii) revise the policy invariance result of semi-endogenous growth frameworks, and iv), show that the transitional effects of an educational reform tend to be qualitatively different from its long-run impact.

**JEL classification:** I25, J24, O11, O31, O41

**Keywords:** human capital accumulation, technological progress, scale-free economic growth, public education policies

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\*Present address: University of Göttingen, Platz der Göttinger Sieben 3, 37073 Göttingen, Germany; phone: +49 551 39 10617; email: klaus.prettner@wiwi.uni-goettingen.de.

# 1 Introduction

The role of education in the process of economic development has been analyzed extensively in the empirical literature. Most of the studies<sup>1</sup> find a positive association between economic growth and measures for overall educational attainment and Lutz et al. (2008) even conclude that

“... better education does not only lead to higher individual income but also is a necessary (although not always sufficient) precondition for long-term economic growth [...] Education is a long-term investment associated with near-term costs, but, in the long run, it is one of the best investments societies can make in their futures.” (Lutz et al., 2008, p. 1048).

Fortunately, in this context, the data shows tremendous improvements of education indicators within industrialized countries over the last decades. Table 1 displays the mean years of schooling of the population aged 15+ for the G-8 countries in 1960 and 2010. There has been a huge increase over time, with annual growth rates between 0.5% and 2%. The table also contains pupil-teacher ratios in primary education, the substantial declines of which indicate that educational investments per child and per year have also been steadily rising. These observations and the fact that the G-8 countries featured substantial increases in living standards over the corresponding time-frame are consistent with the results of the empirical studies mentioned above.

Despite these findings and the seminal theoretical contributions of Nelson and Phelps (1966), Lucas (1988) and Galor and Weil (2000) — showing different mechanisms by which education exerts a positive influence on economic prosperity — the main focus of R&D-based growth theory has long been on technological progress as being determined by the R&D effort of an *uneducated* workforce. In one of the first models of this type, Romer (1990) acknowledged that the aggregate human capital stock of an economy and not raw, uneducated, labor is the driving force behind technological progress, but he did not model this idea explicitly. Within these frameworks, therefore, the aggregate human capital stock exhibits the same properties as raw labor does. Consequently, these frameworks cannot be used to analyze investments in education and their impact upon technological progress and

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<sup>1</sup>See for example Barro (1991), Sachs and Warner (1995), Bils and Klenow (2000), Krueger and Lindahl (2001) and the survey of Durlauf et al. (2005).

Table 1: Mean years of schooling and pupil-teacher ratios in primary education for the G-8 countries

Country	Mean years of schooling		Pupil-teacher ratios	
	1960	2010	1971	2009
Canada	8.31	11.37	23.00*	17.42*
France	4.20	10.53	22.79	18.73
Germany	5.15	11.82	17.46*	13.00
Italy	4.86	9.88	21.62	10.33*
Japan	8.02	11.59	26.39	18.05
Russia	5.16	8.84	27.95*	18.06
U.K.	7.04	9.75	24.86*	17.96
USA	9.25	12.20	14.05	13.87

The data has been obtained from Barro and Lee (2010) and the World Bank (2012) “Education Statistics”. Note that the indicated year differs for the entries marked with an asterisk because of missing data. The base years for pupil-teacher ratios are 1972 for Canada, 1995 for Germany, 1981 for Russia and 1985 for the USA. The end years for the same data series are 2000 for Canada and 2007 for Italy.

economic prosperity.

Another disadvantage of early R&D-based growth models in the vein of Romer (1990) has been their support of a strong scale effect in the sense that the size of a countries’ population determined its long-run economic growth prospects. While it has been shown by Kremer (1993) that the scale effect was indeed important in economic history prior to the twentieth century for the world as a whole, it has been refuted by Jones (1995a) and Jones (1995b) for individual countries and their growth experiences over the second half of the twentieth century. This paved the way for semi-endogenous growth models in the vein of Jones (1995a) that removed the strong scale effect in a way that the long-run economic growth rate positively depended on population *growth* but not anymore its *size*. However, even this implication has been severely criticized on the basis of empirical evidence that rather supports a *negative* association between economic growth and population growth (see for example Brander and Dowrick, 1994; Kelley and Schmidt, 1995; Ahi-tuv, 2001; Bernanke and Gürkaynak, 2001). Furthermore, the removal of the strong scale effect came at the price that the long-run economic growth rate within early semi-endogenous growth models was rendered invariant to

economic policy.<sup>2</sup>

In light of this short discussion, the aim of our paper is threefold. First, we want to implement the notion of *publicly* financed education into R&D-based economic growth frameworks to introduce human capital accumulation. While the assumption of *privately* financed education might be justifiable for the United States, it does not fit for European countries because there, education systems are largely financed by the state (cf. Docampo, 2007; OECD, 2011, p. 232). Furthermore, we want to introduce a realistic production process for human capital by relaxing the implicit assumption often made in the literature that the sole input in human capital accumulation is time and effort by those to be educated (or by their parents). In contrast, our model features an education sector that employs teachers to build up the human capital stock of the next generation. Consequently, an increase in educational investments has the realistic side effect that the additional labor required in the education sector has to be drawn away from other productive sectors of the economy.

Second, we attempt to reconcile theory and evidence by showing that our model allows for both a negative and a positive relationship between economic growth and population growth. The negative relationship is more likely to prevail for countries in which the education sector is well developed and population growth is slow, that is, typically for modern industrialized countries. This implication is consistent with the empirical findings of Brander and Dowrick (1994), Kelley and Schmidt (1995), Ahituv (2001) and Bernanke and Gürkaynak (2001). The positive relationship, on the other hand, is more likely to prevail for countries in which the education sector is badly developed and population growth is fast. Since this primarily applies for countries in an early stage of development, our results are also consistent with the empirical findings of Kremer (1993).<sup>3</sup>

Third, we aim to reintroduce scope for policymakers to influence the long-run economic growth rate which would be consistent with the implication of Dinopoulos and Thompson (1998), Peretto (1998), Young (1998) and Howitt (1999). In so doing we show that public educational investments are

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<sup>2</sup>See Dinopoulos and Thompson (1998), Peretto (1998), Young (1998) and Howitt (1999) for critique of this implication and potential ways to circumvent it.

<sup>3</sup>However, we do not want to overstretch the R&D-based growth framework and acknowledge that it is only suited for a description of countries that have already established sound property rights and a certain industrial base.

important drivers of long-run growth. This result is in turn consistent with the empirical literature on the interrelation between education and economic prosperity that we mentioned above.

The basic mechanism of our model is the following. Human capital is used as an input in three sectors that compete for it on the labor market: workers produce goods in the final goods sector, scientists produce ideas in the R&D sector and teachers produce human capital for the next generation in the education sector. The government collects taxes and uses the proceeds to pay the wages of the teachers. Consequently, an increase in taxes raises the number of teachers and thereby draws labor from the other sectors. This harms economic growth in the *short-* to *medium* run. However, the increase in the number of teachers fosters human capital accumulation and thereby increases productivity of the next generations. This in turn raises the *long*-run growth perspectives of the economy.

Our model is related to other recent developments in the literature that try to address the shortcomings of standard R&D-based growth theory. However, we are not aware of any model that is able to cope with all the mentioned aspects within one single framework. Dalgaard and Kreiner (2001), Strulik (2005) and Strulik et al. (2011) implement privately financed education into R&D-based growth theory to develop models that support a negative association between economic growth and population growth. While Dalgaard and Kreiner (2001) and Strulik (2005) emphasize that newborns do not have any education and therefore a larger birth rate slows down growth of average human capital and therefore hampers economic development, Strulik et al. (2011) rely on a child quality-quantity trade-off in the vein of Becker (1993) to show that a shift toward having fewer but better educated children can lead to a larger aggregate human capital stock and therefore to faster economic growth. This implication has in turn been challenged by Prettnner et al. (2012), who do not find empirical evidence that the quality-quantity trade-off is — as an isolated mechanism — strong enough to overturn the negative influence of declining fertility on the stock of aggregate human capital. As a consequence, they argue for a more general description of the education sector.

Some aspects of human capital accumulation in the context of R&D-based growth theory have also been analyzed in the articles by Eicher (1996), Arnold (1998), Funke and Strulik (2000) and Arnold (2002). In these con-

tributions, however, the growth rate of the population is assumed to be zero. This means that human capital accumulation fully adopts the role that population growth has had in standard R&D-based semi-endogenous growth models and that the interrelations between population growth and human capital accumulation — as well as their joint impact upon technological progress — cannot be addressed.

One article that analyzes publicly financed education (in the form of subsidies for private education) in the context of R&D-based growth is Grossmann (2007). Similar to the models of the previous paragraph, population growth is not considered, which rules out the possibility to study the interrelations between demographic change and human capital accumulation. Furthermore, the framework does not explicitly model an education production sector. However, one of our central results, the growth promoting effect of public educational investments, is consistent with the results of Grossmann (2007).

This paper proceeds as follows: Section 2 contains the theoretical model and the derivation of the growth rates of endogenous variables along the balanced growth path. We analytically assess the dependence of these growth rates on the underlying parameters, in particular, population growth and public education policies. In Section 3 we numerically analyze the implications of an increase in public educational expenditures for economic growth during the transition to the new balanced growth path. Finally, Section 4 discusses the results, draws conclusions for economic policy and highlights scope for further research.

## 2 The model

This section describes the discrete time overlapping generations version of the R&D-based economic growth framework based upon Romer (1990) and Jones (1995a).<sup>4</sup> Furthermore, we introduce a governmentally funded education sector that employs teachers to educate the young and analyze its implications for long-run economic growth perspectives.

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<sup>4</sup>Due to the isomorphism between R&D-based growth models with horizontal and vertical innovations (cf. Grossman and Helpman, 1991; Aghion and Howitt, 1992; Segerström, 1998, for the latter), the growth effects of educational investments would not be different when using a model of vertical innovation as baseline framework.

## 2.1 Basic assumptions

The basic structure of our model economy follows Diamond (1965). There are three phases of an individual's life cycle: childhood, adulthood and retirement. Children do not face economic decisions but they receive publicly funded education, the intensity of which determines their human capital level as an adult. Adults, whose cohort size at time  $t$  is given by  $L_t$ , inelastically supply their skills on the labor market, consume, and save for retirement. The retirees in turn finance their consumption expenditures out of savings carried over from adulthood. We treat population growth as exogenous and assume that adults give birth to  $n > 1$  children such that the population grows at rate  $n - 1$ . Endogenizing population growth and private educational investments along the lines of Strulik et al. (2011) would complicate the model structure and obscure the basic mechanisms we aim to highlight.

There are four sectors: final goods production, intermediate goods production, R&D and education. Two production factors can be used in these sectors: capital and labor. The latter is available in three different forms: i) workers in the final goods sector denoted by  $L_{t,Y}$ , ii) scientists in the R&D sector denoted by  $L_{t,A}$ , and iii), teachers in the education sector denoted by  $L_{t,E}$ . The final goods sector employs workers and machines supplied by the intermediate goods sector to produce for a perfectly competitive consumption good market. The Dixit and Stiglitz (1977) monopolistically competitive intermediate goods sector produces the machines used in the final goods sector with capital as variable production factor and one machine-specific blueprint as fixed input. The blueprints are in turn supplied by the R&D sector, which employs scientists to produce them. Finally, the education sector employs teachers to produce individual human capital for the next generation denoted by  $h_{t+1}$ . The expenditures for the education sector are financed by taxing wages of adult workers. Following Mankiw et al. (1992) by assuming that human capital and raw labor are perfect substitutes allows us to write aggregate human capital employment as  $H_t = h_t L_t$ .

## 2.2 Consumption side

Suppose that adults maximize their discounted lifetime utility determined by consumption in adulthood and after retirement in the vein of Diamond



(1965)

$$\max_{c_t, s_t} u_t = \log c_t + \beta \log(R_{t+1} s_t), \quad (1)$$

where  $c_t$  denotes consumption,  $s_t$  represents savings carried over to retirement,  $\beta = 1/(1 + \rho)$  refers to the discount factor with  $\rho$  being the discount rate, and  $R_{t+1}$  denotes the gross interest rate paid on assets between generations  $t$  and  $t + 1$ . Note that each time period corresponds to one generation and therefore lasts for 25 years. Assuming full depreciation of capital over the course of one generation, the gross interest rate corresponds to the capital rental rate and is given by  $1 + r_{t+1}$  with  $r_{t+1}$  being the net interest rate. The budget constraint of a young adult reads

$$(1 - \tau)w_t h_t + l_t = c_t + s_t, \quad (2)$$

where  $\tau$  denotes the income tax rate,  $w_t$  represents the wage per efficiency unit of labor and  $l_t$  are lump-sum redistributions of the monopolistic rents accruing in the intermediate goods sector after a patent has expired (see section 2.3.3 for details). Consequently, the left hand side of the budget constraint refers to total lifetime income of an individual, which can be spent on consumption during adulthood or consumption after retirement. The results of the maximization problem are expressions for optimal consumption and savings

$$c_t = \frac{l_t + (1 - \tau)h_t w_t}{1 + \beta}, \quad (3)$$

$$s_t = \frac{\beta (l_t + (1 - \tau)h_t w_t)}{1 + \beta}, \quad (4)$$

exhibiting the standard properties for logarithmic utility, that is, they are increasing in wage income and lump-sum governmental transfers and decreasing in tax rates and the discount factor because the latter reduces savings and thereby lifetime interest income.

### 2.3 Production side

This subsection describes the production structure in the four sectors: final goods production, intermediate goods production, R&D and education. The treatment of the former two sectors is fairly standard (cf. Romer, 1990; Jones, 1995a; Strulik et al., 2011) and the description can be brief. Since

we augment the standard framework to account for an income tax financed public education sector that employs labor to produce human capital of individuals (and thereby increases the productivity of subsequent generations), the education sector and the R&D sector compete for talents on the labor market. To our knowledge, this trade-off has not been analyzed in the literature and we will therefore describe it in more detail.

### 2.3.1 Final goods sector

Final output  $Y_t$ , being consumed by the individuals in the economy and representing the gross domestic product (GDP), is produced according to the production function

$$Y_t = H_{t,Y}^{1-\alpha} \sum_{i=1}^{A_t} x_{t,i}^\alpha, \quad (5)$$

where  $H_{t,Y}$  is human capital employed in the final goods sector,  $A_t$  is the technological frontier, that is, it represents the most modern blueprint that has been developed in the R&D sector,  $x_{t,i}$  is the amount of the blueprint-specific machine  $i$  used in final goods production and  $\alpha$  is the elasticity of final output with respect to machines. Due to perfect competition in the final goods market, production factors are paid their marginal products. This means that the wage rate per unit of human capital and prices of blueprints are given by

$$w_{t,Y} = (1 - \alpha) H_{t,Y}^{-\alpha} \sum_{i=1}^{A_t} x_{t,i}^\alpha = (1 - \alpha) \frac{Y_t}{H_{t,Y}}, \quad (6)$$

$$p_{t,i} = \alpha H_{t,Y}^{1-\alpha} x_{t,i}^{\alpha-1}. \quad (7)$$

Note that the derived prices for machines rely on the property that individual intermediate goods producing firms are deemed to be small in comparison to the whole sector. Consequently, the contribution of one such firm to the output of the whole sector can be neglected.<sup>5</sup>

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<sup>5</sup>Sometimes an integral is used instead of the sum in equation (5) to capture this issue.

### 2.3.2 Intermediate goods sector

We assume that a single intermediate goods producer is able to convert capital  $k_{t,i}$  one for one into machines  $x_{t,i}$  after it has purchased the corresponding blueprint from the R&D sector. Therefore, its operating profit reads

$$\pi_{t,i} = p_{t,i}k_{t,i} - R_t k_{t,i} \quad (8)$$

and profit maximization leads to the familiar outcome of Dixit and Stiglitz (1977) that firms charge prices for machines that are a markup  $1/\alpha$  over marginal cost. Hence, we have

$$p_{t,i} = \frac{R_t}{\alpha} \quad (9)$$

and there is symmetry between firms such that the index  $i$  can be dropped. As another consequence of symmetry, we know that each firm employs  $k_t = K_t/A_t$  units of capital, where  $K_t$  denotes the aggregate capital stock. Consequently, the aggregate production function becomes

$$Y_t = (A_t H_{t,Y})^{1-\alpha} K_t^\alpha, \quad (10)$$

where technology appears as human capital augmenting.

### 2.3.3 R&D sector

The R&D sector employs scientists with a human capital level  $H_{t,A}$  and productivity  $\delta$  in order to develop new blueprints. The production function of a firm in the research sector can be written as

$$A_{t+1} - A_t = \delta A_t^\phi H_{t,A}, \quad (11)$$

where  $\phi$  measures the extent of intertemporal knowledge spillovers. In case that  $\phi = 1$  we would be in the Romer (1990) environment and sustaining an exponential growth rate of technology would not become ever more difficult as the technological frontier expands. We see from equation (11) that a constant amount of human capital in research would then suffice to have perpetual technological progress and therefore positive long-run economic growth. In contrast, if  $\phi < 1$ , we would be in the Jones (1995a) environment and a constant long-run growth rate of technology would either require a

constant inflow of additional scientists into R&D, or a continuous increase in education of the scientists already employed, or both. Since we have positive population growth and individual human capital accumulation, no balanced growth path exists in the Romer (1990) environment. Instead, the Romer (1990) specification would lead to hyper-exponential growth, an implication that is at odds with the stylized facts of economic development (cf. Kaldor, 1957). Consequently, we restrict our attention to  $\phi < 1$  from now on. Firms in the R&D sector maximize their profits

$$\pi_{t,A} = p_{t,A} \delta A^\phi H_{t,A} - w_{t,A} H_{t,A}, \quad (12)$$

with  $p_{t,A}$  being the price of a blueprint and  $w_{t,A}$  being the wage rate of scientists. This leads to the optimality condition

$$w_{t,A} = p_{t,A} \delta A_t^\phi, \quad (13)$$

where wages of scientists increase in the prices of blueprints. The reason is that if R&D firms can charge higher prices of blueprints, they would strive to expand their production. This would require them to attract workers from the other two labor-using sectors of the economy: final goods production and education. To be able doing so, these firms would have to pay higher wages.

It is assumed that patent protection for a newly discovered blueprint lasts for one generation. Afterwards the right to sell the blueprint is handed over to the government which redistributes the proceeds in a lump-sum manner. This assumption simplifies the exposition considerably and allows us tracing the transitional dynamics because we do not require interest rates to remain constant over time (cf. Strulik et al., 2011, for a comparable mechanism). R&D firms can charge prices for blueprints that are equal to the operating profits of intermediate goods producers in time period  $t$  (when patent protection is valid) because there is always a potential entrant in the intermediate goods sector willing to pay that price due to free entry. To put it differently, in case that blueprints were less (more) expensive, firms would have an incentive to enter (exit) the market and consequently the stable equilibrium involves zero overall profits. Therefore, we can write prices for

blueprints as

$$p_{t,A} = (\alpha - \alpha^2) \frac{Y_t}{A_t}, \quad (14)$$

which follows from equations (7) and (9) and the fact that  $x_i = k_i$  for all  $i$ .

#### 2.3.4 Education sector

The education sector employs teachers financed by the proceeds of income taxes in order to produce human capital (cf. Gersbach et al., 2009, who use a comparable financing scheme for basic research in a hierarchical growth model). We assume a balanced governmental budget such that

$$\tau w_t h_t L_t = w_t h_t L_{t,E}, \quad (15)$$

where the left hand side represents governmental revenues, that is, the proceeds of taxing the total wage bill  $w_t h_t L_t$ , and the right hand side represents governmental expenditures, that is, the wages paid for teachers in the education sector. This implies that the number of employed teachers is  $L_{t,E} = \tau L_t$ . The education sector produces schooling intensity, denoted by  $e_t$ , according to

$$e_t = \xi \frac{L_{t,E}}{n L_t} = \xi \frac{\tau}{n}, \quad (16)$$

where  $\xi$  measures the productivity of teachers and  $\tau/n$  denotes the teacher-pupil ratio. This implies that the intensity of schooling increases in the productivity of teachers and in public educational investments per child. Note that, *ceteris paribus*, faster population growth lowers the teacher-pupil ratio and thereby the schooling intensity. Building upon Mincer (1974) and following Hall and Jones (1999), Bils and Klenow (2000) and Caselli (2005), schooling intensity translates into individual human capital according to  $h_{t+1} = \exp \left[ \tilde{\psi}(\xi \tau / n) \right] h_t$ , where  $\tilde{\psi}(\cdot)$  measures the extent to which it does. Note that this assumes that schooling intensity plays a comparable role as “years of schooling” does in the empirical literature. In the context of an overlapping generation model with fixed period length, an increase in years of schooling would indeed be tantamount to an increase in schooling intensity. As regards the particular specification of the human capital accumulation function, Bloom and Canning (2005) use a linear relationship that is based upon evidence by Psacharopoulos (1994). We follow their approach such

that

$$h_{t+1} = \exp \left[ \psi \left( \xi \frac{\tau}{n} \right) \right] h_t \quad (17)$$

with  $\psi = \text{const.}$  Altogether, equation (17) implies that if the government does not invest in education at all, the human capital of the successive generation would be the same as those of their parents. This can be justified by the notion that, without formal education, people are observing and learning from their parents and peers (cf. Strulik et al., 2011, p. 8). Furthermore, if people would not observe and learn from others at all, the model would lack positive economic growth in equilibrium, which would be at odds with stylized facts of economic development for modern societies (cf. Kaldor, 1957; Acemoglu, 2009; Galor, 2011).<sup>6</sup>

## 2.4 Market clearing and the balanced growth path of the economy

Labor market clearing implies that the total amount of available human capital is either employed in the final goods sector, in the education sector, or in the R&D sector, that is, we have  $h_t L_t = h_t (L_{t,E} + L_{t,A} + L_{t,Y}) \Rightarrow H_t = H_{t,E} + H_{t,A} + H_{t,Y}$ . Furthermore, we know that wages in all sectors have to equalize such that  $w_{t,E} = w_{t,A} = w_{t,Y}$ , otherwise one or more sectors would not be able to attract any workers and the economy ended up in a corner solution. Equalizing expressions (6) and (13), using equation (14), and noting that employment in the education sector is  $\tau L_t$ , yields demand for workers in the final goods sector and in the R&D sector as, respectively,

$$H_{t,Y} = \frac{A_t^{1-\phi}}{\alpha \delta}, \quad (18)$$

$$H_{t,A} = (1 - \tau) H_t - \frac{A_t^{1-\phi}}{\alpha \delta}. \quad (19)$$

Recalling that  $H_t = h_t L_t$  and  $H_{t,E} = h_t L_{t,E}$ , we see that an increase in the population size or in individual human capital immediately leads to more employment of aggregate human capital in education and in science. The latter fosters technological progress such that  $A_{t+1}$  rises by more than it

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<sup>6</sup>Of course it can be questioned whether a positive economic growth rate can be sustained indefinitely facing scarce resources, a limited carrying capacity of the environment and bounded space on earth. However, we do not insist that our model holds for  $t \rightarrow \infty$ , but that it represents a reasonable approximation for a certain period of time.

would have otherwise. This in turn increases human capital employment in the final goods sector in generation  $t + 1$ . Altogether the development of new blueprints can then be described by

$$A_{t+1} = \delta(1 - \tau)A_t^\phi h_t L_t - \frac{1 - \alpha}{\alpha} A_t, \quad (20)$$

where the dynamic trade-off that public educational investments imply is the following: while increasing taxes pulls labor from the R&D sector into the education sector, it also increases human capital accumulation and therefore the productivity of the next generation's scientists. In the short- to medium run, the negative effect of the decrease in the number of scientists on the development of new blueprints will dominate, whereas in the long run, the positive effect of better education on the productivity of scientists will prevail.

Full depreciation of physical capital and capital market clearing imply that the aggregate physical capital stock of an economy in generation  $t + 1$  is equal to aggregate savings. Furthermore, goods market clearing ensures that aggregate consumption together with aggregate savings is equal to total output such that

$$K_{t+1} = s_t L_t = Y_t - c_t L_t. \quad (21)$$

These identities can then be used to eliminate the lump-sum redistributions of the government to the households. After doing so, the equation governing the accumulation of aggregate capital reads

$$K_{t+1} = \frac{\beta}{1 + \beta} \left( \frac{A_t^{2-\phi}}{\alpha \delta} \right)^{1-\alpha} K_t^\alpha. \quad (22)$$

Putting all information together, the system fully describing the equilibrium dynamics of our model economy is therefore given by

$$A_{t+1} = \delta(1 - \tau)A_t^\phi h_t L_t - \frac{1 - \alpha}{\alpha} A_t, \quad (23)$$

$$h_{t+1} = \exp\left(\frac{\psi \xi \tau}{n}\right) h_t, \quad (24)$$

$$L_{t+1} = n L_t, \quad (25)$$

$$K_{t+1} = \frac{\beta}{1 + \beta} \left( \frac{A_t^{2-\phi}}{\alpha \delta} \right)^{1-\alpha} K_t^\alpha. \quad (26)$$

Note that these equations hold during the transition to the balanced growth path *and* along the balanced growth path itself. Making use of the definition of a balanced growth path, that is, that the growth rate of a variable does not change over time, we can derive the long-run rate of technological progress as

$$g_A = [(g_h + 1)(g_L + 1)]^{\frac{1}{1-\phi}} - 1 = \left[ \exp\left(\frac{\psi\xi\tau}{n}\right) n \right]^{\frac{1}{1-\phi}} - 1, \quad (27)$$

where  $g_j$  denotes the growth rate of variable  $j$ . For the aggregate capital stock it follows either from equation (26) or from inspection of the aggregate production function that its long-run balanced accumulation rate is given by

$$\begin{aligned} g_K &= (g_h + 1)(g_L + 1)(g_A + 1) - 1 = \left[ \exp\left(\frac{\psi\xi\tau}{n}\right) n \right]^{\frac{2-\phi}{1-\phi}} - 1 \\ &= (g_A + 1)^{2-\phi} - 1. \end{aligned} \quad (28)$$

Denoting per capita GDP by  $y_t$  and putting everything together, the growth rates of aggregate GDP and per capita GDP are, respectively,

$$g_Y = (g_h + 1)(g_L + 1)(g_A + 1) - 1 = \left[ \exp\left(\frac{\psi\xi\tau}{n}\right) n \right]^{\frac{2-\phi}{1-\phi}} - 1, \quad (29)$$

$$g_y = (g_h + 1)(g_A + 1) - 1 = \left[ \exp\left(\frac{\psi\xi\tau}{n}\right) \right]^{\frac{2}{1-\phi}} n^{\frac{1}{1-\phi}} - 1. \quad (30)$$

Technological progress is driven by growth in aggregate human capital, which is composed of individual human capital and the population size. It might seem that a decrease in either of these variables decreases the long-run growth rate of the economy. This, however, misses the point that human capital accumulation is inversely related to the population growth rate via the latter's negative influence on the teacher-pupil ratio. The question which of the two effects prevails when population growth declines will be discussed in Proposition 1.

Note that per capita GDP, the crucial measure for prosperity in growth theory, not only increases with the rate of technological progress, but, additionally, with the rate of individual human capital accumulation. Since human capital accumulation is complemented by physical capital accumula-



tion, constant returns to both of these accumulable factors in the aggregate production function ensure that long-run growth of per capita GDP would persist, even in the absence of technological progress. This illustrates that human capital exerts its positive influence on economic growth via *two* channels in our framework. The first channel is a direct effect that follows the mechanism described in Lucas (1988): human capital and physical capital accumulation *together* increase individual labor productivity, which prevents the decreasing returns of physical capital accumulation to become a binding constraint for long-run development. The second channel is the indirect effect based upon the mechanism described in Romer (1990) and Jones (1995a): human capital accumulation fosters technological progress, which in turn increases labor productivity and economic growth. Altogether, the balanced growth path of the economy described by equations (28), (29) and (30) is consistent with the stylized facts of economic development expressed by Kaldor (1957).

Now we can state the first central analytical result of our paper.

**Proposition 1.** *The long-run growth rates of technology and per capita GDP decrease in response to faster population growth if the education sector of an economy is well-developed and the population growth rate is low. The converse holds true for an economy with fast population growth and a badly developed education sector.*

*Proof.* We take the derivatives of the growth rates of technology and per capita GDP with respect to population growth

$$\frac{\partial g_A}{\partial n} = \frac{\left[ \exp\left(\frac{\psi\xi\tau}{n}\right) n \right]^{\frac{1}{1-\phi}} (n - \xi\tau\psi)}{n^2(1 - \phi)}, \quad (31)$$

$$\frac{\partial g_y}{\partial n} = \frac{\left[ \exp\left(\frac{\psi\xi\tau}{n}\right) n \right]^{\frac{2-\phi}{1-\phi}} (n - \xi\tau(2 - \phi)\psi)}{n^3(1 - \phi)}. \quad (32)$$

The first expression is negative if the state of the education sector — as measured by the product of public investments in education represented by taxes,  $\tau$ , productivity of teachers,  $\xi$ , and the Mincerian coefficient governing the translation of the schooling intensity into human capital,  $\psi$ , — is sound, while the population growth rate,  $n$ , is low. Qualitatively the same result holds true for the growth rate of per capita GDP.  $\square$

The economic intuition behind these results is that growth of aggregate human capital is either due to growth of individual human capital or due to growth of the population size. An increase in population growth, which — by itself — positively impacts upon aggregate human capital accumulation, simultaneously decreases the teacher-pupil ratio. This in turn has a negative impact on the evolution of aggregate human capital. If the education sector is well developed and the population growth rate is low, the negative effect would dominate and population growth would therefore negatively impact economic growth. This is most likely to be the case for developed countries, which would be consistent with the evidence found by Brander and Dowrick (1994), Kelley and Schmidt (1995), Ahituv (2001) and Bernanke and Gürkaynak (2001). If, on the other hand, the education sector is badly developed and population growth is high, the positive effect would dominate and population growth would therefore positively impact economic growth. This is most likely to be the case for countries in an early stage of industrialization which would be consistent with the evidence found by Kremer (1993).

Another interesting aspect is that the proof of Proposition 1 indicates that there exists a certain parameter range for which technological progress negatively depends on an increase in population growth, while the converse holds true for per capita output growth. The mathematical reason is that the negative part in the numerator is multiplied by  $2 - \phi > 1$  in the derivative of  $g_y$  with respect to  $n$ . The intuitive explanation is rooted in the property of this model that individual human capital accumulation not only exerts its positive growth effect via the R&D sector but additionally through the channel suggested by Lucas (1988), that is, it increases productivity of workers in the final goods sector. Since faster accumulation of human capital is accompanied by faster physical capital accumulation, constant returns with respect to these two production factors on the aggregate level imply an additional positive impact of education on output growth. Now we turn to the second central analytical result of our paper.

**Proposition 2.** *The long-run growth rates of technology and per capita GDP unambiguously increase in public educational investments.*

*Proof.* We take the derivatives of the growth rate of technology and per

capita GDP with respect to the tax rate

$$\frac{\partial g_A}{\partial \tau} = \frac{\left[ \exp\left(\frac{\psi \xi \tau}{n}\right) n \right]^{\frac{1}{1-\phi}} \xi \psi}{n(1-\phi)}, \quad (33)$$

$$\frac{\partial g_y}{\partial \tau} = \frac{\left[ \exp\left(\frac{\psi \xi \tau}{n}\right) n \right]^{\frac{2-\phi}{1-\phi}} \xi (2-\phi) \psi}{n^2(1-\phi)}. \quad (34)$$

Since both of them are unambiguously positive, the proposition holds.  $\square$

This result is different compared to standard semi-endogenous growth models (cf. Jones, 1995a; Segerström, 1998) because it suggests scope for economic policy to influence the long-run economic growth rate. This would rather be in line with the second wave of scale-free economic growth models advocated by Dinopoulos and Thompson (1998), Peretto (1998), Young (1998), Howitt (1999) and Dalgaard and Kreiner (2001). The policy measure to be taken is to increase investments in public education. In this regard, our model is consistent with the empirical literature suggesting a positive association between education and economic growth (cf. Barro, 1991; Sachs and Warner, 1995; Bils and Klenow, 2000; Krueger and Lindahl, 2001; Lutz et al., 2008). The reason for this effect to prevail is that — in the long-run and for a constant population growth rate  $n$  — there is only a positive effect of increasing education on aggregate human capital accumulation. Hence, in the long run, effective labor unambiguously grows faster in all sectors of the economy if the government raises educational investments. However, in the short- and medium run, that is, during the transition to the new balanced growth path, there could also be negative growth effects of increases in public educational investments because the education sector draws labor from the R&D sector. This represents the “near term costs” mentioned by Lutz et al. (2008), which can be quite substantial. We turn to this issue in the next section, where we simulate an increase in educational expenditures and therefore keep track of the short- and medium-term costs as well as of the long-term benefits.

### 3 Simulating an increase in public educational expenditures

To address the question how the model economy is affected by an increase in public educational expenditures in the short- and medium run, we simulate the dynamic system displayed in equations (23) to (26) in the software package developed by Diks et al. (2008). The parameter values and justifications for using them are given in Table 2. We try to choose parameters to be consistent with data on the growth process of the United States obtained from World Bank (2012) or otherwise to be in line with the corresponding literature and aim to present a reasonably justified picture of the short- and medium-run response to an increase in public educational investments.

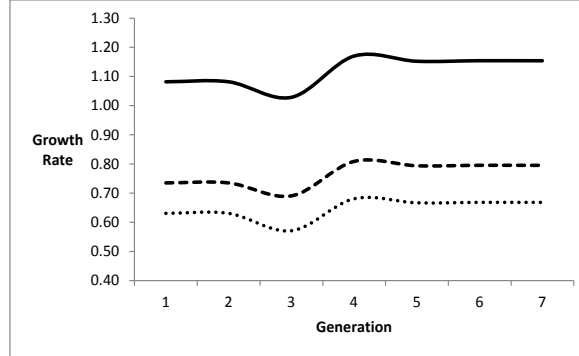
Table 2: Parameter values for simulation

Parameter	Value	Justification
$\beta$	0.3	Value implies a yearly discount rate of 5%
$\alpha$	0.33	Value is common in the growth literature; see for example Jones (1995a)
$\delta$	10	Parameter is free to choose; it changes the magnitude of the response to shocks during the transition period
$\xi$	10	The parameter values for $\xi$ and $\phi$ imply $g_y$ consistent with World Bank (2012) data for the United States
$\phi$	0.5	
$\tau$	0.0819	Value is implied by World Bank (2012) data for the United States
$\psi$	0.091	Value is commonly used/inferred; see for example Psacharopoulos (1994) and Bloom and Canning (2005)
$n$	1.2	Value implies population growth of 0.7% per year

The results of doing so are depicted in Figure 1. We assume that the economy initially moves along the balanced growth path. At generation 3 a 1 percentage point increase in public educational expenditures as a fraction of GDP occurs. Afterwards the behavior of the economy is traced for another four generations, that is, for 100 years.

We see that the effect of an increase in public educational investments

Figure 1: Simulation of an increase in public educational expenditures



Note: Time is displayed on the x-axis and growth (between two generations) is displayed on the y-axis. The solid line refers to capital, the dashed line to output per capita and the dotted line to technology. Initially, the economy moves along the balanced growth path. At the third generation, a 1 percentage point increase in public educational expenditures as a fraction of GDP occurs. Afterwards the economy is traced for another four generations, that is, for 100 years.

at impact is such that labor is drawn away from the R&D sector into the education sector which slows down technological progress (dotted line), per capita GDP growth (dashed line) and aggregate capital accumulation (solid line) for one generation. This reflects the “near term costs” of education according to Lutz et al. (2008). In the subsequent generation, when the better educated workforce enters the labor market, the growth rate of technology, per capita GDP and the aggregate capital stock reach a peak. This is due to an upward level shift of aggregate human capital *and* to faster growth of individual human capital (cf. Trimborn et al., 2008, for the transitional effects of level shifts in standard semi-endogenous growth models). Afterwards the growth rates of technology, per capita GDP and aggregate capital converge toward their new balanced growth path levels, which are higher than before the increase in educational investments. This represents the long-term benefits of education according to Lutz et al. (2008). Note that the long-run outcome is consistent with the claim expressed in Proposition 2.

## 4 Discussion

We set up an R&D-based economic growth model with a *public* education sector as prevalent in most European countries (cf. Docampo, 2007; OECD, 2011). First, this allows us to generalize the R&D-based growth literature to take education, which is an empirically important determinant of economic development, into account. We show that the long-run growth rate of the economy is not only affected by technological progress (being itself driven by population growth and human capital investments) but is further enhanced by sustained increases in the skills of the labor force together with faster physical capital accumulation. Consequently, the framework is able to bridge the gap between growth models relying solely on human capital accumulation like Lucas (1988) and the R&D-based growth literature of Romer (1990) and Jones (1995a).

Second, we show that the long-run growth rates of technology and per capita output are sensitive to changes in governmental education policies. Therefore we challenge a property of early semi-endogenous growth models in the vein of Jones (1995a) and Segerström (1998) in favor of later scale-free growth models in the spirit of Dinopoulos and Thompson (1998), Peretto (1998), Young (1998) and Howitt (1999). Our results suggest that educational investments are very important to foster long-run economic development. However, there might be substantial short- and medium-run costs associated with the implementation of growth promoting education reforms because resources from other sectors would have to be transferred to the education sector. Moreover, the benefits of education do not materialize immediately because it takes time until the next generation enters the labor market. This essentially pins down to the dynamic trade-off between benefiting future generations at the expense of currently tax paying adults and might be one major reason why policy-makers are reluctant to implement costly education reforms.

Third, our model framework suggests that increases in population growth might harm long-run economic growth perspectives in case that the education sector of an economy is well developed and population growth is slow. This primarily applies to industrialized countries in the second half of the twentieth century and therefore has the potential to explain the negative correlation between economic growth and population growth found in em-

irical studies for this time frame (cf. Brander and Dowrick, 1994; Kelley and Schmidt, 1995; Ahituv, 2001; Bernanke and Gürkaynak, 2001). Nevertheless, our model is also consistent with evidence for earlier stages of industrialization when public education sectors were typically less developed and population growth was still quite fast: In this case our framework supports a positive correlation between economic growth and population growth, which is consistent with the empirical findings of Kremer (1993).

As already indicated, some aspects of the results in our paper have been shown within other frameworks. In particular, the notion that long-run economic growth is not solely driven by exogenously given population growth was the main reason for integrating horizontal and vertical innovations to remove the scale effect in otherwise endogenous growth models (cf. Dinopoulos and Thompson, 1998; Peretto, 1998; Young, 1998; Howitt, 1999). Moreover, *private* educational investments represent a main driving force behind long-run economic development for example in Dalgaard and Kreiner (2001) and Strulik et al. (2011). However, we are confident that our paper i) represents a consistent framework for analyzing these issues and their interrelations simultaneously, ii) sheds some light on the notion and importance of public education and especially on the connection between education and population growth, and iii), allows for a fairly general dependence of economic prosperity on population growth that is even consistent with the historical evidence.

We also acknowledge that our framework is highly stylized and some important issues cannot be treated within its realms. Possible extensions might therefore reveal other aspects of the connection between economic growth, education and demography. For example, the population growth rate and private educational investments could both be endogenized along the lines of Strulik et al. (2011) to analyze potential feedback effects between (public and privately financed) education, fertility and the teacher-pupil ratio. In particular, this could prove to be a useful framework for analyzing the extent to which public and private education complemented one another in the course of the industrial revolution (cf. Mokyr, 2005; Galor et al., 2009; Galor, 2011).

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