

Dang, Jing; Gillman, Max; Kejak, Michal

**Working Paper**

## Real business cycles with a human capital investment sector and endogenous growth: Persistence, volatility and labor puzzles

Cardiff Economics Working Papers, No. E2011/8

**Provided in Cooperation with:**

Cardiff Business School, Cardiff University

*Suggested Citation:* Dang, Jing; Gillman, Max; Kejak, Michal (2011) : Real business cycles with a human capital investment sector and endogenous growth: Persistence, volatility and labor puzzles, Cardiff Economics Working Papers, No. E2011/8, Cardiff University, Cardiff Business School, Cardiff

This Version is available at:

<https://hdl.handle.net/10419/65841>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

**Cardiff Economics  
Working Papers**

Jing Dang, Max Gillman and Michal Kejak

*Real Business Cycles with a Human Capital Investment  
Sector and Endogenous Growth: Persistence,  
Volatility and Labor Puzzles*

E2011/8

Cardiff Business School  
Cardiff University  
Colum Drive  
Cardiff CF10 3EU  
United Kingdom  
t: +44 (0)29 2087 4000  
f: +44 (0)29 2087 4419  
[www.cardiff.ac.uk/carbs](http://www.cardiff.ac.uk/carbs)

ISSN 1749-6101  
March 2011

This working paper is produced for discussion purpose only. These working papers are expected to be published in due course, in revised form, and should not be quoted or cited without the author's written permission. Cardiff Economics Working Papers are available online from: <http://www.cardiff.ac.uk/carbs/econ/workingpapers>  
Enquiries: [EconWP@cardiff.ac.uk](mailto:EconWP@cardiff.ac.uk)

# Real Business Cycles with a Human Capital Investment Sector and Endogenous Growth: Persistence, Volatility and Labor Puzzles

Jing Dang, SGCC, China;  
Max Gillman, Cardiff Business School, UK  
Michal Kejak, CERGE-EI, Prague

March 29, 2011

## Abstract

A positive joint two-sector productivity shock causes Rybczynski (1955) and Stolper and Samuelson (1941) effects that release leisure time and initially raises the relative price of human capital investment so as to favor it over goods production. This enables a basic *RBC* model, modified by having the household sector produce human capital investment sector, to succeed along related major dimensions of output, consumption, investment and labor, similar to the international approach of Maffezzoli (2000). By modifying the dynamics relative to the important work of Jones et al. (2005), two key US facts stressed by Cogley and Nason (1995) are captured: persistent movements in the growth rates of output and hump-shaped impulse responses of output. Further, physical capital investment has data consistent persistence within a hump-shaped impulse response. And Gali's (1999) challenging empirical finding that labour supply decreases upon impact of a positive productivity shock is reproduced, while volatility in working hours is also data-consistent because of the substitution between market and nonmarket sectors.

**JEL Classification:** E24, E32, O41

**Keywords:** Real business cycle, human capital, persistence, volatility, labor

# 1 Introduction

Traditional real business cycle (*RBC*) models have long been criticized for their lack of an interior propagation mechanism to spread the effect of a shock over time, starting with Cogley and Nason (1995) and Rotemberg and Woodford (1996). The dynamics of output predicted by a standard exogenous growth business cycle model tend to closely resemble the exogenous *TFP* innovations, so that the shock has to be highly autocorrelated. Still, related to this, Cogley and Nason (p. 492) summarize two stylized facts about the dynamics of US GNP that prototypical *RBC* models are unable to match:

“GNP growth is positively autocorrelated over short horizons and has weak and possibly insignificant negative autocorrelation over longer horizons. Second, GNP appears to have an important trend-reverting component that has a hump-shaped impulse response function.”

In basic *RBC* models that only rely on physical capital accumulation and intertemporal substitution to spread shocks over time, another problem is that the output and investment growth are often negatively and insignificantly autocorrelated over all horizons and output and investment usually have only monotonically decreasing impulse response curves following a positive technology shock. This is fixed most often by keeping exogenous growth and adding an ad hoc quadratic adjustment cost of physical capital, perhaps combined with habit persistence.

Labour supply volatility also tends to be low relative to US data: the one-sector standard *RBC* model in King and Rebelo (1999) predicts the volatility of labour supply to be about a half of that of output, compared to data with labour supply fluctuating nearly as much as does output. Adding external labor margins with exogenous growth helps on this,<sup>1</sup> but Gali (1999)

---

<sup>1</sup>Hansen (1985) has an indivisible labour supply, Rogerson (1988) an external labor margin, Burnside and Eichenbaum (1996) a factor-hoarding model, and Wen (1998) habit formation in leisure.

emphasizes that *RBC* models still cannot reproduce the empirical finding that labour supply decreases after a positive goods sector productivity shock, as described in Gali and Hammour (1991). Many complex approaches within exogenous growth have been taken to combat Gali's important critique.

Here we demonstrate that all of these dynamic features can be reproduced by taking a standard *RBC* model with a "household" or "home" sector,<sup>2</sup> except that the home sector produces human capital investment instead of a separate good that enters the utility function; and there is now an endogenous growth balanced growth path (*BGP*) equilibrium. The human capital investment does directly add utility, but rather affects the effective wage through a trade-off going back at least to Becker (1975). Next, we let the productivity shock be identical across both goods and human capital investment sectors, as if it were a single aggregate productivity shock. Unlike a typical *TFP* shock, this aggregate shock causes a permanent effect to levels of consumption and output as the growth rate of human capital gets shocked upwards, leading to resolution of the salient facts mentioned. The "internal propagation mechanism" is simply that the aggregate productivity shock causes reallocation across sectors with the goods output gradually rising, goods sector labor at first falling, and physical capital investment having its expected hump shape. The shock results can be explained in standard international trade terms: a Rybczynski (1955) effect whereby an increase in the supply of a factor, this being more human capital as the agent takes less leisure, favors the sector intensive in that factor by lowering its relative price and increasing its demand, this being the human capital investment sector.<sup>3</sup> Simultaneously, there is a Stolper and Samuelson (1941) effect in the other direction of an increase in the relative price of output of one sector, being the human capital investment sector, that raises the quantity supplied by shifting resources towards more human capital investment. The relative

---

<sup>2</sup>See the seminal papers of Greenwood and Hercowitz (1991) and Benhabib et al. (1991), updated for example by Rupert et al. (2000).

<sup>3</sup>Rybczynski (1955): "Our conclusion is that an increase in the quantity of one factor will always lead to a worsening in the terms of trade, or the relative price, of the commodity using relatively much of that factor." Less leisure use increases the usage rate of human capital in productive activity, effectively increasing its supply.

price of human capital investment at first rises and then falls

Such features are absent in Jones et al. (2005) who also have such an aggregate productivity shock, but only a one sector economy, while the intersectoral reallocation induced by the human capital investment sector creates a concave economy-wide production possibility frontier, as discussed in Mulligan and Sala-I-Martin (1993;section IIIb). Perli and Sakellaris (1998) has a constant elasticity of substitution aggregator of skilled and unskilled labour, without a balanced growth path equilibrium or shocks to the human capital investment sector. Maffezzoli (2000) has an extended model relative to ours, with spillovers and two countries. DeJong and Ingram (2001) include human capital investment as a second sector and their empirical findings and those of Dellas and Sakellaris (2003) both suggest significant substitution between skills acquisition or higher education and competing labour market activities over business cycle frequencies, which add support to the approach of our paper.

Sections 2 and 3 set out the model, its equilibrium, and a postwar US data based calibration. Section 4 shows numerical results, with Section 5 conducting sensitivity analysis. Section 6 compares the results to Jones et al. (2005), using four variants of the two-sector model, including one case that nests the one sector model. Section 7 concludes.

## 2 Model environment

### 2.1 The model

The representative agent maximizes the expected sum of discounted utility derived from a stream of consumptions and leisure, denoted by  $C_t$  and  $L_t$  at time  $t$ . With  $A > 0$ , and  $\sigma > 0$ , the time  $t$  utility is given by

$$U(C_t, L_t) = \frac{(C_t L_t^A)^{1-\sigma} - 1}{1 - \sigma},$$

which satisfies necessary conditions for existence of a balanced growth path equilibrium (King et al., 1988). The representative agent is confined by a time endowment constraint for every period  $t$ , where  $N_t$  is the fraction spent

in goods production, and  $M_t$  in human capital investment production:

$$N_t + M_t + L_t = 1 \quad (1)$$

The laws of motions of physical capital  $K_t$  and human capital  $H_t$ , with  $\delta_k$  and  $\delta_h$  denoting the assumed constant depreciation rates, and  $I_{kt}$  and  $I_{ht}$  denoting investment in physical and human capital, are

$$I_{kt} = K_{t+1} - (1 - \delta_k)K_t \quad (2)$$

$$I_{ht} = H_{t+1} - (1 - \delta_h)H_t \quad (3)$$

Denote by  $Y_t$  the real goods output that corresponds to the notion of *GDP*;  $A_g$  is a positive factor productivity parameter;  $Z_t$  is a productivity shock described below;  $K_t$  is the physical capital stock that has been accumulated by the beginning of period  $t$ ;  $V_t$  is the share of the physical capital stock being used in the goods sector;  $V_t K_t$  is the amount of capital used in goods production.  $H_t$  is stock of human capital at the beginning of period  $t$ ;  $N_t$  denotes the share of time used in goods production;  $N_t H_t$  represents the “effective labour input”, or more simply the amount of human capital used. And  $\phi_1 \in [0, 1]$  is share of physical capital in the production function:

$$Y_t = F(V_t K_t, N_t H_t) = A_g Z_t (V_t K_t)^{\phi_1} (N_t H_t)^{1-\phi_1} \quad (4)$$

The technology shock to physical sector is assumed to evolve according to a stationary autoregressive process, described in log form as:

$$\log Z_{t+1} = \rho_z \log Z_t + \varepsilon_{t+1}^z.$$

The innovations  $\varepsilon_{t+1}^z$  is a sequence of independently and identically distributed normal random variables with mean zero and variance  $\sigma_z^2$ .

Human capital is reproducible in a separate sector. Social activities in the real economy that typically are thought of as corresponding to this sector include formal education, job trainings and, some argue, elements such as health care. Production of human capital investment also is constant return to scale in terms of physical and human capital inputs.  $I_{ht}$  denotes the new human capital produced in this period;  $A_h > 0$  is the productivity parameter

for the human capital sector;  $S_t$  represents the productivity shock to human sector;  $1 - V_t$  is the remaining fraction of physical capital allocated to the human capital investment sector;  $M_t$  denotes the fraction of human capital used in production; and  $\phi_2$  is the rental share of physical capital in the value of the human capital investment output:

$$I_{ht} = G[(1 - V_t)K_t, M_t H_t] = A_h S_t [(1 - V_t)K_t]^{\phi_2} (M_t H_t)^{1-\phi_2}. \quad (5)$$

The productivity shock to human capital sector takes the form

$$\log S_{t+1} = \rho_s \log S_t + \varepsilon_{t+1}^s,$$

where the innovations  $\varepsilon_{t+1}^s$  is a sequence of independently and identically distributed normal random variables with mean zero and variance  $\sigma_s^2$ .

With no externalities, the competitive equilibrium of the economy coincides with the result of the social planner problem, which is stated as:

$$\begin{aligned} & \underset{C_t, V_t, L_t, N_t, M_t, H_{t+1}, K_{t+1}}{MAX} && E_0 \sum_{t=0}^{\infty} \beta^t \frac{(C_t L_t^A)^{1-\sigma} - 1}{1-\sigma} \\ & s.t. && (4), (5), (1), (2), (3) \end{aligned} \quad (6)$$

## 2.2 Equilibrium

**Definition 1** *A general equilibrium of this model is a set of contingent plans  $\{C_t, K_{t+1}, H_{t+1}, V_t, L_t, N_t, M_t\}$  that solve the central planner's maximization problem (6) for some initial endowment  $\{K_0, H_0\}$  and exogenous stochastic technology processes  $\{Z_t, S_t\}$ , with initial conditions  $\{Z_0, S_0\}$ .*

**Definition 2** *A deterministic balanced growth path equilibrium of this model is a set of paths  $\{\bar{C}_t, \bar{K}_{t+1}, \bar{H}_{t+1}, \bar{V}_t, \bar{L}_t, \bar{N}_t, \bar{M}_t\}$  that solve the central planner's maximization problem (6) for some initial endowment  $\{K_0, H_0\}$  and exogenous technology parameters  $\{\bar{Z}_t = 1, \bar{S}_t = 1\}$ , such that  $\{\bar{C}_t, \bar{K}_{t+1}, \bar{H}_{t+1}\}$  grow at a common trend, and  $\{\bar{V}_t, \bar{L}_t, \bar{N}_t, \bar{M}_t\}$  are constant.*

For existence and uniqueness of the deterministic *BGP* equilibrium, note that the maximization problem is nonconcave, because the human capital stock has asymmetric effects on different uses of time: it enhances productive



time but not leisure, allowing for potentially multiple steady states.<sup>4</sup> There may be multiple steady states but in Appendix A, uniqueness of the steady state is shown to be reduced down to the uniqueness of a single variable, the balanced growth rate. Numerical checks on the calibrations, with robustness to sensitivity analysis, finds that there is always a unique internal steady state so that leisure time on balanced growth path is between 0 and 1 (See Ben-Gad, 2007).

Also the usual sufficient second order conditions guaranteeing optimality do not apply, in that the Arrow (1968) condition is not met generically and the Mangassarian (1966) condition is not met at least for the particular calibration. However, Ladron-De-Guevara et al. (1999) show in a similar endogenous growth model with leisure that stable steady states with non-complex roots correspond to optimal solutions (theorem 3.1 p. 614 and in their appendix). In the baseline calibration here, and in various alternative specifications, the dynamics of the state-like variable  $\left(\frac{K}{H}\right)$  near the unique steady state is stable with non-complex roots, with the implication that the first order conditions should correspond to a maximum.

## 2.3 Equilibrium Dynamics

With  $\lambda_t$  and  $\mu_t$  the co-state variables to physical and human capital respectively, such that the first-order conditions are

$$\begin{aligned} U_{1,t} &= \lambda_t, \quad U_{2,t} = \lambda_t F_{2,t} H_t, \quad U_{2,t} = \mu_t H_{2,t} H_t, \quad \lambda_t F_{1,t} = \mu_t H_{1,t}, \\ \lambda_t &= E_t \beta \left( \lambda_{t+1} V_{t+1} F_{1,t+1} + \mu_{t+1} (1 - V_{t+1}) H_{1,t+1} + 1 - \delta_k \right), \\ \mu_t &= E_t \beta \left( \mu_{t+1} M_{t+1} H_{2,t+1} + \lambda_{t+1} N_{t+1} F_{2,t+1} + 1 - \delta_h \right). \end{aligned}$$

Define  $P_t \equiv \frac{\mu_t}{\lambda_t}$  as the relative price of human capital in terms of physical capital. Note that since physical capital and goods output are perfect substitutes (output can be turned into new physical capital without cost) then  $P_t$  is also the price of the human capital investment sector relative to the goods sector. Also denote by  $r_t$  and  $W_t$  the own marginal productivity conditions

---

<sup>4</sup>To see this, rewrite agents' utility function as:  $U = \frac{(C_t(L_t H_t)^A H_t^{-A})^{1-\sigma} - 1}{1-\sigma}$ . The objective function loses the property of joint concavity because of the term  $H_t^{-A}$ .

of physical and human capital such that  $r_t \equiv F_{1,t}$  and  $W_t \equiv F_{2,t}$ . The first order conditions can be stated as

$$\frac{AC_t}{L_t} = W_t H_t \quad (7)$$

$$\frac{1 - \phi_1}{\phi_1} \frac{V_t K_t}{N_t H_t} = \frac{1 - \phi_2}{\phi_2} \frac{(1 - V_t) K_t}{M_t H_t} \quad (8)$$

$$P_t = \frac{Z_t A_g}{S_t A_h} \left( \frac{\phi_1}{\phi_2} \right)^{\phi_2} \left( \frac{1 - \phi_1}{1 - \phi_2} \right)^{1 - \phi_2} \frac{V_t K_t}{N_t H_t}^{\phi_1 - \phi_2} \quad (9)$$

$$1 = E_t \beta \left[ \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{L_{t+1}}{L_t} \right)^{A(1-\sigma)} (1 + r_{t+1} - \delta_k) \right] \quad (10)$$

$$1 = E_t \beta \left[ \left( \frac{P_{t+1}}{P_t} \right) \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{L_{t+1}}{L_t} \right)^{A(1-\sigma)} \left( 1 + (1 - L_{t+1}) \frac{W_{t+1}}{P_{t+1}} - \delta_h \right) \right] \quad (11)$$

Equation (7) sets the marginal rate of substitution between consumption and leisure equal to the relative price of leisure; (8) equates weighted factor intensities across sectors; (9) expresses the relative price of human capital as a function of the factor intensity in the goods sector in general, but shows it is exogenously determined if  $\phi_1 = \phi_2$ . Equations (10) and (11) are intertemporal capital efficiency, or "arbitrage", for human and physical capital, where the "capacity utilization" factor of human capital is one minus leisure,  $(1 - L_{t+1})$ , and it affects both the dynamics and the growth rate<sup>5</sup>. The dynamics of the model are summarized by two complementary sets of conditions: static equilibrium conditions that govern intratemporal resources allocations (equations (7), (8) and (9)) and dynamic conditions that determine investment decisions (equations (10) and (11)).

By equations (1), (8) and (9),

$$\frac{V_t (1 - N_t - L_t)}{N_t (1 - V_t)} = \frac{\phi_1 (1 - \phi_2)}{\phi_2 (1 - \phi_1)}, \quad (12)$$

---

<sup>5</sup>In contrast, Collard (1999) allows human capital to enter utility function directly by specifying a momentary utility function similar to  $\frac{(C(LH)^A)^{1-\sigma} - 1}{1-\sigma}$ . Human capital is then fully utilized such that its net return is  $\frac{W}{P} - \delta_h$ . In our results, human capital capacity utilization plays a key role in that it affects the steady state growth rate:  $[(1 + (1 - L) \frac{W}{P} - \delta_h) / (1 + \rho)]^{1/\sigma} - 1$ .

if an aggregate productivity shock causes decreases in both leisure  $L_t$  and labor in the goods sector,  $N_t$ , then it must be also that the share of physical capital in the goods sector,  $V_t$ , also must fall in order for the righthandside of equation (12) to remain constant. This is in fact what impulse responses show to be the case in the relevant section below. However this demonstrates the sense in which leisure produces a type of asymmetry that drives dynamic results in the sense of the Rybczynski (1955) increase in a factor.

The relative price ends up rising initially, and falling later, as a result of the productivity shock, and this gives a full general equilibrium basis in a change in exogenous processes for the Stolper and Samuelson (1941) theorem. Unlike an unspecified reason for the relative price to rise, which Stolper and Samuelson (1941) say is not important to specify in their footnote 3, here the aggregate productivity shock causes the subsequent price and marginal product changes as tempered at the same time by a Rybczynski effect through the decrease in leisure.

Consider that capital factor rewards by equations (8) and (9), can be derived analytically as functions of  $P_t$ :

$$r_t = S_t^{\frac{\phi_1-1}{\phi_1-\phi_2}} Z_t^{\frac{1-\phi_2}{\phi_1-\phi_2}} \Psi_r P_t^{\frac{\phi_1-1}{\phi_1-\phi_2}}, \quad (13)$$

$$\Psi_r = \phi_1 A_h^{\frac{\phi_1-1}{\phi_1-\phi_2}} A_g^{\frac{1-\phi_2}{\phi_1-\phi_2}} \left( \frac{\phi_2}{\phi_1} \right)^{\frac{\phi_2(\phi_1-1)}{\phi_1-\phi_2}} \left( \frac{1-\phi_2}{1-\phi_1} \right)^{\frac{(1-\phi_2)(\phi_1-1)}{\phi_1-\phi_2}},$$

$$W_t = S_t^{\frac{\phi_1}{\phi_1-\phi_2}} Z_t^{\frac{-\phi_2}{\phi_1-\phi_2}} \Psi_w P_t^{\frac{\phi_1}{\phi_1-\phi_2}}, \quad (14)$$

$$\Psi_w = (1-\phi_1) A_h^{\frac{\phi_1}{\phi_1-\phi_2}} A_g^{\frac{-\phi_2}{\phi_1-\phi_2}} \left( \frac{\phi_2}{\phi_1} \right)^{\frac{\phi_1\phi_2}{\phi_1-\phi_2}} \left( \frac{1-\phi_2}{1-\phi_1} \right)^{\frac{\phi_1(1-\phi_2)}{\phi_1-\phi_2}}.$$

**Proposition 3** *The sign of the derivative of  $r_t$  and  $W_t$  with respect to  $P_t$  depends only on the factor intensity ranking.*

**Proof.** Given the assumption that human capital investment is relatively more human capital intensive than goods production, so that  $\phi_1 > \phi_2$ , then by equations (13) and (14),  $r'_t(P_t) < 0$  and  $W'_t(P_t) > 0$ . ■

**Corollary 4** *An increase in the price of human capital relative to physical capital, given unchanged relative productivity parameters between sectors, increases the reward to human capital while decreasing the reward to physical capital.*

**Proof.** Consider that from equations (13) and (14),

$$\hat{W}_t - \hat{r}_t = \frac{\hat{P}_t - (\hat{Z}_t - \hat{S}_t)}{\phi_1 - \phi_2} \quad (15)$$

with " $\hat{\cdot}$ " denoting the variable's percentage deviation from its corresponding steady state value. With  $\phi_1 > \phi_2$ , and identical shocks such that  $\hat{Z}_t = \hat{S}_t$ , an upswing in  $P_t$  causes  $\hat{W}_t - \hat{r}_t$  to increase, where  $W_t$  rises and  $r_t$  falls. ■

This is a general equilibrium form of the Stolper and Samuelson (1941) theorem: in a two-sector production model, an increase in the relative price of output of one sector rewards relatively more the factor that is used more intensively in this sector.

In equilibrium, the rate of return to physical capital equals the rate of return to human capital plus some form of "capital gain" of human capital investment, along with differentiated covariance risk effects. From equations (10) and (11),

$$\begin{aligned} & E_t [1 + r_{t+1} - \delta_k] \\ = & E_t \left[ \frac{P_{t+1}}{P_t} \left( 1 + (1 - L_{t+1}) \frac{W_{t+1}}{P_{t+1}} - \delta_h \right) \right] \\ & \frac{Cov_t \left[ \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{L_{t+1}}{L_t} \right)^{A(1-\sigma)}, (1 + r_{t+1} - \delta_k) \right]}{E_t \left[ \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{L_{t+1}}{L_t} \right)^{A(1-\sigma)} \right]} \\ & + \frac{Cov_t \left[ \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{L_{t+1}}{L_t} \right)^{A(1-\sigma)}, \frac{P_{t+1}}{P_t} \left( (1 - L_{t+1}) \frac{W_{t+1}}{P_{t+1}} + 1 - \delta_h \right) \right]}{E_t \left[ \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{L_{t+1}}{L_t} \right)^{A(1-\sigma)} \right]} \end{aligned}$$

This "no-arbitrage" condition suggests how the adjustment process is stable when human capital investment sector is more human capital intensive than

the goods sector (i.e.  $\phi_1 > \phi_2$ ). For simplicity of presentation, note that with equal covariance terms, and letting  $\delta_h = \delta_h \equiv \delta$ , and  $L_{t+1} = 0$  for the moment, then equation (15) allows the no-arbitrage equation to reduce to

$$\hat{P}_t = \left( 1 + \frac{r}{1+r-\delta} \frac{1 - (\phi_1 - \phi_2)}{\phi_1 - \phi_2} \right) E_t \hat{P}_{t+1},$$

where  $r$  is the steady state value for  $r_{t+1}$ . The coefficient  $1 + \frac{r}{1+r-\delta} \frac{1 - (\phi_1 - \phi_2)}{\phi_1 - \phi_2}$  is greater than 1 *iff*  $\phi_1 > \phi_2$  given normal parameters ranges so that  $r - \delta > 0$ .<sup>6</sup>

On impact of a positive aggregate shock, the relative price of human capital investment increases initially, as physical capital investment can be made without cost from goods output while human capital investment requires time and so is relatively scarce. This induces resources flow from the goods sector to the human capital investment sector. However the increase in leisure, which reinforces the magnitude of the increase in the human capital investment, also pressures down the relative price  $P_t$  and in subsequent periods, this price decreases and the direction of the inter-sectoral resource transfer reverses. As the effect of the shock dies out in subsequent periods, labour flows back slowly to the goods sector due to an optimal spreading of the inter-sectoral adjustment cost across periods.

The shock also gives an inverse relation between productivity and market employment: when productivity increases, labor is shifted from the goods sector to the human capital investment sector, even as output in the goods sector expands.<sup>7</sup> Rather than encouraging goods sector employment, higher productivity results in an initially lower employment rate (excluding the household sector). Market output still increases mildly because the positive technology effect dominates the negative effect induced by the outflow of labor, and of physical capital.

---

<sup>6</sup>Similar results are found in Barro and Sala-I-Martin (1995) and Bond et al. (1996).

<sup>7</sup>Gali and Hammour (1991, p.15) suggest "Recessions have a 'cleaning-up' effect that causes less productive jobs to be closed down. This can happen either because those jobs become unprofitable, or because recessions provide an excuse for firms to close them down in the context of formal or informal worker-firms arrangements. As a consequence, the average productivity of jobs will rise."

## 2.4 Normalization

The characterization of the equilibria of similar two-sector endogenous growth models is in Caballe and Santos (1993) and Bond et al. (1996), without leisure, and in Ladron et al. (1997) with leisure. Due to nonstationarity of steady state, the standard log-linearization method does not apply directly. However, if those growing variables are transformed to have stationary distributions, one can linearize the model in the neighborhood of the stationary transformation. To compute the impulse response function of output, non-stationary variables can be normalized by discounting at the rate of their common constant *BGP* growth rate  $\gamma$ , which is independent with the initial resource endowments:

$$c_t \equiv \frac{C_t}{(1 + \gamma)^t}, \quad k_t \equiv \frac{K_t}{(1 + \gamma)^t}, \quad h_t \equiv \frac{H_t}{(1 + \gamma)^t}$$

In the nonstochastic version of the transformed model, all variables will converge to and continue to stay on a particular *BGP* once the initial values for the physical and human capital are given, with no indeterminacy of *BGP* once the initial resource endowment is fixed.

For simulations of this stochastic growth model, however, a new *BGP*, in general, will be triggered when a shock occurs to the economy. In other words, the non-stationary variables do not converge back to the previous *BGP* after even a temporary shock. Normalization by a deterministic trend is only valid to attain impulse response functions that capture the reactions of variables after only one shock, rather than repeated shocks. The normalization method used to simulate the model is to divide all growing variables by the current stock of human capital such that variables in ratios are constant along nonstochastic *BGP*:

$$c_t \equiv \frac{C_t}{H_t}, \quad k_t \equiv \frac{K_t}{H_t}, \quad \gamma_{ht+1} \equiv \frac{H_{t+1}}{H_t}.$$

For details on solving the model numerically under the two different scaling methods, please refer to Appendix B.

### 3 Calibration

Gomme and Rupert (2007) detail a calibration for business cycle statistics using models with a second "household" sector. The calibration is therefore made close to that of Gomme and Rupert except where Perli and Sakellaris and others provide estimates used for the human capital sector specifically, here as a special case of household production. The data set is US quarterly from 1954 to 2004, as provided by Gomme and Rupert; Appendix C provides a detailed data description. All parameters are on a quarterly basis unless stated otherwise.

Table 1 presents the calibrated parameters and target values of variables. Utility is assumed to be log, with a 1.55 leisure preference weight, and a unitary coefficient of relative risk aversion; the physical capital share in the goods sector is 0.36, as is standard; the time preference discount factor is 0.986. For the period, the US GDP, aggregate consumption and investment, on average, grew roughly at a common rate 0.42% per quarter, providing the targeted balanced growth path growth rate. The depreciation rate of physical capital is 0.20, to match in the steady state the empirical physical capital investment to output ratio of approximately 25.3%.

Early results by Jorgenson and Fraumeni (1989) suggest an annual depreciation rate of human capital between 1% and 3%; Jones et al. (2005) estimate a lower bound for this at about 1.5%, while using an intermediate value at 2.5% yearly, which corresponds to about 0.625% quarterly; DeJong and Ingram (2001) estimate 0.5% per quarter. We follow this latter estimate and use it for the baseline case.

Labour supply is targeted at 0.3, with Jones et al. (2005) having a low-end value of 0.17, and Gomme and Ruppert (2007) at 0.255. Leisure is 0.54 compared to 0.505 in Gomme and Ruppert, and human capital investment time is 0.16 compared to 0.24 of household time in Gomme and Ruppert.

Perli and Sakellaris (1998) assume the human capital investment sector in theory has its real economy counterparts in two social activities: education and on-the-job training, similar to Becker (1975). Using data from Jorgenson and Fraumeni (1989), they calculate the contribution of physical capital to

educational output at 8%, with labour's share at 92%. For job training, they assume the same technology as for goods production, arriving at a weighted average of the share of physical capital in human capital investment between 11% and 17%. We use the lower bound of 0.11 for the baseline calibration.<sup>8</sup>

The technology shock to the goods sector is calibrated in typical fashion given the well-known difficulty in separating out human capital. The resulting autocorrelation coefficient of  $\log Z_t$  recovered from Solow residuals is about 0.95 and the variance of innovation is about 0.0007, a result close to Perli and Sakellaris. The technology shock to the human capital investment sector is assumed identical to the shock to physical sector, every period, so there is in essence just one aggregate shock affecting both sectors, as in Jones et al. (2005). Separate sectoral shocks are allowed in the section below on sensitivity analysis. The scale parameter associated to physical sector,  $A_g$ , is normalized to one and  $A_h$  is set equal to 0.0461.

## 4 Numerical results

### 4.1 Impulse response functions

Figure 1 shows the impulse response functions for an equal technology shock to both sectors simultaneously for selected nonstationary variables. Similar to data, the reaction of consumption and output is small on impact and continues to increase in subsequent periods, while investment shows a hump and human capital rises initially and then declines monotonically. The initially small reaction of output on impact is the joint effect of the relative price and Rybczynski (1955) effects, pushing factors towards the human capital sector even as goods productivity rises. In subsequent periods, the flow back of factors towards the goods sector starts to reinforce the now-fading of the goods sector productivity shock, so as to sustain the long-lasting expansion in output. The hump response of physical capital investment emerges since it is the difference between output rising faster than consumption. The responses of these variables do not resemble the goods sector technology shock

---

<sup>8</sup>See also Einarsson and Marquis (1999).



Baseline Calibration of Parameters		
$\beta$	Subjective discount factor	0.986
$\sigma$	Coefficient of relative risk aversion	1
$A$	Weight of leisure in preference	1.55
$\phi_1$	Share of physical capital in physical sector	0.36
$\phi_2$	Share of physical capital in human sector	0.11
$\delta_k$	Depreciation rate of physical capital	0.02
$\delta_h$	Depreciation rate of human capital	0.005
$A_g$	Scale parameter for goods sector	1
$A_h$	Scale parameter of human sector	0.0461
$\rho_z = \rho_s$	Persistence parameter of shock	0.95
$\sigma_z^2 = \sigma_s^2$	Variance of innovation	0.0007
Target Values of Variables		
$\gamma$	BGP growth rate	0.0042
$r$	Steady state real interest rate	0.0185
$A_h$	Scale parameter of human sector	0.0461
$N$	Steady state working time	0.3
$M$	Steady state learning time	0.16
$L$	Steady state leisure time	0.54
$A$	Weight of leisure in preference	1.55
$\frac{C}{Y}$	Steady state consumption-output ratio	0.75
$\frac{I_k}{Y}$	Steady state physical investment-output ratio	0.25
$V$	Steady state share of physical capital in goods sector	0.89

Table 1: Calibration of the two-sector SEG model

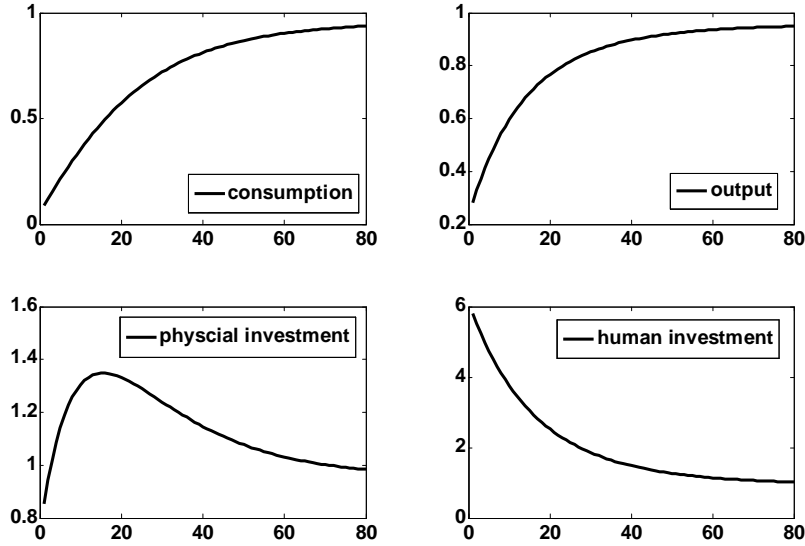


Figure 1: Impulse response functions to technology shock

itself, indicating a sense in which the human capital sector causes an "internal propagation mechanism".

Figure 2 shows positive aggregate shock effect on selected stationary variables, which return to the initial equilibrium after the transitory shock. Leisure decreases on impact due to higher productivity in the productive use of time; working hours decrease and learning time increases. The decline of working hours on impact is consistent with the empirical finding of Galí (1999), who identifies a negative correlation between productivity and working hours using VAR evidence. Therefore the observed decline in working hours in face of higher labour productivity is consistent with this *RBC* model. The "physical capital allocation" refers to the variable  $V_t$ , the share of physical capital in the goods sector, which declines as resources flow to the human capital investment sector.

Figure 3 shows how the aggregate productivity shock affects the marginal input products versus the relative sectoral output price, of human capital investment to goods output. It demonstrates that the Stolper and Samuelson

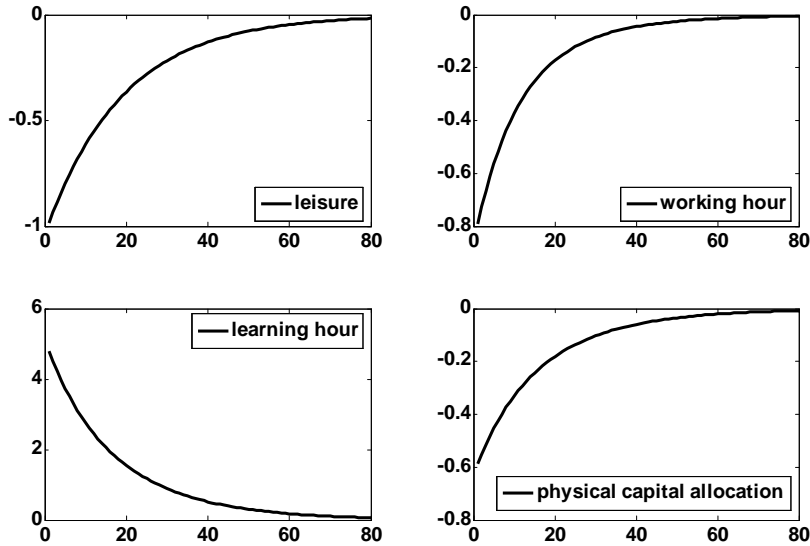


Figure 2: Impulse response functions to technology shock

(1941) effect of equation (15) holds in this general equilibrium. The relative price of human capital  $P_t$  is higher than its steady state value when  $\hat{W}_t$ , the top-most curve at period 1, lies above  $\hat{r}_t$ . And  $P_t$ , the bottom curve, rises initially above 0, but then falls below 0 as  $\hat{W}_t$  falls below  $\hat{r}_t$ .

## 4.2 Persistence and volatility

Table 2 reports the statistics computed from US data and a simulated sample of 30,000 periods. The data set to calculate moment statistics is the same as what is used for calibration. Due to the endogenous growth component of the model, the nonstochastic steady state of the model economy is growing at an endogenously determined rate. The nonstationarity of steady state means it is not possible to compute standard volatility statistics. An alternative approach is to calculate moment statistics of growth rates of variables, which by construction have stationary distributions along the *BGP*, as in Jones et al. (2005).

The third column of Table 2 shows that US data suggests the consumption

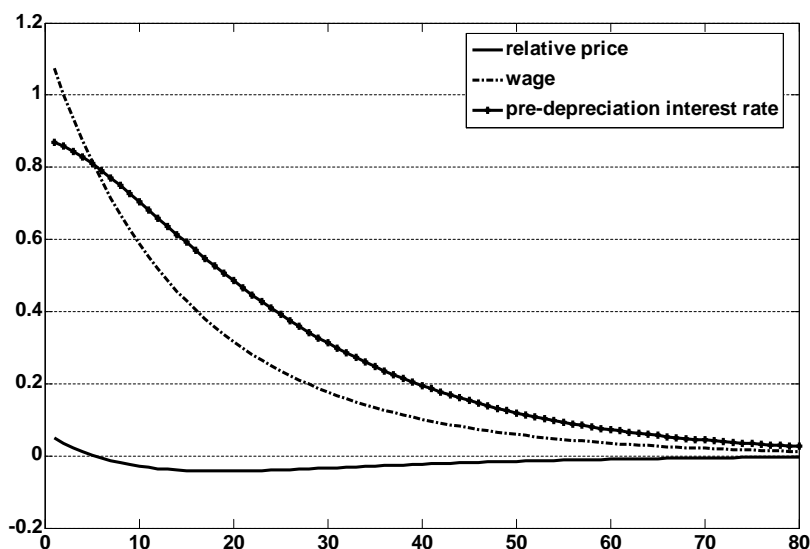


Figure 3: Impulse response functions to technology shock: Stolper-Samuelson effect

growth rate fluctuates about half as much as output growth, which in turn fluctuates about half that of investment growth. And the endogenous growth model fits these volatilities quite well although, with some under-prediction. The model's volatility of output growth is 0.82 compared to 1.14 in the data; simulated consumption growth volatility is 0.43 compared to 0.52 in the data; and the simulated investment growth volatility is 2.23 compared to 2.38 in the data. The endogenous growth model shows resolution of the labour volatility puzzle; in Table 2, the model's simulated volatility of hours is 0.54, well matching its empirical counterpart of 0.52.

The fourth to sixth columns of Table 2 show a weakness of the model, in general terms of too much higher order persistence. The model replicates the autocorrelation properties of output growth data strikingly well in the first order autocorrelation coefficient, producing exactly the same degree of first-order persistence as observed in the data. However, higher order autocorrelation coefficients in the data fall to zero more quickly than those simulated from the model.

Note that the autocorrelation coefficient of investment growth is usually not reported in business cycle research. But in the data, the growth rate of investment is autocorrelated at an even higher degree than those of output and consumption (0.38 compared to 0.29 and 0.24). Conventional *RBC* models fail to reproduce the persistence of investment growth for the same reason as they fail for output growth, yet the model captures some of this persistence, matching it in the third-order term. For working hours, the model does well but generates somewhat less persistence than in the data.

With regards to the contemporaneous correlations between output growth and other variables and the lead-and-lag pattern, in general, the model fits the data well. Consumption and investment growth are pro-cyclical both in the model and data. However, in the data, labour supply is only slightly negatively correlation with output growth, at  $-0.07$ , but the model predicts labour supply to be more strongly counter-cyclical, at  $-0.73$ . In addition, output growth is mildly and positively correlated with next period labour supply in the data (0.01) while the model predicts a negative value for the same correlation ( $-0.67$ ).

## 5 Sensitivity analysis

This section presents tests on the robustness of the results obtained previously regarding business cycle persistence and cyclical moments to alternative specifications of exogenous parameters. For a first alternative specification, consider lowering the autocorrelation coefficient of the aggregate productivity shock down from 0.95. Combining this variation with an increase in the human capital depreciation rate from 0.005 up to 0.015, there is some ability to decrease the aggregate shock autocorrelation downwards and still retain a similar ability to match the business cycle data, a somewhat striking feature.

Table 3 shows for example that with  $\rho_z = \rho_s \equiv \rho = 0.85$  and  $\delta_h = 0.015$ , the match of output growth persistence is still good; the match with consumption and investment growth persistence improve, while the labor persistence falls below the data level. And the volatility of the growth of these variables falls further down from the data levels. A decrease from

$x_t$		$\sigma(x_t)$	$\rho(x_t, x_{t-j})$			$\rho(\gamma_{Y_t}, x_{t+j})$					
			$j =$	1	2	3	-2	-1	0	1	2
$\gamma_{Y_t}$	data	1.14		0.29	0.16	0.03	0.16	0.29	1	0.29	0.16
	model	0.82		0.29	0.27	0.25	0.27	0.29	1	0.29	0.27
$\gamma_{C_t}$	data	0.52		0.24	0.14	0.19	0.20	0.37	0.49	0.27	0.16
	model	0.43		0.78	0.75	0.73	0.35	0.38	0.83	0.50	0.49
$\gamma_{I_{kt}}$	data	2.38		0.38	0.24	0.11	0.17	0.39	0.75	0.41	0.24
	model	2.23		0.14	0.11	0.10	0.19	0.21	0.96	0.15	0.11
$N_t$	data	5.52		0.99	0.96	0.93	-0.22	-0.18	-0.07	0.01	0.07
	model	5.54		0.92	0.85	0.73	-0.37	-0.40	-0.73	-0.67	-0.62

Table 2: Business Cycle Statistics and Simulations for Baseline Calibration

$\gamma_x$  is the growth rate of variable  $x$ ;  $N$  is fraction of time spent working in the goods sector;  $\sigma(x)$  measures variable's percentage deviation from the mean;  $\rho(x, y)$  is the correlation coefficient of variables  $x$  and  $y$ . The model predicts  $\gamma_Y, \gamma_C, \gamma_{I_k}$  and  $N$  to have stationary distributions along *BGP*. Therefore, US aggregate data on  $Y, C, I_k$  are logged and first-differenced and data on working hours is in levels. Unit root tests on the data suggest that the logged and first differenced series of output, consumption and physical investment are stationary, but not the level of per-capita working hours. The variability of per-capita working hours is therefore normalized by the mean and measured by  $\frac{\sigma(N)}{E(N)}$ .

	Persistence of $x$				Volatility of $x$				
	$x =$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$
US data		0.29	0.24	0.39	0.99	1.14	0.52	2.38	5.52
Baseline ( $\rho = 0.95$ )		0.29	0.77	0.14	0.92	0.82	0.43	2.36	5.44
$\rho = 0.90, (\delta_h = 0.015)$		0.63	0.70	0.64	0.82	0.63	0.38	1.43	4.21
$\rho = 0.85, (\delta_h = 0.015)$		0.31	0.63	0.24	0.77	0.69	0.30	1.81	3.41
$\rho = 0.80, (\delta_h = 0.015)$		0.16	0.61	0.09	0.73	0.75	0.26	2.16	2.93

Table 3: Changes in the aggregate shock autocorrelation

$\rho = 0.95$  to  $0.85$  is a significant decrease in the persistence built into the shock process, made possible by the additional human capital sector.

While identical shocks to both sectors appear necessary in experiments to generate the reasonable results thus far presented, one modest deviation from identical shocks is presented next through different correlation coefficients of the shock innovations. A generalized representation of exogenous forces in the two-sector model is to represent sector-specific shocks as a vector autoregressive process:

$$\begin{bmatrix} \log Z_{t+1} \\ \log S_{t+1} \end{bmatrix} = \begin{bmatrix} \rho_z & 0 \\ 0 & \rho_s \end{bmatrix} \begin{bmatrix} \log Z_t \\ \log S_t \end{bmatrix} + \begin{bmatrix} \varepsilon_{t+1}^z \\ \varepsilon_{t+1}^s \end{bmatrix}$$

where  $\varepsilon_{t+1}^z$  and  $\varepsilon_{t+1}^s$  are i.i.d. disturbances to  $\log Z_{t+1}$  and  $\log S_{t+1}$  respectively. Assuming 0 elements in the upper-right and lower-left positions in the autocorrelation coefficient matrix implies no technology diffusion across sectors. The variance-covariance matrix of the disturbances is:

$$V \begin{bmatrix} \varepsilon_{t+1}^z \\ \varepsilon_{t+1}^s \end{bmatrix} = \begin{bmatrix} \sigma_z^2 & \sigma_{zs} \\ \sigma_{zs} & \sigma_s^2 \end{bmatrix}$$

where  $\sigma_{zs} = \rho_{zs}\sigma_z\sigma_s$ , and  $\rho_{zs}$  is the correlation coefficient of  $\varepsilon_t^z$  and  $\varepsilon_t^s$ . Still assuming that  $Z_t$  and  $S_t$  have the same specifications of  $\rho_z = \rho_s \equiv \rho$  and  $\sigma_z^2 = \sigma_s^2$ , realizations of  $Z_t$  and  $S_t$  can be different if a departure is made from the baseline assumption that  $\rho_{zs} = 1$ . Table 4 displays the model's simulated persistence and volatility for different values of  $\rho_{zs}$ . It emerges that as  $\rho_{zs}$  falls, output and investment growth persistence fall, consumption growth persistence rises and then falls, and labor growth falls only slightly.

	Persistence of $x$				Volatility of $x$				
	$x =$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$\gamma_N$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$
US data		0.29	0.24	0.39	0.99	1.14	0.52	2.38	5.52
Baseline ( $\rho_{zs} = 1$ )		0.29	0.77	0.14	0.92	0.82	0.43	2.36	5.44
$\rho_{zs} = 0.995$		0.16	0.71	0.05	0.92	1.08	0.44	3.33	5.62
$\rho_{zs} = 0.99$		0.11	0.68	0.01	0.92	1.27	0.46	4.03	5.81
$\rho_{zs} = 0.95$		0.03	0.49	-0.04	0.90	2.29	0.60	7.66	7.00
$\rho_{zs} = 0.9$		-0.02	0.35	-0.05	0.89	3.16	0.73	10.67	8.09
$\rho_{zs} = 0.7$		-0.04	0.24	-0.06	0.87	5.33	1.11	18.14	11.62

Table 4: Business cycle statistics for sector-specific shocks

The high values of  $\rho_{zs}$  may be justified, for example, with inventions such as the internet improving productivity economy-wide. Overall, the baseline of 1 appears the perform best.

Three other sets of sensitivity analysis are presented, for variations in the share of physical capital in human sector ( $\phi_2$ ), the rate of depreciation of human capital ( $\delta_h$ ) and the coefficient of relative risk aversion ( $\sigma$ ), in Tables 5, 6, and 7. For example, Jones et al. (2005) emphasize the importance of the coefficient of relative risk aversion.

Table 5 shows the baseline is still probably the best specification for  $\phi_2$ , although trade-offs between better persistence and better volatility results are apparent. Table 6 for changes in  $\delta_h$ , expressed in quarterly units, correspond to a yearly range between 1% and 6%. As  $\delta_h$  gets bigger, growth rates of output, consumption and physical capital investment all becomes more autocorrelated, indicating a higher degree of persistence. For instance, autocorrelation coefficient of output growth is as high as 0.94 when  $\delta_h$  is 0.015. This suggests that increasing the depreciation rate of human capital produces greater persistence of the model's variables. For volatility, growth rates of output and physical investment fluctuate less while consumption growth fluctuates more as  $\delta_h$  increases. The volatility of labour supply does not seem to be affected by  $\delta_h$ .

For Table 7, the model generates little persistence when  $\sigma$  rises up to 1.5. Changes in  $\sigma$  slightly affect labor supply growth persistence, but have a large impact on the volatilities of variables, in a non-monotonic fashion except for



	Persistence of $x$				Volatility of $x$				
	$x =$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$
US data		0.29	0.24	0.39	0.99	1.14	0.52	2.38	5.52
Baseline ( $\phi_2 = 0.11$ )		0.29	0.77	0.14	0.92	0.82	0.43	2.36	5.44
$\phi_2 = 0.03$		0.14	0.19	0.12	0.93	0.99	0.71	1.97	6.77
$\phi_2 = 0.05$		0.20	0.31	0.16	0.93	0.92	0.60	1.98	6.50
$\phi_2 = 0.07$		0.26	0.46	0.17	0.93	0.85	0.52	2.02	6.26
$\phi_2 = 0.09$		0.27	0.62	0.15	0.92	0.84	0.47	2.17	5.95
$\phi_2 = 0.13$		0.28	0.91	0.10	0.92	0.86	0.40	2.62	5.11
$\phi_2 = 0.15$		0.23	0.96	0.07	0.92	0.91	0.38	3.00	4.46
$\phi_2 = 0.17$		0.18	0.98	0.05	0.92	1.01	0.37	3.55	4.06

Table 5: Sensitivity of physical capital share in human sector

	Persistence of $x$				Volatility of $x$				
	$x =$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$
US data		0.29	0.24	0.39	0.99	1.14	0.52	2.38	5.52
Baseline ( $\delta_h = 0.005$ )		0.29	0.77	0.14	0.92	0.82	0.43	2.36	5.44
$\delta_h = 0.0025$		0.18	0.75	0.06	0.93	0.92	0.39	2.88	5.53
$\delta_h = 0.0075$		0.44	0.78	0.29	0.91	0.76	0.44	1.89	5.38
$\delta_h = 0.0100$		0.66	0.79	0.60	0.90	0.72	0.49	1.56	5.58
$\delta_h = 0.0125$		0.84	0.80	0.85	0.89	0.69	0.51	1.37	5.52
$\delta_h = 0.0150$		0.94	0.81	0.89	0.88	0.71	0.54	1.47	5.60

Table 6: Sensitivity of human capital depreciation rate

	Persistence of $x$				Volatility of $x$				
	$x =$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$	$\gamma_Y$	$\gamma_C$	$\gamma_{I_k}$	$N$
US data		0.29	0.24	0.39	0.99	1.14	0.52	2.38	5.52
Baseline ( $\sigma = 1$ )		0.29	0.77	0.14	0.92	0.82	0.43	2.36	5.44
$\sigma = 0.6$		-0.07	-0.07	0.08	0.81	40.68	49.33	19.02	66.52
$\sigma = 0.7$		0.02	0.05	0.13	0.91	6.42	6.32	7.40	24.20
$\sigma = 0.8$		0.20	0.11	0.93	0.91	1.50	1.86	1.61	10.59
$\sigma = 0.9$		0.96	0.49	0.36	0.91	0.54	0.62	1.86	7.00
$\sigma = 1.1$		0.12	0.25	0.07	0.93	1.13	0.65	2.66	4.66
$\sigma = 1.2$		0.07	0.12	0.04	0.93	1.36	0.87	2.90	4.14
$\sigma = 1.3$		0.04	0.07	0.03	0.93	1.51	1.02	3.04	3.57
$\sigma = 1.4$		0.03	0.05	0.02	0.94	1.62	1.15	3.14	3.42
$\sigma = 1.5$		0.01	0.03	0.00	0.94	1.70	1.24	3.21	3.17
$\sigma = 2.0$		-0.01	0.00	-0.02	0.94	1.95	1.53	3.43	2.48

Table 7: Sensitivity of coefficient of relative risk aversion

labor.

## 6 Comparison with Jones et al. (2005b)

### 6.1 Timing of responses

As pointed by Jones et al. (2005), their model is a traditional one-sector *RBC* model if human capital depreciates at the same rate as physical capital: the difference in depreciate rates is the only asymmetry introduced between physical and human capital. Four variations are considered here, with differences in sectoral human capital intensity, and in relative depreciation rates of capital. In case 1, goods production and human capital investment production are treated symmetrically, produced by an identical technology and with equal capital depreciation rates, and so correspond to a standard one-sector *RBC* model ( $\phi_1 = \phi_2$ ,  $\delta_k = \delta_h$ ). In case 2, human capital investment is assumed to be produced by the same technology producing goods, but with a slower depreciation rate for human capital relative to physical capital ( $\phi_1 = \phi_2$ ,  $\delta_k > \delta_h$ ); the parameterized model in this case is essentially the same as the one-sector model in Jones et al. (2005). In case 3, the production of human capital investment is more human capital intensive than

goods production, but depreciation rates on physical and human capital are equal ( $\phi_1 > \phi_2, \delta_k = \delta_h$ ). Finally, case 4, as in the baseline model, assumes that human capital investment is more human capital intensive than goods production and that human capital depreciates at a slower rate than does physical capital ( $\phi_1 > \phi_2, \delta_k > \delta_h$ ).

Figure 5 shows the responses to a positive aggregate technology shock, for the four cases described above, for working hours and human capital investment time hours, and in Figure 6 for consumption and output. Except the first case, working hour and learning time move in opposite directions following the productivity shock, as is consistent with the empirics in Dellas and Sakellaris (2003) finding significant substitution between education and competing labour activities over business cycles. However only cases 3 and 4 show the initial drop in working hours as in Gali (1999).

In all four cases, the consumption response is smooth, due to the intertemporal substitution effect. However, only in cases 3 and 4, are the trajectories for output smoothly rising as in data. This indicates the role of cross-sector factor intensity disparity in generating output persistence. Similarly, the ‘V’ shape response of working time in cases 3 and 4, in contrast to the ‘^’ shape response in cases 1 and 2, and in standard one-sector models, gives rise to the hump in the impulse response curve of output.

## 6.2 Persistence and volatility of some variants

Table 8 reports the moments statistics for the four cases. Overall, case 4 matches the empirical data best. In case 1, the traditional *RBC* model, the autocorrelation coefficients for output and investment growth are both very close to zero, showing a lack of persistence that is a well-known failing of traditional *RBC* models. Another major problem in case 1 is the too-low simulated working-hour volatility, also a well-known drawback of original *RBC* models. For case 2, growth rates of investment and output are significantly negatively autocorrelated, in contrast to the data. These inconsistencies between model simulations and data indicate that asymmetric depreciation rates of capitals appear to be unable to match certain key persis-

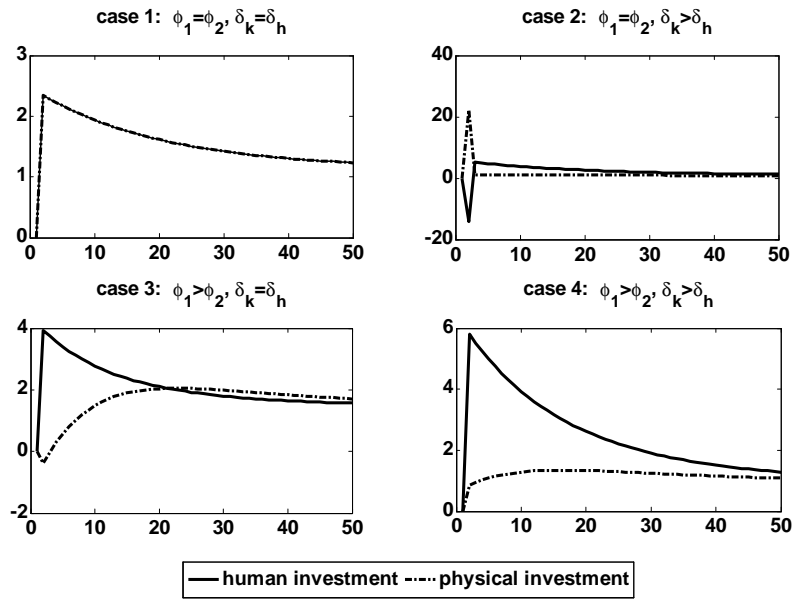


Figure 4: Comparing impulse response functions to technology shock: physical and human capital investments

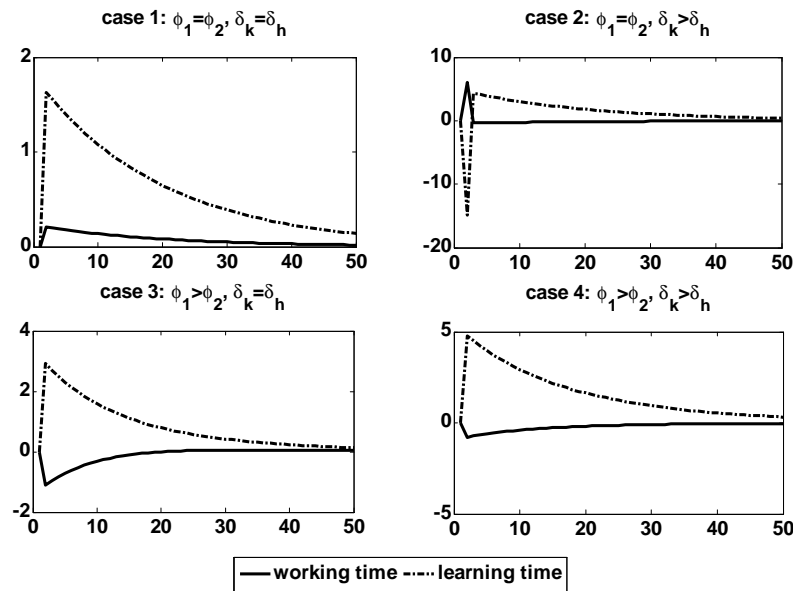


Figure 5: Comparing impulse response functions: working hours and learning time

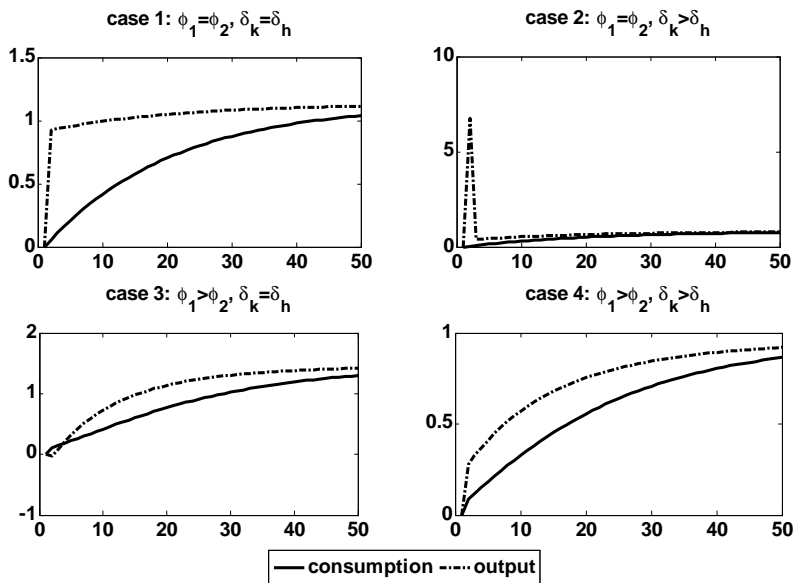


Figure 6: Comparing impulse response functions: consumption and output

tence and moment statistics. Case 3 with different factor intensities across sectors appears successful in replicating moment statistics, but generates rather too much persistence. For example, output and consumption growth in the model are autocorrelated with coefficients of 0.86 and 0.81 respectively while in the data the counterparts are only 0.29 and 0.24. In case 4, human capital is assumed to depreciate at a slower rate of 0.005 per quarter. The results show that lowering the human capital depreciation rate reduces the simulated degree of persistence to a level closer to US observations.

Quantitatively, our results in our case 2 corresponding to Jones et al. are quite different, if qualitatively similar. This results because a direct comparison to Jones et al. (2005) using our model confronts several difficulties, involving data frequency and the definitions of "output" and "consumption". Jones et al. use yearly data frequency while we use a quarterly frequency.<sup>9</sup> This makes the annual investment-to-capital ratio, in general, four times

<sup>9</sup>This frequency issue is also pointed out by Maury and Tripier (2003) who find that a version of the Jones et al. model on a quarterly basis does not perform as well as it does on a yearly frequency.

		case 1	case 2	case 3	case 4
	data	$\phi_1 = \phi_2$ $\delta_k = \delta_h$	$\phi_1 = \phi_2$ $\delta_k > \delta_h$	$\phi_1 > \phi_2$ $\delta_k = \delta_h$	$\phi_1 > \phi_2$ $\delta_k > \delta_h$
$\sigma(\gamma_Y)$	1.14	2.51	25.09	0.86	0.82
$\sigma(\gamma_C)$	0.52	0.48	0.37	0.61	0.43
$\sigma(\gamma_{I_k})$	2.38	6.38	82.93	2.25	2.23
$\sigma(N)$	5.52	1.57	16.71	6.01	5.44
$\rho(\gamma_{Y_t}, \gamma_{Y_{t-1}})$	0.29	0.01	-0.50	0.86	0.29
$\rho(\gamma_{C_t}, \gamma_{C_{t-1}})$	0.24	0.95	0.95	0.81	0.78
$\rho(\gamma_{I_{kt}}, \gamma_{I_{kt-1}})$	0.38	-0.02	-0.49	0.48	0.14
$\rho(\gamma_{N_t}, \gamma_{N_{t-1}})$	0.99	0.95	-0.02	0.86	0.92
$\rho(\gamma_{Y_t}, \gamma_{C_t})$	0.49	0.35	0.02	0.68	0.83
$\rho(\gamma_{Y_t}, \gamma_{I_{kt}})$	0.75	0.99	1.00	0.87	0.96
$\rho(\gamma_{Y_t}, \gamma_{N_t})$	-0.07	0.35	0.75	-0.73	-0.73

Table 8: Comparing business cycle statistics for the variants

as large as the quarterly counterpart. Therefore, yearly investment accounts for a bigger fraction of capital stock than when measured on quarterly basis, making volatility as measured by annual data significantly less than that measured by quarterly data. This explains the good performance of Jones et al. (2005) regarding volatility statistics, while our case 2 above does not find this.

The second difference is that Jones et al. (2005) define consumption to include investment to human capital:  $C + I_h$ , and define output as the sum of consumption, investment in physical capital and investment in human capital:  $C + I_k + I_h$ , using our notation. Since the shocks have opposite effects on investments to the two capitals, the variabilities of this "composite consumption" and "composite output" are substantially reduced, as compared to our standard definitions. If variables are re-defined in Jones et al. (2005) by considering human capital investment to be the non market goods as in case 2, then the model's simulation successes deteriorate.

## 7 Conclusion

Adding the human capital investment sector creates a key difference relative for example to the benchmark work of Jones et al (2005), in terms of the timing order of the responses of investments to physical and human capital to a technology shock. In the two-sector model here, people tend to increase human capital stock immediately after a good shock and accumulate physical capital with a delay. Investments to the two capitals then adjust differently following an aggregate productivity shock, enabling the model to successfully reproduce the output growth and investment persistence, hump-shaped impulse responses for output and investment, greater labor volatility, and Gali's (1999) labor decrease after a positive productivity shock, so as to be broadly consistent with US data.

These results were explained intuitively in terms of sectoral reallocations as in international trade theory, in particular the Stolper and Samuelson (1941) theorem and the Rybczynski (1955) effect. Sensitivity analysis included examination of simulation results with respect to key parameter assumptions, as well as relaxing the baseline assumption that the sectoral shocks are an identical aggregate shock. When very high correlations are assumed between the sector-specific shocks, similar simulation properties result, with the implication that an identical aggregate productivity shock, as in Jones et al (2005), across both goods and human capital investment sectors best fits the data.

## References

- [1] Arrow, K.J., 1968. Applications of control theory to economic growth. In: Dantzig, G.B., Veinott, A.F. Jr. (Eds.), *Mathematics of the Decisions Sciences*. American Mathematical Society, Providence, RI.
- [2] Barro, R.J., Sala-I-Martin, X., 1995. In: 'Economic Growth'. McGraw-Hill, Inc. pp. 181.

- [3] Becker, Gary S., 1975, *Human Capital: A Theoretical and Empirical Analysis*, New York: Columbia University Press for NBER.
- [4] Ben-Gad, Michael, "Sufficiency Conditions and the Existence of Equilibria in the Two-Sector Endogenous Growth Model with Leisure," 2007.
- [5] Benhabib, J., Rogerson, R., Wright, R., 1991. 'Homework in Macroeconomics: Household Production and Aggregate Fluctuations'. *The Journal of Political Economy* 99, No. 6, 1166-1187.
- [6] Bond, Eric W., Ping Wang, and Chong K. Yip, 1996. 'A general two-sector model of endogenous growth with human and physical capital: balanced growth path and transitional dynamics'. *Journal of Economic Theory* 68, 149-173.
- [7] Burnside, C., Eichenbaum, M., 1996. 'Factor-hoarding and the propagation of business cycle shocks'. *The American Economic Review*, vol. 86, No. 5, 1154-1174.
- [8] Caballe, J., Santos, M.S., 1993. 'On endogenous growth with physical and human capital'. *The Journal of Political Economy*, vol. 101, No. 6, 1042-1067.
- [9] Cogley, T., Nason, J.M., 1995. 'Output dynamics in Real-Business-Cycle models'. *The American Economic Review*, vol. 85, No. 3, 492-511.
- [10] Collard, F., 1999. 'Spectral and persistence properties of cyclical growth'. *Journal of Economic Dynamic and Control* 23, 463-488
- [11] Cooley, T.F., Prescott, E.C., 1995. 'Economic growth and business cycles' in 'Frontiers of Business Cycle Research' In: Cooley, T. (Ed.), *Frontiers of Business Cycle Research*. Princeton University Press, Princeton, 1-38.
- [12] DeJong, D.N., Ingram, B.F., 2001. 'The cyclical behaviour of skill acquisition'. *Review of Economic Dynamics* 4, 536-561.



- [13] Dellas, H., Sakellaris, P., 2003. 'On the cyclicity of schooling: theory and evidence'. *Oxford Economic Papers* 55, 148-172.
- [14] Einarsson, T., Marquis, H., M., 1999. 'Formal Training, On-the-Job Training and the Allocation of Time'. *Journal of Macroeconomics* 21, No. 3, 423-442.
- [15] Gali, J., 1999. 'Technology, Employment, and the Business Cycle: Do Technology Shocks Explain Aggregate Fluctuations?' *American Economic Review* 89, No. 1, 249-271.
- [16] Gali, J., Hammour, M., 1991. "Long run effects of business cycles". Working Paper 92-26, Columbia University.
- [17] Gomme, P., Rupert, P., 2007. 'Theory, measurement and calibration of macroeconomics models'. *Journal of Monetary Economics* 54, 460-497.
- [18] Greenwood, J., Rogerson, R., Wright, R., 1995. 'Household production in real business cycle theory.' In: Cooley, T. (Ed.), *Frontiers of Business Cycle Research*. Princeton University Press, Princeton, 157-174.
- [19] Hansen, Gary D., 1985, "Indivisible labor and the business cycle," *Journal of Monetary Economics*, 16(3, November): 309-327.
- [20] Jones, L.E., Manuelli, R.E., Siu, H.E., 2005. 'Fluctuations in convex models of endogenous growth, II : Business cycle properties'. *Review of Economic Dynamics* 8, 805-828.
- [21] Jorgenson, D.W., Fraumeni, B.M., 1989. 'The accumulation of human and non-human capital, 1948-1984.' in: Lipsey, R.E., Tice, H.S., (Eds.), *The Measurement of Savings, Investment and Wealth*, The University of Chicago Press, Chicago, IL, pp. 227-282.
- [22] King, R.G., Rebelo, S.T., 1999. 'Resuscitating Real Business Cycles' in 'Handbook of Macroeconomics' by Taylor, J., Woodford, M.. In press.

- [23] King, R.G., Plosser, C.I., Rebelo, S.T. 1988. "Production, Growth and Business Cycles I: The Basic Neoclassical Model". *Journal of Monetary Economics* 21, 195-232.
- [24] Ladron-de-Guevara, A., Ortigueira, S., Santos, M.S., 1999. "A Two-Sector Model of Endogenous Growth with Leisure". *The Review of Economic Studies*, Vol. 66, No. 3, 609-631.
- [25] Ladron-de-Guevara, A., Ortigueira, S., Santos, M.S., 1997. "Equilibrium dynamics in two-sector models of endogenous growth". *Journal of Economic Dynamics and Control* 21 115-143.
- [26] Lucas, R.E., 1988. 'On the Mechanics OF Economic development'. *Journal of Monetary Economics* 22, 3-42.
- [27] Lucas, R. E., and Prescott, E. 1974. "Equilibrium Search and Unemployment" *Journal of Economic Theory* 7, 188–209.
- [28] Mangasarian, O.L., 1966. Sufficient conditions for the optimal control of nonlinear systems. *Siam Journal on Control* IV (February), 139–152.
- [29] Maury, TP, Tripier, F. 2003. 'Output persistence in human capital-based growth models'. *Economics Bulletin*, vol. 5, No. 11, 1-8.
- [30] Marco Maffezzoli, 2000. "Human Capital and International Real Business Cycles," *Review of Economic Dynamics*, 3(1): 137-165.
- [31] Mulligan, C.B., Sala-I-Martin, X., 1993. "Transitional Dynamics in Two-Sector Models of Endogenous Growth". *The Quarterly Journal of Economics*, Vol. 108, No. 3, 739-773.
- [32] Perli, R., 1998. 'Indeterminacy, home production, and the business cycle: A calibrated analysis'. *Journal of Monetary Economics* 41, 105-125.
- [33] Perli, R., Sakellaris. P., 1998. 'Human capital formation and business cycle persistence'. *Journal of Monetary Economics* 42, 67-92.

- [34] Rogerson, Richard, 1988. "Indivisible labor, lotteries and equilibrium," *Journal of Monetary Economics*, 21(1, January):3-16.
- [35] Rupert, Peter, and R. Rogerson, R. Wright, 2000. "Homework in labor economics: Household production and intertemporal substitution," *Journal of Monetary Economics*, 46(3, December): 557-579.
- [36] Rybczynski, T. M. (1955). "Factor Endowment and Relative Commodity Prices". *Economica* 22 (88): 336–341.
- [37] Sakellaris, P., Spilimbergo, A., 1999. 'Business cycle and investment in human capital: international evidence on higher education'. *Carnegie-Rochester Conference Series on Public Policy* 1999.
- [38] Stolper, W. and Samuelson. P. (1941). "Protection and real wages." *Review of Economic Studies*; 9(1): 58-73.
- [39] Uhlig, H., 1999. "A toolkit for analyzing nonlinear dynamic stochastic models easily". In: Marimon, R., Scott, A. (Eds.), *Computational Methods for the Study of Dynamic Economics*, Oxford University Press, Oxford, pp. 30–61.
- [40] Uzawa, H., 1965. 'Optimally Technical Change in at Aggregative Model OF Economic Growth'. *Internationally Economic Review* 6, 18-31.
- [41] Wen, Y., 1998. 'Can a real business cycle model pass Watson test?'. *Journal of Monetary Economics* 42, 185-203.

## A Uniqueness of steady state

Since proof of uniqueness of the steady state is viewed as infeasible in such numerically solved models, here the uniqueness of the steady state is demonstrated for the given calibration. Express the first order conditions and constraints of the two-sector model by the variables' long-run values (variables

with no time subscript denote their long-run values and  $A_g$  is normalized to unity):

$$\frac{AC}{(1-N-M)H} = (1-\phi_1) \left( \frac{VK}{NH} \right)^{\phi_1} \quad (16)$$

$$\frac{1-\phi_1}{\phi_1} \frac{VK}{NH} = \frac{1-\phi_2}{\phi_2} \frac{(1-V)K}{MH} \quad (17)$$

$$(1+\gamma)^{-\sigma} = \frac{1 + \phi_1 \left( \frac{VK}{NH} \right)^{\phi_1-1} - \delta_k}{1 + \frac{1-\beta}{\beta}} \quad (18)$$

$$(1+\gamma)^{-\sigma} = \frac{1 + (N+M)A_h(1-\phi_2) \left( \frac{(1-V)K}{MH} \right)^{\phi_2} - \delta_h}{1 + \frac{1-\beta}{\beta}} \quad (19)$$

$$\gamma = \left( \frac{VK}{NH} \right)^{\phi_1-1} V - \delta_k - \frac{C}{K} \quad (20)$$

$$\gamma = A_h \left( \frac{(1-V)K}{MH} \right)^{\phi_2} M - \delta_h \quad (21)$$

Where  $\gamma$  is the balanced growth rate. Define  $f_k \equiv \frac{VK}{NH}$  and  $f_h \equiv \frac{(1-V)K}{MH}$ . The simultaneous equation system can then be rearranged in 6 unknowns ( $f_k, f_h, N, M, \gamma, \frac{C}{K}$ ):

$$\frac{A}{1-N-M} \frac{C}{K} (Nf_k + Mf_h) = (1-\phi_1) f_k^{\phi_1} \quad (22)$$

$$\frac{1-\phi_1}{\phi_1} f_k = \frac{1-\phi_2}{\phi_2} f_h \quad (23)$$

$$(1+\gamma)^{-\sigma} = \beta \left( 1 + \phi_1 f_k^{\phi_1-1} - \delta_k \right) \quad (24)$$

$$(1+\gamma)^{-\sigma} = \beta \left[ 1 + (N+M)A_h(1-\phi_2) f_h^{\phi_2} - \delta_h \right] \quad (25)$$

$$\gamma = f_k^{\phi_1-1} \left( \frac{Nf_k}{Nf_k + Mf_h} \right) - \delta_k - \frac{C}{K} \quad (26)$$

$$\gamma = A_h f_h^{\phi_2} M - \delta_h \quad (27)$$

The exogenous information set is  $(A, \beta, \sigma, \phi_1, \phi_2, \delta_k, \delta_h, A_h)$ . Uniqueness of the solution to the above system of equations can be reduced down to the uniqueness of variable  $\gamma$ . To see this, one can solve for  $f_k, f_h, N, M, \frac{C}{K}$  in terms of  $\gamma$  using equations 23 to 27 :

- from equation 24,  $f_k = \left( \frac{(1+\gamma)^{-\sigma} - 1 + \delta_k}{\phi_1} \right)^{\frac{1}{\phi_1 - 1}}$
- from equation 23,  $f_h = \left( \frac{(1-\phi_1)\phi_2}{(1-\phi_2)\phi_1} \right) f_k$
- from equation 25,  $N + M = \frac{(1+\gamma)^{-\sigma} - 1 + \delta_h}{A_h(1-\phi_2)} f_h^{-\phi_2}$
- from equation 27,  $M = \frac{\gamma + \delta_h}{A_h} f_h^{-\phi_2}$
- from equation 26,  $\frac{C}{K} = f_k^{\phi_1 - 1} \left( \frac{Nf_k}{Nf_k + Mf_h} \right) - \delta_k - \gamma$

Substitute all these into equation 22 to obtain a highly nonlinear function in  $\gamma$ :  $\Theta(\gamma) = 0$ . Then one can find the zeros of  $\Theta(\gamma)$  for the baseline calibration of exogenous parameters:  $A = 1.5455$ ,  $\frac{1-\beta}{\beta} = 0.0142$ ,  $\sigma = 1$ ,  $\phi_1 = 0.36$ ,  $\phi_2 = 0.11$ ,  $\delta_k = 0.02$ ,  $\delta_h = 0.005$ ,  $A_h = 0.0461$ . The numerical solution shows that there is only one internal solution that satisfies  $0 < L < 1$ :

$$\gamma^* = 0.0042, L^* = 0.542, N^* = 0.298, M^* = 0.160, \left( \frac{K}{H} \right)^* = 11.06$$

## B Normalization

### B.1 Deterministic discounting

Let  $c_t \equiv \frac{C_t}{(1+\gamma)^t}$ ,  $k_t \equiv \frac{K_t}{(1+\gamma)^t}$ ,  $h_t \equiv \frac{H_t}{(1+\gamma)^t}$ . The system consisting of equations (39) to (45) changes to:

$$\frac{Ac_t}{1 - N_t - M_t} = (1 - \phi_1) Z_t \left( \frac{V_t k_t}{N_t h_t} \right)^{\phi_1} h_t \quad (28)$$

$$\frac{(1 - \phi_1) V_t}{\phi_1 N_t} = \frac{(1 - \phi_2)(1 - V_t)}{\phi_2 M_t} \quad (29)$$

$$P_t = \left( \frac{\phi_1}{\phi_2} \right)^{\phi_2} \left( \frac{1 - \phi_1}{1 - \phi_2} \right)^{1 - \phi_2} \left( \frac{V_t k_t}{N_t h_t} \right)^{\phi_1 - \phi_2} \quad (30)$$

$$1 = E_t \beta \left\{ \begin{array}{l} \left( \frac{c_t}{c_{t+1}} \right)^\sigma (1 + \gamma)^{-\sigma} \left( \frac{1 - N_{t+1} - M_{t+1}}{1 - N_t - M_t} \right)^{A(1-\sigma)} \times \\ \left[ \phi_1 Z_{t+1} \left( \frac{V_{t+1} k_{t+1}}{N_{t+1} h_{t+1}} \right)^{\phi_1 - 1} + 1 - \delta_k \right] \end{array} \right\} \quad (31)$$

$$1 = E_t \beta \left\{ \begin{array}{l} \left( \frac{P_{t+1}}{P_t} \right) \left( \frac{c_t}{c_{t+1}} \right)^\sigma (1 + \gamma)^{-\sigma} \left( \frac{1 - N_{t+1} - M_{t+1}}{1 - N_t - M_t} \right)^{A(1-\sigma)} \times \\ \left[ (N_{t+1} + M_{t+1}) (1 - \phi_2) S_{t+1} \left( \frac{(1 - V_{t+1})k_{t+1}}{M_t h_{t+1}} \right)^{\phi_2} + 1 - \delta_h \right] \end{array} \right\} \quad (32)$$

$$c_t + (1 + \gamma) k_{t+1} - (1 - \delta_k) k_t = A_g Z_t (V_t k_t)^{\phi_1} (N_t h_t)^{1-\phi_1} \quad (33)$$

$$(1 + \gamma) h_{t+1} - (1 - \delta_h) h_t = A_h S_t [(1 - V_t)k_t]^{\phi_2} (M_t h_t)^{1-\phi_2} \quad (34)$$

The system can then be log-linearized and expressed in percentage deviations:

$$0 = Ax_{t+1} + Bx_t + Dy_t + Fu_t \quad (35)$$

$$0 = E_t (Gx_{t+1} + Hx_t + Jy_{t+1} + Ly_t + Mu_{t+1}) \quad (36)$$

Where  $y_t = [\hat{c}_t, \hat{V}_t, \hat{N}_t, \hat{M}_t, \hat{P}_t]'$ , a vector collecting all control variables; and  $x_t = [\hat{k}_t, \hat{h}_t]'$ , containing two endogenous state variables; and  $u_t = [\hat{Z}_t, \hat{S}_t]'$ , containing exogenous state variables. The model is then solved by method of undetermined coefficients and the solution is characterized by two recursive equations:

$$x_{t+1} = Px_t + Qu_t \quad (37)$$

$$y_t = Rx_t + Su_t \quad (38)$$

$P, Q, R$  and  $S$  satisfy the conditions listed in Appendix B.2. Responses of variables collected in  $y_t$  and  $x_t$  to innovations to  $u_t$  can then be calculated.

## B.2 Stochastic discounting

The first order conditions of the two-sector model and the constraints are:

$$\frac{AC_t}{1 - N_t - M_t} = (1 - \phi_1) Z_t \left( \frac{V_t K_t}{N_t H_t} \right)^{\phi_1} H_t \quad (39)$$

$$\frac{(1 - \phi_1) V_t}{\phi_1 N_t} = \frac{(1 - \phi_2) (1 - V_t)}{\phi_2 M_t} \quad (40)$$

$$P_t = \left( \frac{\phi_1}{\phi_2} \right)^{\phi_2} \left( \frac{1 - \phi_1}{1 - \phi_2} \right)^{1-\phi_2} \left( \frac{V_t K_t}{N_t H_t} \right)^{\phi_1 - \phi_2} \quad (41)$$

$$1 = E_t \beta \left\{ \begin{array}{l} \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{1 - N_{t+1} - M_{t+1}}{1 - N_t - M_t} \right)^{A(1-\sigma)} \times \\ \left[ \phi_1 Z_{t+1} \left( \frac{V_{t+1} K_{t+1}}{N_{t+1} H_{t+1}} \right)^{\phi_1 - 1} + 1 - \delta_k \right] \end{array} \right\} \quad (42)$$

$$1 = E_t \beta \left\{ \begin{array}{l} \left( \frac{P_{t+1}}{P_t} \right) \left( \frac{C_t}{C_{t+1}} \right)^\sigma \left( \frac{1-N_{t+1}-M_{t+1}}{1-N_t-M_t} \right)^{A(1-\sigma)} \times \\ \left[ (N_{t+1} + M_{t+1}) (1 - \phi_2) S_{t+1} \left( \frac{(1-V_{t+1})K_{t+1}}{M_{t+1}H_{t+1}} \right)^{\phi_2} + 1 - \delta_h \right] \end{array} \right\} \quad (43)$$

$$C_t + K_{t+1} - (1 - \delta_k)K_t = A_g Z_t (V_t K_t)^{\phi_1} (N_t H_t)^{1-\phi_1} \quad (44)$$

$$H_{t+1} - (1 - \delta_h)H_t = A_h S_t [(1 - V_t)K_t]^{\phi_2} (M_t H_t)^{1-\phi_2} \quad (45)$$

And  $Z_t$  and  $S_t$  are governed by an exogenous vector autoregressive process:

$$\begin{bmatrix} \log Z_{t+1} \\ \log S_{t+1} \end{bmatrix} = N \begin{bmatrix} \log Z_t \\ \log S_t \end{bmatrix} + \varepsilon_{t+1} \quad (46)$$

Where  $N$  is  $\begin{bmatrix} \rho_z & 0 \\ 0 & \rho_s \end{bmatrix}$  and  $\varepsilon_t$  is  $\begin{bmatrix} \varepsilon_t^z \\ \varepsilon_t^s \end{bmatrix}$ .

The system that consists of seven equations in terms of seven endogenous variables  $(C_t, K_{t+1}, H_{t+1}, V_t, N_t, M_t, P_t)$  is non-stationary because  $C_t, K_t$  and  $H_t$  are growing in steady-state. To achieve stationarity, define new variables in the following way:  $c_t \equiv \frac{C_t}{H_t}$ ,  $k_t \equiv \frac{K_t}{H_t}$ ,  $\gamma_{ht+1} \equiv \frac{H_{t+1}}{H_t}$ , where  $\gamma_{ht}$  is the gross growth rate of human capital stock. Rewrite the system in terms of stationary variables:

$$\frac{Ac_t}{1 - N_t - M_t} = (1 - \phi_1) Z_t \left( \frac{V_t k_t}{N_t} \right)^{\phi_1} \quad (47)$$

$$\frac{(1 - \phi_1) V_t}{\phi_1 N_t} = \frac{(1 - \phi_2) (1 - V_t)}{\phi_2 M_t} \quad (48)$$

$$P_t = \frac{Z_t}{S_t} \left( \frac{\phi_1}{\phi_2} \right)^{\phi_2} \left( \frac{1 - \phi_1}{1 - \phi_2} \right)^{1-\phi_2} \left( \frac{V_t k_t}{N_t} \right)^{\phi_1 - \phi_2} \quad (49)$$

$$1 = E_t \beta \left\{ \begin{array}{l} \left( \frac{c_t}{c_{t+1}} \right)^\sigma \gamma_{ht+1}^{-\sigma} \left( \frac{1-N_{t+1}-M_{t+1}}{1-N_t-M_t} \right)^{A(1-\sigma)} \times \\ \left[ \phi_1 Z_{t+1} \left( \frac{V_{t+1} k_{t+1}}{N_{t+1}} \right)^{\phi_1 - 1} + 1 - \delta_k \right] \end{array} \right\} \quad (50)$$

$$1 = E_t \beta \left\{ \begin{array}{l} \left( \frac{P_{t+1}}{P_t} \right) \left( \frac{c_t}{c_{t+1}} \right)^\sigma \gamma_{ht+1}^{-\sigma} \left( \frac{1-N_{t+1}-M_{t+1}}{1-N_t-M_t} \right)^{A(1-\sigma)} \times \\ \left[ (N_{t+1} + M_{t+1}) (1 - \phi_2) S_{t+1} \left( \frac{(1-V_{t+1})k_{t+1}}{M_t} \right)^{\phi_2} + 1 - \delta_h \right] \end{array} \right\} \quad (51)$$

$$c_t + k_{t+1} \gamma_{ht+1} - (1 - \delta_k)k_t = A_g Z_t (V_t k_t)^{\phi_1} N_t^{1-\phi_1} \quad (52)$$

$$\gamma_{ht+1} - 1 + \delta_h = A_h S_t [(1 - V_t)k_t]^{\phi_2} M_t^{1-\phi_2} \quad (53)$$

The next step is to rewrite these equations in steady state and calibrate the model to fit targeted variables given the steady state constraints are binding. The log-linearization method is now applicable to this transformed system. First, apply the first-order Taylor expansion for each individual equation around the steady state. Although this is a straightforward exercise, it is awkward to display all linearized equations due to the length of some equations. To summarize, the linearized system involves seven difference equations in seven variables:  $\hat{c}_t, \hat{V}_t, \hat{N}_t, \hat{M}_t, \hat{P}_t, \hat{k}_t, \hat{\gamma}_{ht}$ .

Variables expressed in the form of ratios over human capital stock need to be transformed into first differences. The method to do this is shown through an example of consumption. Recall that  $c_t \equiv \frac{C_t}{H_t}$ , so the growth rate of aggregate consumption can be calculated as below:

$$\begin{aligned} \gamma_{ct+1} &= \log C_{t+1} - \log C_t \\ &= \log c_{t+1} - \log c_t + \log H_{t+1} - \log H_t \\ &= (\log c_{t+1} - \log c) - (\log c_t - \log c) + \log \frac{H_{t+1}}{H_t} \\ &= \hat{c}_{t+1} - \hat{c}_t + (\log \gamma_{ht+1} - \log \gamma_h) + \log \gamma_h \\ &= \hat{c}_{t+1} - \hat{c}_t + \hat{\gamma}_{ht+1} + \log \gamma_h \end{aligned}$$

Where  $c$  and  $\gamma_h$  are steady-state values of  $c_t$  and  $\gamma_{ht}$ . Growth rates of other variables can be derived similarly. The model is solved using Uhlig's (1999) toolbox.

### B.2.1 For Referee: Solution Methodology Details

Next, condense the system in vector form with distinction made between deterministic equations and expectational equations. To simplify notation, let  $y_t = [\hat{c}_t, \hat{V}_t, \hat{N}_t, \hat{M}_t, \hat{P}_t]'$ , a vector collecting all control variables; and  $x_t = [\hat{k}_t, \hat{\gamma}_{ht}]'$ , containing two endogenous state variables<sup>10</sup>; and  $u_t = [\hat{Z}_t, \hat{S}_t]'$ ,

<sup>10</sup>Although  $\hat{\gamma}_{ht}$  is named an endogenous state variable here, the policy function does not depend on this variable. This is because  $\gamma_{ht}$  is not present in the system of equations from 47 to 53 (only  $\gamma_{ht+1}$  exists). Therefore, the only effective state variable is  $\hat{k}_t$ .



containing exogenous state variables. Thus, the system is reorganized as follows:

$$0 = Ax_{t+1} + Bx_t + Dy_t + Fu_t \quad (54)$$

$$0 = E_t(Gx_{t+1} + Hx_t + Jy_{t+1} + Ly_t + Mu_{t+1}) \quad (55)$$

Where  $A, B, F$  are  $5 \times 2$  matrices;  $D$  is a  $5 \times 5$  matrix;  $G, H, M$  are  $2 \times 2$  matrices; and  $J, L$  are  $2 \times 5$  matrices. Equation (54) summarizes five deterministic equations and equation (55) represents two expectational equations. Elements in  $A, B, D, F, G, H, J, L, M$  are given numerically by the values of exogenous parameters and the steady state solution of the model. As before, represent the solution to this system by two equilibrium recursive law of motions:

$$x_{t+1} = Px_t + Qu_t \quad (56)$$

$$y_t = Rx_t + Su_t \quad (57)$$

Where  $P$  and  $Q$  are  $2 \times 2$  matrices and  $R$  and  $S$  are  $5 \times 2$  matrices. Substituting the two recursive equations back into equation (54) and (55) and equating coefficient matrices associated to  $x_t$  and  $u_t$  to zero lead to four simultaneous matrix equations in  $P, Q, R$  and  $S$ . Solving these matrix equations will complete characterizing the solution. According to Uhlig (1999),

- $P$  satisfies the matrix quadratic equation

$$0 = -JD^{-1}AP^2 + (G - JD^{-1}B - LD^{-1}A)P + H - LD^{-1}B \quad (58)$$

Notice that since there are two endogenous state variables ( $\hat{k}_t$  and  $\hat{\gamma}_{ht}$ ) in this case,  $P$  is a  $2 \times 2$  matrix, other than a scalar in the one-sector *RBC* model. Hence, solving for  $P$  requires solving this matrix quadratic equation. Again, a necessary condition for this quadratic equation to make sense is matrix  $D$  is nonsingular.

- $R$  is given by

$$R = -D^{-1}(AP + B) \quad (59)$$

- $Q$  satisfies

$$\left(-N' \otimes JD^{-1}A + I_2 \otimes (JR + G - LD^{-1}A)\right) Vec(Q) = \quad (60)$$

$$Vec\left((JD^{-1}F - M)N + LD^{-1}\right) \quad (61)$$

Where  $Vec(\cdot)$  is column-wise vectorization;  $\otimes$  is Kronecker product;  $I_2$  is identity matrix of size  $2 \times 2$ .

- $S$  is given by

$$S = -D^{-1}(AQ + F) \quad (62)$$

The crucial part in deriving the solution is to solve the matrix quadratic equation in (58). To have a stationary recursive solution, one should pick up the solution for  $P$  whose eigenvalues are both smaller than one. Once  $P$  is solved, the rest of the solution is not hard to derive.

## C Data Description, Summary Statistics

The data set covering from the first quarter of 1954 to the first quarter of 2004 is downloadable from <http://clevelandfed.org/research/Models/rbc/index.cfm>. According to Gomme and Rupert (2007), output ( $Y$ ) is measured by real per capita GDP less real per capita Gross Housing Product. They argue that income in home sector should be removed when calculating market output using NIPA data set. The price deflator is constructed by dividing nominal expenditures on nondurables and services by real expenditures. Population is measured by civilians aged 16 and over. Consumption ( $C$ ) is measured by real personal expenditures on nondurables and services less Gross Housing Product. Gomme and Ruppert report four types of investments: market investment to nonresidential structures, market investment to equipment and software, household investment to residential products and household investment to nondurables. Investment ( $I$ ) here corresponds to the simple sum of these four types of investments. Working hours ( $N$ ) is measured as per capita market time. Figure 7 depicts growth rates of output, consumption and investment over the periods from 1954.1 to 2004.1. Several observations are reflected in this picture:

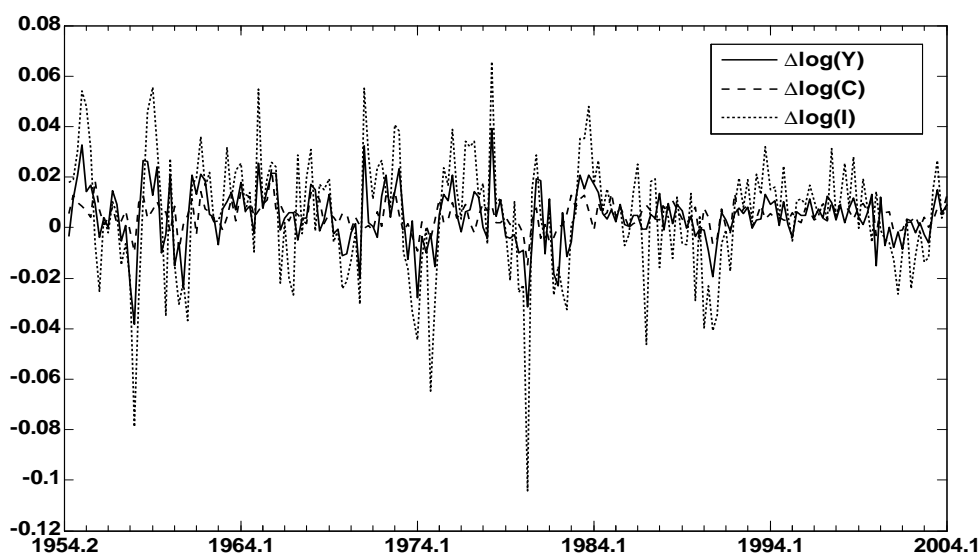


Figure 7: Plot of US data from 1954.1 to 2004.1

1. Output growth fluctuates more than consumption growth; investment growth fluctuates more than output growth.
2. Consumption growth and investment growth are strongly procyclical.
3. Economy fluctuates substantially less after 1980s.

Table 9<sup>11</sup> summarizes the observed business cycle properties numerically. The first panel of table 9 shows that output, consumption and investment grow at similar rate over time. This is in line with the balanced growth path hypothesis. The second panel reflects the relative order of variabilities of main macro variables in figure 7. The third panel shows that the growth rates of variables are all positively autocorrelated. The last panel confirms

---

<sup>11</sup>The second moment results are actually the standard deviation of the net growth rate multiplied by 100. For example, the standard deviation of the net output growth ( $\Delta \log Y$ ) is 0.0114. Since standard deviation of the net growth rate equals that of the gross growth rate, this number (when multiplied by 100) can be interpreted as the percentage deviation of gross output growth from its mean.

<b>Mean</b>			
$E(\Delta \log Y)$	$E(\Delta \log C)$	$E(\Delta \log I)$	$\frac{E(N)}{E(N)}$
0.0042	0.0047	0.0045	1
<b>Fluctuation</b>			
$\sigma(\Delta \log Y)$	$\sigma(\Delta \log C)$	$\sigma(\Delta \log I)$	$\frac{\sigma(N)}{E(N)}$
1.14	0.52	2.38	5.6
<b>Autocorrelation</b>			
$\rho(\Delta \log Y_t, \Delta \log Y_{t-1})$	$\rho(\Delta \log C_t, \Delta \log C_{t-1})$	$\rho(\Delta \log I_t, \Delta \log I_{t-1})$	$\rho(N_t, N_{t-1})$
0.29	0.24	0.39	0.98
<b>Cross-correlation</b>			
$\rho(\Delta \log Y_t, \Delta \log Y_t)$	$\rho(\Delta \log Y_t, \Delta \log C_t)$	$\rho(\Delta \log Y_t, \Delta \log I_t)$	$\rho(\Delta \log Y_t, N_t)$
1	0.49	0.75	-0.07

Table 9: Business cycle statistics in US data from 1954.1 to 2004.1

that consumption and investment growth rates are procyclical and working hours are slightly countercyclical.