

Homework #6
Economics 411
Due Wednesday, November 11
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1. Consider the endogenous growth model with human capital discussed in class. One sector produces a homogeneous output good, which is transformed one-for-one into consumption and investment. The homogeneous output good is itself produced using a Cobb-Douglas production function:

$$c_t + k_{t+1} - (1 - \delta) k_t = k_t^\alpha n_t^{1-\alpha}.$$

Another sector produces human capital according to the following accumulation equation:

$$h_{t+1} = h_t + \lambda (h_t - n_t),$$

where $\lambda > 0$, $c_t \geq 0$, $k_{t+1} \geq (1 - \delta) k_t$, $0 \leq n_t \leq h_t$, and h_0, k_0 are given. Preferences are:

$$\sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\gamma}}{1-\gamma},$$

$\gamma > 0$. To ensure boundedness, we require $\beta(1 + \lambda)^{1-\gamma} < 1$.

- (a) Reformulate the efficient allocation problem for this economy as one of solving a functional equation. Show that the efficient allocations are characterized by a unique set of policy rules, $x_{t+1} = f(x_t)$, $y_t = g(x_t)$, where $x_t = k_t/h_t$ and $y_t = h_{t+1}/h_t$. (Hint: begin by noting that the solution to the functional equation can be represented as the fixed point of an operator on the space of bounded functions, and that that operator satisfies Blackwell's conditions to be a contraction mapping.)
- (b) Set $\alpha = 1/3$, $\delta = 0.10$, $\beta = 0.97$, $\lambda = 0.04$, $\gamma = 1.1$. Compute steady state values of x , y . How do these values change with α and with λ ? Provide intuition.
- (c) Sketch how you could use the perturbation method to approximate g and f .

- (d) Suppose there are two parallel growth economies like the one in this equation, that are identical. Suddenly, one of them suffers a drop in its stock of physical capital. Will output and the stock of physical and human capital eventually become identical again in these two economies? Suppose one of the economies instead experiences a proportional drop in *both* physical and human capital. Do there exist forces that will subsequently reduce the resulting difference in the two economies?
- (e) Construct a decentralized equilibrium for this economy. Do the equilibrium outcomes support the efficient allocations?
2. Consider the model economy associated with Romer's model of growth through specialization. That is, preferences are given by

$$\sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\gamma}}{1-\gamma}, \gamma > 0.$$

The technology for producing final goods is:

$$y_t = \int_0^{M_t} x_t(i)^\alpha di, \quad M_t > 0, \quad 0 < \alpha < 1. \quad (1)$$

To produce $x_t(i)$ units of the i^{th} intermediate good requires

$$\frac{1}{2}(1 + x_t(i)^2) \quad (2)$$

units of capital if $x_t(i) > 0$ and zero units of capital if $x_t(i) = 0$. The following capital market clearing condition must be satisfied:

$$\int_0^{M_t} \frac{1}{2}(1 + x_t(i)^2) di = k_t, \quad (3)$$

where k_t is the beginning-of-period t aggregate stock of capital. The initial capital stock, $k_0 > 0$, is given. The resource constraint is:

$$c_t + I_t \leq y_t, \quad (4)$$

and the aggregate capital accumulation technology is given by:

$$k_{t+1} = (1 - \delta)k_t + I_t.$$

The efficient allocations for this economy solve the planning problem: maximize utility with respect to $\{M_t, k_{t+1}, y_t, c_t, x_t(i), i \in (0, M_t)\}_{t=0}^{\infty}$, subject to the various constraints.

- (a) Explain why economic efficiency dictates $x_t(i) = \bar{x}_t$ for $i \in (0, M_t)$. From here on, you may simply assume $x_t(i) = \bar{x}_t$ for all $i \in (0, M_t)$.
- (b) Show that the planning problem for the Romer economy coincides with the planning problem for the Ak model. In particular, show that the problem can be written,

$$\max_{\{k_{t+1} \in \Gamma(k_t)\}_{t=0}^{\infty}} \sum_{t=0}^{\infty} \beta^t F(k_t, k_{t+1}),$$

where

$$F(k, k') = \frac{[(A + 1 - \delta)k - k']^{1-\gamma}}{1 - \gamma} = \max_{\bar{x}_t, M_t} \frac{c_t^{1-\gamma}}{1 - \gamma}.$$

The last maximization is subject to (1)-(4), and the given values of k_t, k_{t+1} . Display an expression for the value of A in terms of model parameters. In addition to verifying the form of F , show what the constraint set, Γ , is.

- (c) Identify a set of parameter values under which positive growth is efficient, although the growth rate in the market decentralization analyzed in class is zero.
- (d) The problem with monopoly power is that it results in an inefficiently low level of activity (in the Romer model, the root of this inefficiency is the monopoly power that leads monopolists to pay a rental rate on capital that is less than its social marginal product). In the Romer model we have just seen that this manifests itself in the form of inefficiently low growth. The pace at which new varieties of specialized inputs (e.g., specialized manufactured goods, specialized labor) are introduced is too slow in the market economy. Some sort of intervention in the market economy is desirable. One possibility is to subsidize the activities of monopolists. Accordingly, let $p(i)x(i)$ be the revenues of the i^{th} monopolist in the absence of taxes or subsidies. A subsidy rate,

τ_t , raises the revenues of the i^{th} monopolists to $p(i)x(i)(1 + \tau_t)$. The total cost, G_t , to the government of this subsidy scheme is

$$G_t = \int_0^{M_t} p(i)x(i)\tau_t di.$$

Suppose G_t is financed by a lump sum tax levied on households. That is, the household budget constraint is modified as follows:

$$c_t + k_{t+1} - (1 - \delta)k_t = r_t k_t + w_t n_t - T_t,$$

where T_t represents taxes paid by the representative household to the government. Suppose the government balances its budget period by period:

$$T_t = G_t.$$

Find the subsidy rate, τ_t , that causes the allocations in the market economy to coincide with the efficient allocations.

Note: These results have to be interpreted with caution. You have identified an ideal form of government intervention, which makes the private market economy efficient. However, the intervention we investigated abstracts from any social inefficiencies that may be induced by the fact that the subsidy to monopolists have to be financed with taxes. We abstracted from this by assuming that the tax on households is administered in lump-sum form. In practice, such taxes are not available. The only taxes we have in actual economies are attached to specific economic activities (like the income tax) and so they distort those specific activities. So, the problem of ‘fixing’ the inefficiency in the Romer model is actually more complicated than this question makes it out to be.